CHAPTER I

MACROECONOMIC PERFORMANCE OF ASEAN+ 3 ECONOMIES

by Dr. Liberty S. Patiu

Prior to the Asian financial crisis, many East Asian economies have outgrown their traditional relationship-based to a market-based business, particularly in the field of finance. The aftermath of the crisis in 1997 saw the different member economies of the ASEAN + 3 struggling to contain the adverse effects of the crisis on individual country financial sector performance, while the International Monetary Fund took measures to contain its global effects. When the dust finally settled and initial assessments were made of the scope and seriousness of financial distress, individual recovery plans were subsequently drawn to initiate reconstruction efforts at the level of the financial institution.

No matter how idealistic transformation would be to respond to these advances in the global market, it cannot be denied that developed economies are far better off than developing and least-developed ones.

TABLE-1. Gross Domestic Product Growth Rate

Country	Year									
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
PRC	10.42	9.8	8.7	7.8	7.2	7.9	7.3	8.1	9.4	9.5
Korea, Rep. of	9.17	7	4.6	-6.85	9.5	8.5	3.8	7	3.1	4.6
Japan			1.8	-1.2	0.2	2.8	0.4	-0.3	2.5	4.5
Indonesia*	7.8	4.7	-13.0	0.3	-	-	3.8	4.4	4.9	5.1
Malaysia	9.8	10	7.3	-7.4	6.1	8.9	0.3	4.3	5.4	7.1
Philippines	4.7	5.8	5.2	-0.57	3.4	6	1.75	4.3	4.6	6
Singapore	8	8.2	8.6	-0.76	6.8	9.6	-1.95	3.2	1.4	8.4
Thailand	9.2	5.9	-1.37	-10.5	4.4	4.75	2.2	5.3	7	6.1
Brunei	3	1	3.6	-4	2.6	2.8	3	2.8	3.2	1.7
Cambodia	6.5	5.3	5.7	4.96	12.6	8.4	5.5	5.2	7.05	7.7
Lao PDR	7.4	6.9	6.9	4	7.3	5.8	5.8	5.8	5.8	6.9
Myanmar	6.9	6.4	5.7	5.8	10.9	13.7	11.3	12	13.8	12.6
Viet Nam	9.5	9.3	8.2	5.8	4.8	6.8	6.9	7.1	7.3	7.69

Source: Asian Development Bank; Note: *Indonesia's data from 1995-1999 were taken from the country summary report by IMF. Base year prices for Real GDP for each countries are: Cambodia - 1993, Indonesia - 1993, Lao PDR - 1990, Malaysia - 1987, Myanmar - fiscal year 1985 to 1986, the Philippines - 1985, PRC - 1978, the Republic of Korea - 1995, Singapore - 1990, Thailand - 1988, and Vietnam - 1994.

Given their varying degrees of development, ASEAN+3 economies showed different growth performances. There is high degree of financial openness in Japan, Korea, and Singapore and, more recently, in China, while emerging economies like Malaysia, Thailand, the Philippines and Indonesia also provided varying results as contrasted to centrally planned economies.

Economies reflected either steady or gradual deterioration in the growth rates of the Gross Domestic Product (GDP). Asia Economic Monitor (AEM) of ADB reported that compared to other East Asian economies, other ASEAN member economies, specifically Brunei Darussalam, Cambodia, Myanmar and Vietnam, were not so affected by economic slowdown during the crisis, as they were less dependent on external trade and investments. Economic Analytical Unit [2002] reported that Indonesia and Lao PDR's GDP growth rates were affected by high inflation rates, which reached 60% and 90% of the country's GDP, respectively. It attributed the same to lax macroeconomic policy, which is common among most economies in East Asia.

Individual country statistics uncovered the economic slowdown in 1998 and also for the period covering 2001-2003. The downward revisions in the 1997 to 1998 growth were particularly sharp for Republic of Korea, Thailand, Malaysia and Indonesia. Vietnam, Brunei and Lao PDR also experienced the same problem but were not as worse as the four crisis-affected economies. Immediately after 1999, GDP performance languished especially for Philippines, Korea, Malaysia and Indonesia. Except for Brunei Darussalam, China and the other five economies reflected increasing growth rates.

The upsurge in export transactions, compared to import transactions, supports GDP's rapid growth. Only Myanmar and Vietnam reflected robust growth rate improvements starting 1999 with Vietnam recording the highest and fastest growth for the period at a rate of 9.9 per cent with 1999 level growing by 87.9 percent from the 1998 figures.

Among the more developed economies, the People's Republic of China reflected steady growth. Singapore and Japan showed slow growth rates mainly due to the slowdown in international trade transactions, particularly in the region. Singapore heavily relied on the exportation of electronic goods, which was affected by a slowdown in global demand [Financial Stability Review, 2004].

For the crisis-affected economies, exports growth started to stagnate as competition started to become stiff due to the entry of new markets such as China, Vietnam and Mexico. This slow growth was found to have contributed to the asset prices in the equity and property markets [Nellor, 1999]. On the other hand, deteriorating trade transactions (particularly exports), coupled by exchange rate fluctuations affected the ASEAN 5 economies especially in the semi-conductor industry [Australia's Department of Foreign Affairs and Trade, 2002].

In Malaysia, there was also a striking stagnation in export's growth rates compared to year-on-year import's growth; particularly in 1998 were a negative export growth rate of 18.75 percent. Aside from the low demand for electronic products, increasing cost and overvaluation of the ringgit had contributed to the problem [Mohd and Tan, 1999]. Thailand's performance from 1997 until 1998 was better as export transactions grew from 7.23 percent to 8.24 percent, respectively, compared to the negative growth rates in its imports transactions [Ibid.].

TABLE-2. Export and Import of Goods and Services Growth Rate

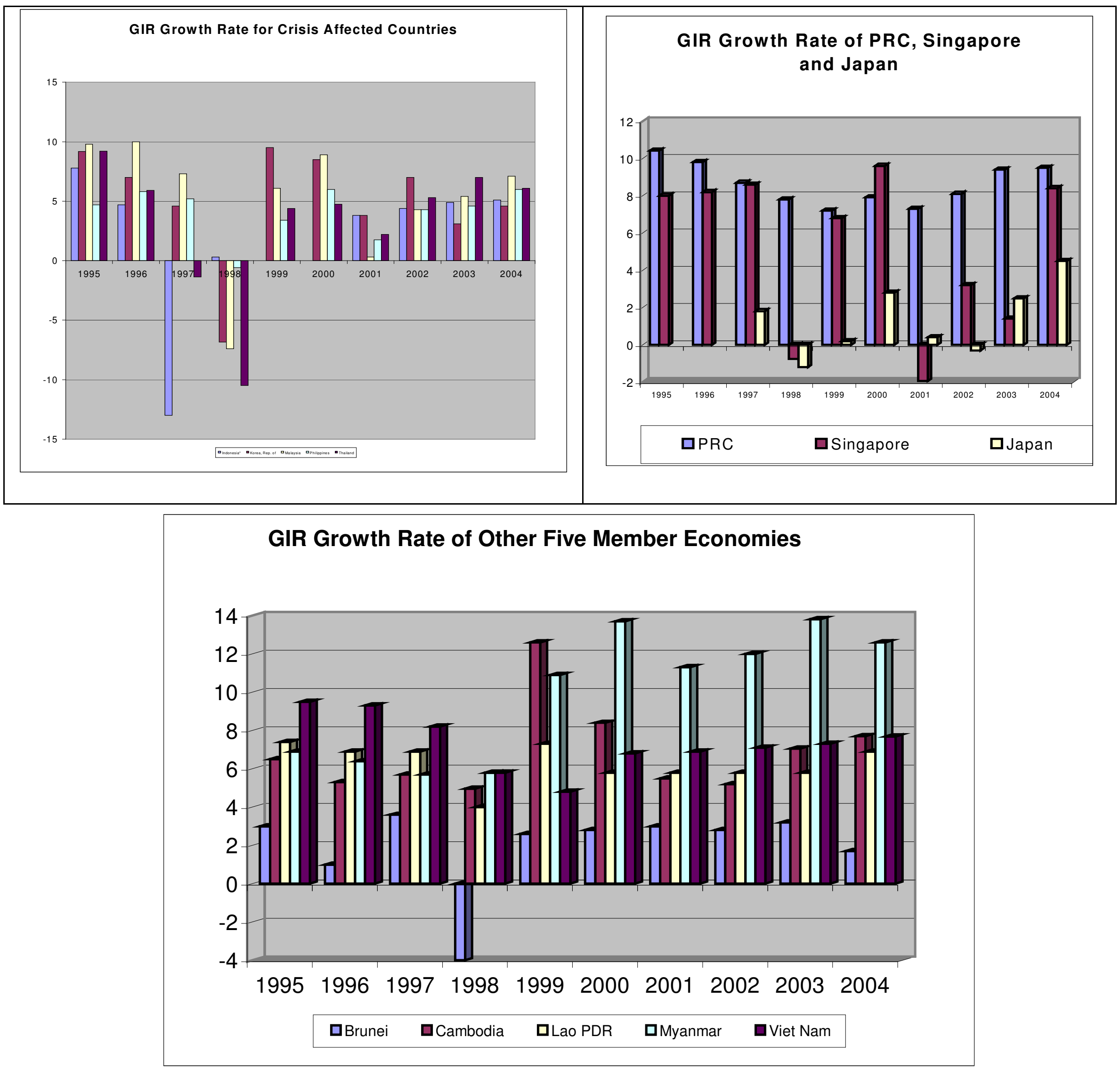
Exports										
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Korea, Rep. of	24.39	12.17	21.63	12.65	14.62	19.14	-2.73	13.26	15.6	19.67
China*	-	-	-	-	-	27.9	6.8	22.4	34.6	35.4**
Japan*	-	6.4	11.5	-2.4	1.4	12.5	-.6.1	7.9	10.1	-
Indonesia	-	-	-	-	-	-	0.64	-1.21	8.19	8.47
Malaysia	18.96	9.23	5.49	0.49	13.16	16.07	-7.5	4.49	5.7	16.31
Philippines	12.04	15.4	17.15	-21.03	3.62	17.05	-3.44	3.59	4.1	14.13
Singapore*					5.4	16.8	-8.6	4.4	12.2	19.3
Thailand	15.44	-5.52	7.23	8.24	9.03	17.49	-4.21	11.99	7.03	9.64
Brunei	-	-	-	-	-	-	-	-	-	-
Cambodia	34.57	-19.09	38.07	-2.32	39.42	41.23	18.87	20.75	-	-
Lao PDR	-	-	-	-	-	-	-	-	-	-
Myanmar	-22.02	10.18	24.09	-0.88	6.76	79.29	16.47	20.58	-30.01	-
Vietnam	-	41.2	24.6	2.4	23.2	25.2	4.3	23.8	30.2	22.3
Imports										
Korea, Rep. of	22.95	14.32	3.46	-21.81	27.8	20.06	-4.17	15.21	10.08	13.84
China*	-	-	-	-	-	35.2	8.1	21.3	39.8	35.8**
Japan*	-	13.2	1.0	-6.6	3.3	9.3	0.2	1.9	5.0	-
Indonesia*	27.6	26.4	28.1	41.7	26.9	-	4.18	-4.25	2.73	24.95
Malaysia	23.7	4.89	5.82	-18.75	10.56	24.37	-8.61	6.35	4.24	20.68
Philippines	16.02	16.74	13.49	-14.7	-2.8	4.27	3.52	4.72	9.84	5.94
Singapore*	-	-	-	-	9.5	14.8	-12.4	1.2	7.3	21.7
Thailand	19.97	-0.61	-11.3	-21.64	10.49	27.12	-5.5	13.7	8.47	13.48
Brunei*	-	-	-	-	-	-	-	-	-	-
Cambodia	32.67	-4.11	6.57	0.86	29.87	32.38	12.91	16.61	-	-
Lao PDR*	-	-	-	-	-	-	-	-	-	-
Myanmar	19.81	-7.42	3.43	16.63	-0.79	-7.98	10.95	-17.5	-22.48	-
Vietnam*	-	25.5	0.2	-1.1	1.1	34.5.	2.3	22.1	29.1	25.0

Asian Development Bank. IMF and National Authorities.
*: Source: IMF Individual Country Summaries/Staff Report for the 2004 Article IV Consultation.
**: Estimated data.

Both Korea's export and import transactions grew heftily each year except in 2001 when it registered negative growth rates of 2.73 per cent for exports and 4.17 per cent for imports. Trade business in Thailand was promising; hence, the value of its transactions was affected by the devaluation of baht against US Dollar. This can also be seen from the decline in the growth rate of its international reserves during these years. The firm resolution by the government to bounce back from this trade reversal showed improvement in foreign reserves starting 1999.

While the impact of the crisis was not serious for Brunei, Cambodia, Lao and Vietnam compared these crisis-affected economies, their export growth was also affected just like the other economies [Economic Analytical Unit, 2002].

FIGURE-1. Gross International Reserves



Source: Asian Development Bank, IMF and National Authorities

Meanwhile, Japan and China's export growth lagged behind import growth rates. A closer look at the data reveals that China's performance was better than Japan's performance, particularly in its export transaction starting 2002. From a high export growth rate of 12.5 percent in 2000, Japan registered a *negative* 6.1 percent growth rate due to the movement of its imports. The transition of China to a market-oriented economy and its impressive performance in the world market led to its success [Nasution, 1999]. The influx of foreign direct investment was also evident as it provided cheaper cost of labor. Despite slight or almost steady growth rate in its gross international reserves, performance was remarkable.

In Indonesia, international reserves were high prior to the crisis. In 1996, it started to decline, and actually worsened in 1997 when several banks started to become illiquid and the Bank of Indonesia had to finance the current account deficit and defend the rupiah [Ibid.]. The free floating system adopted in 1997 paved way to the further depreciation of rupiah, which further exposed banks to currency and interest rate risks and caused further bankruptcy among financial institutions.

In Thailand, on the other hand, fiscal and monetary policies tightened. As banks borrowed Thai baht in the foreign exchange swap market, other fundamentals continued to deteriorate particularly with the high inflation rate and large unhedged currency borrowings by private corporations, thereby causing the depletion in the international reserves. It further reported that approximately 8.7 billion was used to defend the currency [Werner, 1999]. Malaysia was not as adversely affected since its government was able to maintain its international reserves level except, in 1998. Korea and Thailand also reflected negative growth rates in 1998 after which growth began to increase as it maintained prices at stable rates, fiscal surplus and high savings and investments [Mohd, 1999].

For Myanmar, Cambodia and Vietnam, exports growth moved quicker than imports due to the incessant increase in the value of world oil prices. Even if demand slightly declined, the escalating prices of these products made the value of exports high compared to imports transactions. Unlike Vietnam, Myanmar showed continuous rise in its international reserves growth rate, while Cambodia's increasing growth rates for the 10-year period showed decelerating reserves growth: negative 33.3 percent from 2002 until 2003. Compared to Brunei Darussalam, Lao PDR showed impressive international reserve growth rate especially from 1999.

As a whole, signs of deceleration in the foreign trade transactions' growth, particularly exports were obvious. The current trend indicates that the initial impact of trade liberalization is petering out. Hence, trade flows slowly reverted to their normal trend after 1999. For the oil-rich countries, the continuous increase in the world prices did not affect currency values. Moreover, improved economic performance clearly demonstrates that adequate financial and other structural reforms were already apparent in Singapore and Japan to ensure vibrant economic conditions and healthy financial environment in the ASEAN+3 region.

CHAPTER 2

REGION'S FINANCIAL CRISIS AND THE NON-PERFORMING LOANS PROBLEM

by Dr. Liberty S. Patiu

The literature conducted on non-performing loans [i.e. Fung et al., 2004; Kaminsky and Leiderman, 1998; and Kaminsky and Reinhart, 1996] attributed the Asian crisis to the region's lending boom [Goldstein, 1996; Nellor, 1999; and Collyns and Senhadji, 2000] and its high debt levels [Krugman, 1996]. One study examined how banks were adversely affected in their operations as a result of their high loan exposures to domestic private sectors [Aghion, Baccheta and Banerjee, 2000], which led to the crisis; while others used the indicator system [Zhuang and Dowling, 2002; Kaminsky, 2000] in identifying evidences of early warning signs of systemic risks either in the form of financial crisis, currency crisis or banking system crisis or a combination of any of these crises.

A. FINANCIAL INSTITUTIONS' LENDING ACTIVITIES

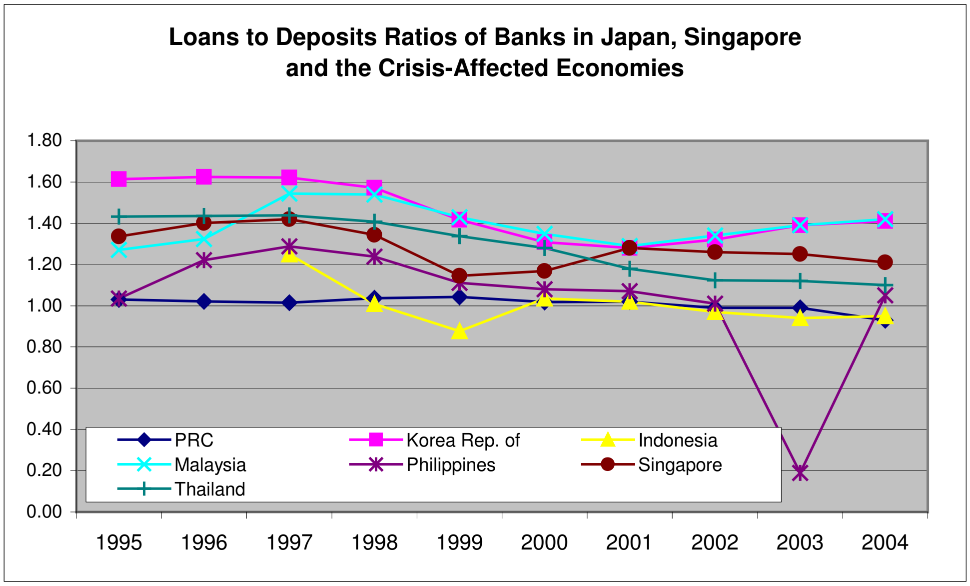
Prior to the crisis, banks in the region exhibited higher loans to deposits ratios to boost up profitability while minimizing cost of funds. Because borrowers are likely to default in their loan repayment commitments during periods of economic deterioration, highly leveraged portfolios naturally expose banks to unwanted credit and maturity risks. [Downes, Marston and Otker, 1999].

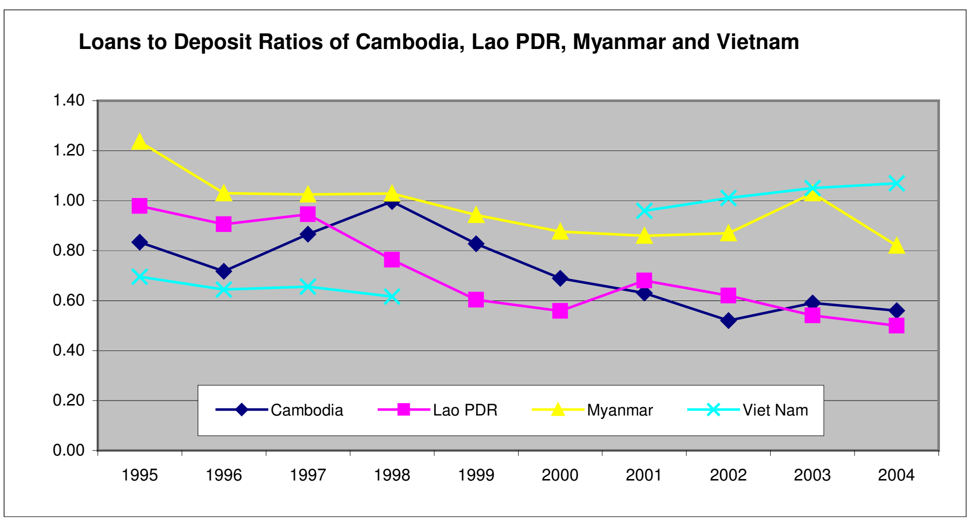
Until 1998, Korea, Japan, Thailand, Malaysia and Singapore showed high loans-to-deposit ratios, reflecting banks' risk appetite. Investments in either equities or securities comprised only a small portion of banks' asset portfolio, and incomes from loans became very attractive as the property and manufacturing businesses continued to prosper in Asia.

For the other economies, high ratios before and during the crisis were noticeable, not because of the surge in loan demand by private sector, but by the high share of loans provided to State-Owned Enterprises. In Vietnam, Lao PDR and Myanmar, low deposit portfolio was observable. Despite the liberalization of entry in the banking system, concentration of loans to SOEs exposed the banks to greater credit risks, since majority (90 percent) of the banking systems' loan transactions were dominated by State-Owned Commercial Banks [Oh, 2000]. This impeded the development of banks because they were not required to implement credit screening and monitoring. In 1999, low ratios were evident especially in Cambodia, Lao PDR, Thailand and People's Republic of China. Other economies like Malaysia, Indonesia and Philippines reflected varying results.

The lending boom was also attributable to the absence or lack of market for bond market in many countries. Given the increasing demand for credit, loans transactions were not adequately managed and scrutinized due to insufficient and/or ineffective bank discipline. Weak corporate governance in the banking system was discovered in most of the economies in the East Asian region.

FIGURE-2

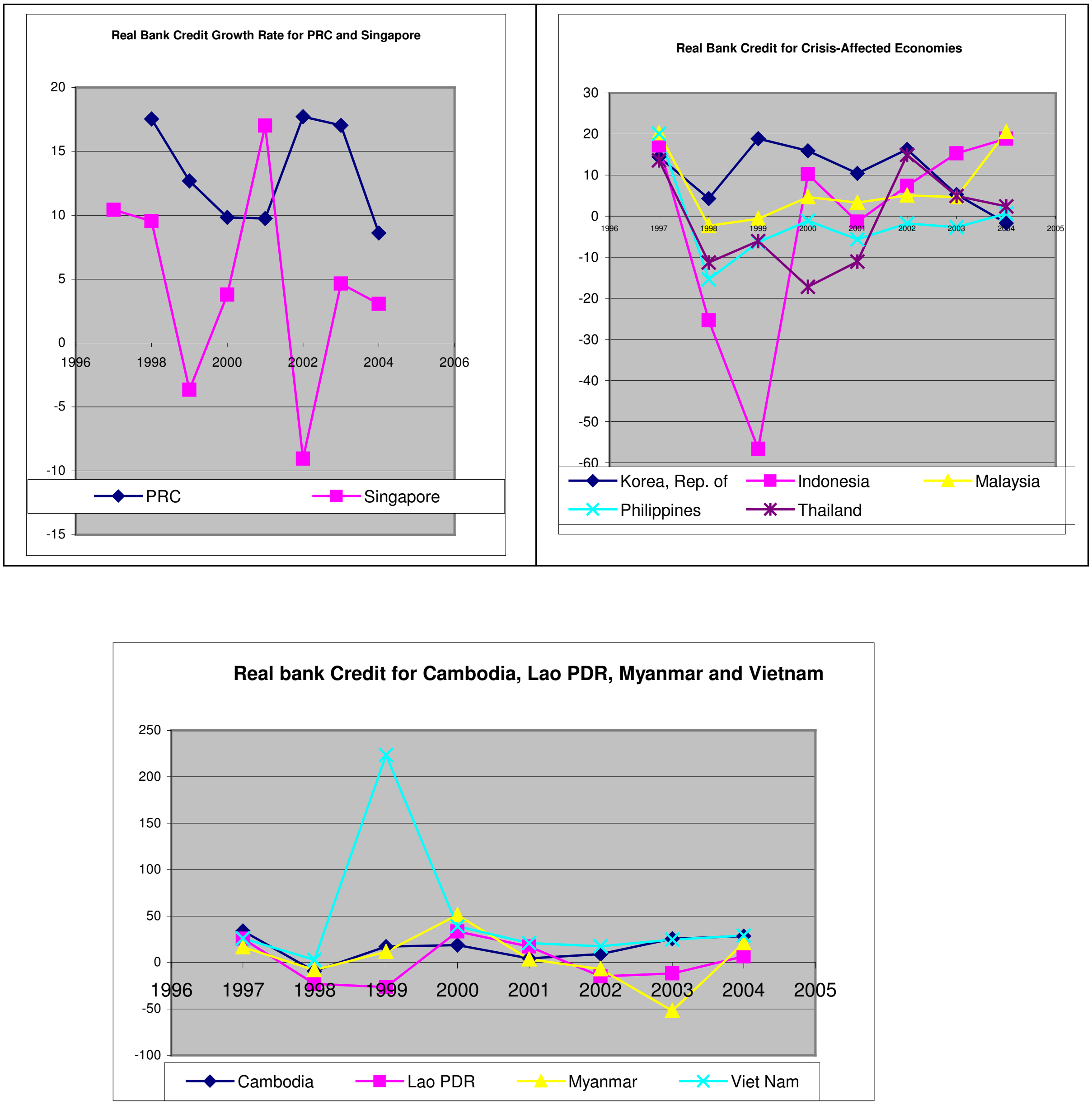




Source: Asian Development Bank, National Authorities and International Financial Organizations.

From 1997 to 1999, there was a significant contraction in the growth of real credit in almost all economies. Starting 1999 Korea, Myanmar, Cambodia and Vietnam registered high growth rates in their lending transactions starting. This was brought about by the firm resolution of the government in their respective economies to open their market in the international business environment. Moreover, Australia's Department of Foreign Affairs and Trade [2002] reported that the deteriorating credit demand in the region could be attributed to the decreasing demand for loans and the unwillingness of the banks to lend.

FIGURE-3. REAL BANK CREDIT GROWTH RATE



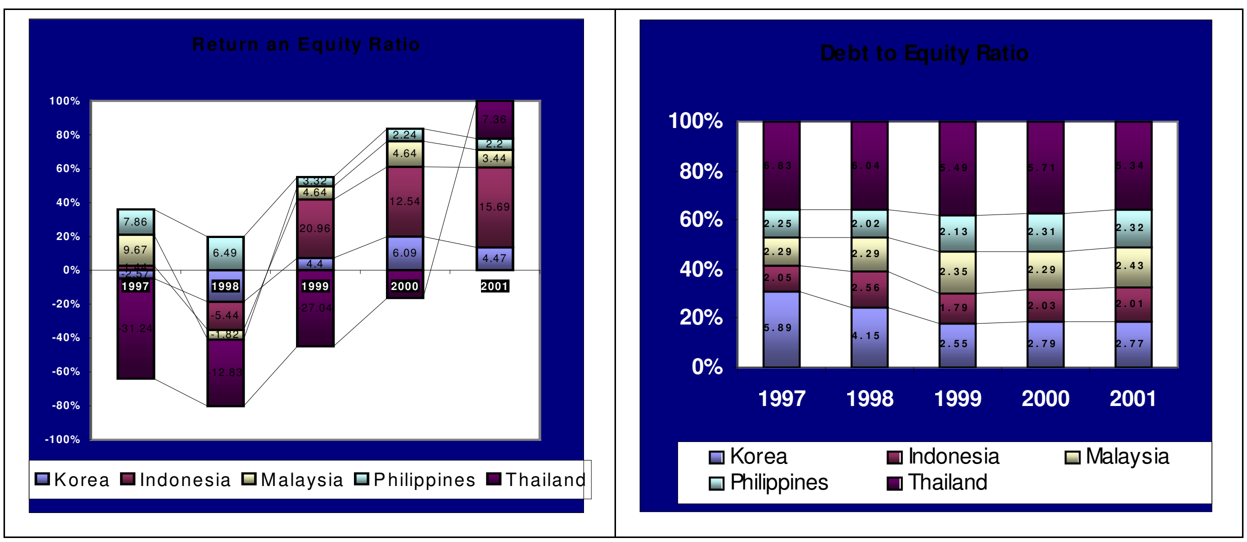
Source: Asian Development Bank.

For Korea, recovery was quite easier compared to other crisis-affected economies due to the deliberate move by the government to manage escalating NPLs [Ji and Park, 1999]. Most banks realized the importance of protecting their balance sheet accounts, particularly the quality of their asset portfolios and their operating results to mitigate the possible losses arising from the increasing levels of NPLs. Moreover, this was also triggered by weak loan demand from the corporate sector due to the increasing cost of borrowings. Year 1999 reflected Vietnam's aggressive lending activities, both to the State-Owned Enterprises (SOEs) and private sectors with a 224% credit growth.

In Japan, credit growth rate in the banking system ranges from 0.0% or negative 1 percent since 1995 because of the relaxation of or the relatively low interest rate environment as a result of the current problems faced by financial institutions [Baba et al, 20005]. In line with this discernible deterioration of the country's financial system, Bank of Japan had introduced quantitative easing policy (QEP) in 2001 to provide sufficient liquidity supply in the system by using the current account balances as the operating policy targets.

On the other hand, real bank credit had significantly declined for the crisis-affected economies, except for Korea, which registered continuous yet erratic growth rates after the crisis compared to the other four economies. Despite the gradual decline in credit growth, Indonesia, Malaysia and Korea experienced rapid growth in outstanding real bank credit to control the increasing household loans and to reduce risks associated with institutional lending [Asia Economic Monitor, 2002]. The banks' goal of minimizing credit risks and burdens facilitated the shift from high loan portfolios to investment in securities that are considered safe and had likewise provided reasonable returns.

FIGURE-4. Corporate Sector's Return on Equity and Debt-to-Equity Ratio of Crisis Affected Economies



Source: ADB and National Authorities.

Figure-4 depicts that corporate sectors in Thailand and Korea have high debt-to-equity ratios of 5.89 and 6.83 in 1997, respectively. Moreover, the private sector generated poor returns on investments as shown in their profitability ratios (**Figure-5**). Higher return-on-assets ratios were evident among Indonesian firms as they continued to reduce their debt-to-equity ratios especially in 2000 where a high return-on-assets ratio of 20.96

percent was evident. These levels declined or flattened, and are still high comparable to Thailand, Malaysia and Philippines, with approximately the same debt-to-equity ratios. It ranges from moderately high ratio to high ratio, reflecting greater leverage among borrowers and higher exposure by banks to credit risk.

The other ASEAN member countries were not severely affected by the crisis as real bank credit continued to rise in terms of the value of loan transactions. It was only in Lao PDR that sudden deceleration in the performance of bank credit was evident [ADB, 2000].

What is surprising to note is that while the crisis-affected economies were adversely affected by the financial turmoil, Cambodia and Vietnam registered loan portfolio growth rates after 2000. Benefits derived from these transactions were not enhanced nor profit orientation inherent in the system as the Government continued to require State-owned Banks to extend unconditional loans to SOEs. In Vietnam, banks' credit exposures to various enterprises exposed them to high credit risk as a result of their desire to benefit from businesses and their willingness to lend, especially when the demand emanated from the government officials or the State thereby impairing banks' capital [Thien, n.d.].

Notwithstanding the various improvements in the system, the corporate sector's debt-to-equity ratios for the crisis-affected countries were either stable or improving. At the onset of the crisis, companies reported high debt-to-equity ratios particularly in Korea and Thailand, which resulted to a negative return on equity ratios for the two economies.

Companies in Thailand were adversely affected by the crisis until 2000, compared to the Korean companies whose recovery was apparent after 1998. Banks and financing companies were involved in providing credit to private sectors, such as construction, property and petrochemical businesses whose average ratios range from 1.5 to 2.1 [Kawai and Takayasu, 1999]. After the crisis, companies posted remarkable return-on-equity ratios starting 1999 until 2000 at 4.4 percent and 6.9 percent, respectively. Despite these reported steady ratios, return-on-equity ratios were deteriorating from a high of 7.86 percent in 1997 to 2.2 percent in 2001.

Only Malaysia was not greatly affected by the crisis as companies posted almost stable or improving debt-to-equity ratios and return-on-equity ratios. While there were many companies that were restructured by the government during and after the crisis, reported that most the companies were insolvent and the deliberate restructuring activities undertaken by the government had helped in the recovery of surviving and new companies in 1999 [East Asia Analytical Unit of Australia's Department of Foreign Affairs and Trade, 2002].

After the crisis, most of the companies operating in Indonesia were insolvent, as total private sector external borrowings reached approximately US$60 billion, representing 25% of its gross domestic product [Chou, 1999]. This proved very helpful as the private sector industries, through the Indonesian Debt Restructuring Agency (IDRA), were able to reschedule their maturing obligations and had converted foreign loans to local currencies at reasonable rates. In fact, foreign debt by the private sector was US$61 billion in 1997 compared to $48 billion in 1995 [Ibid.].

Banks in Korea were affected by corporate insolvencies as private manufacturers provided support funds or credit to the buyers. Moreover, most of the problems on local funds were attributed to loan exposures by banks to aggressive yet highly-leveraged large companies. This had impaired banks' assets and loan portfolios. At an early stage, corporate clients were forced to improve their debt-to-equity ratios, which gave impetus for banks to be active in consumer lending.

Table-3 shows the credit cultures adopted by the ASEAN+3 economies. Except for Indonesia, which depended on both policy and collateral-based transactions, the other four crisis-affected economies used collateral-based lending. Despite these credit support measures adopted by banks in these economies, they were still adversely affected approximately to the same degree as those banks that used the two-way approach and were highly controlled by the State, such as Korea and Indonesia.

TABLE-3. Banks Credit Culture in the ASEAN + 3 Economies

Country	Credit Culture
Korea, Rep. Of	Combination of Policy and Collateral-based Lending
PRC	Combination of Policy and Collateral-based Lending
Japan	Collateral-based Lending
Indonesia	Combination of Policy and Collateral-based lending
Malaysia	Collateral-based lending
Philippines	Collateral-based lending
Singapore	Collateral-based lending
Thailand	Collateral-based lending
Brunei	Collateral-based lending
Cambodia	Policy Lending by SOBs
Lao PDR	Policy Lending by SOBs
Myanmar	Policy Lending by SOBs
Viet Nam	Combination of Policy and Collateral Based lending

Source: Compiled by researcher from various studies.

State-Owned Banks provided the largest chunk of these loans. As firms were unable to make interest payments, bank's lending activities turned sour. High NPLs expose the banks to higher risk, low profitability and even capital impairment, as large loss provisions are allotted for non-performing loans problem [Downes, Marston and Otker, 1999].

China's State-Owned Banks dominated the industry and the share of the four large State-Owned banks in the country's loan portfolios was very high. Except for Brunei Darussalam, where the government does not borrow from SOCB [IMF, 1999] and banks were reported to have high liquidity positions, the other four member economies provided loans that were directed by the government to fund operations and specific activities of the State-Owned enterprises. As mentioned in the country reports, lending activities impede the ability of these banks to maximize their gains. Despite recapitalization of these banks through additional capital infusion by the government, the bad debts incurred each year added up to the problem and made it difficult for the government to mitigate the problem.

Unlike a currency crisis, the financial crisis could affect the banks' output as a result of credit intermediation disruption through credit constraints, poor payment system, collateral value and other credit assessment mechanisms [Hutchison and Noy, 2005]. This can be manifested from the contraction in the lending activities of banks in some economies particularly for the six affected economies, which led to the fall of the corporate sectors' tradable goods. Its adverse effect on non-tradable services continued to spread thereby resulting to the bankruptcy of firms and the subsequent insolvency of some banks.

Moreover, it is believed that rapid credit expansion, deterioration in the bank's loan values and unsustainable credit practices such as directed, connected or insider lending coupled by weak prudential regulations triggered the problem. The increasing role of market forces only triggered disparities between weak and strong financial institutions masked by increasing demand for funds from the corporate sector. When weaker banks' business turns lemons, insolvency is likely to occur which causes these banks to be ineffective and unable to continue sound banking operations.

Except for the Philippines and Malaysia, the crisis-affected economies had undertaken rapid financial liberalization abruptly and instituted prudential regulations that were loosely monitored, particularly in the field of credit management. There was high demand for loans from private sectors, as they took advantage of fast growth brought about by high foreign direct investments.

B. SUPERVISORY AND REGULATORY FRAMEWORKS AND THEIR EFFECTS ON SELECTED PERFORMANCE INDICES

Some of the crisis-affected economies took on post-crisis reforms, especially in Korea where the government made fundamental changes in its laws to respond to the problem. Moreover, its goal in making itself one of the most progressive economies and in placing its financial system in the limelight paved way to its fast recovery and success [Cho, 1999].

Like Singapore, China's attempt to expand and open its market in the international arena enabled it to withstand the vicious effect of the crisis. Despite its success, China was not exempted from the NPL problems. As is common among closed economies, transparency in the financial system was inexistent to protect political or national interest. This hampered the development and harmonious resolution of the financial sector's problem.

TABLE-4. Assessment of Supervision and Regulatory Framework among the ASEAN+3 Member Economies

Country	Supervision		Prudential Regulation		Corporate Governance	
	PRE-CRISIS	POST-CRISIS	PRE-CRISIS	POST-CRISIS	PRE-CRISIS	POST-CRISIS
PRC	Strong	Strong	Weak to Moderate	Strong	High/ Strong	Very Strong/Very High
Korea	Strong	Very Strong	Strong	Very Strong	Weak to Moderate	Moderate to High
Japan	Very Strong	Very Strong	Strong	Strong to Very Strong	Moderate	Strong
Indonesia	Weak (Lacking and lax)	Weak to Moderate	Moderate (Delays in implementation)	Moderate to Strong	Implicit (Indonesian Company Law of 1995)	*Towards implementation of Committee for Corp. Gov. and Code of Corp.
Malaysia	Strong	Very Strong	Strong	Very Strong	Weak to Moderate	Moderate to Strong
Philippines	Strong	Strong	Moderate	Strong	Weak	Moderate
Singapore	Very Strong	Very Strong	Strong	Very Strong	Strong	Very Strong
Thailand	Weak	Strong	Weak	Moderate to Strong	Weak	Moderate
Brunei	Very Weak	Weak	Very Weak (Other FIs must be coordinated)	Weak	Weak	Implicit
Cambodia	Weak	Weak (Must be expanded and strengthened)	Moderate	Strong (Per ADB)	Very Weak	Weak
Lao PDR	Very Weak	NA	Very Weak	NA	Very Weak	NA
Myanmar	Very Weak	NA	Very Weak	NA	Very Weak	NA
Viet Nam	Very Weak	Moderate	Weak to Moderate	Moderate	Weak	Steps were undertaken

Source: Based on researcher's assessment as gathered from various literature/studies reviewed.

ADB's report [2001] emphasizes the existence of weak supervisory capacity and inadequate regulatory framework that impairs the government in providing a competitive environment in the financial system. Banks in the region have either inadequate or low prudential framework. No matter how idealistic, the absence of an effective system of financial regulation and supervision derails government efforts to succeed. Delayed enforcement of the law or poor supervision further magnifies the problem.

Table-4 depicts the supervisory and regulatory framework practiced by member economies in the region. In many economies, supervision or regulation is centralized at the Ministry of Finance, with central banks or Securities and Exchange Commission under its control. What is worthwhile to note is that these regulatory or supervisory authorities were given independence to establish and implement policies that enhances competition. There are also instances when some of these functions are inter-related while others are conflicting; hence, duplication of work may arise which will at times impede growth. Worse situations happen when the decision-making activities become vulnerable to the government or Ministry's bureaucratic set-up or intense intervention.

While Singapore, Japan, Philippines, Korea, Malaysia and People's Republic of China showed either strong or very strong supervisory framework, other countries reflected otherwise, ranging from weak to moderate frameworks. In the case of Indonesia, regulation and banking laws were in place but the lenient implementation of the laws coupled by weak supervision made it vulnerable to shocks. For most of the Korean companies, which were closely held by *chaebols* and other selected owners, firms became vulnerable to risk as the economy suffered inefficiency [Nam, Suh-Park and Kim, 1999]. Among those that were instituted by the government to make corporate governance structure open and increase management transparency was to require listed companies to have 25 per cent outside directorship which allows minority representation in the board. Moreover, institutional investors are allowed to exercise voting rights in their trust accounts while foreign investors can influence corporate decisions.

Japan had corporate governance structure even prior to the financial crisis, but it was not strictly implemented. In 1997, the corporate governance code, which highlights the principles to modernize and uplift the governance of Japan's private sector, tried to be more responsive to the needs of the international business environment while maintaining Japanese business traditions [JCGF Principles, 2001]. But the existing regulatory framework made it difficult for banks to seize and recover collaterals at high price especially when those that were provided are related to working capital requirements or are collaterals that are difficult to dispose at the firm level.

A review of the NPL problems revealed that it occurred either as a result of inadequate prudential measures for classifying loans/assets in most-crisis affected economies or due to the absence of laws for measuring and managing NPLs among the other five member economies. Moreover, hasty liberalization undertaken before the crisis paved way to the full liberalization of capital flows and the deregulation of credit controls and interest rates, which were proven to be unsustainable at the national level. Except for Vietnam and Brunei, capital flow, credit and interest rates are still repressed among the other three member economies (Cambodia, Myanmar and Lao PDR) prior to the crisis. This is due to the slow transition of these economies to openness in the international arena.

Weak or poor corporate governance practices exacerbated the problem. Prior to the crisis, only the practices of Singapore, Japan and China were characterized as either strong or very strong. Singapore, which reported high corporate governance practices, was able to withstand the external shocks. For the other economies, poor governance of banks had contributed to the growth of non-performing loans and assets in their asset portfolios.

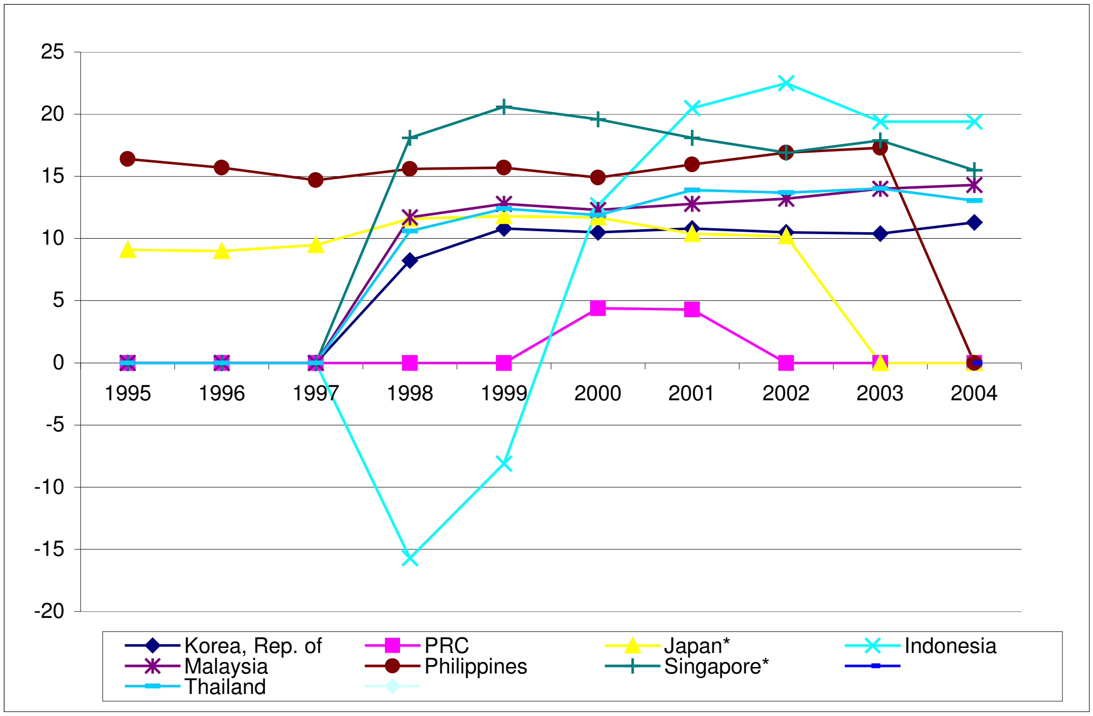
In the Philippines, corporate governance was not strictly practiced particularly before the Asian Financial Crisis, as most of the corporations were closely held or were held by conglomerates. The financial crisis made both firms and financial institutions vulnerable to risk. ADB reported that the country, through SEC, had approved the Code of Corporate Governance not only for local corporations but also subsidiaries of foreign corporations. Its manual of Corporate Governance incorporates not only the Corporation Code but also Securities Regulation Code and international best practices.

Several governance initiatives undertaken by Lao PDR were corporate governance was found to be very weak as corruption proliferated in all levels, especially in activities that involved tax payment evasion, commissions and other activities [ADB, n.d.]. Revenues, funds allocation and public trust were adversely affected. Moreover, problems on institutional capacity made it quite difficult for the country to achieve good governance objectives by the government. Another ADB study [2000] revealed that policies and procedures were formulated through the assistance of ADB as part of its goal of introducing governance and accountability at all levels of SOCB's operations. Moreover, improvements in the credit transactions, particularly in the non-performing loan ratios, were evident at a rate of 5% by 2003. The same applies for Cambodia where banks are characterized by very weak governance practices (ADB, 2000).

The Organization for Economic Co-operation and Development highlights the collaboration among several Asian countries that incorporates OECD's Principles of Corporate Governance in formulating common policy objectives of improving governance practices in Asia. Collaborative effort requires strong commitment by the country where regulations are not enough for its success but its implementation is very critical. This is a practical way of viewing reforms as efforts become futile if they were not taken considerably. Aside from protecting minority interest and shareholders, accounting and auditing standard and financial disclosure are important. While working towards common standards, economies in Asia work towards the use of international standards that facilitate transparency and comparability in the region. This goal may be quite difficult for the other ASEAN countries like Brunei, Cambodia, Myanmar and Lao PDR, which are just in the process of transformation by opening up their markets.

Weak capital in the banking system decreases profitability due to narrow lending margins. The capital funds held by banks provided adverse implications in maintaining stability in the financial system. It can be noted that the average risk-weighted capital adequacy ratios (CAR) of commercial banks in the crisis-affected economies and Japan are above the international standards set by the Bank for International Settlements.

FIGURE-5. Capital Adequacy Ratio of Banking Industry in Selected ASEAN+3 Economies



N

NOTE: Data for Japan were culled from the study made by Masahiro Kawai (2004) entitled: "Reform of the Japanese Banking System. These ratios were taken from major banks in Japan
Data for Philippines were taken from PDIC Website. Data for 1995-1999 represents capital to risk assets ratio while data for 2000-2004 represents qualifying capital/total risk-weighted assets
*Financial Stability Review 2004

Until 1999, Indonesia posted negative capital adequacy ratios as it was hardly hit by the currency and financial crisis due to political unrest and weak monetary and fiscal policies compared to the other crisis-affected economies. Hence, the government instituted several measures to improve these ratios in line with the BIS norm [Chou, 1999]. Figure-5 reveals that in 2000, sudden improvement in the ratios of these banks was evident due to strong prudential regulations and the Indonesian government's recapitalization to strengthened financial conditions. In fact, among the seven countries, it exhibited the highest ratios especially in 2001 and 2002 with CAR of 20.5 percent and 22.5 percent, respectively.

Banks in the Philippines also posted high capital adequacy ratios even prior to the crisis. It was only in 1997 and 2001 when ratios were decreasing; hence, they are still above the international norm of 8 percent or BSP's acceptable capital ratio of 10 percent (www.bsp.gov.ph). This was brought about by improved foreign and universal banks' performance as they moved towards improving their asset quality and infused additional capital in line with the three-year capital build-up program (for the period ranging from 1998 until 2000) by the Monetary Authority of BSP.

Thailand, Malaysia and Korea posted relatively low ratios compared to Philippines and Indonesia but ratios were also above BIS norm. Malaysia exhibited a stable increase in its capital adequacy ratios from a low of 11.7 percent in 1998 to a high of 14.3 percent in 2004, which is equivalent to an average growth rate of 22.2 percent.

TABLE-5. Assessment of the Use and Implementation of Capital Adequacy Standards

Country	Capital Adequacy Standards	
	PRE-CRISIS	**POST-CRISIS**
PRC	Weak	Weak to Moderate
Korea	Moderate to Strong (BIS - Some banks have below CAR ratios)	Strong to Very Strong (BIS - New and Improved)
Japan	(BIS)	(BIS)
Indonesia	Existing 8% ratio but weak enforcement	Initially reduced to 4% and again implemented
Malaysia	Strong	Very Strong (strict implementation)
Philippines	Strong (Uses: 10% CAR)	Very Strong adopts BIS Standards
Singapore	Very Strong (BIS Standards)	Very Strong (BIS Standards)
Thailand	Moderate (Adopts BIS but below minimum: 7% & 5.5%)	Moderate to Strong
Brunei	Weak (BIS but reporting is voluntary)	Weak to Moderate
Cambodia	Moderate to Strong	Moderate to Strong (BIS Standards and well-capitalized)
Lao PDR	Weak	Weak to Moderate
Myanmar	Weak	Weak
Viet Nam	Weak	Weak to Moderate

Based from researcher's assessment gathered from various literature/studies.

TABLE-5 indicates the member economies' pre- and post-crisis capital adequacy standards. It explains how regulatory bodies responded to the increasing use of international standards either as part of their move towards liberalization, as a form of adjustment in their financial and structural transformation from command to market-based economy or as a means in assessing how banking reforms has progressed in aligning regulations with international best practices..

Thailand's capital adequacy framework was weak prior to the crisis [Kawai and Takayusu, 2000]. The three-year Financial Development Plan for the period 1990-1992 featured the use of BIS capital adequacy ratio. Moreover, existing capital adequacy regulations underestimated the impact of non-performing loans, particularly new NPLs and the aging of NPLs. It was reported that [Ibid.]:

> *With slow and inadequate corporate debt restructuring, the existing NPLs tend to age into high risk categories and some of the restructured debts return to NPL status, thus requiring further provisioning and exacerbating capital shortfalls…International experience suggests that rapid absorption or recognition of losses and aggressive restructuring would accelerate economic recovery over the medium term, as it facilitates real sector restructuring and restores bank lending capacity.*

China's monetary authority issued rules that required banks to maintain minimum risk weighted capital adequacy ratio of 8 percent. The 4.4 percent and 4.3 percent CAR posted in 2000 and 2001 for Chinese banks were accounted for by the State-Owned Banks' ratios [ADB AEM Regional Update, 2004].

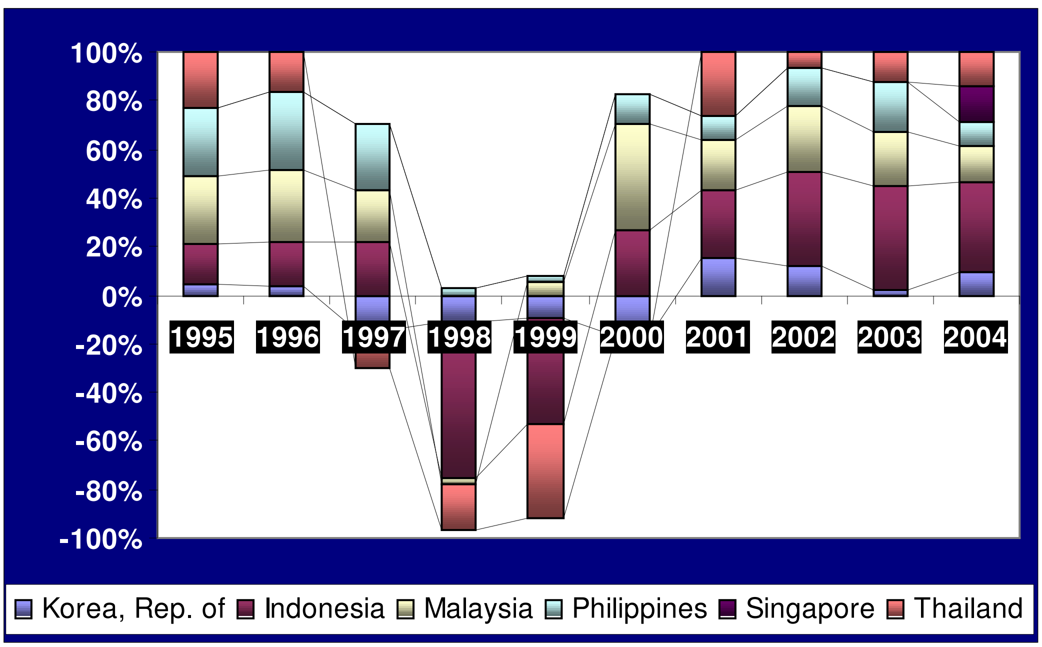
The biggest sector of China's banking system provided loans to businesses and individuals that procured funding from JCBs and foreign banks [Wei and Wang, 1997]. Because these banks were obliged to lend to State-Owned Enterprises, it impaired their ability to maximize their operations. The IMF cited that as of 1999, Brunei's banking system reported above the international standard's minimum CAR. However, it must be stressed that these ratios are deceiving since banks voluntarily submit reports and the government had not so far imposed penalties for non-compliance.

On the other hand, the average capital-assets ratio of SOCBs in Vietnam is only 5.5 per cent while non-state owned banks ratio is 16.5 percent [Oh, 2002]. There is a clear disparity with how the two bank ownerships are being managed and how the government finances the several projects of SOEs. Approximately 90% of the capital of the banking system is at risk [Ibid.]. If a 50% recovery rate on SOCBs' NPLs is expected, and despite prudential measures recovery is not achieved, the problem will exacerbate.

What had worsened the problem is that it had allowed banks in 1996 to extend loan maturities that were at risk, eliminated collateral requirements for SOE borrowings and transferred budgetary resources to SOCBs to write-off of NPLs in the banks' books. This is quite alarming considering that non-performing loan provisions could expose SOCBs to risks that will eventually lead to insolvency and undertake unprofitable projects [Ibid.].

FIGURE-6 below shows the capital adequacy ratios of selected economies in the region. Korea and Thailand exhibited deteriorating and lower bank profitability until 2000. Unlike Korea, Thailand posted high NPLs (**see Table-6**), thereby resulting in low returns from investments. Despite this, banks continued to provide loans at a slower pace compared to the pre-crisis years. From 1997-2000, profitability ratios were negative from a ratio of minus 31.24 percent to minus 4.96 percent. A great relief for Thai Banks was eminent in 2001 when the ratio reached 7.36 percent, which is even higher compared to Malaysia, Philippines and Korea. Performance continued to increase and reports revealed that improved performance was accounted for by the sale and transfer of NPLs by banks to AMCs or rapid disposition agencies [AEM, 2001-2005].

FIGURE-6. Profitability (ROA) of Banks in Selected ASEAN+3 Economies



Source: Asian Development Bank and National Authorities.

Thus, the NPLs coupled by the overall poor asset quality had weakened the capital of some banks and other non-bank financial institutions. Some economies did not require banks to report capital ratios, or if the same is required, many ratios were overstated or not reviewed. Other economies were quite lenient in their regulatory requirements for capital support/buffers or did not conform to BIS standards.

As monetary authorities continued their medium- to long-term restructuring measures, they immediately implemented Basel 1 capital standards in their reporting disclosures, while the other five member economies were required by the IMF to follow standards. Cambodia's banks are well capitalized [ADB, 2001], while China's banks was reported to have high capital ratios; however, disclosure of financial performance is still not open to the public, especially for State-Owned Banks.

The deterioration of ROA of banks in Korea and Indonesia could also be attributed to high loan loss provisions provided for credit card transactions [ADB Regional Update, 2004]. Among the reforms that were instituted to minimize banks' exposure to risky business was the requirement among banks to extend credit to SMEs. This move can adversely affect bank's profitability and is viewed as counter-productive due to lower returns that can be derived from the business venture.

While Brunei, Cambodia, Lao PDR, Myanmar, Vietnam and China are still in the process of economic transition, each country's banking system remains dominated by State-Owned Banks. Despite their number, combined assets posed an adverse impact on their performance. Studies reveal that this set-up contributed to operational inefficiencies, as banks were unable to maximize their operations. Since these are directed loans, the effectiveness of the other sectors of the economy declines as credit supply is limited or funding favors State-Owned Enterprises [Wei and Wang, 1997]. In most of these countries, SOEs continued to operate; others were merged or bailed out, thereby leaving the State Government to recapitalize their operations through state-budget and other sources. But this was very unproductive since SOCBs continued to pursue directed credit transactions [Chung, 2003; Cull and Xu, 2000].

C. THE NON-PERFORMING LOANS (NPL) PROBLEMS AND SELECTED INTERNAL CONTROL PRACTICES

TABLE-6 exhibits the non-performing loan ratios of selected ASEAN+3 economies for the period 1997-2004. Japan's NPL problem during the Asian crisis was not serious compared to Korea and China; Japan already experienced a crisis in the early 1990s. For Japan, the problem dates back to 1990 when load and stock prices deteriorated and caused great credit exposure among banks [Ito and Harada, 2004]. Like other economies, NPLs were mostly attributed by the real estate loans which had mushroomed starting 1995.

During the early 1990s, the failure of the three of its major financial institutions in 1997 paved the way to another banking crisis for Japan [Kawai, 2004; Nakaso, 2001; Hoshi, 2001]. This crisis, which resulted from the collapse of the Japanese economic bubble, affected the country's economy [Moi, 2004]. In 1998, NPLs reach its peak, amounting to U$1.0 trillion with estimated losses ranging from 40 to 50 percent [Barth, Carpio and Levine, 1998].

TABLE-6. Bank Non-Performing Loans as a Percentage of Total Loans

Country	1997	1998	1999	2000	2001	2002	2003	2004
Korea	3.9	5.8	7.1	8.9	3.3	2.4	2.6	1.9
PRC	40*	-	-	22.4	29.8	26	20.4	15.6
Japan*	5.5	6.1	5.4	5.3	8.4	7.2	5.2	-
Indonesia	30-35	49.9	33	34.4	28.6	22.1	17.9	13.4
Malaysia	-	8.0	6.4	6.3	8.1	7.5	6.8	5.8
Philippines	5.4	11.1	12.8	14.3	16.4	15.5	14.7	14.2
Singapore	-	-	5.3*	3.4	3.6	3.4	3.2	2.9
Thailand	16.8	45.02	38.93	17.73	10.4	15.7	15.7	12.02
Brunei Darussalam	3.0**	5.0**	-	-	14.9	15.4	12.5	-

Asian Development Bank, Monetary Authorities and individual country reports (for 13 countries)
**International Monetary Fund – Country report as of 1999
China – 1997 data for state-owned banks
Thailand – 1997 data from the study "The Economic Crisis and Bank Restructuring in Thailand by Kawai and Takayasu (ADB 2000)
1997 ratio for Indonesia was gathered from the study conducted by Lan (February-May 2000)

This is quite alarming considering that Japan is the second biggest economy in the world. On the basis of the 6.1 percent ratio for 1998, the NPL ratio represents only a small portion of the total portfolio. Moreover, cheaper credit and ineffective oversight by top management after the burst of the economic bubble resulted in providing investment activity loans to various enterprises [Moi, 2004]. When its NPL-total loan ratios were compared to the other economies, the impact of the crisis was either low or moderate. Despite efforts by the government to solve the problem, years 2001 and 2002 posted high ratios of 8.4 percent and 7.2 per cent, respectively. This is quite perplexing considering the low NPL ratios in Japan's banking system.

While the initial impact of this problem was not significant among the other five member economies, the structure of each economy's financial system and the economic regime made these countries vulnerable to crisis. Out of the five member economies, only

Brunei Darussalam has data on its banks' NPL ratios. Thus, comparison among them would not be possible nor can one assume they were not affected by the financial crisis. Brunei's problem occurred after the collapse of Amedeo Development Corporation, which was suspected to have caused the country to use 50 percent of Brunei's foreign exchange reserves (http://www.bruneidirect.com/IFC/International_Financial_Centre.htm).

Despite Korea's deliberate move to hasten NPL resolution, NPL portfolio continued to increase until 2000. China and Indonesia were hard hit by the crisis with NPL ratios at 40% and 30%-35% in 1997, respectively. The problem even worsened for Indonesia as NPL reached 49% in 1998, only to decline gradually during the succeeding years (**Table-6**).

Bottelier [2005] cited that NPL ratio impairs the ability of the banks to maximize their profits and weakens the government's ability to achieve fiscal reforms, as value of the state's contingent NPL-related debts cannot be accurately estimated. This is quite alarming as NPLs continued to increase and had impaired the capital and asset portfolios of banks. In China, for instance, most of the loans to SOEs are non-performing and the government continued, even after the crisis, to extend credit to these enterprises, which accounted to 70% of the new loan releases.

On the other hand, Oh [2000] presented that official ratios gathered for NPLs range from 5 percent to 7 percent. A non-performing loan is defined as a loan whose interest is left unpaid for up to six months. Since data provided were not accurate, sources revealed that the estimated loan ratio is approximately 20 percent. Approximately 12% of the bank loans were overdue and this represents the portion of un-recovered losses arising from this upsurge brought about by its weak structural and financial reforms [Ibid.]. Vietnam's overdue loans as of 1997 reached VND8.1 billion which is equivalent to 9.8 percent of the entire banking industry's total resources. Oh further attributed Vietnam banks' poor performance on the policy lending practice extended to State-Owned Enterprises as NPL ratios continued to increase.

ADB [1998] also reported that the poor performance by Lao's State-Owned Commercial Banks could be attributed to banks' accounting and auditing practices of not allotting certain provisions for monitoring non-performing loans. Outlined in the technical capacity building activities undertaken by ADB are the improvements in credit operations, internal audit and risk management activities of banks. In another study [ADB, 2002], proposals were provided to assist SOCBs' in solving to the worsening and increasing NPL problem, which can be undertaken on a case-to-case basis by increasing collection and recovery rates.

Some economies took aggressive measures to address these problems by aligning their existing accounting and auditing standards with international best practices as can be gleaned on **TABLE-7** in the succeeding page. Thailand's loan loss provision prior to the crisis was weak (**TABLE-8**).

TABLE-7. Selected Financial Institution's Accounting/Auditing Standards & Financial Reporting System among ASEAN+3 Member Economies***

Country	Accounting/Auditing Standards		FS Reporting/ Transparency	
	PRE-CRISIS	POST-CRISIS	PRE-CRISIS	POST-CRISIS
PRC	Weak	Moderate	Weak (Lacks system of reporting)	Weak to Moderate
Korea	Moderate to High	High	Weak to Moderate	High to Very High
Japan	High to Very High	High to Very High	High to Very High	High to Very High
Indonesia	Weak to Moderate	Moderate	Weak	Moderate
Malaysia	Weak to Moderate	Moderate to High	Moderate to High	High
Philippines	Weak to Moderate	Moderate	Moderate to High	High
Singapore	High to Very High	Very High	Very High	Very High
Thailand	Weak	NA	Weak	Moderate
Brunei	Weak	NA	Weak (not international accepted acting standards)	Weak
Cambodia	Very Weak	in 2003 it implemented standards based on IAS	Weak	Weak
Lao PDR	Very Weak	Weak	Very Weak	NA
Myanmar	Very Weak	Very Weak (No law was passed)	Very Weak	NA
Viet Nam	Weak	Moderate	Very Weak	Moderate

Compiled by the researcher from various sources based from the assessment of the researcher.

*** The analysis of this table/sub-section was prepared and written by Dr. Belinda S. Mandigma.

TABLE-8. Credit Risk-Assessment on Loan/Asset Classification and Loan-Loss Provisioning in the ASEAN+3 Region

Country	Loan/Asset Classification		Loan Loss Provisioning	
	PRE-CRISIS	POST-CRISIS	PRE-CRISIS	POST-CRISIS
PRC	Weak	Moderate	Weak	Weak to Moderate
Korea	BIS Stringent	BIS (Stringent and more conservative)	BIS Stringent	BIS (Stringent and more conservative)
Japan	High to Very High	High to Very High	High	High to Very High
Indonesia	Weak	NA	Weak	Moderate
Malaysia	Weak to Moderate	NA	Weak to Moderate	Moderate to High
Philippines	Moderate to High	High	Moderate to High	High
Singapore	Very High	Very High	High	Very High
Thailand	Weak	Moderate	Weak	Moderate to High (Strengthened)
Brunei	Very Weak	Very Weak	Very Weak	Very Weak
Cambodia	Very Weak	NA	Very Weak	NA
Lao PDR	Very Weak	NA	Very Weak	NA
Myanmar	Very Weak	NA	Very Weak	NA
Viet Nam	Very Weak	Moderate	Very Weak	Moderate

Compiled by the researcher from various sources based from the assessment of the researcher.

While there were existing regulations, provisioning was made to assets that were overstated, which in effect proved to be inadequate. Regulations incorporate classification of loans according to the number of times monthly payment is due rather than considering the present value of the cash flows that can be generated from the loans as prescribed by BIS [Oh, 1999]. Immediately after the crisis, part of the restructuring process includes the requirement on banks to write down capital in the recognition of financial losses arising from non-performing loans portfolios [Kawai and Takayusu, 2000].

In the Philippines, accounting standards can be rated as moderate. Despite strict adherence to the international standards, enforcement of the law had been the problem especially when it comes to financial disclosure. Stephen Wells (1999) cited that the role of the Securities and Exchange Commission had not been successful in implementing the standards especially since companies do not positively view financial disclosure. Despite active involvement by accounting firms, they cannot do much as they have a business to protect. With many economies adopting the standards, Philippines religiously adopted changes towards improving accounting standards. Established in 1981, the Accounting Standards Council had adopted the IAS to fit to financial conditions to conform to the country's requirements through the Statement of Financial Accounting Standards (SFAS) by revising the first six (6) standards in 2001. Another development would include the requirement on disclosure for all firms, compared before where it only applies to listed companies [www.sec.gov.ph].

Accounting standards for Myanmar, Cambodia and Lao PDR were found to be weak due to the absence of specific procedures for monitoring performances, particularly in credit transactions (www.adb.adbonline.com). If there are existing laws, the same were not clear or were found to be inadequate and are not internationally accepted. These laws were only designed to serve the requirements of the monetary authorities in line with its policies and goals. In Lao PDR, Cambodia and Myanmar, accountants and auditors started organizing associations, or forming strategic alliances in coordination with the government to discuss issues to monitor activities relating to credit or financial institutions' operations [ADB, 1999-2002].

It can be noted that some started drafting the guidelines, which at the minimum, would ensure monitoring bank performance in effectively managing NPL, if not in line with the international accounting standards [ADB, 1999-2002]. Financial reporting that ensures appropriate disclosure of financial statements or other information was aligned to the regulatory framework, which was instituted to respond to these problems. For the other five member economies, their governments took initiatives to ensure transparency through the auspices of multi-lateral agencies like, IMF, ADB and World Bank (see country reports). But the process was quite slow considering that abrupt changes were implemented as part of the financial packages that were extended to them [Ibid.].

Prior to the crisis, Vietnam did not have auditing and accounting standards. But through the technical assistance made by ADB, the Accounting Standards Board was created in 1999 to monitor standards in Vietnam, paving the way for the establishment of Vietnamese Accounting Standards Board [Narayan and Goden, 2000].

China utilizes four (4) categories in classifying loans of commercial banks, namely, normal, overdue, doubtful and bad loans. However, even if the central bank assigns loan recovery probability rate to each category, banks were given leeway to determine the recovery rate for outstanding loans based on past credit experiences and collection efforts that are considered subjective [Bottelier, 2005]. Central Bank introduced new loan classification with five (5) major categories, namely, performing, special mention, sub-standard, doubtful and loss). This somehow had improved the loan classification and monitoring system; but made measurement of NPL-related borrowings difficult.

Korea and Malaysia's financial sectors were quite stable compared to other economies in East Asia [Claassens, Djankov and Klingebiel, 1999]. In Vietnam, loans are not classified based on the international standards [Oh, 1999]. There is no standard definition or adequate requirements for classifying loans. It had been a practice that a 90-day loan is still *not* classified as overdue account. Moreover, provisioning requirement is not also aligned with the BIS standards as allowance for bad debt ranges from 1% to 2%, and can still be adjustable if the loan is collateralized. As cited by Masina [1999], the government needs to control and regulate credit particularly when the loan is classified as past due. His findings revealed that credit policies were in conflict with the development strategy projects that were proposed by international multilateral agencies.

In the case of Cambodia, it was recommended that they produce financial statements and reports in accordance with international accounting and auditing standards [ADB, 2001]. Prior to the crisis, there were hardly associations of accounting professionals organized in the country. Local accounting firms' activities were not internationally driven except for those that were undertaken by international expatriates as their standards with respect to the parent company's accounting and auditing procedures. It was envisioned that establishing Cambodia Public Sector Accounting Standards could be utilized as an initial step to improve existing accounting and auditing standards in Cambodia, if there is any. In fact, one of the recommendations in the 2001 study conducted by ADB stressed that Cambodia's banks must develop and improve their existing accounting and auditing standards by using common standards. Since financial statement reporting is not required, only few companies prepare financial statements. This practice impedes capital market development and exposes banks to various risks.

Also in Lao PDR, the ADB and the IMF vigorously conducted seminars and trainings on accounting processes and financial reports, internal audit and credit appraisal activities [ADB, 2002]. Templates for standard financial reporting were provided to simulate actual process. To complete the training, reports were generated for internal control purposes and to increase transparency in the system once it is already in place. Moreover, the technical team can monitor strict adherence to the contract between ADB and Lao PDR.

CHAPTER 3

MEASURES TO RESOLVE NON-PERFORMING LOAN PROBLEMS

by Dr. Liberty S. Patiu

A. SELECTED RESTRUCTURING INITIATIVES UNDERTAKEN AFTER THE CRISIS

There was a remarkable degree of presence and participation of foreign financial institutions in the financial markets of most East Asian economies. In Korea, China, Japan, Singapore, Indonesia and Thailand, 100% foreign participation was provided either as part of restructuring phase or as part of their economic transition.

Downes, Marston and Inci [1999] provided a forward-looking framework by evaluating system-wide vulnerability and quantitative assessment of the financial institutions' financial conditions. Further structural reforms through improvements in government legislations and instituting related-institutional activities were put in motion to ensure the government's regulatory capabilities, promote market discipline, reduce moral hazard problems and allow comprehensive restructuring activities.

To date, the restructuring pace and NPL resolution within the region took the form of deposit guarantees, liquidation or closure of insolvent banks, nationalization, mergers and acquisitions or recapitalization to rehabilitate or revive banks and other financial institutions that were in the brink of failure. Some of these measures were proven to be slow as activities became susceptible to political interference, which inhibit growth and prudential operations within the system.

As cited in the previous discussions, state ownership proliferates and commands significant share in the financial system China, Korea and the other ASEAN 5 economies. Korea was able to solve NPL problems and suppressed financial distress due to sound financial reforms. In Brunei, on the other hand, policy credit is customary, despite increased foreign bank participation in the financial system [IMF, 2000]. This practice hinders commercial orientation and affects other potential investments in the country arising from its international trade transactions.

B. USE OF DEPOSIT GUARANTEES PROVIDED TO SOLVE NPL PROBLEMS/FINANCIAL CRISIS

The role of the government in the allocation of credit and its pricing is very important. One of the most difficult tasks confronting the government is the degree to which certain regulatory restrictions are imposed on the activities of financial institutions. Hence, these are sometimes viewed as advantageous to banks where excessive risk-taking activities are minimized at certain levels.

TABLE-9. Deposit Guarantees Provided by the Government in Selected ASEAN+3 Economies

Country	Deposit Guarantees/Insurance	Ceiling	Type (Blanket, Limited Guarantee, Loans	Name of Agency/ Supervisory Function	Year Established	Insurance Require-ment/ (Premium)	Funding
China	Deposit Insurance System (public)	NA	W/ govt approval; not operational in the near future	State Council's/Not Disclosed	Approval Jan. 2005	Not disclosed	Insurance Premium
Phils*	Public	PHP 40,000 PHP 100,000 PHP 250,000	1963	Philippine Deposit Insurance Corp./Yes	1963	Compul-sory	Paid-n Capital and Insurance Premium
Japan	Deposit Insurance System (Private FIs and Govt)	JPY10.0 million per depositor Demand Deposit – April 2005	Limited Guarantee Deposit Guarantee Limited 2002	Deposit Insurance Corporation (DIC)/ None	1971 1996 2002	Compul-sory	
Indonesia		Deposits of IDR100 million	Blanket Guarantee – 1998 Deposit Insurance Law	Indonesian Bank Restructuring Agency (public) Government None	1998 July 2005		
Korea	Public	KWN 20 million No limit KWN50 million	Limited Guarantee Blanket Guarantee Partial Deposit Insurance System	Korea Deposit Insurance Corp. Public/Private	1995 1998 2001	Compul-sory	
Malaysia	None yet	NA	NA	Not disclosed	NA	NA	
Singapore	None yet FI covered: banks and finance companies	NA	Proposal: Deposit Insurance System with limited deposit guarantee	Not disclosed	NA	NA	
Thailand			Implicit Insurance System General/blanket Guarantee 1997 New deposit insurance agency 2004	Financial Institutions Development Fund	1985	Mandatory for all deposit taking institutions	Fund from MOFA Insurance Premium

Source: Based from the table presented by Birgit Baxendale, Federal Reserve Bank of San Francisco and constructed by the authors from the study from said study.
For Philippine Data: http://www.iadi.org/html/App/SiteContent/Complete%20Surveys/Feb%202003%20-%20IDIS%20DB/PDIC%20-%20Philippines%20SumQ2A1.PDF#search='PDIC DEPOSIT INSURANCE'
For Japan: www.fsa.go.jp

TABLE-9 reflects the different guarantees provided by the governments to temporarily respond to the escalating NPL problems. Since many economies in the region do not have a formal deposit insurance system, restructuring activities, particularly in liquidating insolvent banks, were slow for orderly and timely liquidation process. In the case of Lao PDR, some of the strategies proposed by ADB [1998] to strengthen supervision and regulation are the establishment of a formal deposit insurance company, the use of uniform bank account charts and/or the requirement for disclosure procedures in line with international accounting standards. ADB (2002) cites "*the overall governance structure in the Lao PDR requires resolute and sustainable improvement of the ability to formulate, implement and enforce market-oriented policies and development projects.*"

It is believed that any failure in establishing appropriate rules of the game in the management of financial services especially financial transactions will contribute to the worsening problem. When this is considered at the firm level, despite sound laws/regulations, these rules are sometimes ignored especially if the risk appetite is geared towards maximized profits and a promised growth.

Among the eight (8) economies in the East Asian region, the Philippines was the first to establish a deposit insurance (1963), followed by Japan (1971) through the establishment of a compulsory deposit insurance among commercial banks, credit cooperatives and credit associations. In China, the government provided implicit guarantee of State Owned Bank's deposits as most of these funds were diverted to fund NPLs [Bottelier, 2005]. The Philippines provided a maximum deposit guarantee of PHP10,000 in 1963 and had subsequently increased deposit insurance coverage to PHP100,000 (in 1992) and PHP250,000 per depositor per banks to respond to the changing needs in the financial environment [PDIC, 2003]. In a study conducted by PDIC, it was revealed that the maximum deposit insurance coverage (MDIC) of 4.11 percent of the country's GDP is even higher than IMF and World Bank's recommendation of twice the per capita GDP for the MDIC level [Wesaratchakit, 2002].

Unlike the Philippines and Japan, Thailand introduced implicit insurance system that provided assistance to financial institutions' depositors and creditors through its Financial Institution Development Fund (FIDF). Aside from enhancing financial stability through depositors' protection scheme, FDIF was created to improve the legal basis and institutional framework for the management of troubled banks [Ibid.]. This is one of the goals of the deposit insurance system to ensure public safety as a result of the imprudent banking operations of insolvent banks. However, this results to a high degree of deposit concentration for large accounts, which could affect the performance of the financial institutions.

In 1997, Thailand provided a blanket guarantee that covered deposits and non-subordinated liabilities while in 2004 the new deposit insurance agency was set-up [Cau, 1997]. This helped mitigate moral hazard and provided stability in the financial system. In 2006, Thailand approved a draft to establish a new deposit insurance agency that will replace the general deposit guarantee. It envisions providing a high guarantee on deposits from THB50.0 million to THB1.0 million until its final implementation.

Korea also provided limited guarantee of deposits amounting to KWN 20 million in 1995, but temporarily suspended the ceiling set on deposit coverage during the crisis. Ji and Park [1999] cited that the blanket guarantee, which temporarily replaced the limited to a full deposit guarantee on pseudo-deposits and deposit liabilities, was made possible as part of IMF's financial assistance. However, some banks abused this, which provided higher interest rates on deposits. Considering the broader aspects of their DIC, it shifted back to limited guarantee to prevent moral hazard.

Studies on deposit insurances [Garcia (1997); Milhaupt (1999)] revealed that Japan introduced a series of safety nets to protect depositors and to ensure banking stability within the financial system. Enacted in 1971, its role was only to provide premium to depositors of failed banks on a limited basis. In 1985, it was expanded from being a provider of public funds insurance made by distressed banks to its role of extending financial assistance to financially-troubled banks [Cau, 2005]. In 1996, it provided blanket guarantee as instability in the banking system continued to thrive. The new organizational structure of DIC led to the joint ownership between Bank of Japan and private financial institutions, and had temporarily changed its direction in addressing the serious problem within the financial system.

Garcia [1996; 1999] pointed out that the government's shift from the use of one model to another was aimed at addressing the issue immediately through the use of a formal deposit insurance system, the increase in risk-adjusted premium, which according to Wesaratchakit [2002] was utilized by Malaysia. It does not have a formal deposit guarantee or insurance system; however, the government guaranteed full depositors and creditors' protection in 1998. Oh [1999] stressed that this move by Malaysian government was made to contain potential moral hazard that may arise as a result of excessive deposit withdrawals that will cause a drain in the banks' coffers. The problem did not last long as the market stabilized and paved way to the lifting of said blanket guarantee.

Like Garcia, Lindgren [1999] pointed out that after the monetary authorities saw the weaknesses of the existing insurance scheme and the need for managing distressed banks, Korea, Indonesia and Thailand provided blanket guarantees temporarily until the problem was contained. The Philippines was the only crisis-affected economy that did not adopt this measure; hence, PDIC continued its role in managing the situation to minimize bank failures.

Other methods used were aimed at temporarily increasing deposit guarantee and reducing the value once the situation normalizes. This is only one form of the emergency measures adopted by the government to prevent moral hazard and help financial institutions recover immediately. Although this assistance is generally extended to most of the insolvent banks, there are instances where live banks or financial institutions can avail of it to prevent potential bank runs that may arise.

Even if the traditional public blanket guarantees may be provided to protect depositors and investors, these must not be used to permanently subsidize insolvent banks or banks in financial distress. Especially for economies that adopt directed credit by the State's government to fund insolvent SOEs, this form of bail out may not prove to be effective especially when the credibility of the government is compromised and financial deepening is desired within the system.

C. GOVERNMENT-LED FINANCIAL ASSISTANCE TO ENSURE LIQUIDITY IN THE FINANCIAL SYSTEM

For the crisis-affected institutions, government of each country provided temporary liquidity into the country's financial system to prevent further damages or losses. Since corporate and individual borrowers and investors rely from banks for their financing and investment activities, the government, on top of the deposit guarantees provided temporary liquidity support to these institutions. Of the five economies, Thailand government's total liquidity support amounted to THB1.037 billion, which represents 22 per cent of the country's GDP. As cited in **Table-10**, the government provided guarantee support on all banks and other deposit-taking institutions except for the finance companies whose operations were suspended [Economic Analytical Unit, 2002].

Table-10 also reveals that majority of these funding from the government to temporarily bail the banks out from their financial problems happened during the crisis to maintain stability in the financial system.

TABLE-10. Government-led Financial Support in Selected ASEAN+3 Economies

Country	Stock of Support	Form	% in GDP	Date/(s)
Japan*	JPY 60 trillion	Loans		1997
PRC*	RMN270 Billion RMB 1.4 trillion	Bond Excess Reserves w/ CB		1998
Korea	KWN 10.2 trillion	Deposits and Loans	13%	1997
Malaysia	MYR 35 billion	Deposits	13%	1998
Philippines	PHP 18.6 billion	Emergency Loans and Overdrafts	0.8%	1997-1998
Thailand	THB 1.037 billion	Loans from FDIF	22%	1997-1998
Indonesia	IDR 170 trillion	Overdrafts	20%	June 1998

Source for Japan: http://www.wsws.org/news/1998/sep1998/jap-s04.shtml
Source: http://www.imf.org/external/pubs/ft/op/opfinsec/op188.pdf

However, the financial support provided varying results, especially in Indonesia, which was hardly hit by the financial crisis due to other mitigating factors such as political and economic instability [Nasution, 1999]. Bank of Indonesia provided liquidity support among banks whose capital adequacy ratios were below 4.0 percent, representing more or less than 200 percent of the banks' capital; moreover, these banks were under IBRA's close supervision [Chou, 1999]. These loans were beneficial and were made possible either through loans, deposits overdrafts and lines of credits. IMF [1999] reported that banks and other non-bank financial institutions like finance companies and merchant banks also benefited from the emergency loans.

In Japan, the government injected additional funds in the banking system to restructure the problematic and insolvent banks. The Bank of Japan often injected capital into the banking system to curb any possible crisis in the system [Kawai, 2004]. Approximately JPY60 trillion was provided: JPY17 trillion was used to nationalize failed banks, JPY18 trillion to recapitalize some banks and JPY25 million to purchase healthy banks' shares which in turn can provide more liquidity in the system [Australia's DFAT, 2002]. As a result of the insolvency of the credit cooperatives and Jusen institutions, the Ministry of Finance was forced to inject funds to cut losses from these institutions. This was followed by another series of liquidity support amounting to JPY30 trillion to support large banks [Ito and Harada, 2004].

In Indonesia, the government's estimated cost of recapitalization amounted to approximately IDR351.6 trillion or USD50.0 billion. Through IBRA, the government provided funding to 54 banks in excess of the capital of IDR200 million or those banks with capital adequacy ratios below 5.0. These funding from the Bank of Indonesia had handicapped its monetary policies. The series of liquidity support totaled approximately the total outstanding loans of the 54 banks [Chou, 1999].

On the other hand, Chinese government provided immediate support through the use of restructuring bond issued by the Ministry of Finance and through AMCs, which purchased NPLs at par value amounting to RMB1.4 trillion through state-owned AMCs. This is because, the four large SOCBs affected by the severe NPL problem continued to have in their portfolio NPLs that subsequently affected its financial condition [Bottelier, 2005].

It is now clear that economies, in the face of these problems, sought to undertake financial restructuring because the cost on the part of the government would have been larger if it the problem were not contained. Banks will not only be affected by the financial crisis; sectors and stakeholders, which rely from them for their financial requirements, are affected as well. Besides, the international financial markets will be at risk as confidence in the country's stability is affected. Claessens [1999] stressed that liquidity support must not be extended to bankrupt or insolvent financial institutions. If the same problem is not acted upon immediately, the cost to the government becomes high due to capital flight. Hence, regulatory authorities must be vigilant and oversight must be exercised to curb the problems.

While some banks were nationalized through large public capital injection, monetary authorities should immediately address privatization efforts following ongoing restructuring efforts as soon as the business activities normalize and immediately after banks are able to cope up with their capital adequacy and profitability problems. The same applies to the government's objective of providing liquidity support and deposits guarantees, which is believed to provide confidence in the banking system and protect depositors' welfare and prevent possible moral hazard.

Severely weak and non-viable financial institutions must not be restructured, as the costs of restructuring by the government through recapitalization, nationalization or temporary rehabilitation of financial institutions are high [Lindgren et al, 1999]. In some instances, the government's ability to manage the country's monetary and fiscal policies may be impaired. If it will continue to absorb these costs, public debt would augment and may affect the growth of the economy. This resolution of some distressed financial institutions' performance may prevent any systemic risk that may occur during the period and is deemed unavoidable in the short term. Other measures that were undertaken due to the failure of some financial institutions had allowed financial institutions to make aggressive and strategic consolidation either through mergers or acquisitions. For the crisis-stricken economies, strong banks have entered new markets by expanding and acquiring distressed institutions with State or government's support.

CHAPTER 4

USE OF ASSET MANAGEMENT COMPANIES AS ALTERNATIVE TO RESOLVE NPL PROBLEMS OF ECONOMIES IN THE REGION

by Dr. Neriza M. Delfino

Because of the magnitude and scale of effects of the crisis, the different governments and central banks in the ASEAN + 3 region had to intervene to take major roles in the recovery efforts. Government played a prominent and decisive role in resolving the financial crises by effectively leading and guiding the restructuring process through financial support, nationalization of troubled institutions, establishment of centralized agencies to manage non-performing loans and facilitate corporate debt workouts. Other cases saw government, instead, choosing a set of policies and a framework addressing the long term needs of the financial sector while allowing market forces to lead the process of NPL resolution [ADB Bank and Corporate Restructuring website].

Both market-led and government-led approaches were extensively discussed in the literature as essentially the two main forms of restructuring and recovery methods. A market-led approach draws on the private sector to facilitate restructuring efforts, purposely to avoid any budgetary implications, mitigate problems of moral hazard and make more efficient any debt workout by letting competition prevail in the acquisition and disposal of non-performing assets and loans. Government-led approaches are believed to offer immediate results in the reduction of non-performing loans but this is generally found to weigh heavily on the fiscal budget and possibly create moral hazard problems [Ibid.].

Proper management and disposition of impaired assets is one of the most critical and complex task involved in a successful and speedy NPL resolution and bank restructuring effort [Klingebiel, 2000]. Bank restructuring has often been accompanied by corporate debt restructuring, with generally a greater percentage of NPLs accounted for by non-financial enterprises. When the crisis struck the region, banks became overly cautious of lending, even to qualified borrowers. The increasing NPL problem hampered banks' intermediation roles, as these institutions grappled with collection problems and legal issues.

For a number of the countries of ASEAN + 3, the creation of asset management companies (AMCs) became a viable option. Troubled assets can either be handled by financial institutions, through their existing organizational structure (particularly those recapitalized), by bank-managed or centrally government-run asset management companies. Indisposed assets can be subjected to traditional liquidation processes. Other than maximizing the value of disposed assets, banks by their very nature are expected to maintain creditor discipline in the system. The type of management structure utilized depends on the availability of public funds, as well as talent and a reliable resource pool [Ingves, 2001].

A. BACKGROUND ON THE GENERAL PROVISIONS OF ASSET MANAGEMENT COMPANIES

Asset management companies (AMCs) are special purpose limited liability companies or agencies, which can be privately or publicly owned. Such entities facilitate the transfer of NPLs from financial institutions, generally in exchange for consideration (like recapitalization), financing and resolution of problem loans and assets, expert management of problem loans through reconstruction and rehabilitation, specialist management of loan security as well as providing for the expert and focused supervision of the process of maximizing net returns over some reasonable timeframe. The benefits accruing from the disposition of bad or defaulted loans through AMCs allow banks to fulfill their responsibilities in financial intermediation while paving the way for specialist asset rehabilitation and management skills to be more focused on distressed asset value enhancement.[1]

AMCs are set up for two main purposes: 1) to help expedite corporate restructuring and 2) to dispose of assets acquired or transferred to the government through rapid disposition vehicles. If a significant portion of the NPLs involve corporate debt and the underlying problem results from excessive leverage, restructuring is advisably done in a manner allowing the corporate entity to still operate profitably. For distressed industrial and commercial firms still deemed economically viable, its foreclosure can exacerbate an already fragile economic system [Ingves, 2001]. For AMCs created only for asset disposition, requisites for success entail 1) the purchase of liquefiable assets, 2) an AMC that is largely politically independent, 3) the AMC possesses a highly skilled resource base, 4) the legal environment has the necessary bankruptcy and foreclosure laws firmly in place, 5) there is the availability of a good information and management system, greater transparency in operations and processes and, not to say the least, 6) there should be appropriate funding for asset acquisition and disposition [Klingebiel, 2000].

B. DECENTRALIZED BANK-BASED SET-UP FOR RESOLUTION OF NON-PERFORMING LOANS

Cooke and Foley [1999] identify two bank-based AMC approaches: workout units and bad banks. In the former, NPAs and NPLs are moved to a separate bank department and the account remains in the bank's books. As for bad banks, the NPAs and NPLs are transferred to a separate affiliate organization that specializes in managing bad assets. In the latter, such assets will cease to appear in the bank's books after transfer. Any of these set-up affords the bank opportunity for maximum recovery and possibly success in restructuring while, at the same time, maintaining loan client relationships. Banks, to a large extent, are believed to be better placed to resolve NPLs than centralized AMCs because of the amount and quality of client information already in possession of the bank. NPL resolutions likewise enable the bank to improve loan approval and monitoring procedures. Bank-based AMCs have greater operational flexibility and can be valuable in retaining qualified personnel. The success, however, of such a decentralized approach

[1] Sourced from Malaysia's National Asset Management Company: Definition and Structure website.

assumes the absence of any ownership links between the bank and the financially distressed client to avoid any conflicts of interest [Klingebiel, 2000].

In an economy with poorly developed legal infrastructure and one which favors debtors, the creation of private AMCs may add more to the problem than it contributes to the solution, as such companies would only incur greater costs as a result of delays in the negotiations for restructuring the loan while facing increased risk of deterioration in asset values of the collateral [Hiragawa and Pasadilla, 2004]. One of the more exposed sectors during the crisis was the property sector with loans denominated in foreign currency. As the currency crisis became full blown, property values dropped and lending institutions were reluctant to liquidate such acquired assets in a depressed market.

A high level of transparency is required if bank-run AMCs would want to remain true to their mandate of disposing assets. Concerns regarding window-dressing were also noted in the literature with the transfer merely a cosmetic one to fulfill a regulatory requirement which often was promulgated as a response to the crisis and for which such occurrence could not be eliminated. If an effective regulatory framework was in place together with the appropriate disclosure and accounting mechanisms and a strong monitoring agency, the chances of window-dressing and pricing assets beyond market value ceases to become major concerns for the decentralized approach. And even if all of these requirements are in place, more importantly, the supervisory authority must possess the powers and incentives to enforce the rules without political interference from influential groups.

C. CENTRALIZED GOVERNMENT-BASED SET-UP FOR RESOLUTION OF NON-PERFORMING LOANS

A centralized, government-based set-up for asset recovery provides a more focused approach while consolidating skills, expertise and resources under one entity. The chance for recovery and, at the same time, maximizing the value of the asset being disposed increases, especially as knowledge and skills are built solely for this purpose. Centralization, according to Klingebiel [2000], can also assist in the securitization of assets as it centralizes the ownership of collateral with a central government agency, providing greater leverage over debtors. Distressed loans are removed from the banks. In turn, the banks can concentrate on their important role of financial intermediation. With no links to the ownership of neither the bank nor the client, a government-based AMC will have a greater chance of collecting on the loan. The other benefits of this set-up are improved prospects for orderly sectoral restructuring, application of uniform workout practices, and easy monitoring and supervision by government [Ibid.].

Many of the member countries of ASEAN + 3 took major actions on the disposition of distressed loans but, because a number of the accounts are from influential clients, governments at times found it difficult to insulate an AMC from political pressures, especially when the agency also handles the restructuring of the NPLs [Claessens and Klingebiel, 2000].

D. ASEAN + 3 EXPERIENCE IN THE ESTABLISHMENT OF AMCS

The Asian financial crisis exposed the fragile state of financial infrastructure in the affected countries of East Asia with the sudden rise in NPLs, due essentially to credit risk management weaknesses and the lack of prudential practices. Realizing the more serious effects of curtailing intermediation activities on the economies of these countries, the different governments took action of isolating the adverse effects of the financial crisis through efforts at restructuring loans in default while rehabilitating firms affected through established AMCs. These agencies worked with time-bound, focused objectives of restructuring and disposing non-performing loans while preserving the underlying assets supporting them.

AMC MODELS

Previous studies on AMCs reveal countries affected by the crisis adopting either one or a hybrid of the two major approaches to acquiring, managing and disposing NPLs. From the beginning, Indonesia, Korea and Malaysia chose government-led approaches to banking sector or specific bank client restructuring and NPL disposal while Thailand, at first, took on a more focused specific approach, where authorities intervened directly in the restructuring of finance companies, at the same time allowing a market-oriented decentralized approach for NPL resolutions by the banking system. Thailand did not initially plan out the use of a government-led AMC until 2001. The Philippine and Singapore governments adopted a decentralized approach to NPL resolutions by leaving this function to the banks and to privately-run AMCs, but providing for legislative guidelines and incentive programs for operation. **Table-11** presents the form that selected countries in East Asia have adopted regarding the resolution of NPLs.

TABLE-11. Summary of AMC models in Selected Asian Countries

Country	"Bad Bank" (Assets transferred to a special bank department)	Government Entity (Assets transferred to a government agency)
China	x	x
Indonesia		x
Japan		x
Korea		x
Malaysia		x
Philippines	x	
Singapore	x	x
Thailand	x	x
Vietnam		x

Sources: Various country reports. Authors' assessment. Cooke and Foley, "The Role of the Asset Management Industry: An East Asian Perspective."

Taking decisive action to mitigate the effects of the financial crisis and realizing the costs involved to control any of its adverse effects on the financial system, most of the ASEAN+3 affected countries saw the need to centralize the management and resolution of NPL problems through government-run AMCs. But these were largely subject to limitations on the overall regulatory and information structure existing in each country, considering the timing and speed of NPL dispositions and restructuring, while, at the same time, being cautious of preventing the value of the underlying assets from further diminishing.

GUIDING PRINCIPLES

Among the very first in the literature to recognize the need to effectively manage NPL problems was the study by Cooke and Foley [2000], which identified 18 guiding principles in the creation and operation of AMCs:

- Assess the scope, magnitude, and implementations of the nonperforming asset (NPA) problem objectively and thoroughly.
- Develop and implement business plans for prompt action.
- Recognize the need for and obtain objective expert advice.
- Select and coordinate the appropriate NPA resolution strategy and AMC model.
- Establish clear goals and objectives.
- Promote the transparency and consistency of operations.
- Minimize potential conflicts of interest in AMC operations.
- Provide AMC with adequate operational authority.
- Provide the objective oversight and governance of the AMC.
- Provide AMC with adequate purchase and operational funding.
- Assess the need for and provide AMC with special legal powers.
- Organize AMC to maximize its efficiency and expertise.
- Develop performance-based asset management and recovery plans and principles.
- Plan for the best use of private-sector asset management.
- Promptly evaluate and implement management information systems.
- Value assets carefully, consistently, and objectively.
- Provide essential asset management in the interim,
- Support asset value enhancement decisions with cost-benefit analysis.

Other studies on AMCs used this same framework for the analysis of the different approaches from this literature. Such studies subsequently identified a few of these features as accounting for the success in NPL resolution.

An examination of the functions given to government-run AMCs reveals that these publicly-run companies have primarily been tasked not only to relieve financial institutions of their non-performing loans and asset problems through asset disposition but likewise develop and deepen capital markets. Such functional coverage made it essential for the

AMCs to follow sound management and organizational principles. A few of these principles seem to stand out as critical to the efficient and effective management of AMCs, particularly with reference to clear goals and mandates, adequate funding, special legal powers and expertise in the handling of NPLs.

Studies of AMCs, as a response to improved banking and financial sector intermediation efforts, were limited at the time the crisis occurred, leaving many of the crisis-affected countries to experiment with different models in an attempt to find the best working solution. As to be expected with generally untested models, the initial results pertaining to their adoption varied from country to country.

MANDATES AND ENABLING LAWS

The affected countries, by way of the AMC, responded in different manners to addressing the NPL problem. Each crisis-affected economy generally saw the urgent need to establish a centralized form of AMC and come up with what they deem as appropriate policy responses, reflected in mandates and enabling laws established for this purpose.

Countries like China, Indonesia, Japan, Korea and Malaysia established centralized forms of AMCs because of the size of impaired assets that had to be restructured and subsequently disposed of and which required substantial amounts of funds that no single private investor would have the capacity to finance (much less manage) with a limited pool of experts. Much of the expertise for loan restructuring is still lodged with most financing institutions and an AMC may take much longer to acquire the same resource base. Korea's KAMCO seem to be an exception as their expertise in non-performing loan collateral disposition (mostly property) have been in place way before the crisis, that taking on the new function did not involve much substantial adjustment costs.

Furthermore, with the exception of Korea, China and Japan, most of the mandates and enabling laws of the rest of the East Asian economies were created as a response to the Asian financial crisis. In the case of Singapore, the Financial Sector Review Group in 1998 relied more on international funds management to augment the operations of domestic AMCs and fund managers for its NPL resolution. In the Philippines, the failure of the Asset Privatization Trust to dispose of NPLs were a combination of the lack of political will and enforcement within its designated life, necessitating the establishment of the Special Purpose Vehicle Act to alleviate the growing NPLs of commercial banks. Some of the common features of the enabling laws include having special mandates, being time-bound and highly centralized in operation and authority.

Studying several East Asian countries in the late 1990s, Cooke and Foley [1999] noted that Thailand generally was able to deal with the NPL problems of finance companies but unable to solve the NPL problems in the banking sector. Korea was still grappling with the legislative authority of its government AMC to make working-capital advances to debtor companies. The Philippines, at the time, was still seemingly unaffected by NPL problem (but this was made manifest subsequently) while Indonesia is reported to have one of the most severe NPL problems.

TABLE-12. Summary of AMC Mandates and Year of Set Up

Country	Asset Management Company	Year of Set Up	Official Mandate
China	Great Wall, Orient Asset, Cinda Asset, Huarong Asset	all in 1999	Restructuring/Rapid Asset Disposition
Indonesia	Indonesia Bank Restructuring Agency (IBRA)	1998	Restructuring
Japan	Resolution and Collection Corporation (RCC)	1999	Rapid Asset Disposition Collection
Korea	Korea Asset Management Corporation (KAMCO)	1962	Restructuring/Rapid Asset Disposition
Malaysia	Danaharta	1998	Restructuring/Rapid Asset Disposition
Thailand	Thai Asset Management Company (TAMC)	2001	Restructuring
Vietnam	Debt Asset Trading Corporation (DATC)		Restructuring

Source: Compiled from various websites and individual country AMC description from various articles.

TABLE-13. Summary of Significant AMC-Enabling Laws

Country	Enabling Law(s)
China	1999 – State Council Executive Order 2000 established and capitalized one AMC for each of the four major commercial banks
Indonesia	1998 – Establishment of the Indonesian Bank Restructuring Agency
Japan	1998 – Establishment of the Financial Reform Bill and the creation of the Resolution and Collection Corporation
Korea	1997- Act on the Efficient Disposal on Non-Performing Assets of Financial Institutions and Establishment of the Korea Asset Management Corporation
Malaysia	1998 – Establishment of Danaharta through the Danaharta Act
Philippines	1986 – Establishment of the Asset Privatization Trust 2003 – Establishment of the Special Purpose Vehicle Act
Singapore	1981 – Establishment of the Government of Singapore Investment Corporation (GIC)
Thailand	1997 – Establishment of the Financial Sector Restructuring Agency 2001 – Establishment of the Thai Asset Management Corporation
Vietnam	2004 – Establishment of the Debt and Asset Trading Company

Source: Compiled from various websites and individual country AMC description from various articles.

By 2003, significant changes in the NPLs status in East Asia have occurred. In the Third Session for the Asian Insolvency Forum, organized by the OECD in Seoul, it is now the Philippines which has incurred a serious NPL problem, while other East Asian countries were either gaining ground or have made significant improvement in NPL disposition. This same forum discussed such issues pertaining critically to the management of the balance of the NPLs held by a national AMC, when its statutory life ends. This is the case of IBRA in Indonesia, Danaharta in Malaysia and TAMC in Thailand which are either at or close to their statutory limits.

When the enabling laws were set up, the NPLs were looked at as individual transactions, but as in the Korean and later the Thailand experience show, pooling can be an effective way of disposing these accounts. Fung et al. [2004] has examined the operations of the different AMCs in selected ASEAN + 3 member economies and have analyzed these along several themes, including mandates, the challenges of NPL acquisition and resolution progress as well as recovery performance. In terms of mandate and structure, most of the AMCs took on simple asset disposal and loan restructuring programs. **Table-12** shows all of the AMCs, except for Thailand and Indonesia, as having been given both mandates.

Thailand's and Indonesia's mandates were limited to the restructuring of acquired NPLs. For China, in the initial years of its set up, the four AMCs were mainly tasked to restructure problematic accounts through debt-for-equity swaps involving hundreds of state enterprises [Ma and Fung, 2002] and only recently have these AMCs been allowed to sell acquired NPLs or their underlying assets. Japan's Resolution and Collection Corporation (RCC) has been focused on loan collection and recovery of debts with restructuring being a function of late. The Indonesian Bank Restructuring Agency (IBRA) was an AMC established essentially for loan restructuring but is pressured by budgetary concerns to dispose of some of the NPLs. Korea's KAMCO had a clear mandate to dispose of acquired assets but had to give a hand to the restructuring for *chaebols* that form the foundations for conglomerates dominating the Korean economy.

An overall assessment, on the basis of strategic plans, of these AMCs shows the more established ones generally having a clear idea of the scope of the NPL problem and what to do with it. The area of major concern remains the impact of the AMCs on the overall legal and regulatory environments, including risk assessment policies.

As in most studies of AMCs, particularly those cited in an ADB 2005 report, the first stage in resolving the NPL problem is to close and liquidate insolvent banks, then comes the resolution of NPL problems through disposition and restructuring while the final stage can be the creation of securitization methods to sustain recapitalization efforts. Securitization consists mainly of asset differentiation and the use of trust products, which rely on risk diversification, cash flow packaging techniques and collateralization [Chen, 2004]. ADB reports that with substantial progress having been made in the resolution of distressed assets since the financial crisis, a few of the centralized and publicly owned AMCs have started winding down operations in preparation for closure. Danaharta of Malaysia expects to wrap-up operations in December 2005. As early as 2001, Danaharta has ceased acquiring NPLs from financial institutions. The remaining task under this AMC has been passed on to the Asset Management Body under the Ministry of Finance. The IBRA ended its term in February 2004, with its AMC arm divesting government shareholdings in four distressed banks. The Special Purpose Vehicle Act of 2002 for the Philippines lapsed in April 2005 but draft legislation is now pending in Congress for its extension [ADB Asia Economic Monitor, 2005]. With a large majority of its NPL problems resolved, KAMCO is now shifting gear to handle credit card problems in the Korean consumer market. They have also taken a more global outlook to take advantage of expertise built up through the years to provide service to addressing the NPL problems of other countries in Asia.

TERM OF AMC EXISTENCE

The operational life of an AMC is highly dependent on its design, as it influences the course such a company takes, its structure and operating cost. Much of the term of an AMC's existence hinges on a clear understanding of the nature of the problem loans and the strategies to take with regards to its desposition. Even warehousing the NPL should be an option, should such a move prove to be the most logical path to preserve the loan's value and rehabilitate the borrower or corporation back to health. Cooke and Foley [1999] stress asset disposition process should not be delayed unnecessarily. An orderly and competitive disposition process will help strengthen investor confidence in the commitment to resolve NPA problems. Ideally, the planning phase should take only about six months, immediately followed by the start up of operations within the next four to eight months and the formal longer term operating phase of about three to five years [Ibid.]. If only to prevent the occurrence of moral hazard problems among financing institutions, with the continued existence of AMCs, the overriding goal is foremost disposal or restructuring after acquisition but with the possibility to extend its life beyond its expected sunset date. AMCs could possibly graduate to become experts in NPA disposition but with their services becoming more market-based and professionally run to reflect the competitive nature of a new market emerging in this field of service.

It is rather understandable that some governments have preferred a fixed life span for their AMCs as their continued existence may only contribute to the moral hazard problems in the system. Furthermore, it is has been found that government-run AMCs are best set up to serve a specific but rather temporary purpose and allow private AMCs to take on the role of mediating for NPLs on a more commercialized basis to prevent any dependence of continued recapitalization of affected banks through their sale of NPLs at book value. Since private AMCs would necessarily have to be in the business to create value for acquired assets for sale to prospective buyers, the industry NPL buying and selling it generates will remain competitive and would increasingly become more transparent, especially when foreign investors were to take interest in setting up AMCs.

Malaysia, with the most developed financial market of those seriously affected by the crisis, has been one economy taking pride in the success of Danaharta, whose mandate has been fulfilled on schedule with an impressive recovery ratio of 58 percent. Its existence of only seven years is justified by the swift manner in which the loans have been disposed, considering that the appropriate lgal framework was put in place prior to its set-up, not to mention the special legal powers accorded Danaharta to subject the banks and their borrowers to strict requirements of NPL disposition, tied to a recapitalization effort that was well-funded and well-managed.

Much remains to be seen with the amount of time given to the four Chinese AMCs towards NPA resolution. But China is under some pressure to have all NPL problems resolved prior to 2007 (though life terms have been set at 10 years for all four AMCs) because the commitment to WTO to open China's doors to foreign banks would take effect. China's banking reforms and legislation would need to keep pace with these developments. Chinese banks have to be beefed up in terms of capital adequacy ratios, preferably exceeding the level imposed by Basel II.

Thailand's TAMC is expected to be operational only until 2011 or 2013 at most (similarly a 10 year period from inception) because of the nature and amount of NPLs that need to be resolved from both the banks and finance companies that were force to close in 1998. The issue may not only be the amount but also the number of loans needing resolution.

KAMCO is an exception, as it does not have any sunset date. Its existence was not a result of the financial crisis but dates back to 1962 when it was established as a subsidiary of the Korea Development Bank to assist in the disposition of government-acquired assets. More than four decades of experience in asset disposition and other ancillary services have made KAMCO a model for other Asian countries contemplating on creating a similar outfit for this type of specialized financial service.

SUPERVISORY RESPONSIBILITIES

Supervisory responsibilities of the AMCs are generally lodged either with a financial supervisory authority, the country's central bank, the ministry of finance, or, as in the case of Japan, a deposit insurance agency. China's Ministry of Finance and The People's Bank of China (PBOC) have been responsible for overseeing the functions of China's four AMCs: Great Wall, Orient, Cinda and Huarong. Lately these AMCs have likewise been reporting to the China Banking Regulatory Commission (CBRC) which takes over the functions of PBOC over it supervision. RCC is guided by the Deposit Insurance Corporation of Japan (DICJ), which assists the former in managing real estate purchased from companies and failed financial institutions. One of the more effective powers of DICJ is in uncovering hidden assets of debtors by exercising investigative powers under the Deposit Insurance Law and the Financial Revitalization Law (RCC website). TAMC was established more by Emergency Decree (B.E. 2544) that came into force on June 2001.

GOVERNANCE AND TRANSPARENCY

Proper governance and a high level of transparency provide the public with time relevant information on the functions and performance of the AMC. These requirements are all the more important considering the short life span of these institutions and the costs it entails taxpayers' money to prevent the financial sector from the threat of collapse. KAMCO, Danaharta, the IBRA and TAMC all release annual reports, including the AMC's statement of assets and liabilities. The latest annual reports on KAMCO and Danaharta are as recent as December 2005. The availability of up-to-date information is a clear sign of the seriousness of the AMC to make known to the public the status of NPLs in the financial system and on its resolve to meet its objectives within the fixed timeframe allowed of its existence. Annual reports on China's AMCs are not made public. But the PBOC and CBRC provide statistics on resolution progress on the AMCs.

LEGAL ENVIRONMENT

The legal environment in which an AMC operates is vital to the proper functioning and effective resolution of NPL problems. Outdated bankruptcy laws make it difficult for both parties to the loan transaction to act legally to the interest of both. On the other hand, debtors can hide behind laws that could prevent the acquisition and disposition of collateral that secures the loan. In situations where the borrower is insolvent, bankruptcy laws often make it difficult for a company to pursue voluntary bankruptcy [Fung et al, 2004]. Restructuring of the entity and its debts then becomes delayed while at the same time the value of the credit declines. Countries like the Philippines, Indonesia, and Thailand and, to a certain extent, Malaysia, find their legal environments essentially wanting of a legal infrastructure conducive to the effective and efficient resolution of NPLs. For most of these East Asian countries, laws are time consuming, inefficient and unpredictable [Cooke and Foley, 1999]. In Indonesia, court systems have been criticized as not only being inefficient but is largely perceived to be corrupt. In Malaysia, the legal process can be lengthy, cumbersome and therefore costly, while the enforcement of secured claims in Thailand has not been as efficient as expected.

Some AMCs have been provided special legal powers to circumvent the law that facilitate asset transfer, for some even by force, if only to contain the problems brought forth by bank client financial distress. Indonesia's IBRA has been afforded such rights to seize assets of non-cooperative debtors without seeking court approval. Though it is not clear if IBRA's functions of restructuring bad loans benefited from such privilege, NPLs were effectively transferred at a shorter period of time than if such privilege were not granted. It was also through a banking law in February 1999 that IBRA gained full access to all assets of banks under its control. Even banks in which the Suhartos have major stakes were not spared from being placed under IBRA control when a bank run crippled its operations, forcing shareholder and management shake-up. Danaharta has been authorized to dispose of transferred assets even without permission from the assets' original owners. TAMC, on the other hand, has been given especial power to force debtors to enter into negotiation for loan repayment [Harigawa and Pasadilla, 2004]. Other than financial accountability, it is believed that AMCs should be free from political influence. However, considering the nature by which most East Asian AMCs have been created, where the supervisory agency is still the government, there is much doubt as to the complete independence of these companies from government intervention.

AMC FUNDING

Clearly adequate funding must be provided for the effective operations of an AMC. There have been basically two approaches to the funding of AMCs. One is by way of the fiscal budget and the other is by issuing bonds, guaranteed by the government. However, in as much as this is seen as a burden to taxpayers, the approach involving the swapping of NPLs for government guaranteed bonds provide certain benefits - impact on government budget will be less immediate; bond interest could be factored into asset pricing and repayment timing can be related to the expected timing of recovery [Cooke and Foley, 1999]. Government-guaranteed bonds have replaced IBRA-acquired NPLs, with some minimum holding period, a feature that can make these bonds attractive to the private sector.

For KAMCO, a majority (about 90%) of funding emanated from bond issuances, with short term maturities, and the remaining funding requirements sourced from its central bank, government financial institutions and the Korea Development Bank. Danaharta's funding came from the government's budget with only a portion having been covered by a bond issuance program, which are tradable. Part of Danaharta's funding was obtained from loans from Malaysia's Employees Provident Fund and Khazanah Nasional (the investment holding arm of the Malaysian government) of about RM 3.5 billion. The Philippines' Asset Privatization Trust (APT) was funded by the Department of Finance although no amount has officially been published. The four Chinese AMCs (capitalized at RMB 10 billion each) have also been funded through bond issuances (amounting to RMB850 billion) and borrowings (about RMB55 billion). Despite the large amount of capitalization for these AMCs to boost its operations and increased capacity of deliverance, there is still much doubt as to their repayment capability.

The amount of initial capital for centrally managed AMCs is small and its rate of cash recovery is low [Fung et al, 2004]. TAMC, whose main mandate was to restructure NPLs, expect to benefit only minimally from restructuring efforts because of limited capitalization. Much of its initial funds had to be sourced from the Bank of Thailand. Except for Danaharta and KAMCO, cash recovery from its asset disposal and restructuring activities has been insufficient for other government-run AMCs in the region to carry out their main tasks effectively.

ASSET TRANSFER AND RESOLUTION AND ASSET PRICING

A primary task of public AMCs is the removal of a substantial portion of NPLs from the banking system. Speedy NPL removal is important to AMCs, as it is often a precondition for successful NPL resolution [Danaharta Annual Report, 2003]. One of the more important initial concerns of an AMC involves the type of asset that would have to be purchased from the banks. AMCs, when managed by the government, cannot essentially cherry pick on the types of loans or assets that will be acquired, except perhaps with the magnitude of the loan amount and the security or collateral that supports the NPL. But generally, the banks would want to maintain NPLs with higher rates of success in restructuring and debt collection. Banks would prefer to transfer NPLs that have aged and have less chances of immediate liquidation. For these types of loans, substantial discounts will have to be expected by banks in the negotiation with AMCs. Though this may severely affect bank balance, subsequent write-off will eventually produce the same outcome and the sooner the financial institution is able to face this reality, the sooner it can get back on its feet to fulfill its main intermediation functions.

TABLE-14. AMC FUNDING AND NATURE OF SOURCE

Country	Nature and Source of Funding
China	Each of the AMCs funded at RMB 10 million augmented by bond issuance of RMB 850 Million and RMB 55 million borrowings
Japan	…
Indonesia	Rp 599 trillion issued in bonds for liquidity support, and recapitalization.
Malaysia	RM 28 billion limit for government guaranteed bonds
Philippines	…
Thailand	B 1.1 trillion in liquidity support plus B 800 billion limit on bonds for recapitalization. B 38.4 billion in capital support schemes.
Vietnam	VND 2 billion provided by government for debt and NPL purchase

Source: ABD Report on Bank Restructuring, individual central banks, various articles.

When asset is transferred from the bank to an AMC, the nature of the borrowing entity, the ownership of the underlying asset and the type of bank, from which the loan or managed underlying asset emanates, are often the key elements in the decision. If the opportunity cost of losing a borrower client, as a result of the asset transfer, would be substantial, the account is better left with the bank. Banks will likewise be in a better position to collect on secured but defaulted loans if the legal environment benefits the financial institution. Some of the economies of the ASEAN+3 have chosen to acquire and sell assets only from banks that are being resolved by liquidation or merger and thereby under the control of government such as in the case of Thailand. In other ASEAN + 3 economies, government assistance is extended only to distressed but still viable banks that can remain open with recapitalization. Government-run AMCs in Indonesia, Korea and Malaysia took this route.

ADB reports that since 1998, the cumulative transfer of NPLs to public AMCs is $155 billion in China, $111.1 billion in Korea, $37 billion in Indonesia, $20 billion in Thailand and $13 billion in Malaysia in 2004. By 2005, Malaysia and Thailand are said to basically have completed the transfer. Korea and China still saw some minor small transfers of impaired loans to centralized AMCs [ADB Asia Economic Monitor, 2005]. Transactions in the transfer of assets are rather straightforward when the bank (selling bad loans) and the AMC are both government owned and controlled. A private bank selling assets to an independent private AMC would be involved in arm's-length transaction that should be devoid of conflicts. This issue becomes more difficult and complicated when the transactions are between private banks and publicly owned AMCs [Ingves et al, 2000].

Danaharta, in its 2003 annual report, cites that the pricing methods used by Asian AMCs for the NPL acquisition can greatly affect the pace of asset transfers, the selling bank's financial statement, loss allocation and recapitalization programs. The use of book value or fair market value has been two of the most widely used approaches in the pricing of NPLs.

TABLE-15. Approaches to Asset Transfers by Selected AMCs

	Indonesia	Korea	Malaysia	Thailand
Ave. acquisition price (% of book value)	100	36.1	46	33.2
Pricing approach used				
Book Value	Yes	No	No	No
Fair Value	No	Yes	Yes	No
Others	No	No	Yes	Yes

Source: BIS Statistics in Danaharta's 2003 Annual Report.

The pricing mechanism adopted by AMCs is largely dependent on the effect that the transfer of the NPL to the AMC will have on the bank's balance sheet (**Table-15**). For Korea and Malaysia, that have adopted a fair value approach to pricing of NPLs, the disposition of asset occurred at a faster rate. Book value, as a valuation method, seems to be a major impediment towards the speedy disposition of assets in Indonesia and Thailand. Clearly Indonesia's requirement of 100% average acquisition price of book value seems unacceptable by regional, much less, by global standards. One must add to this problem the lack of a mechanism for the abandonment of control by asset owners, creating a stand-off with creditors rejecting debt write-offs as a result of this reluctance [ADB Asia Economic Monitor, 2003].

KAMCO's experience provides rich insights into its effective pricing strategy. Its policy of pricing NPL purchases evolved as it gained experience through time. Initially after the Asian crisis, KAMCO employed the method of "blanket purchase on the condition of an ex post facto settlement". This meant lengthy and contentious negotiations on the final settlement price. The discount rates used by this method were tied up to the loan loss provisioning rates. At present, assets are priced using a formula reflecting the essential characteristics, terms and conditions of the loan, with the price adjusted through negotiations, but which should not deviate much from the original offer price. Secured loans are expectedly priced higher and that financial institutions, that were to be closed, never had the upper hand in pricing negotiations. With KAMCO's experience, it seems that when prices are lower and approaching its real market level, this provided enough leeway for the private AMC market to price itself in and compete, thereby possibly facilitating the development of the market for NPLs [He, 2004].

Thailand's TAMC adopted a pricing structure based on the value of the collateral excluding any personal guarantees. The rules for pricing are prescribed by the TAMC board. Book value pricing is likewise practiced but this excludes applicable reserve amount. Book value has been defined as the total principal amount of the loan plus accrued interest for a three-month period, prior to the transfer date. In effect, a cap has been placed on the amount of interest charges the bank has failed to collect from the borrower to be passed on to TAMC [Pornavalai, 2001].

Regardless of the type and size of the NPL as well as the type and size of financing institution, all asset transfers from the bank or financial institution to an AMC is best executed at market value. Any transfer, therefore, can entail bank write-offs on losses to be incurred as a result of asset transfer, since most of these loans have been recorded at book value. The losses, however, can be augmented by recapitalization from government. AMCs cannot serve as means to boost bank capital with the sale of NPLs which simply leads to moral hazard problems.

Ernst and Young's 2004 Global Non-Performing Loan Report estimates that the Asian regions' governments and banks have succeeded in removing more than US$ 1 trillion of NPLs from bank balance sheets, accomplished through various resolution measures including loan collections, restructuring and reclassification; sale of NPLs to international investors; permanent write-offs and the use of AMCs. Of particular interest is the amount of loan transferred to AMCs as of 2004. **Table-16** is an excerpt from said report reflecting NPL transfers of selected ASEAN + 3 economies.

TABLE-16. NPL Transfers to AMCs in Selected ASEAN + 3 Economies (in US billions)

Country	NPLs in all FIs	NPLs in AMCs
China	307	107
Indonesia	16.9	5
Japan	330	112
Korea	15	45
Philippines	9	…
Thailand	18.8	5

Source: Ernst & Young 2004 Asia Pacific Financial Solutions.

Korea is way ahead of the pack in NPL transfers to AMCs as it had started venturing into overseas acquisition from foreign institutions regarding loans to Daewoo's overseas subsidiaries. Most of the overseas loans were unsecured with the portfolio varying widely from ordinary loans to overdrafts, trade related financing, documents against acceptance and letters of guarantee and overseas issued corporate bonds. The various overseas loans involved 368 different financial institutions in 28 countries [KAMCO Annual Report, 2005].

Thailand's state-owned banks are required to strip out distressed debts whereas private banks can decide to sell or not to sell NPLs to TAMC. State banks transfer loans that only involve multiple numbers of creditors. This accounts for the low transfer amounts to TAMC. Indonesian banks supervise by IBRA are required to sell for 1 rupiah their category 5 loans (or loans with no chance of being restructured) which comprise the bulk of bank loans, while category 3 and 4 assets may be sold to IBRA only if both parties can agree to a price.

China's state-owned banks and their AMCs are under pressure to acquire and dispose of assets in preparation for going public and for foreign banks entering China in 2007 under agreements with the World Trade Organization. The four AMCs – Cinda, Great Wall, Huarong and Orient – are expected to dispose of their entire portfolio by 2009. These AMCs are resolving their NPLs through revised repayment plans, discounted borrower pay-offs, collateral sales and selling assets to third party investors [Ernst and Young, 2004].

The amendment in the Financial Reconstruction Law (FRA) in January 2002 made it possible for Japan's RCC to acquire NPLs in an open market on a competitive basis through bids. These roles have more recently been expanded to include securitization, business rehabilitation and asset liquidation [Ibid.].

In the Philippines, with the Special Purpose Vehicle (SPV) having been enacted into law, the Act's primary benefit concern distressed borrowers' voluntary surrender of collateral. However, the vast majority of NPL borrowers are not agreeable to such arrangement. The Act imposes restrictions on SPV-qualified transactions, prohibiting sellers to retain more than 5% carried interest in the resolution of transferred assets [Ibid.].

Vietnam's Debt Asset Trading Corporation (DATC) is new in this business and is looking to its neighbors in the region for much needed guidance on the set-up and management of its existing AMC which has been tasked to establish a clean up of NPLs and potentially assist state-owned enterprises in its debt payments.

ASSET DISPOSITION AND RECOVERY

There have been differences in the asset disposition and recovery among the ASEAN + 3 member economies. Factors believed to account for these differences include the size of impaired loans, ownership of these loans, the legal environment of the AMC, general market environment and resolution approaches. There are a number of techniques that have been adopted by AMCs in the disposition of assets. One of the most traditional methods is through auction, sale of underlying asset with initial recourse to the original seller. More recently, joint venture partnership has become a popular mode of disposition; however, this is second only to individual and bulk sales [He, 2004].

In terms of asset disposition, IBRA is reported to have had one of the highest NPL ratios. On the other hand, Danaharta and KAMCO, both with upgraded and effective legal environments have accomplished much of their mandates and disposed of the bulk of their NPLs and NPAs at fairly record time, enabling Danaharta to start winding down its operations while KAMCO had ventured into overseas NPL acquisitions, especially acquiring NPLs of troubled overseas Korean corporate operations. KAMCO and Danaharta stand out, as well, on the basis of cash recovery ratio of 58 and 47 per cent, respectively, over the face value of transferred asset in 2003 [Hagiwara and Pasadilla, 2004]. Figures released in 2004 for KAMCO and Danaharta show 50% and 58% recovery ratios. The decline for KAMCO could have been as a result of the continued acquisition of NPLs by KAMCO, especially from their *chaebols* like Daewoo.

Danaharta, on the other hand, was mandated to take on NPLs only for a specific period of time and thereafter had the sole function to dispose of the NPLs. Japan's RCC has not been at par with others in the region with regards to its performance especially as it confronts declining property values in Japan. TAMC is not in the business of auctioning off NPLs and, to the extent that its functions are limited, could not be completely judged of its effectiveness in fulfilling its mandate. Furthermore, TAMC was only established in 2001 with a targeted sunset on 2011 to 2013, it would be too soon to judge its effectiveness.

The latest available statistics with China shows cash recovery of 26.2% for all four AMCs. Most of the NPLs of China's AMCs have been problem loans where high recovery rates are deemed generally not possible. As for the first quarter of 2005, the recovery ratios for the four AMCs are Huarong – 19.85%, Great Wall – 10.41%, China Orient – 22.82% and Cinda – 33.64%. [Gilligan, 2005]. Low asset disposal of the four AMCs can also be attributed to being concentrated on debt-for-equity swaps which was government-initiated to serve an immediate goal, which is to uplift the financial performance of state-owned enterprises within a limited period of time [Ma and Fung, 2002].

A comparative set of data on the different criteria for which AMCs are evaluated is contained in the appendix of this study for reference purposes.

CHAPTER 5

THE ASSET MANAGEMENT INDUSTRY IN ASEAN+3 IN TRANSITION

by Professor Rene B. Hapitan

A cursory survey of the capital market development and the level of financial liberalization show that the more advanced economies in the ASEAN+3 region have very healthy and vibrant levels of activities, relative to the less developed ones (**Table-17**).

TABLE-17. Assessment of Capital Market Development and Level of Financial Liberalization

Country	Capital Market Development	Level of Financial Liberalization
Brunei	Early stages of development, plans to become a center for Islamic banking	Limited securities activity; low market liquidity
Cambodia	Early stages of development but growing steadily since 2000	Very limited; no bond market; few investors
China	Sound and healthy.	Improving; some areas still restricted to foreign financial institutions
Indonesia	Recovering; devaluation of the currency remains a continuing concern, need to restructure and institute reforms	Improving; there is still a need to deepen the reforms in order to accelerate economic growth
Japan	Generally healthy.	Improving; financial system still highly dependent on banking assets
Korea	Slight deterioration in investment and consumption and rather dull stock market; high potential	Improving; Financial system highly dependent on banking assets and still suffering from NPLs
Lao PDR	Underdeveloped; heavy reliance on foreign funding or loans from multilateral agencies	Very limited; reforms are on-going to increase potential
Malaysia	Generally healthy.	Limited; restrictions on entry barriers to entry, especially in banking and insurance
Myanmar	None	No to very few activity; highly restrictive to foreign entities
Philippines	Declining; despite improved capital markets, political instability threatens gains made.	High level of liberalization but thin
Singapore	Strong growth, moderate tightening aimed at reducing imported inflation.	High level of liberalization; still many opportunities available for bilateral and multilateral cooperation
Thailand	Solid growth, weakened somewhat by calamities but recovering	Limited but improving; high potential
Vietnam	Rapid growth, brought by strong foreign trade and investments	Limited; capital market not closely linked to the monetary market; low market liquidity.

In the case of China, Korea, Japan, and Singapore, there is still enough growth potential to attract domestic and local investors, despite its high levels of capital market and financial liberalization. For Thailand, Malaysia, and Vietnam, high level of growth need to be managed in order to prevent overheating and vulnerability to external shocks. In the case of the Indonesia and Philippines, efforts to reform the capital markets remain hampered by political instability. Finally, Brunei, Lao PDR, Cambodia, and Myanmar, need to open up their markets to allow foreign investments and expand their capital base.

Underscoring the weaknesses of many Asian economies in terms of the financial infrastructure such as banks is the lending practice of commercial banks that relies on the market value of real estate assets as collateral on loans. Lan [2000] highlights some of the fragility of the banking sector in some East Asian economies and easily points out the prevalence of weak regulations and/or accounting disclosure practices (**Table-18**). Thus, even if these economies are able to remedy many of their NPL problems, practices and policies that have led to their creation in the first place present a unique and sometimes difficult problem for the AMIs.

Reflecting on the impact of the Asian financial crisis, Ingves [2001] identified three important elements in coming up with a comprehensive strategy for systemic banking crises: (1) liquidity and confidence; (2) stabilization and bank restructuring; and (3) recovery. In the case of problematic assets/loans, it was recommended that this:

> "*…can either be handled by financial institutions themselves (for those institutions that are recapitalized); by bank-specific or centralized asset management companies, or they can be put through traditional liquidation processes. The assets should be managed or disposed of in such a way as to maximize their net present value while at the same time maintaining creditor discipline in the system. The types of impaired assets and the availability of asset management talent should to a large extent, determine the choice of asset management structure and strategies. Once the banking system has been restructured and regained its health, the blanket guarantee is revoked.*"

In transferring assets to AMCs, information and risk assessment remains key. In the classic study of Kumar and Arora [1995] in determining an alternative model for risk classification of banks, they underscored the non-availability of data in completing the CAMEL or C-rating system and introduced a "R" risk rating, which has become the pre-cursor of the risk-based asset and liability models contained in Basel I and II. Other earlier studies on differential valuation implications of loan loss provision [Liu, Ryan, and Wahlen, 1997], information risk as a determinant of asset returns [Easley, Hvidkjaer, and O'Hara, 2002], and the relationship of judgment, personal involvement, and experience in the audit of bank loans [Jeffrey, 1992] highlight the "people" aspect in information and risk management.

The choice of the actual structure, however, must take into account the peculiarities of the Asian financial system. In Asia, AMIs can be viewed in two perspectives, namely from a well-developed financial infrastructure in economies like Japan, Singapore and Hong Kong or from an extremely low or no development at all in other economies. This was also magnified by an economic slowdown in the region and other parts of the world that is hoped to be short-lived and resolved. The AMI in East Asia, in contrast to the form it takes among developed or more advanced emerging markets has, for most of the

ASEAN+3 economies, been intentionally established to allow the banking institutions to pursue their mandates. Such was the situation particularly after the financial crisis of 1997, thus necessitating a transfer of non-performing loans to specialized institutions that could better manage such loans through reconstruction or rehabilitation, financing and resolution of problem loans and assets or the specialized management of loan security, maximizing returns within an acceptable timeframe. Essentially the banks can move on to provide lending with asset management companies taking on the responsibility of distressed asset value enhancement. This is also evident in China's asset management activities where losses incurred by four state banks were estimated to reach US$200 billion.

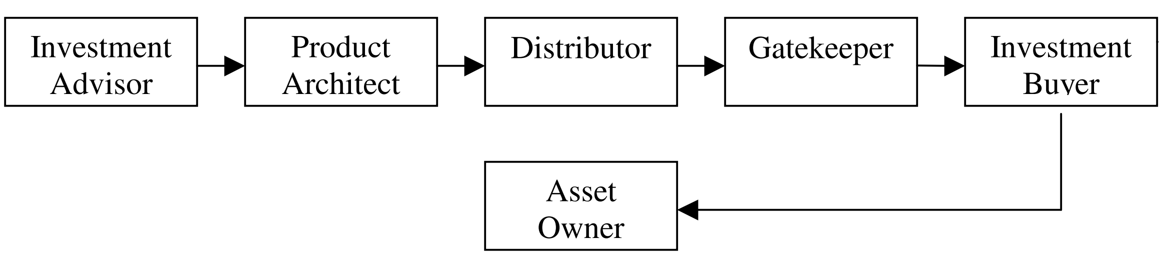
TABLE-18. Financial Fragility in Asia: Contributing Factors

	Singapore	**Hong-kong**	**Indonesia**	**South Korea**	**Philippines**	**Malaysia**	**Thailand**
Related party lending			Yes	Yes	Yes	Yes	Yes
Weak capital & loan reserves			Yes	Yes		Yes	Yes
Weak supervision/compliance			Yes	Yes		Yes	Yes
Weak regulations/accounting disclosure	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Weak under-regulated non-banks			Yes	Yes		Yes	Yes

Source: Lan, Doan Phuong. (2000). "The Asian Financial Crisis and its Implication for Vietnam's Financial System.

Beh and Abonyi (2000) illustrate the following components of AMIs, which are key in understanding what the industry needs to move forward (**Figure-7**).

FIGURE-7. Structure of the Asset Management Industry



S

ource: Beh and Abonyi (2000). "Structure of the Asset Management Industry."

Reflecting on the implications of **Figure-7**, the development of the AMIs in the ASEAN+3 region must identify and remedy the various bottlenecks that impede acceleration of the capital markets and level of financial liberalization. A review of the bottlenecks (**Table-19**) show that with a few exceptions, the major stumbling block of accelerating the AMI growth the regulatory and legal framework surrounding the ASEAN+3. This is evident in countries such as the Philippines where bank secrecy laws have made it difficult to simply transfer assets to AMCs.

In their seminal work written in the 1980s, Dierickx and Cool [1989] provided the important factors that lead to asset stock accumulation. They assert that "*unless the opportunity cost of those (scarce) assets is properly accounted for, measured returns of product market activities will be inflated…(T)he managerial problem stems from the fact that hidden cross-subsidization, in turn, distorts performance appraisal and capital allocation decisions*." This realization in turn explains to a great deal why, despite the vast amount of resources at the disposal of many ASEAN+3 countries, the potential for improved market activity and economic growth remains a function of the speed of financial liberalization reforms being instituted by these counties.

TABLE-19. Bottlenecks of AMIs

Country	Bottlenecks
China	Legal and political status; market diversification; governance
Indonesia	Legal and political status; funding; supervision; governance
Japan	Legal and political status; market diversification; governance
Korea	Residual NPLs
Malaysia	Residual NPLs
Philippines	Legal status; supervision; governance
Singapore	Market expansion; diversification
Thailand	Market expansion; diversification
Vietnam	Legal status; funding; supervision; governance

Sources:
Beh and Abonyi (2000). "Structure of the Asset Management Industry: Organizational Factors in Portfolio Investment Decisions"
Cooke and Foley. "The Role of the Asset Management Entity: An East Asian Perspective"
Frenkel, Hommel, and Rudolf (eds). (2005) "Risk Management, Challenge and Opportunity 2nd ed."
Ingves (2001). "Bank Crises and Beyond: Lessons Learned from Asia"
Klingebiel (2000). "The Use of Asset Management Companies in the Resolution of Banking Crises: Cross-Country Experiences."

Asset management can be broadly defined from the retail and the institutional side and the development of the industry can be looked at in terms of how these two "markets" are either able to feed into each other or contrbute individually to the economies they belong to. After examining the so-called transition economies in Central Europe, China, and Russia, Walder [2003] has come to the conclusion that the impact of markets is contingent on observable difference in the distribution of power and property, an observation that can also apply to the difference in the level of asset management sophistication in the ASEAN+3.

McKinsey & Co. projects that Asia's asset management fund pools will reach by US$11 trillion by 2010 from US$6.8 trillion in 2001, with institutional funds managed outgrowing retail by almost 4.5 times (**Table-20**). The same report cited that similar to what happened in the United States and Europe in the 1980s and 1990s, "demographic, behavioral, and regulatory trends are likely to combine to drive impressive financial asset accumulation in Asia for the rest of this decade and beyond." These so-called "drivers of growth" have been identified as follows: aging populations, which will boost the pension market; changing behavior of retail investors, due to concerns about retirement and savings; improved supply of funds, which will benefit fee-based products; pension reform, and changing behavior of institutional investors, mostly driving the outsourcing market. [Bowers, Gibb and Wong, 2003].

TABLE-20. Projected Growth of Asia's Management Fund Pools (in US$ trillion)

Retail Funds			Institutional Managed Funds					
			Pension		Life Insurance		Corporate Funds	
	2001 Actual	2010 Projected	2001 Actual	2010 Projected	2001 Actual	2010 Projected	2001 Actual	2010 Projected
Total	0.4	2.0	2.8	5.2	2.5	2.6	1.1	1.2

Source: McKinsey & Co., as cited in "Banking in Asia, 2nd edition" by Bowers, Gibb & Wong

Using varied sources, retail assets under management are expected to grow at an average of 20% to 21%, and be led by Japan, which will comprise more than half. It is important to note that even this rate, Japan, China, Korea and Taiwan will form the bulk of the growth in ASEAN+3. In the retail side, where competition abound, local products and risk-limiting products are necessary and access and control of ritual channels are critical to educate and serve retail investors. [Ibid, p. 251]. In the Philippines, for example, investors initially became receptive to the Unit Trust Fund, which increase net asset values (NAVs) to high levels in a short period of time. However, when the market corrected given the impact of the oil prices and other adverse economic and financial developments, many investors withdrew causing a mild panic among the market.

The rise of the role of the professional investment manager (investment advisor) has been made possible because of the inherent effects of information asymmetry and the "lemons theory". As Chan, Chen, and Lokonishok [2002] point in the case of mutual funds, the fund's stated objective (such as growth or income) historically served as a limited form of product differentiation. However, these descriptions are generally too vague to be very informative." Such reliance on the investment manager can also give rise to what they call "agency and behavioral considerations." This is supported by Gemill and Thomas [2002], who found that (at least for closed-end funds) funds more difficult to arbitrage have larger discounts due to the censoring of the discount by the arbitrage bounds, and the freedom of managers to increase charges when arbitrage is costly. Hotchkiss and Ronen [2002] farther support this when using daily and hourly high-yield bond transaction process, stocks do not lead bonds in reflecting firm-specific information and that the measures of market quality are no poorer for the bonds than for the underlying stocks. Easley, Hvidkjaer, and O'Hara [2002] were able to establish that not only does information affect prices, a difference of 10 percentage points in the probability of information-based trading between two stocks leads to a difference in their expected returns of 2.5 percent per year.

These studies indicate that if information is made available and if arbitrage and speculation are held to tolerable levels, the asset management industry in that economy is more likely to succeed.

It is also significant that given the structure of the industry presented by Beh and Abonyi [2000] in **Figure-7**, revenue and profits are mainly captured by distributors [Ibid, p. 253], through management fees and other fee based structure, where revenues among distributors can reach as high as 82 percent [Ibid.].

TABLE-21. Retail Assets Under Management in Selected Asian Countries (in US$ billion, except CAGR)

	2001	2010 Projected	CAGR (%) Projected
Japan	265	1,300	19
Korea	43	170	16
Hong Kong	24	90	16
Taiwan	24	150	23
China	16	190	32
India	15	80	20
Malaysia	11	40	16
Singapore	6	30	17
Thailand	4	15	17
Philippines	0	2	-
Indonesia	0.5	6	32
Total Asia	407	2,000	20
Total Asia (ex-Japan)	142	770	21

Source: McKinsey & Co., as cited in "Banking in Asia, 2nd edition" by Bowers, Gibb & Wong.

The lack of diverse products for many ASEAN+3 countries represents both a problem and an opportunity. In the equities were there has been marked volatility over the years, retail investors has moved towards the more stable time deposits but where returns are also low (**Table-22**).

On the institutional side, the emergence of outsourcing to external managers will remain key (**Table-23**). Since many of these external managers have considerable global experience, many ASEAN+3 countries will look at outsourcing to diversify their markets and establish their presence outside their boundaries.

Strieter and Singh [2005] support the importance of outsourcing. Studying public and corporate pension plans, they linked performance-related and business relationship factors for four asset categories: equities, fixed-income, real estate, and derivative/commodities/currencies. The resulting frameworks are found in **Figures 9 to 11**.

TABLE-22. Financial Returns Across Selected Asian Markets vs. the U.S, 1991-2001

	Annualized Returns (%)			Asset Class Performance	
	Equities	Residential Real Estate	Time Deposits	Best Performing	Worst Performing
Japan	-7.5	-2.7	1.6	Time deposits	Equities
Singapore	3.0	5.8	3.4	Real estate	Equities
Hong Kong	10.3	1.5	5.7	Equities	Real estate
Taiwan	1.6	-1.8	6.7	Time deposits	Real estate
Korea	1.3	-1.7	9.6	Time deposits	Equities
Indonesia	4.1	4.5	17.5	Time deposits	Equities
Thailand	-11.3	2.9	7.8	Time deposits	Equities
Malaysia	2.2	4.8	6.6	Time deposits	Equities
India	5.3	n.a.	10.4	Time deposits	Equities
Philippines	-12.0	n.a.	10.3	Time deposits	Equities
United States	12.2	10.6	5.1	Equities	Time deposits

Source: McKinsey & Co., as cited in "Banking in Asia, 2nd edition" by Bowers, Gibb & Wong.

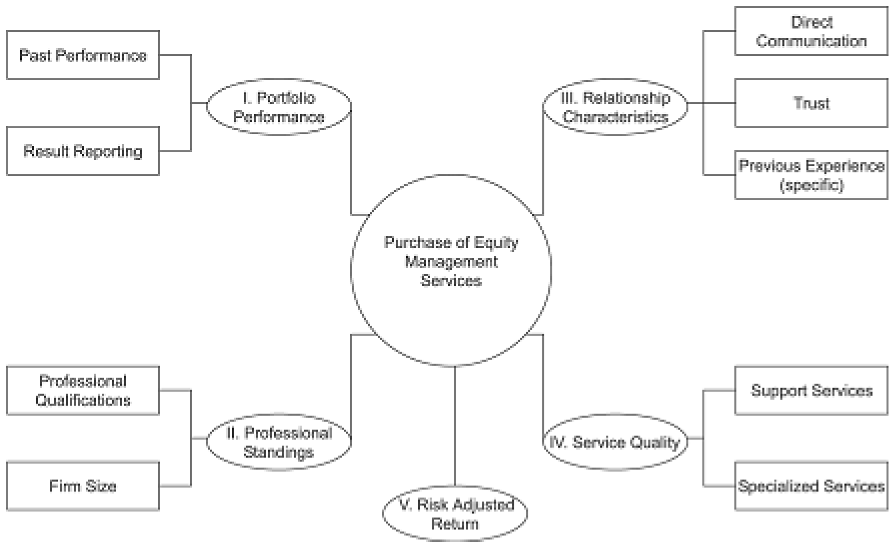
TABLE-23. Institutional Assets in Asia, 2001 and 2010

	Institutional Assets 2001 (USbillion)	% Outsourced to External Managers	Institutional Assets 2010 (USbillion)	% Outsourced to External Managers
Japan	5,221	34	6,200	36
Korea	286	41	740	47
Singapore	244	70	430	76
Hong Kong	192	74	400	81
Taiwan	136	31	320	34
China	131	59	450	72
India	64	10	260	10
Malaysia	59	4	110	20
Thailand	20	31	55	37
Philippines	9	13	25	15
Indonesia	6	12	15	20
Total Asia	6,366	37	9,000	42
Total Asia (ex-Japan)	1,146	49	2,800	54

Source: McKinsey & Co., as cited in "Banking in Asia, 2nd edition" by Bowers, Gibb & Wong.

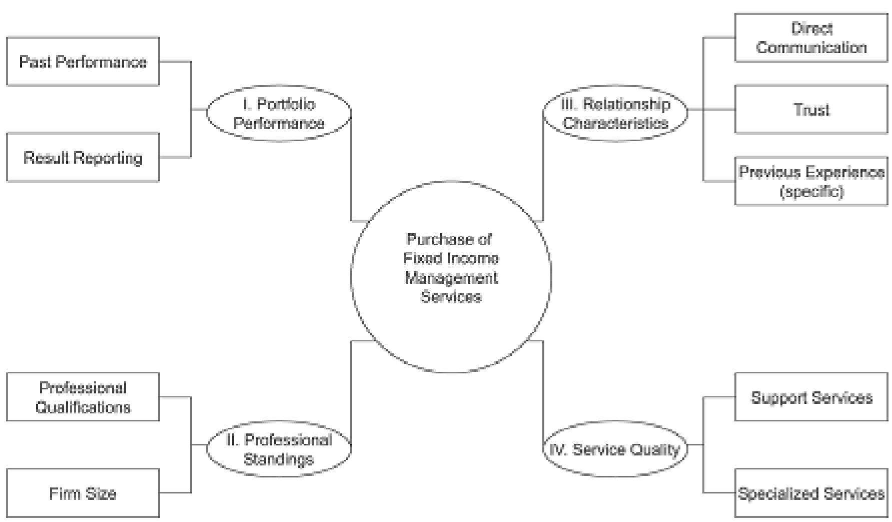
In all the frameworks that have been presented, it is only in the purchase of equities where the risk-adjusted return is a separate factor for consideration, whereas in real estate it is part of reporting and in derivatives, commodities, and currencies, it is part of return and experience. This explain why in many of the ASEAN+3 economies, equities are the worst performers. Risk is not reflected both quantitatively (stock price as a premium) and qualitatively (as matter of information or public disclosure). When accompanied by regulation and governance concerns, many in the ASEAN+3 economies become unattractive investment sites.

FIGURE-8. Framework for Investment Management Service Purchase – Equities



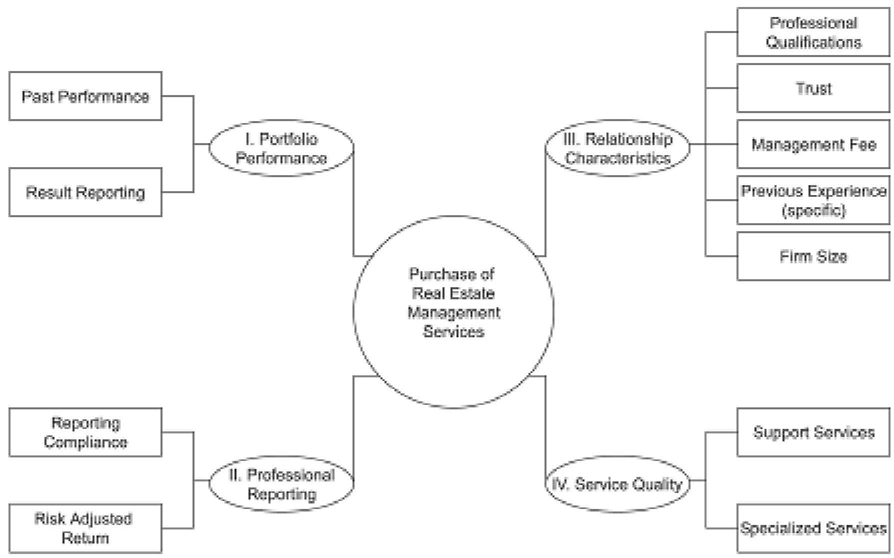
Source: Strieter & Singh (2005). "The Determinants of Acquisition of Outside Investment Management Service Providers in Public and Corporate Pension Plans and Endowments.

FIGURE-9. Framework for Investment Management Service Purchase – Fixed Income



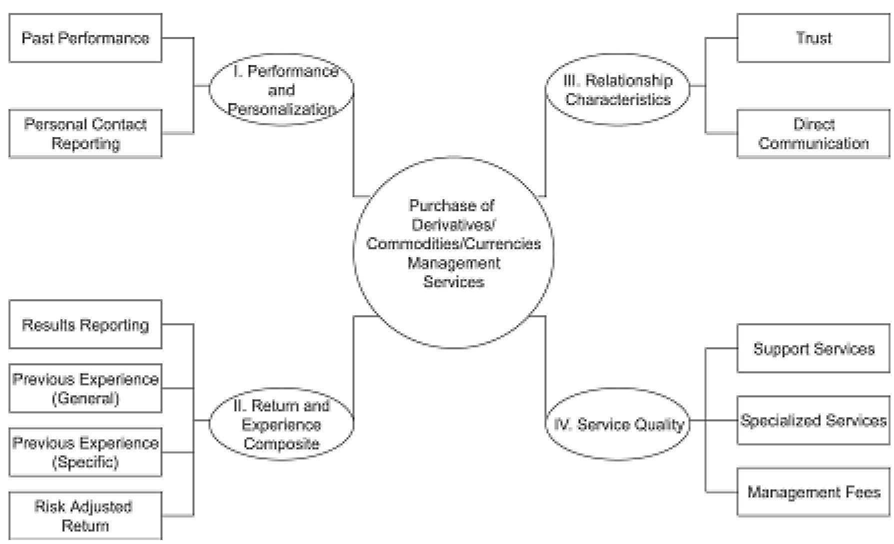
Source: Strieter & Singh (2005). "The Determinants of Acquisition of Outside Investment Management Service Providers in Public and Corporate Pension Plans and Endowments.

FIGURE-10. Framework for Investment Management Service Purchase – Real Estate



Source: Strieter & Singh (2005). "The Determinants of Acquisition of Outside Investment Management Service Providers in Public and Corporate Pension Plans and Endowments.

FIGURE-11. Framework for Investment Management Service Purchase – Derivatives, Commodities, Currencies



Source: Strieter & Singh (2005). "The Determinants of Acquisition of Outside Investment Management Service Providers in Public and Corporate Pension Plans and Endowments.

A curious development is the situation of "residual NPLs", where (despite aggressive marketing) there remain NPLs that need be sold or disposed. In a forum organized by the OECD, "the residue NPLs" or the balance of the NPLs held by a national AMC after it has dealt with NPLs that it has been able to successfully resolve or after its statutory life has ended was seen in the case of IBRA in Indonesia, Danaharta in Malaysia and TAMC in Thailand, which are either at or close to their statutory limits [OECD, 2003].

Another innovative schemes for asset disposition involved government initiatives to sell NPLs in "bulk" or "pools". When the enabling laws were set up, the NPLs were looked at as individual transactions, but as in the Korean and later the Thailand experiences show, pooling can be way of disposing of these accounts. Lehman Brother and Woori Finance Holdings took another initiative by giving the foreign investor the right of first refusal to buy as many of the NPLs as it chooses [International Financial Law Review, 2002].

Good corporate governance is another key issue the development of AMIs. Because of the reliance of the buyer/investor in information, they can easily fall prey to low market values but with a corresponding higher level of risk. As the level of asset disposal slows down, the overall market could be affected. Allowing foreign partnerships and joint ventures is also highly encouraged but the legal and regulatory framework must be clear as well.

Still, the importance of a good and healthy financial environment will allow for more diverse products and markets for AMIs. And the relationship is circular - the environment feeds in to more products and products, which in turn feeds into the environment. Take the case of Singapore, the best Asian model. By slowly working on the impediments of its own economic and financial development, it was able to move out of the Asian financial crisis and instead go outside Asia for its investments. China, Japan, and Korea are not far behind, but structural bottlenecks mentioned earlier could make it difficult to catch up with Singapore in terms of growth potential.

The lessons are quite clear as far as the country reports are concerned. While the approaches have been different the ones that have been quite successful were able to address the following issues:

1. Governance – the successful AMCs were clearly given mandates to be as transparent as possible.

2. Banking reform – the transfer of AMCs is only effective if the banking structure itself is reformed. That is, avoiding policies and procedures that led to the accumulation of the NPLs in the first place.

3. Political will in implementation – Countries that have able to ward off government intervention and some instances judicial proceedings are able to dispose the assets quickly and effectively.

4. Organizational competency and independence – While AMCs have inherently been at a disadvantage in terms of the lack of experience and skills, the learning curve is usually accelerated by hiring competent but more importantly, independent officers.

The recommended policies differ across the ASEAN+3 economies given the level of development of AMIs in the region. For the developed markets such as Singapore, China, Japan, and Korea, it is recommended that:

1. More products are developed to ensure a deeper selection for the market. Potential growth areas would be along asset-backed securities such as those backed by commercial or residential mortgage, collateralized debt obligations, and other similar securities.

2. Increased joint ventures with foreign financial institutions be made to take advantage of opportunities for risk-taking. With increased foreign participation, arbitrage can easily be managed.

3. At the micro-level, it is important for fund managers to take advantage of scale activities, because of the fee-based nature of the business. With a substantial portion of the costs fixed (such as information technology, sales and marketing, back-end, and other administrative expenses), there is upward pressure for fees to increase. However, with the highly competitive nature of the AMI, increasing fees may not be a feasible solution.

For the other ASEAN+3 countries, it is recommended that:

1. Regulatory and governance concerns are addressed for there is a perception of lack of transparency in these economies. The cost of doing business is multiplied if the regulatory and overall business environment discourages full and/or adequate disclosure of transactions.

2. Further study should be made to accelerate asset pools to allow asset disposal that covers both the most and least attractive NPLs for AMCs to sell.

3. Other markets must be explored to further expand the product base. Malaysia and Brunei's thrust to develop their countries as centers for Islamic banking and finance is one way to expand the market/product base.

4. Investor education is another important activity to increase awareness of diverse products AMIs offer. Many potential investors have stayed away from the market because they unaware of the risks and returns in investing in these areas.

Ultimately, the key factors that determine the level of success of asset management companies and the asset management industry hinge on the overall business and financial infrastructure present in the economy. It is therefore imperative that issues of banking reform, governance, organizational competence and political will be effectively addressed to ensure AMCs and AMI contribute to the resolution of NPLs and bring long-term improvements in the financial markets of ASEAN+3 economies.

CHAPTER 6

CONCLUSIONS AND POLICY RECOMMENDATIONS

A. CONCLUSIONS

Findings revealed that some of the macro-economic fundamentals prior to the crisis were not in place, especially for Indonesia and the other five economies. Given these constraints, government authorities and the key stakeholders from the different sectors of the economy should quickly invigorate the economy through broad structural reforms that are forward looking yet achievable. In early 1990s, the crisis-affected economies accelerated growth through the expansion of international trade and drove investors to undertake portfolio and direct investments. Moreover, recent developments in the financial system had facilitated in the use of international best practices, particularly in developed economies.

Even if the pace of economic development may seem to move quickly compared to the rest of the world, certain factors may affect a country's performance. In the ASEAN+3 region, the stages of development were evident and varied, particularly when taken in the context of the individual country's financial system. What is remarkable about this is that the size and structure of the financial system have changed a lot. In countries like Singapore and Korea, and more recently, China, sudden recovery in the financial system's performance was backed by series of financial reforms that were introduced and implemented after the crisis.

Against this backdrop, the study assesses the region's problems on non-performing loans and assets and determines how they responded to the remnants left by the crisis. Findings reveal that many countries were severely affected by the crisis especially from 1997 until 1999. Malaysia, Thailand, Indonesia and Japan reflected deteriorating growth rates, while Korea and Singapore had proven better performance in various aspects. Their governments have undertaken several structural and financial reforms to maintain stability within the system. In the case of Thailand, they had opened their economy under IMF supervision. For the newer members of ASEAN, the crisis had reduced their progress towards economic openness. It is far from clear why economies, in the face of process problem had sought to undertake financial sector reforms.

Banks have dominated the financial system in most economies, particularly in the ASEAN+3 region. And because of this, the size and structure of the financial system have changed a lot with financial liberalization, diversification of financial system and/or consolidation of financial services being pursued.

The NPLs of the financial institutions continued to increase and the problem will continue if the government will not aggressively impose sustainable solutions to the problem. This rising NPL trend had been supported by the continued deterioration in the bank's profitability, slow growth in the real bank credit, especially in China and the other five member countries. Banks exhibited increasing NPLs-to-total loans ratios due to the emergence of new bank NPLs, which exacerbates the problem.

While credit continued to grow at varying degrees, banks' performance in China, Vietnam, Brunei, Myanmar and Lao PDR were affected by directed or policy lending which impaired their ability to make profitable ventures. Thus, monetary authorities must be able to assist financial institutions to expedite the NPL disposition. What had worsened the situation is the fact that financial institutions are threatened by the combined weight of the economic slump and weak financial infrastructures.

Despite the mixed results in NPL resolution, it can still be concluded that, on the overall, the set-up of asset management companies has been instrumental in the speed of recovery of the ASEAN region. A common thread responsible for the success of these AMCs pertains to clear mandates, effective and fairly developed legal systems and regulatory environment, clear operating guidelines and a developed and fairly deep financial systems that cushioned the severe effects of the crisis. This form of financial reform adopted after the onslaught of the financial crisis should be looked at as only a one-time solution to the NPL problems. Any AMC must fulfill its one-time objective to help rehabilitate a country's financial system and its closure, for some countries, may become necessary to establish a cap on continuous attempts at rehabilitation. If there is one important goal every government in the region should strive to fulfill, it is to introduce a fairly comfortable level of healthy competition in the financial sector through continued efforts at liberalization and deregulation reforms. Only a well-developed financial system, less dependent on the banking system for primary sources of funds, can be a more effective antidote for the severe effects of an unanticipated external shock.

This experience provides a lasting lesson on the banks to develop capital markets. This problem would have been prevented or controlled at greater lengths had there been a forum for corporate and financial sectors to reduce their leverage and lessen their reliance on banks for long-term finances. The equity and bond market or an asset market, at the minimum, could facilitate the mobilization of cheaper funds and improve corporate governance through increased transparency.

B. POLICY RECOMMENDATIONS

Below are the policy reforms that could be undertaken with regards to NPL resolutions by member countries in the region:

1. Since NPLs are reflections of the systemic problem in the banking sector, it is imperative that policy makers continue their efforts to develop a competitive financial environment free from political interference.

Monetary authorities must assist financial institutions in expediting NPL disposition by imposing stringent credit-related regulations while providing a legal framework for revitalizing distressed institutions or companies on the brink of failure.

2. Measures to encourage commercial orientation need to be addressed, particularly in closed economies where financial institutions are run by the State. In order for financial institutions to flourish and be competitive, less government interventions are recommended. It must hasten privatization efforts of various large- and medium-sized State-Owned Enterprises or banks found unprofitable.

3. Monetary authorities must institute firm resolution strategies regarding the management of NPL problems by decreasing their involvement. Restructuring activities must complement or be aligned with corporate restructuring. Corrective or preventive policy measures undertaken by the government must be time-bound to ensure a level playing field in the financial system.

   In Asia, very few countries have successfully established deposit insurance companies (DICs) that mitigate possible moral hazard problems. For an orderly resolution of NPL problem, the it is imperative to create a deposit insurance company that will provide limited deposit guarantees, manage and dispose insolvent institutions and/or restructure viable institutions.

4. Policy makers must integrate sound corporate governance practices in its all business activities by enhancing transparency in the creation of monetary and fiscal policies, in accounting and auditing standards and in financial reporting disclosures by financial institutions.

   Standards for financial statement disclosures, particularly those relating to NPLs and asset quality, asset classification, appropriate loss recognition and provisioning and single borrower’s limit on loans must be instituted.

   Moreover, maximum loan exposure against capital buffer and the total loans that a bank can hold vis-à-vis assets must be clearly defined in their regulations. Strict adherence to the use of performance indices and standards at par with the international standards must be instituted. For economies where financial infrastructures are low or probably still inexistent, it is imperative to prepare bank personnel to acquire the technical know-how related to credit management in order to effectively implement new regulatory requirements that will be established in the future. Hence, reportorial requirements must be clearly communicated and tightened by setting prudent regulations consistent with international standards.

5. For the other five ASEAN member economies where existing legal and regulatory framework underpin financial institutions' ability to open financial markets, measures to keep pace with the local and international market demands must be considered by removing several barriers to entry. The other eight economies must collaborate on a regional basis by providing any technical assistance it can extend to manage NPL problems based from their past experiences or international best practices.

6. Policy makers at the firm and regional levels must consider medium term or long-term solutions to NPL problems. A process-driven approach aimed at making either preventive or corrective government interventions must be undertaken while pursuing broader financial reforms.

7. Fundamental changes in the existing laws are imperative by hastening efforts at liberalization and deregulation of the financial system (particularly in the banking sector) along with efficient, transparent and reliable legal framework that will complement existing statutory and supervisory framework.

8. At the firm level, extensive reform measures must be undertaken to include:
    a. Sound and clear assessment of the borrowers' capacity to pay loans by strictly implementing credit investigation process and adopting pre- and post-loan monitoring schemes to protect their interests.
    b. Standard-operating procedures that reduce the adverse selection and moral hazard problems is imperative in the risk management activities by establishing a benchmark that will be used by financial institutions in identifying, classifying and managing impaired assets.
    c. Improvements in the quality of information provided to management and other stakeholders that have interest in the institution's business or operations.
    d. Diversification of financial products and services in the financial markets to enhance competition within the system.
    e. Encouragement of commercial and universal banks to increase asset base through equity creation via listings in the stock exchange. Pricing of stocks of commercial banks by the exchange could lead to heightened market discipline of listed companies.

9. At the regional level, cross-border information exchange of agreements can be used as an initial step in strengthening economic ties towards a regional financial system. At the national level, emerging economies may adopt the models used by developed and successful economies in the region (Japan, Korea and Singapore) where regulatory barriers among different financial institutions were removed which paved way to the establishment of a single financial institution that offers diversified products and services. This also calls for an evaluation of and possible changes in the existing financial regulations and supervisory standards that could respond to the changing trends in global financial services and provide a stable

and healthy market-oriented financial system. This can be achieved by strengthening international financial architecture aimed at providing investment-led growth at the national and regional levels through closer coordination among regional authorities.

10. Regional leaders must consider how foreign participation in the financial system can be encouraged. While individual countries had partially liberalized regulations on foreign ownership in the region, this alliance will provide competitive advantage in creating synergy in making Asia the next financial hub in the international arena where additional funds, better financial markets, financial and managerial expertise can be used in fostering the asset management industry.

11. In addressing the funding concern of AMCs, foreign participation in the market may be able to lend credibility to the pricing of assets, affording the market with a more objective assessment of the valuation of NPLs and assets. The use of mark-to-market valuation of assets provides a more objective pricing structure when estimating recovery rates of resolved NPLs.

12. Depending on the NPL levels encountered by a country, the number of AMCs to be set up should be increased, with entry into the industry possibly made with relative ease. Government supervision and regulation, however, should be clearly established to monitor the operation of these AMCs. Performance criteria should likewise be clearly set; it should be measurable and easily compared periodically across time and among AMCs.

13. The expertise built by AMCs over the years may be put to good use by possibly privatizing government-run AMCs and redefining its role after its objectives (as they relate to the financial crisis) have been fulfilled. Internationalization of AMC operations at a regional level can afford effective exchange of expertise. The more profitable and highly-experienced AMCs can assist other countries in their NPL disposition without having these countries set up their own government-run companies. KAMCO seems to be fulfilling this role as China has sought KAMCO's assistance for advice of its own AMC operations.

14. To achieve economies of scale, NPLs of similar nature can be sold to AMCs on a bundled, grouped or packaged basis for ease in management. AMCs can, on the other hand, specialize in the management of certain types of NPLs and build expertise in its restructuring and disposition.

15. Securitization, as an option to enhance the bond markets of ASEAN + 3 member countries through AMCs, should be seriously considered. This can be an effective way to help build capital markets in the region and lessen dependence on the banking system for private funding needs.

16. The resolution of the NPL problems for rehabilitating the financial systems in the ASEAN+3 region is believed to only be the tip of the iceberg. More fundamental problems will have to be examined in assessing the full impact of the crisis. As far as AMCs are concerned, further studies still need be conducted in evaluating the long-term effects of the existence of AMCs and their subsequent forced closure to the improvement in the proper functioning of an affected country's financial system. Analysis should likewise be conducted of the possible moral hazard problems that the establishment of AMCs can create and what measures can be put in place to prevent its occurrence, other than closure of the AMCs, vis-à-vis the long term benefits its existence can provide the financial system.

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APPENDIX 1

SUMMARY OF SELECTED COUNTRIES' ASSET MANAGEMENT COMPANIES

Main Considerations	KOREA	JAPAN	CHINA
Centralized Government-Run AMC	Korea Asset Management Corporation (KAMCO)	Resolution and Collection Corporation (RCC)	Orient Asset Management (ORIENT) Great Wall Asset Management (GREAT WALL) Cinda Asset Management (CINDA) Huarong Asset Management (HUARONG)
Year of Set-Up	1998	1999	1999 for all China AMCs
Sunset Date	Unlimited Life	Unlimited Life	2009 expected sunset for all China AMCs
Mission / Vision / Main Objectives	Vision for KAMCO expresses a commitment to helping financial institutions improve their liquidity and asset soundness while contributing to the development of the financial sector and the national economy	Tasked by government to assume or buy non-performing loans from financial institutions (including bankrupt ones) and accelerate collection of such debt	All four state-owned AMCs were set up purposely to buy bad debts of four major state-owned commercial banks and dispose of them over 10 years, with the purchase of bad debts restoring bank balance sheets
Governing Agency / Body	KAMCO is under the supervision of the Financial Supervisory Commission (FSC) with Korea Development bank (KDB) and the Ministry of Finance and Economy (MOFE) as major shareholders	RCC is provided guidance and advise by the Deposit Insurance Corporation of Japan (DICJ)	All four AMCs report to the Ministry of Finance, the People's Bank of China (PBOC) and the China Securities Regulatory Commission (CSRC). Representatives of these government agencies sit on all the AMC supervisory boards.
Enabling Laws	Functioning only as a subsidiary of KDB, such have been redefined through the 'Act on Efficient Management of NPLs of Financial Institutions and the Establishment of KAMCO' which was ratified in 1997 to reorganize KAMCO as a specialized resolution agency	Acceleration of disposal and collection functions done through the Financial Sector Rehabilitation Program	A State Council Executive Order came into force in 1999 for the establishment and capitalization of Four AMCs, one each for the four commercial banks

Main Considerations	KOREA	JAPAN	CHINA
Official Mandate	Restructuring / Rapid Asset Disposition	Rapid Asset Disposition / Collection	Restructuring / Rapid Asset Disposition
AMC Model Adapted	Government Entity	Government Entity	Bad Bank
Dsiclosure and Transparency	Annual Reports available on website	Annual Reports (not available on website)	Annual Reports (though not available for public consumption) There are reports of improving transparency in Chinese banking statistics, as three of the four big banks have published their NPL estimates on the basis of a new five-category loan classification system resembling international norm.
Funding	KAMCO is the fiscal agent of NPA Fund with resources amounting to 21.6 trillion won, 20.5 trillion won coming from issuance of government guaranteed bank bonds, 573 billion won were assessments of financial institutions and another 573 billion loans from KDB	DICJ issued government guaranteed bonds and injected proceeds into RCC as initial capital. Financing of NPL purchases entirely in the form of capital	Each AMC funded at RMB 10 million, augmented by bond issuance of RMB 850 million and borrowings of RMB 55 million
Legal Environment	Kamco has no explicit powers. Korea's legal infrastructure is more developed than other Asian countries	DICJ, which provides guidance and advise to RCC, makes strenuous efforts to uncover hidden assets of debtors, by exercising the investigative powers given by the Deposit Insurance Law and the Financial Revitalization Law. DICJ has been pursuing civil and criminal liabilities against executives of failed financial institutions and criminal liabilities against debtors for auction interference, obstruction of law enforcement and fraud.	Chinese bankruptcy laws was drafted some 15 years ago and seem outdated given rapid structural change in its economy

Main Considerations	KOREA	JAPAN	CHINA
Asset Transfer	Banks with CAR below 8% required to sell NPLs to KAMCO. NPLs paid for with government guaranteed bonds. Asset acquisition strategy was price- rather than type-driven as KAMCO placed bids on all asset portfolios.	RCC employs liquidation and securitization as useful ways to part with some of the NPLs. RCC tries to boost disposal of NPLs possessed by financial institutions and promoting revitalized private business through making use of trust business functions granted in 2001	Asset transfers are policy-based. AMC purchase of NPL executed uniformly at book value, these were government explicitly authorized; restricted to loans incurred before end 1995 and identified as 'substandard' or 'doubtful' loans before end 1998 under old Chinese loan classification system.
Asset Pricing	KAMCO's policy of pricing NPL purchases evolved through time. Prior to the Asian Financial crisis, KAMCO employed method of "blanket purchase on the condition of an ex post facto settlement'. Discount rates used by this method were tied up to loan loss provision rates. After the crisis, assets priced using formula reflecting characteristics and terms and conditions of the loan with price adjusted through negotiations but not to deviate much from offer price	RCC pays 7%, on average, for its asset acquisition from banks still operational because of its self-imposed 'no loss' policy under strong political resistance to spending taxpayers' money to resolve NPLs at privately-owned banks.	Bank value serves as the acquisition price for carving out NPLs from the four state-owned banks. This is a of case or compound NPL stripping-out and recapitalization of assets used to replace impaired NPLs receive implicit government guarantees.
AMC Performance	1999-2000: Average discount on face value 44% 2000: Asset disposal progressed; 50% assets acquired still to be disposed of. 2001: about 76% of banking sector's NPL transferred to KAMCO. Assets disposed amount to 58% of NPLs 2002: KAMCO disposed 60% of assets under management at average rate of 46%. Slated to terminate any further purchase of NPL by end 2002. NPLs resolved reached 47% 2003: Recover rate reached 47% 2004: Of 65.8% resolved recovery rate was 49.4%	RCC is reported not to provide information on amount of NPA resolved. Anecdotal evidence points to much room for possible acceleration in pace of asset resolution.	As of 2003, China's AMCs have managed to recover 33.6% of asset resolution. However, cash recovery is not expected to exceed 20%. Assets associated with Cinda's NPL portfolio are apparently better at 40% cash recovery. Without Cinda, recovery rate of the rest drops to 17%.

Source: Kamco Annual Reports, various web sites, various articles: Klingebiel, 2002; Ma and Fung, 2002; Fung et al, 2004He, 2004, various Ernest and Young reports.

Main Considerations	INDONESIA	MALAYSIA	PHILIPPINES	THAILAND	VIETNAM
Centralized Government-Run AMC	Indonesian Bank Restructuring Agency (IBRA)	Danaharta	Asset Privatization Trust Corporation (APT)	Thai Asset Management Company (TAMC)	Debt and Asset Trading Company (DATC)
Year of Set-Up	1998	1998	1987	2001	2004
Sunset Date	2004	2005	1991 (was in operation until 2004)	2011	Undefined
Mission / Vision / Main Objectives	Main tasks of restructuring banks transferred to IBRA, recovering bank assets, both physical assets and loans, and recovering state funds formerly disbursed to the banking sector	Main objective is to remove NPL distraction from financial institutions and extract maximum recovery value from NPLs	Tasked with the orderly and fast transfer of NPAs to the private sector, administer assets pending asset disposal. By 1991, APT was made to handle divestiture of very large government corporations	Rationale for establishment is to allow government to address high NPLs in both state-controlled and private financial institutions to set the environment right for banks to commence lending	Used by government as an important means to assist enterprises to resolve long outstanding loans and distressed assets to improve financial health. DATC pilots resolving distressed assets and loans of 20 companies appointed by government
Governing Agency / Body	Ministry of Finance serves as overseer. IBRA board reports to Financial Sector Policy Committee (FSPC)	Bank Negara Malaysia oversees functions of Danaharta	APT supervised by Committee on Privatization (CoP) under the Department of Finance	TAMC fully owned by the Financial Institutions Development Fund (FIDF) and supervised by the Bank of Thailand. Site examination findings reported to the Ministry of Finance	DATC created under the management of the Ministry of Finance
Enabling Laws	IBRA created under Presidential Decree no. 27 of 1998 as an ad hoc institution	Legislative framework provided by the Pengurusan Danaharta Nasional Berhad Act (Danaharta Act)	. . .	Decree via draft of the TAMC Act TAMC created by Emergency	. . .

Main Considerations	INDONESIA	MALAYSIA	PHILIPPINES	THAILAND	VIETNAM
Official Manadate	Restructuring	Restructuring/Rapid Asset Disposition	Rapid Asset Disposition	Restructuring	Restructuring
AMC Model Adapted	Bad Bank	Government Entity	Bad Bank	Government Entity	Government Entity
Disclosure and Transparency	Annual Reports (though not available on the web)	Annual Reports (available on the web until 2005). Quarterly reports likewise available on independent news reports	APT had to submit quarterly reports on performance and financial status to the President and Congress. However, it did not disclose any information on its activities and financial situation and the process of asset sales remained non-transparent	Annual Reports with statement of assets and liabilities are said to be prepared but not available to the public.	Disclosure of NPLs is very limited and remains far behind interna-tional standards and these information were previously considered a secret.
Funding	Rp 599 trillion issued in bonds for liquidity support and recapitalization	RM 28 billion allotted for Dana-harta in the form of government guaranteed bonds	. . .	Bt 1.1 trillion in liquidity support; Bt 800 billion limit on bonds for recapitalization; Bt 38.4 billion in capital support schemes	Chartered capital of VND 2000 billion (US $ 127 million) provided by government for debt and NPL purchase
Legal Environment	IBRA has been afforded such rights to seize assets of non-cooperative debtors without seeking court approval	Danaharta vested with special powers insulating it and NPL purchasers from undisclosed claims after NPL acquisition Special administrators appointed to dispose of assets without going to court, with power to abrogate underlying contract when fore-closing collateral.	APT had no special powers and operational independence, which APT officials believe impeded the pace and effectiveness of asset sale and recovery strategies.	TAMC given special powers to force debtors to enter into nego-tiation for loan repayment	No comprehensive law dealing with corporate insolvency in Vietnam. Insolvency and creditor rights done through many regu-lations including Law on Bank-ruptcy, Civil Law, Ordinance on Economic Contract, among others. Regulations sometimes unclear, inconsistent, leading to different interpretations and applications.

Main Considerations	INDONESIA	MALAYSIA	PHILIPPINES	THAILAND	VIETNAM
Asset Transfer	Banks under IBRA control or supervision were required to sell category five loans to IBRA/ AMUs. IBRA/AMUs pay for NPAs and NPLs with government guaranteed bonds.	Government required banks to reduce NPL levels to 10% or below. Banks receiving capital from Danamodal required to sell their NPLs above RM 5 million to Danaharta. Profit sharing was adopted with banks receiving 80% of any profits earned from recoveries. NPLs were paid with government guaranteed bonds.	Assets transferred (as of 2001) was equivalent to 21.7% of banking system assets. Criteria for asset transfer include size and nature of account (NPL), potential for sale and any special expertise required for asset disposition.	TAMC limited purchase to NPLs with minimum book value of Bt 5 million. Asset price was based on market value with some profit-loss arrangement with the originating financial institutions.	DATC has been dealing with NPAs of state-owned enterprise with historical costs of VND 270 million (US 15.4 million). DATC primarily deals with distressed debts and assets of SOEs or from other government agencies and not from banks. Banks have been allowed to put up their own AMCs.
Asset Pricing	IBRA effectively adopted multi-stage operation, offering blanket guarantee for all creditors, stripping out NPLs and recapitalizing it with government bonds in preparation for eventual sale. This is interpreted as NPL acquisition effectively using book value to transfer NPLs from nationalized banks, except that for IBRA there is no asset received in exchange for the NPLs.	Unlike other AMCs, Danaharta was set-up as a preemptive action to avert the banking crisis and, therefore, did not enjoy compulsory powers of acquisition. All NPLs had to be acquired via a market mechanism - NPL had to be purchased on a willing-buyer-willing-seller basis. Secured loans had purchased price determined by fair value of underlying collateral of NPL with shares and property as acceptable collateral.	APT adopted a purchase price that was stated at book value.	TAMC adopted a pricing structure based on the value of the collateral excluding any personal guarantees. Rules of pricing were prescribed by the TAMC board. Book value price likewise practiced but excludes applicable reserve amount. Book value defined as total principal amount of loan plus accrued interest for a three-month period prior to transfer date, placing cap on interest rate charges.	. . .

Main Considerations	INDONESIA	MALAYSIA	PHILIPPINES	THAILAND	VIETNAM
Asset Pricing		Unsecured loans had purchase price equal to 10% of principal amount outstanding.			
AMC Performance	1999-2000: IBRA raised $2.5 billion from asset sale. Process still comparatively slow. Sales of banks delayed while cases against debtors moved slowly 2000: More than 80% of banking system's NPL transferred to IBRA but with only about 4% disposed. IBRA helps recapitalize seven banks with CAR below 11% 2001: As much as 88% of banks' problem loans have been transferred to IBRA but only 7% has been disposed. 2002: IBRA had only disposed 17% of assets taken from banks. By year end IBRA had only disposed of 20% of AUM 2003: Recovery rate of assets resolved amounted to 27% 2004: Three government bodies take over remaining IBRA tasks.	1999-2000: Average face value of assets 20% 2001: 40% NPLs transferred 2002: Danaharta restructures or approves restructuring all assets acquired from banks. 2003: Recovery rate of assets 58%, highest among crisis affected countries. 2004: Danaharta resolved all acquired NPLs and collected 95% of expected recovery proceeds. Expected recovery rate by end 2005 is 59%.	2001: Government proposed bill for creation of specially designed AMCs or special purpose vehicles. SPV law signed by President. 2004: Central bank announces issuance of certificates of eligibility to allow banks to transfer assets to AMCs set under the SPV law with tax exemption and reduced fees.	1999: Assets sold at average of 70% discount 2000: Thai private banks have set up own AMCs. Asset disposal data scanty. Government announces establishment of centralized AMC. 2001: About half of banking sector's NPL transferred to TAMC, only one-fifth resolved. 2002: By June 2002, TAMC has reached 70% asset resolution Half done for debt restructuring and rest foreclosure of collateral. 2003: Recovery rate of assets resolved at 46% 2004: TAMC redeemed promissory notes amounting to Bt 7.1 billion. 98.8% of acquired assets resolved. Recovery rate at 49.2%.	. . .

Source: Danaharta Annual Reports; various websites; various articles: Klingebiel, 2000; Cooke and Foley, 1999; Tien Loi, 2004; Fung et al, 2004; Ponovalai, 2004;

APPENDIX 2

COUNTRY REPORTS

+ Three (3) Member Countries

1. CHINA
   by Jenny Eizaguirre & Junette Perez
2. JAPAN
   by Jenny Eizaguirre & Junette Perez
3. KOREA
   by Jenny Eizaguirre & Junette Perez

Original Five (5) Member Countries

4. INDONESIA
   by Dr. Neriza Delfino
5. MALAYSIA
   by Dr. Neriza Delfino
6. PHILIPPINES
   by Dr. Liberty Patiu
7. SINGAPORE
   by Dr. Junette Perez & Dr. Neriza Delfino
8. THAILAND
   by Dr. Neriza Delfino & Jenny Eizaguirre

OTHER FIVE (5) MEMBER COUNTRIES

9. BRUNEI DARUSSALAM
   by Dr. Liberty Patiu
10. CAMBODIA
   by Dr. Liberty Patiu
11. LAO PEOPLE’S DEMOCRACTIC REPUBLIC
   by Dr. Liberty Patiu
12. MYANMAR
   by Dr. Liberty Patiu
13. VIETNAM
   by Dr. Liberty Patiu

CHINA

1. COUNTRY MACROECONOMIC PERFORMANCE

The Chinese economy has witnessed some extraordinary changes since the second half of the 1990s. There were sharp increases in urban unemployment, stagnation of labor transfer from the agricultural to the non-agricultural sector and serious deflation. All these transformations revealed a significant deviation from the previous development path such as sustained full employment in urban areas, rapid labor transfer from agriculture to non-agricultural sectors and persistent and significant inflation [Lai, 2006].

In 1995, policymakers and scholars in China became progressively concerned about the potential volatility and risk of its financial system. In the course of the 1997 Asian Financial Crisis, China was fortunate to have prevented a currency crisis and, despite this, even sustain relatively strong growth. This was largely ascribed to its capital controls, as well as a healthy and stable macroeconomic situation [Fan, 2002]. Since 1996, the 'yuan' (Renminbi, RMB) has been convertible in the current account. However, capital account transactions are still restricted. The Chinese authorities are not expected to fully liberalize the financial sector for many years for fear of a collapse in the financial markets and its currency. It could essentially be these capital account restrictions that the government believe shielded China in the 1997-1998 Asian Financial Crisis [The Economist Newspaper Limited, 2004]. At the time, China seemed to remain invulnerable to any future financial crisis, as there were doubts on the effectiveness of China's capital controls [Fan, 2002]. A more disturbing fact is that China's banking industry was no better than those crisis-hit countries.

The Chinese financial system, like those of the crisis-hit countries, heavily relied on banking intermediation. When the crisis occurred, the estimated ratio of non performing loans (NPLs) in China was 24 to 26 percent, which was higher than those in Korea and Malaysia. There were widespread signs indicating the fragility of China's banks and their general unsustainability even in a closed economy, let alone with open capital markets. From the third quarter of 1997, deflation pressure and a slowdown of growth have affected the Chinese economy. And with the Asian financial crisis, the central authority realized the seriousness of this financial fragility and thereby took action to reduce the industry's NPL ratio.

China became a member in the World Trade Organization (WTO) in 2001, a milestone on China's long march to liberalize its economy. China's union with the world economy will accelerate the integration of the global economy. After joining WTO, Chinese enterprises are expected to compete under global standards [Jingu, 2002]. Since joining WTO, China has rapidly become a global economic force, exporting more IT related products than the United States, creating a commodity-market boom, while turning into the world's third-largest car market. Aside from being strong in manufacturing, China is also gaining ground on India in the business of outsourced services [Economist.com, 2006].

To date, China's economy has remained stable and relatively growing, despite measures at macroeconomic control to prevent any overheating of its economic system. Growth reported for the first half of 2005 remained at the same level as the average of last year of 9.5%, with GDP totalling RMB6.74 trillion (USD 812.3 billion) for the first six months of 2005. This was only 0.2% below the comparable figure for the first half of 2004. Clearly, the People's Republic of China is reported to have further strengthened its position as the world's fastest growing economy [Shanghai Flash, 2005]. Current account improvements were further reinforced when China's imports shrank deeply during the first half of 2005 due to the steep slowdown of domestic investment spending caused by the macroeconomic tightening, while exports remained robust with a year-on-year rise of 32.7%, well ahead of the 14% increase in imports and making the trade surplus the main driving force behind the expanding economy.

2. NON-PERFORMING LOANS PROBLEM

In China's banking system, commercial loans and consumer loans that are 90 and 180 days past due, respectively, are generally classified as non-performing [Liu, 2002]. Chinese banks used an asset classification system based on actual loan performance that divided NPLs into three types: 'overdue', 'doubtful' and 'bad' prior to 1999. This approach tended to underestimate NPL as it did not include highly risky loans that were still paying interests and were not yet overdue. By 1999, the international five-tier classification method was introduced; this new method classifies bank loans according to inherent risks, i.e. pass, special-mention, substandard, doubtful and loss [Fan, 2002].

China's NPLs are believed to be problems ascribed to so-called blind banking reforms essentially to fit into the Bank of International Settlement (BIS) regulations, designed for the benefit of advanced economies operating under finance capitalism. For any banking system, NPLs surface mainly as a regulatory issue, that is, adequacy of capital considered by regulators as appropriate for managing risk of loan default.

The Chinese government has paid attention to the problem of NPLs of banks since the middle of the 1990s. Within the period 1992-1997, during which China experienced first a high inflation and then a contraction, the non-performing loans (NPLs) of China's banks grew significantly. This was particularly true for state-owned banks and trust & investment companies. At the end of 1997, NPLs were estimated to be around 35% of the total outstanding loans of financial institutions, as no official figures were directly available [Ye, 2003]. The sudden increase in NPLs was caused by such factors as: (1) the then Agricultural bank of China lent a lot of policy loans to purchase grains at the time grain prices peaked dramatically in 1993-199, which could not be recovered when grain prices declined in 1996-1997; (2) banks could not recover their loans to small enterprises because of operational troubles in the contraction period of 1996-1997 and corrupt practices of local government officials, who were believed to be in cahoots with grass-roots branches of banks, and owners or manager of small enterprises; (3) banks could not recover their loans on real estate that were lent in 1992-1994 due to the subsequent decline in real estate prices affected the ASEAN region during the crisis [ibid.].

In January 1998, data regarding NPLs were eventually disclose and according to reports, the NPL ratio reached 25% to 26% at end-1997, consisting of past-due loans (15 percent), past-due beyond 2 years (8% percent) and bad loans (2 percent) [Pei and Shirai, 2004]. Data released by the government were likely underestimated, as there were wide ranges of dissimilar estimates with respect to NPL ratios. In the paper of Shi [2003], the estimated NPL ratios of State-owned Commercial Banks (SACBs) reached 39% in 1999 and 29% in 2000. Foreign research institutions and credit rating agencies also have different estimates. For instance, Moody's Investors Service estimated that the NPL ratio of SOCBs was in the range of 35% to 70% in 1996, while Morgan Stanley's Dean Witter estimated that the ratio was 36% in 1998 [Li Hongjiang 2002].

Table-CH1 below lists information summarizing this variety of estimations.

TABLE-CH1. ESTIMATED PROPORTIONS OF NPLS AND ESTIMATED COSTS OF CLEAN-UP

Study	Period	Estimate
NPL (as percentage of outstanding loans)		
Li (1998)	End of 1996	24.4%
	Mid-1997	29.2%
Fan (1999)	1997	26.1%
	1998	28.3%
Yuan (2000)		20-29%
J.P. Morgan	1998	>36%
***Clean up costs* (as percentage of GDP)**		
Moody	1999	18.8%
Dornbusch and Givazzi (1999)	1999	25.0%

Source: Fan (2002)

Despite some confusion created by the release of various data estimates, the fact remains that the total amount of China's banking sector NPLs is immense and the problem it presents is serious.

3. MEANS OF RESOLVING THE NPL PROBLEM

The Chinese government established four state-funded asset management companies (AMCs) in 1999 capitalized at RMB10 billion each. These four AMCs namely Huarong, Great Wall, Cinda and Orient, were put up to take over NPLs from the Big Four state banks—Bank of China, Agricultural Bank of China, Industrial Commercial Bank of China, and China Construction Bank. Originally, each AMC was paired with a single state bank – Cinda with CCB, Great wall with ABC, and so on respectively. Afterwards, the AMCs were to purchase NPL packages from any of the four. The Chinese approach in resolving NPLs appears to have followed the Korean model closely, which is reasonable given the similarity of their NPL portfolios, and it was believed that the speedy resolution undertaken by the Korea Asset Management Corporation (KAMCO) was preferable in the Chinese case. KAMCO notably resolved 60% of its acquired loans from the Korean financial market, while making a profit on the final sale of its NPLs [Tay, 2005].

The AMCs are one of the most important mechanisms being used by the Chinese government to clean up the country's NPL mess. Information summarizing these AMCs is reported in **Table-CH2**.

TABLE-CH2. THE PROFILE OF THE FOUR AMCS

Name of AMC	Bank	Year Set Up	Legal Basis	Official Mandate	Sunset Date
Great Wall Asset Management(Great Wall)	Agricultural Bank of China	1999	State Council Executive Order 2000	Restructuring/ Rapid Asset Disposition	10 years
Orient Asset Management(Orient)	Bank of China	1999	State Council Executive Order 2000	Restructuring/ Rapid Asset Disposition	10 years
Cinda Asset Management	China Construction Bank	1999	State Council Executive Order 2000	Restructuring/ Rapid Asset Disposition	10 years
Huarong Asset Management(Huarong)	Industrial and Commercial Bank of China	1999	State Council Executive Order 2000	Restructuring/ Rapid Asset Disposition	10 years

Source: Fung et al(2003)

As wholly state-owned financial institutions, these AMCs remain under the supervision of the Peoples' Bank of China (PBC), with guidance from the State Securities Supervisory Committee of China and the Ministry of Finance. The general mandate of the AMC is to collect debt, restructure, or assign NPLs; convert NPLs into equity; issue financial bonds, borrow from financial institutions; and, recommend companies for listing [Pei and Shirai, 2004]. Specifically, each of the AMC has been mandated to protect the franchise and stability of the originating bank from runs and adverse publicity; to directly improve bank's profitability and clean up their balance sheets; to centralize debts under one creditor so as to simplify negotiation and recovery procedures; to by- pass bureaucratic red tape and expedite collection by means of more drastic actions; and to allow selective NPL packaging in open auctions to optimize disposal [Chen, 2003].

Ma and Fung [2002] discussed the uncertainties regarding the scope of the NPL transfers during the period 1999-2000 and distinctions between the so-called "policy-based" and "non-policy" transfers of NPLs. The main distinctions in such NPL transfers seem to be the timing of the bad debts, the transfer prices of the carved out NPLs and their related financing arrangements. It appears that there could be some profit//loss-sharing agreements for such "non-policy" transfers between the big four banks and the AMCs. The transfer prices are most likely below par. Such transfers, however, could help the banks meet the mandated schedule for reducing NPLs.

Over the course of 1999 and 2000, actual transfers of bad loans took place from the big four banks to the four AMCs. Assets transferred amounted to RMB1.4 trillion (US$169 billion), more than 20% of the big four banks' combined and equivalent to 18% of China's GDP in 1998. The assets transferred from 1999 to 2000 are often regarded as "policy-based" for four reasons. First, the AMC purchase of the NPLs was executed uniformly at book value. Second, the government explicitly authorized the related AMC financing covers such transfers. Third, these NPL transfers were mostly restricted to those loans incurred before the end of 1995 and identified as "substandard" or "doubtful" loans before end-1998 under the old Chinese loan classification system. Fourth, some of the bank assets transferred was selected to serve certain specific government goals such as debt-for equity swaps [Tang 2001a; 2001b].

Nonetheless, since 1999, "market-based" or "non-policy" carve-outs of the NPLs were still held by the big four banks. In addition to policy transfers, other "non-policy" transfers of NPLs from the big four banks to the AMCs appear to have reached at least RMB300 billion in book value. So far, little is known about such non-policy transfers. It appears the total bad assets already acquired by the AMCs from the big four banks, policy-driven or otherwise, might have reached RMB1.7 trillion in book value.

The AMCs held various measures to cope wit the NPLs that include bidding, auctions, restructuring of debt, liquidation and bankruptcy, contracting agreements and Asset Backed Securities (ABS). The most widely used method has been through auction. Generally used practices are (1) packaging debts and establishing an AMC with foreign investors; (2) directly selling the package to domestic or foreign investors, and entrusting the asset package to foreign investors; (3) setting up a securitization fund for each package. In November 2001, Huarong established a first joint venture company with Morgan Stanley and Rongsheng with Goldman Sachs.

Up to the end of 2002, the four major financial asset management corporations have disposed of RMB301.4 billion of NPLs excluding the conversion of liabilities to equities, recovering RMB101.3 billion including RMB67.5 billion of cash [Ye, 2003]. As of June 2003, the data on the amount of NPLs recovered by the AMCs is shown in **Table-CH3**. The AMCs have made some progress in both cash recovery and the rate of recovery.

TABLE-CH3_. BALANCE OF AMCS RECOVERING NPLS (JUNE 2003)

	Cinda	Orient	Greatwall	Huarong	Total
Purchased Sum	3,730	2,674	3,458	4,077	13,939
Settled Asset Sum	941.28	536.8	1204.69	935.67	3014.42
Recovery of Cash Sum	296.25	136.33	129.75	229.96	792.29
Rate of Recovery of Cash	31.47	25.4	10.77	24.58	21.9

Source: Pei & Shirai (2004)

At the beginning of 2004, the government made several changes. First and foremost, the government clearly defined the direction of reform and development for financial AMCs, by setting recovery target for the policy-purchased NPL transferred to the AMCs in 1999, allowing the AMC to purchase assets, and provide NPL servicing business on a commercial basis.

In April 2004, the State Council publicized a regulation governing the entry criteria for AMCs to carry out three commercial businesses. The regulation includes the acquisition of NPL on a commercial basis, asset servicing, and further investment in assets under management (AUM).

Year starters for 2006 witnessed a continued decline in both NPL volume and ratio of commercial banks in China after the ratio dropped for the first time to single-digit levels at the end of last year. The outstanding balance and the ratio of NPLs with the commercial banks, including state-owned commercial banks' (SOCBs), joint holding commercial banks (JSCBs), city commercial banks, rural commercial banks and foreign banks) were reduced by RMB13.76 billion (0.6 % points from the beginning of 2006) to RMB1,312.47 billion (8% equivalence), respectively.

In terms of the composition of the NPLs, the outstanding balance of the loan losses was reduced by RMB0.14 billion from the beginning of 2006 to RMB480.82 billion, accounting for 36.6% of the total NPLs. This reduced doubtful loans from RMB1.43

billion to RMB503.51 billion, accounting for 38.4 per cent; and simultaneously decreasing substandard loans by RMB12.18 billion to RMB328.14 billion, accounting for 25% of the total NPLs [CBRC, 1Q-2006]. In spite of the continuous NPL decline in the banking industry, banks have been advised to be abreast of the new challenges facing the disposal of NPLs, which may arise from the government policies for industrial restructurings and control of overcapacity [ibid.].

4. CHINA'S CAPITAL MARKET

Since China's WTO entry in 2001, China is committed to rapidly continue its economic reforms and include widespread developments in its capital markets. The country's capital market is now in the middle of a crucial period of transition with major opportunities for growth.

BACKGROUND AND STRUCTURE

The financial sector of China bears out separate operations. Financial institutions in any of the three sectors -- banking, insurance and securities -- can only operate within their designated sector and not allowed to mingle operations with other sectors. Fears abound in China's financial sector as it remains doubtful to pursue a mixed operation across sectors in the near future, despite the country has witnessing an increasing number of strategic alliances among commercial banks, insurance and securities companies [Chen, 2001]

The China Securities Regulatory Commission (CSRC) is the regulator for China's financial markets. CSRC has an excellent track record and reputation for pursuing reforms to strengthen the financial markets and enhance corporate governance. It deals with investment funds that manage listed assets, grants approval to the business plans of fund management companies, and sets eligibility conditions for their senior managers.

In April 1998, the Sub-Committee on Standards and Conformance (SCSC) and the China Securities Regulatory Commission (CSRC) were merged to form one ministry rank unit directly under the State Council. As a result of this, both the power and the functions of the CSRC have been strengthened after the reform and essentially a centralized securities supervisory system was established. In September 1998, the State Council approved the provision of CSRC being one of the enterprise units directly under the State Council and the authorized department governing the securities and futures markets of China, further strengthening and clarifying CSRC's functions.

In November 1998, the Chinese government decided to reform and reorganize its national securities regulatory mechanism. Organizations engaged in securities, formerly supervised by the People's Bank of China, were put under the centralized supervision of the CSRC. After the securities law of People's Republic of China

(PRC) has been put into effect, CSRC has become the only management authority of the securities industry. Stock issuance is subject to approval by the CSRC. Along with relevant authorities, CSRC has the right to grant the qualifications of all intermediaries engaged in or related to securities activities.[2] At the same time, bonds list in stock exchange are also supervised by CSRC. While bonds initialed in the inter-bank market are supervised by PRC.

Since 1997, the legal framework of China's financial system has improved significantly. The securities law of PRC was put into effect on July 1, 1999. This law established the basic regulations of China's securities market. For bonds, there are the corporation laws of 1994, which was modified and put into effect on December 25, 1999. Major developments taken place in the regulatory landscape since the promulgation of the Provisional Measures on the Supervision of Securities Investment Funds in 1997. Particularly, in the enactment of Securities Investment Fund Act in 2003 and its implementation in 2004, the legal basis of the investment fund and industry was enhanced after which different rules and regulations for implementing the act have been promulgated to facilitate the sound development of the industry. These rules and regulations are as follows: Regulations on Sales of Securities Investment Funds (June 2004), Regulations on Sales of Securities Investment Funds (June 2004), and Regulations on Operations of Securities Investment Funds (July 2004). The CRSC published the Circular on Issues Concerning Further Improving the Review Procedures for Capital-raising Application for Establishment of Securities Investment Funds in June 2005. This circular included guidelines or protocol on reporting capital raising activities to the CRSC and criteria for acceptable applications. The CRSC have been doing its best efforts to establish a sound legal foundation and regulatory framework for the fund management industry and the process remain ongoing.

PROBLEMS OF THE CAPITAL MARKET

The capital market has played a vital role in the China's economic reform. But Fan Gang, famous economist and director of the National Economy Research Institute of the China Economic Reform Research Foundation, believes that China's capital market lacks "three major things" [People's Daily Online, 2001].

It still lacks "vicious purchase" in the market, meaning the conduct of operation of the market, realizing purchase or control of such operation and reorganizing it to take advantage of the opportunity provided by its poor operation of the market, its problems and the resulting stock market fall. Second, China still lacks many local small securities markets, or so-called "transactions conducted outside the stock market". Finally, Gang stressed that standardized non-securities investment fund is currently also lacking in China's capital market. This kind of investment fund represents an intermediary mechanism for large numbers of small capital owners and the investment activities on the capital market.

[2] This information was sourced from the CSRC website.

Chen Xingdong, Chief Representative of BNP Paribas Peregrine Limited Beijing Representative Office quoted that the most common question foreign managers of mutual funds asked was whether those capitals can survive in the domestic market even though a large number of companies are in want of capital. In Xingdong's opinion, the key problem of China's capital market is regulation, which depends on China's own efforts and finance. He further elaborated that opening the domestic capital market is an indispensable step in boosting domestic capital market because in reality, some of the foreign investment funds take great interest in that.[3]

DEVELOPMENTS AND REFORMS

To address these problems, the Chinese government announced in a general session of the 2005 Beijing Fortune Global Forum, "Understanding China's Capital Markets" salient developments. China has established six ministerial working groups in the past years to tackle major problems regarded as hurdles for the stockmarket, focusing on listed companies, the intermediaries, and the investors.

In April 1995, the China Securities Regulatory Commission (CSRC) issued a new plan for state share reform. This reform plan essentially aimed to make all non-tradable state shares tradable on the market. Consequently, the Chinese stock market has assumed a radically different landscape. According to the latest report in March 2006, hundreds of China's listed companies, with an aggregated market share of more than half of the total capitalization of China's domestic stock markets, have carried out their plans to circulate non-tradable state shares [Almazàn and Huishan, 2006].

The state share reform is a top priority in China, considered a major reform in China's stock market history and a crucial process, as it relates to the fundamental feature of China's stock market [ibid.]. As one of the results of China's transformation, the Composite Stock Index on the Shanghai Stock Exchange, on April 28, the last trading day before the market closed, closed at 1,440.22 points, the highest since it hit an eight low of 998 points [Xinhua, 2006]. A senior CSRC official attributed the positive mainly to restructuring of the share reform, also known as split share structure reform, and the improved legal framework for listed firms and corporate governance.

The split share structure refers to the existence of both tradable shares and about two thirds of shares used to be owned by the state and legal persons as non-tradable ones. To make all their shares tradable, listed companies, which participated in the reform, have to offer additional shares to regulators and investors which were found vital for

[3] Sourced from China Macroeconomic Information Network, found at www.macrochin.com.

the capital market to function as an open and fair market for both majority and minority public share holders.

5. CHINA'S ASSET MANAGEMENT INDUSTRY

In the early 1990s, China's fund management industry began with the creation of the Shenzhen and Shanghai stock exchanges. The first securities investment fund was formed in 1991, and the first company dedicated to fund management was established in 1992. In November 1997, the government promulgated the first set of unified rules designed to regulate the fund management industry: the Interim Measures for the Administration of Securities Investment Funds. These provisional measures formed the basis for the current regulatory framework, as they organized the structure of funds and funds management companies, detailed the obligations on their managers and custodians, and made the China Securities Regulatory Commission (the CSRC) the main approval and regulatory authority, as well as the industry watchdog. On these stronger foundations, fund management in China began a booming expansion. At the end of 1997, a number of closed-ended funds were set up, and more than RMB6 billion (US$750 million) in assets were under management [International Financial Law Review, n.d.].

On 28th October 2003, the Funds Law was adopted by the highest legislative body in China, the Standing Committee of the National People's Congress, emphasizing the importance of the new law and came into force on June 1, 2004. The Funds Law is a permanent and more comprehensive regulatory regime. It is a practical codification of the practices and solutions adopted under the previous regulatory framework of the 1997 Provisional Measures, and of the traditional patterns of securities investment funds. Regulated fund management companies establish contractual funds with approved custodians. These funds can be either closed-ended or open-ended, and may invest in the securities products (so far, stocks, bonds, and monetary market products) authorized by the CSRC.

CHINA'S INVESTMENT VEHICLE

Bonds and equities are China's main asset classes, with no foreign currency trading [The Economist Newspaper Limited, 2004]. Equities are by far the main form of investment vehicle, although urban households commit less than 10% of their financial into equity. As of end-October 2003, the two stock markets, based in Shanghai and Shenzhen, with a cumulative market capitalization of RMB3.9 trillion (US$470 billion), have become the main outlets for these funds. This makes China's equity markets the largest in Asia after Japan.

Government bonds are the other major asset class in China. They account for most domestic debt notes in China, with retail investors holding 60% of these bonds. Under the government's huge deficit funding plan to boost growth since 1997, outstanding treasury bonds rose to RMB1.93 trillion at end-2001 from RMB551billion at end-

1997. Individual investors hold about 60% of Treasury bonds, mainly bought from banks.

The third asset class is the special infrastructure bonds, of which RMB660 billion were issued between 1998 and 2002. Interest rates on treasuries are low compared with savings deposits rates. Investment returns on government bonds are not subject to the 20% tax on interest earnings. In addition, foreign institutions can enter the Chinese market via a joint venture arrangement with a local partner or by acquiring an existing Chinese firm. The foreign partner can hold up to a 33% stake of a fund management firm initially, and can raise its stake to a maximum of 49% at end-2004.

However, while joint ventures may be a solution to a foreign firm's short-term market-entry problem, rushing into poor partnership structures might compromise future success, as has been the case in other industries in China over the years. At the 2002 conference of Asia Society entitled, "Investing in China's Capital Markets: Where Will WTO-Sparked Reforms Lead?" Vincent Duhamel, Principal and Chief Executive, State Street Global Advisors, indicated that many domestic fund management companies have not been inclined to share revenue benefits with foreign partners. While these companies welcome help from foreign partners to build up their infrastructure and to enter into new business areas such as open-ended mutual funds, they are very reluctant to share the revenues from their existing profitable businesses with their foreign partners. In comparison, Chinese securities firms that are currently looking to apply for fund-management licenses are more eager to find a foreign partner to enhance their credibility and increase their chances of getting a license. As a result, these firms are willing to yield a greater equity stake and more management control to their foreign partners.

FUND MANAGEMENT COMPANIES

The CSRC adopted a specific set of procedures further detailing the rules applying to the setting up, approval and regulation of fund management companies in 2004, which became effective on October 1 2004.

In setting up a fund management company, there are prescribed requirements to follow. A fund management company must have a registered capital of at least RMB100 million. It must have a staff engaging in research investment, valuation and marketing, with at least 15 senior management personnel who have qualifications in the fund management industry. Any fund management company must have a main shareholder, who must hold at least 25% of its registered capital. This main shareholder have at least RMB300 million of registered capital and must have operated in the securities and assets management industry for three full years, with sound corporate governance and internal control systems. In addition, it must show "good business results" (meaning it made profits over a three-year period), and it must have no record of violating laws or regulations in the past three years.

Only fund management companies approved by the CSRC may establish and manage funds. However, as a result of the Banking Act and Insurance Act revisions at the end of 2004, banks and insurance companies were allowed to establish fund management companies. Prior to this, bank and insurance companies were not allowed to invest in fund management companies. At least five banks and insurance companies were considering establishing fund management companies within a year. Likewise the "1+1" rule in China is still implemented. Under this rule, each financial institution is banned from investing in more than two fund management companies and can be in controlling position in only one of them.

By the end of 2004, there were 161 funds in China. One hundred seven (107) of these were open-ended funds. Among the open-end funds, 70 were equity type with a combined AUM or RMB 139.7 billion (or 53 percent of the total AUM of open-end funds). Nine out of the 161 funds were MMFs, which were the second largest, having a combined AUM of RMB 63.3 billion or 26 percent. Reflecting the recent performance of Chinese stocks, there was a huge inflow into 2005. As estimated, the AUM of MMFs would double during the first half of 2005.

TABLE-CH4. TYPES OF FUNDS, AS OF END-2004

	Number	AUM (RMB billion)	Share in the Total (%)
Equity-type bond	70	139.7	57.3
Bond-type fund	15	8.3	3.4
Index Fund	8	19.3	7.9
MMFs	9	63.3	26.0
Others*	5	13.1	5.4
Total	107	243.7	100.0

*Note: *Guaranteed Funds are included in this category*
Source: Mutual Funds Research & Evaluation Center HSBC Asset Management.

On December 31 2005, there were 218 funds in China (compared with 110 at end-2003), among which 54 were closed-ended funds and 164 were open-ended funds. Fifty-two (compared to 34 at end-2003) management companies managed these funds. The aggregate net assets value of the assets under management was RMB470 billion, representing about a quarter of the total market capitalization on the Shanghai and Shenzhen stock exchanges, a figure to be compared with the RMB170 billion recorded at end-2003 and RMB6 billion at the end of 1997. Since 2002 and the approval of the first Sino-foreign joint venture fund management company, foreign institutions have rushed in the industry. There were 20 joint venture fund management companies in China at the end of 2005, compared to 13 at end-2004. Although the largest fund management companies so far remain purely domestic companies, the Sino-foreign joint venture companies are catching up, bringing their expertise to an industry that lacks skilled and experienced fund managers.

6. Conclusions and Recommendations

The People's Republic of China will progressively rely on the development of its capital markets to stimulate its economic growth. Despite the great potential for China's capital market, there is still room for improvement at this point.

First, the Chinese government should still make an assessment of their current laws and regulations. In particular, the laws and regulations governing the capital market should be further strengthened, and a comparatively perfected legal system concerning securities regulations focusing on the Securities Law of the People's Republic of China must be formed to provide a solid legal foundation for the standardized development and administration by law of the securities market. The securities market, with the supervision and administration being further strengthened, shall meet with its standardized development. Chinese authorities are willing to restructure and develop the securities markets to make them a main element in financing the Chinese economy, in contrast to bank lending which remains rather inefficient and scarce. From this perspective, they will certainly continue to promote the development of the fund management industry, as they view it as a safe and controlled way to direct billions of domestic savings towards Chinese companies. Foreign investors and international financial firms are now ready to play in this game and their efforts to enter such an enormous market will certainly redouble in 2006.

Second, there are fewer investable products. China's fund management houses have very limited means by which to invest their funds. There are only bonds and equities as the main asset classes, with no foreign currency trading. There are limited markets for currency and interest rate derivatives as well, given strict controls on foreign-exchange transactions on the capital account. No options are traded. Swaps are available from foreign banks only for foreign currencies. More sophisticated derivatives are not traded in China. In an interview with Mr. James Walker, a fund-management expert based in Hong Kong, he pointed out that it's now possible to have some derivative products. He believes that foreign fund managers could use derivatives to try and reduce the sort of risk of a decreasing stock market. Further, they can use the derivatives to hedge against such risk to some extent.

Finally, performance of Chinese partners needs improvement. Some of the partners that foreign fund managers have joint venture with, particularly the subsidiaries of securities companies, have had some difficulties according to Mr. Walker. In particular, foreign partners need to ask themselves if they are willing to accept partial ownership, and not full control, of the new joint ventures. To begin with, foreigners need to cultivate good relationships with China in order to identify and secure the right partners and widen their sourcing networks in the light of their own needs and limitations.

China remains a huge market in all aspects including the opportunities for grab in the asset management industry. At this point, it is quite difficult for China to compete with rather more aggressive players like Korea and Singapore including the United States and the United Kingdom. As a lucrative host for asset management players, China enjoys a rather high bargaining leverage especially among potential entrants, as its government imposes almost everything and every move a new business player may attempt. For instance, its product development, competition policies among suppliers, regulatory issues and other market structure changes are still highly dependent on government initiative and mood.

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JAPAN

1. COUNTRY MACROECONOMIC PERFORMANCE

The Japanese economy appears healthier and regaining forward momentum for a strong recovery than it was in the 1990's when it's average annual growth rate was around only 1%, mild deflation persist but not as destructive as prior years, and a more buoyant consumer demand.

In the 1990s, Japan's economy experienced prolonged recessions since the burst of "bubble" economy. The term "bubble" economy refers to a period when the growth of Japan's money supply fueled massive increases in land and equity prices particularly in the years from 1987 to 1990. Furthermore, after the bursting of the "bubble", Japan's economy experienced slight recovery in 1995 and 1996: real GDP grew 1.5% in 1995 and 3.9% in 1996. In spite of this minor improvement, beginning March 1997, the economy fell into a recession again. Japan's economy experienced a severe condition in the middle of 1998 referred to as a "recessionary vicious cycle". The circumstance was extremely exacerbated by several critical factors such as: critical bad debt problems in the financial sector; increased consumption tax rate from 3% to 5% with constrained fiscal expenditures; the Asian financial crisis; yen depreciation; and the Japanese banks being required premium for LIBOR.

As a result, Japan's real GDP edged downward at the rate –0.7%, and continued downward over April 1998 to March 1999 at the annual rate of –2.4%. Japan's unemployment rate in March 1999 was at the postwar high of 4.6%, compared to 2.9% in 1994. Prices in Japan were showing signs of mild deflation, less than 1%, based on the GDP deflator. Japan's economy is actually on the threshold of the "deflation spiral", which has not happened in the world since the World War II [Koshiba et.al, 2001]. To alleviate the economic instability in 1997 and 1998, the government resorted to extremely expansionary fiscal policy and a structural reform in the financial sector. The growth rate of real GDP was 1.6% in 1997, -2.5% in 1998, 0.2% in 1999, and 1.4% in 2000, based on IMF estimates. The underlying reason for low growth of government spending would be suggestive of the economy's lack of effective aggregated demand.

However, vulnerability recurred in 2002 when a special examination by the supervisory agency found more nonperforming loans (NPL) and with stock prices declining sharply in 2001 and 2002 [Japan Conference, 2002]. Japanese banks were struggling to survive, as writing off NPLs and unrealized losses from equity holdings had exhausted their capital. The government debt-GDP ratio has reached 140%, the worst among the Group of Seven, and government bonds are credit-rated below

Botswana. Many financial institutions hold massive amount of NPLs while borrowers are suffering the deadweight of debt, aggravating the already depressed economic condition in Japan.

Adding to such economic condition is the fact that deflation has persisted in Japan since 1997. Deflation plays destruction with corporate balance sheets since it raises the real value of debt and erodes the value of collateral. Even though nominal interest rates are near zero, Japanese real interest rates are too high. Deflation at the same time discourages investment. Because of the very low nominal interest rates, this state in the financial market causes delays in crucial decisions for lenders. By the time a borrower defaults on its interest payments, the deterioration of the business is often so far advanced that reviving the business is impossible, making the NPL problem worse.

Many things affect deflation: excess capacity, changes in oil prices, and changes in taxes. But fundamentally, inflation is a monetary phenomenon. To cure this dilemma, the Bank of Japan in March 2001, began its current policy of increasing the growth rate of the monetary base, the part of the money supply that is under direct control of the central bank. Since this new policy was adopted, the monetary base has increased by a cumulative 68%, or at an average 24 % per year [Taylor Press Release, 2003]. The government came up with four measures to fight deflation. First, stimulate the economy through tax reform. Second, stimulate demand with a supplementary budget, while expanding the safety net for the unemployed and small and medium enterprises. Third, create new demand in the private sector through deregulation. And four, ease the Bank of Japan's monetary policy.[4]

Japan’s industry recovered in 2004 after suffering from seemingly long period of recession. The country has been able to reduce the large amounts of NPLs that plagued the economy since the early 1990s. However, there were news that even if consumer spending and GDP in the latter part of 2004 indicates recovery, Japan is still not firmly in place after almost 14 years of declining, stagnant, or low growth [Cargil, 2005]. In the first quarter of 2005, economic activity rebounded sharply. GDP increase amounted to 4.9 % SAAR (small and rapid response) in part demonstrating temporary factors such as a bounce-back in private consumption following a weather-related weak previous quarter. Recent indicators such as industrial production, retail sales, and foreign machinery orders continue to expand. The current account surplus rose further to US$180 billion at annual rates. Export growth remained sluggish, and import demand weakened; the balances on non-factor services and investment income improved significantly but mild deflation still persisted. Core inflation (which excludes fresh food) was -0.2% in April 2005, close to the estimated underlying rate of deflation, net of temporary factors [IMF Country Report, 2005].

[4] This was taken from a 2002 speech by Osamu Watanabe.

To date, Bloomberg Asia.com reports that Japan's economy grew faster than economists projected in the first quarter of 2006 while consumers and companies spent more. The world's second-largest economy expanded at an annual 1.9% pace in the three months ended March. The yen gained to reach 110.57 per dollar from 110.76 while Japan's economy grew 3%. Consumer spending rose 0.4 percent in the first quarter, compared with economists' expectations for a 0.1 percent gain [Bloomberg Asia.com, 2006].

2. NON-PERFORMING LOANS PROBLEM

After the collapse of the asset-inflated economic bubble in the early 1990s, a chain of management failures of banks, securities and insurance companies shook the Japanese economy to its foundation. Private financial institutions were strained by massive NPLs. Disposal of these bad loans and implementation of drastic financial reforms have become the major issues facing Japan's devastated financial system.

BAD LOAN PROBLEM

The problems posed by NPLs in Japan have prompted many reactions. Most of them argue that the disposal of NPLs will not necessarily improve the economy while others argued that the large amount of NPLs (so called bad loans) held by Japanese financial institutions lies at the heart of Japan's ongoing economic stagnation. And others say that Japanese banks - even if they manage to clean up NPLs - have no future unless they quickly find a new business model to rid them of their current low profitability.

Japanese banks suffered from bad loans during the financial "bubble" era for the reason that businesses that had previously borrowed money were no longer able to pay back their loans. A bad loan is one where payment has been suspended or renegotiated. On average, repayment on these loans has been about 12% of the original amount. Hence, banks would bear significant losses if they wrote the debt off. The origins of the bad loans are seen in a continued decline in real estate and stock prices, which followed the real estate and stock market collapse of 1991. As some borrowers could not repay their obligations towards the banks, the banks were reluctant to liquidate the loans through the sale of collateral (mostly real estate), since the recovered amount would fall short of the original loan, and result in significant losses [Barseghyan, 2006]. Many Japanese banks have delayed the recognition of such non-performing loans, unlike the U.S. banks, which quickly wrote-off their non-performing loans in the early 1980s. Sumitomo Bank took the lead in March 1995 to write off its NPLs.

Since then, top Japanese banks have begun to write off bad loans, voluntarily following Sumitomo, albeit with strong pressure from the investment community. In theory, Japanese banks need to write off such loans and regain some of their money by taking over the collateral they accepted as a security for the loans when they were first made. The Japanese banks' main reasons for hesitating to write-off NPLs can be attributed to the following: the Ministry of Finance's indecisiveness in recognizing and addressing the non-performing loan problem; the Japanese tax system does not permit tax deductions for write-offs; and insufficient capital for banks to write-off the loans [Herr and Miyazaki, 1999].

DEFINITIONS OF NPLS

The NPL problem is divided into different categories including "loans on which interest payments are in arrears by a financially distressed state of borrowing firms" and "loans which are unrecoverable". These bad debts consist of three kinds of non-performing loans: risk management loans, loans by assets assessment based on the Financial Reorganization Law, and loans by self-assessment. There are differences in purpose, object loans, division methods, and reserve cover ratio, and so on among these non-performing loans [Hoshino, 2002].

Definitions of NPLs have often been the source of confusion because there are at least three definitions that are referred to and these definitions have changed over time. In particular, risk management loans and loans disclosed under the Financial Reconstruction Law (FRL) classification are officially published NPLs in the sense that they are based on the criteria specified by a law or bylaw. Although they have different breakdowns, their two definitions broadly coincide, and hence produce similar figures for outstanding loans. Whereas, loans subject to self-assessment are classified, depending upon borrower creditworthiness, in line with guidelines (the "Inspection Manual") produced by the Financial Services Agency (FSA) [Inaba et.al, 2005].

ESCALATING NPLS

The problem is compounded by a rise in nonperforming commercial loans associated with prolonged recession and weak recovery. And it is further combined by the fact that Japanese banks' large equity holdings suffered as the Japanese stock market fell. The Nikkei 225 stock price index reached its peak at 38,915 on the last business day of 1989, and then tumbled to below 15,000 by the summer of 1992 [Hutchison, 1997].

The Bank of Japan Quarterly Bulletin [2002] reported that Japanese banks have disposed of more than 90 trillion yen in NPLs since 1990. Nonetheless, NPLs continue to be the most undermining factor in Japan's financial system. **Table-JP1** illustrates that the cumulative amount of All Banks' NPL disposal (cost of loan-loss provisioning, loan write-offs, and others) stood at about 90 trillion yen. This is equivalent to about 80 percent of the increase in loans during the late 1980s (1986 through 1990) or about 110 trillion yen (about 40 trillion yen of which is for construction, real estate, and finance companies).

TABLE-JPY1. DISPOSAL OF NONPERFORMING LOANS

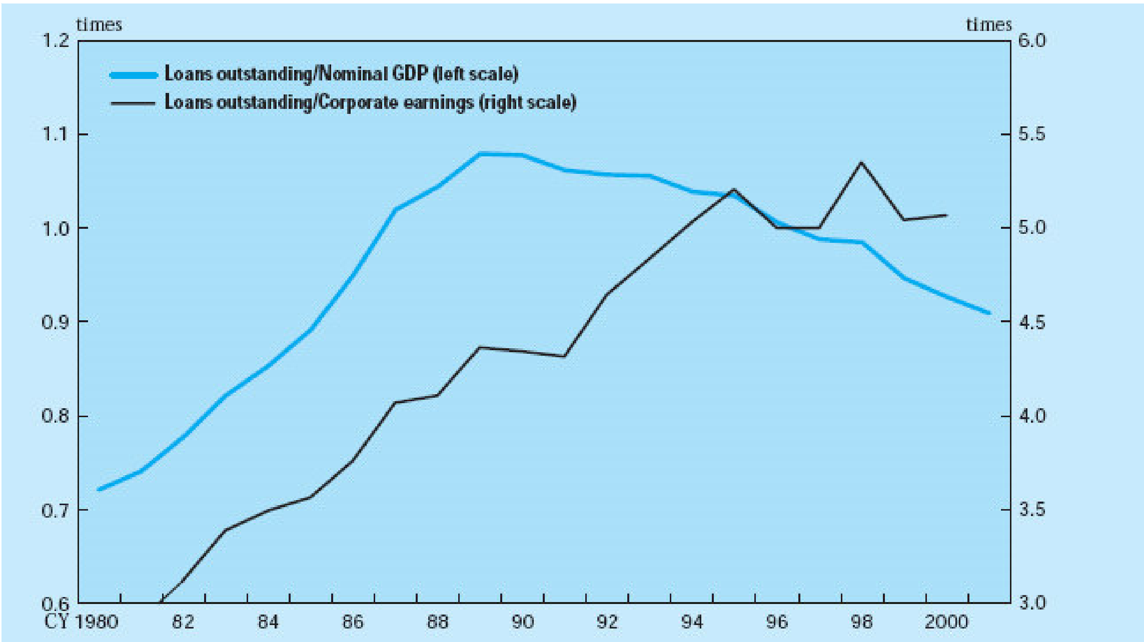
tril. yen

Fiscal year	1992	93	94	95	96	97	98	99	2000	01	Total
All Banks[1]	1.6	3.9	5.2	13.4	7.8	13.3	13.6	6.9	6.1	9.7	81.5[2]
City banks, long-term credit banks, and trust banks	1.6	3.9	5.2	11.1	6.2	10.8	10.4	5.4	4.3	7.7	66.7

Notes: *1.* The figures for All Banks from fiscal 1992 through 1994 are only for city banks, long-term credit banks, and trust banks.
2. Including disposal of NPLs by bankrupt banks, disposal of NPLs from fiscal 1992 through 2001 amounted to about 90 trillion yen on a cumulative basis.

Source: Bank of Japan

FIGURE-JPY1. RATIO OF LOANS OUTSTANDING TO NOMINAL GDP



Note: *1.* "Corporate earnings" is operating surplus in the National Accounts.

Source: Bank of Japan

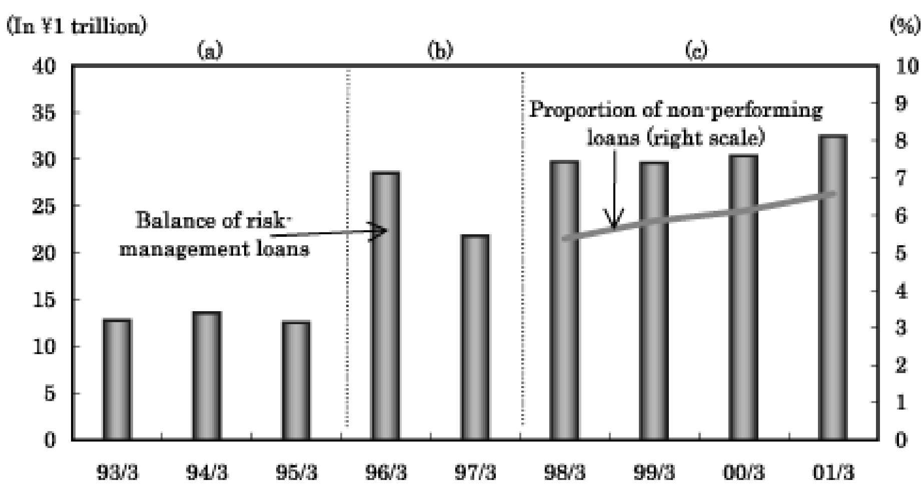
The ratio of loans outstanding to nominal GDP peaked in 1989 at 1.1 times, declining since then to 0.9 times at present, which is a level observed before the bubble period while the ratio of loans outstanding to corporate earning still remains high. **Figure-JP1** suggests that it has become difficult to explain why a substantial amount of new NPLs continues to be generated solely by the bursting of the bubble.

The Annual Report on Japan's Economy and Public Finance (2000-2001) reported that the outstanding balance of NPLs held by Japanese banks, as measured by the outstanding balance of "risk-management loans" of all banks, is also rising. Even after the definition of risk-management loans was revised to its present definition, in the year ending in March 1998, non-performing loans have remained at the high level of around ¥30 trillion and hit an all-time high of about ¥32.5 trillion in the year ending in March 2001. During this period, the proportion of non-performing loans (risk-management loans / total loans) has also been increasing and hit 6.6% in the same period.

By comparison, the proportion of non-performing loans of U.S. commercial banks has stayed at around 1% in recent years. The total risk-management loans of "deposit-taking institutions," including *shinkin banks* (credit associations) and credit cooperatives, amounted to ¥43.4 trillion in the year ending March 2001.

Many have observed that the NPLs of Japanese banks continue to increase for more than 10 years since the collapse of the bubble economy. In the Annual Report on Japan's Economy and Public Finance (2000-2001), the government of Japan cited that the factors that increased NPLs are: the definition of NPLs (what should be included in NPLs) was expanded gradually until the year ending in March 1998; and the pace of banks' move to clear their non-performing loans off their balance sheets (by such means as legal liquidation) and credit waiver was slower than the pace of the incidence of fresh non-performing loans. Incidentally, clearing NPLs off one's balance sheets is also called "final disposal" or "clearing off balance sheet" of non-performing loans

FIGURE-JPY2. CHANGES OF NON PERFORMING LOANS



Source: Compiled from Financial Services Agency materials.
Notes: 1. The definition of risk-management loans differs depending on the period: (a) from FY 1992 to FY 1994, (b) from FY 1995 to FY 1996, and (c) from FY 1997 onward.
2. Before March 1995, only debts of city banks, long-term credit banks and trust banks were counted.
3. Proportion of non-performing loans is non-performing loans / total loans.

3. MEANS OF RESOLVING THE NPL PROBLEM

EVALUATION OF NPLS

To deal with NPLs, the Bank of Japan Quarterly Report (2002) suggested that Japanese banks should begin with an appropriate assessment of their economic value. The outstanding classified assets under the Financial Reconstruction Law, which are often used to express the size of NPLs, include loans already provisioned for and cover a portion of loans that are already secured by collateral. Concurrently, the economic value of some so-called “other loans needing attention,” not included in outstanding classified assets, might have depreciated. Therefore, in evaluating the degree of the NPL problem, banks should review the reduced economic value of the loans, and focus on the portion of such loans that are not provisioned for, i.e., the net amount which needs to be disposed of.

In September 2002, Mr. Hakuo Yangisawa, Minister for Financial Services of Japan have elaborated Japan’s policy and measures for disposal of NPls. The first step performed by the Ministry of Financial Services in Japan was to take measures for more meticulous assessment of NPLs and strict provisioning. The second step involved measures taken to accelerate further removal of non-performing loans from banks' balance sheets. These measures were intended to encourage major banks to remove the existing loans extended to borrowers who had been classified as "in danger of bankruptcy or below", within the subsequent two business years, and those newly classified as such within the following three business years. The third point was about the expansion of the operational range of the Resolution and Collection Corporation (RCC). The original mandate of the RCC, unlike the Resolution Trust Corporation (RTC) of the United States, was assigned mainly for debt collection. The Diet, however, amended a law in active collaboration with the government to enhance the function of RCC and its capabilities.

DISPOSAL OF NON-PERFORMING LOANS

According to the Bank of Japan (2001), the banking industry’s net profits have grown only minimally after the collapse of the bubble economy. The banks suffered a net loss in FY 1995, 1997 and 1998. A comparison of net business profits with the amount of non-performing loans disposed shows that banks were unable to cover the costs for NPL disposal for seven consecutive years since 1994. Banks had to dispose of a large amount of non-performing loans after the collapse of the bubble economy because of new non-performing loans encountered by the industry and a decline in the value of collateral caused by falling land prices. **Figure-JP3** shows that the banks net profits deteriorated with a number of them virtually ending in the red. The term “virtually in the red" means that the amount of non-performing loans disposed were larger than the banks' net business profits.

If the amount of non-performing loans disposed continues to exceed banks' net business profits, banks will continue to suffer large net losses. Banks must dispose of non-performing loans as early as possible and dispel market concerns about a sharp increase in non-performing loans and a delay in the disposal of these same. The Bank of Japan recommended that banks should speed up NPL disposition to corporate borrowers, particularly those whose business performance is not expected to improve and ascertain losses by utilizing private/legal liquidation or selling the non-performing loans to the Resolution and Collection Corporation (RCC) as set forth in the Basic Policies and the Front-Loaded Reform Program. Furthermore, it is important to promote measures focused on restructuring/rehabilitation of borrowers from the standpoint of turning non-performing loans into sound loans and preventing the incidence of fresh non-performing loans.

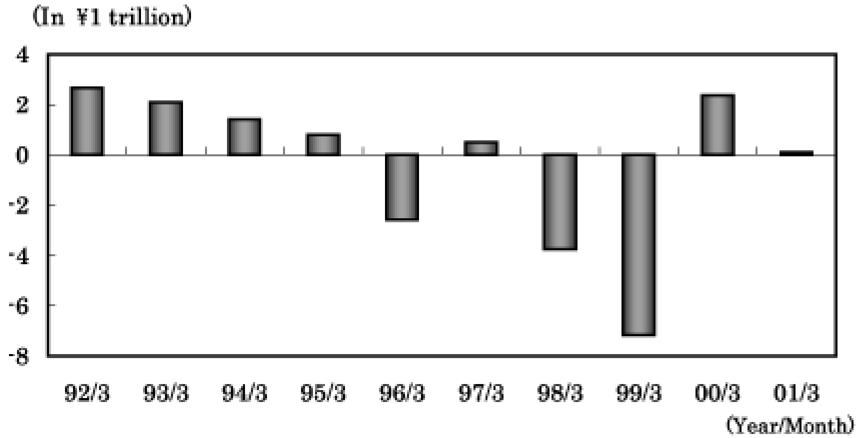
STRATEGIES FOR DISPOSING NON-PERFORMING LOANS

A comprehensive approach is required to resolve the NPL problem in Japan. The creation of the Resolution and Collection Corporation (RCC), as patterned after the U.S. Resolution Trust Corporation (RTC) (complete word) initiative, was aimed at purchasing NPLs from Japanese banks. It is a full subsidiary of the Deposit Insurance Corporation of Japan (DICJ) through the merger of the Housing Loan Administration Corporation (HLAC) and the Resolution Collection Bank in 1998. Its mandate includes**:** to recover loans from Jusen (a housing loan corporation, a non government entity); to collect NPLs from failed institutions; to collect NPLs from sound financial institutions; and to subscribe shares to enhance the capital adequacy of financial institutions [Chen, 2003].

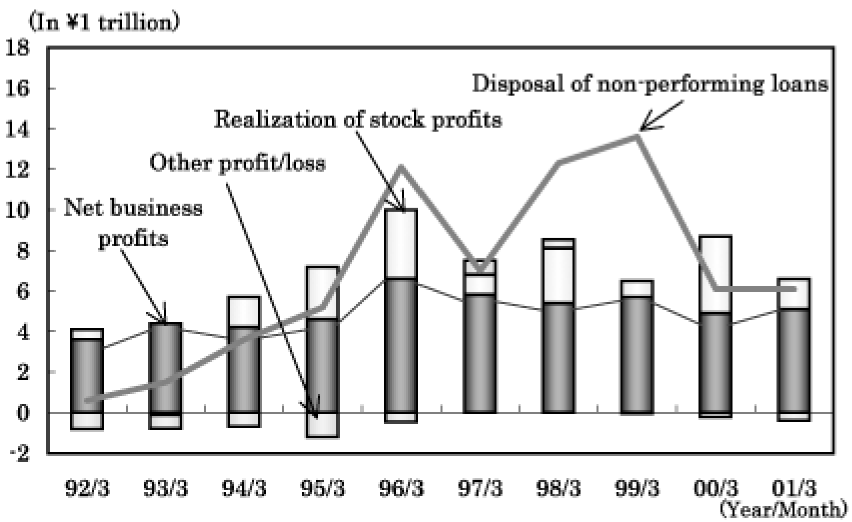
In 2002, the Ministry of Foreign Affairs of Japan reported several prospects for an early resolution of the NPL problem. These prospects are as follows: rigorously implementing special inspections, further accelerating the disposal of NPLs, actively purchasing asset by RCC, and promoting the establishment of corporate reconstruction funds.

The disposal of NPLs was to be accelerated by selling the assets to RCC and actively utilizing corporate reconstruction funds. The Deposit Insurance Corporation and the RCC shall actively purchase non-performing loans using various means, including the assets-in-trust method and utilization of corporate reconstruction funds. Moreover, a "headquarters for the promotion of the asset purchase" (a tentative name) shall be established in the RCC in order to actively engage in the acquisitions.

FIGURE-JPY3. CHANGES OF BANK PROFITABILITY
(NET PROFITS DETERIORATING)



Loss on disposal of non-performing loans exceeding net business profits



Source: Developments in Profits and Balance Sheets of Japanese Banks in Fiscal 2000 and Banks Management Tasks, Bank of Japan

Notes: 1. Net profits are based on all banks and pretax, etc.
2. Net business profits exclude bad debt disposal expenses (overall allowance for credit losses and write-offs in trust accounts).

In view of the recent revision to the Financial Reconstruction Law, the Deposit Insurance Corporation and the RCC are obliged set appropriate prices whereby non-performing loans are to be purchased at market prices. As a provision against possible secondary losses, collection profits generated by Article 53 of acquisitions is to be appropriated to a fund (Market-Price Acquisitions Fund) and utilized for the effective implementation of acquisitions at market prices. In order to ensure the smooth purchase of non-performing loans, the Deposit Insurance Corporation and the RCC shall adjust their use of Article 53 acquisitions scheme.

ADVANCES AND DEVELOPMENTS

The effect of these measures was clearly became manifest in the major banks' statement of accounts and the prospects of their financial conditions announced at the beginning of January 2004. Prime Minister Koizumi Junichiro stated in his policy address to the Diet that, "*The total amount of nonperforming loans of major banks has fallen by more than ¥9 trillion [$81.8 billion at ¥110 to the dollar] over the past 18 months, and the nonperforming loan ratio is also steadily decreasing toward the target figure."* The nation's goal is to reduce by half the amount of nonperforming loans as a percentage of all loans from March 2002 to March 2005, and Koizumi expressed confidence that this goal will be met. In addition, he pledged that "the nonperforming loan issue will be resolved in fiscal 2004 [April 2004-March 2005]."

As of the end of September 2003, the average ratio of nonperforming loans as a percentage of total loans of the six major banking groups was 6.5%, a drop from the level of 8.3% recorded at the end of March 2003 [Web Japan Online, 2004].

In August 2005, the International Monetary Fund reported that further advances also have been made in strengthening the banking system. Tightened regulation of major banks under the Program for Financial Revival (PFR), together with corporate sector improvements, have reduced nonperforming loans (NPLs) and supported ratings upgrades. The total amount of NPLs of all banks based on the definition in the FRL as of end-March 2005 is 17.9 trillion yen. The figure decreased by 8.7 trillion yen from 26.6 trillion yen as of end-March 2004.

FIGURE-JP4. NPLS AND RATIO OF NPLS TO TOTAL LOANS

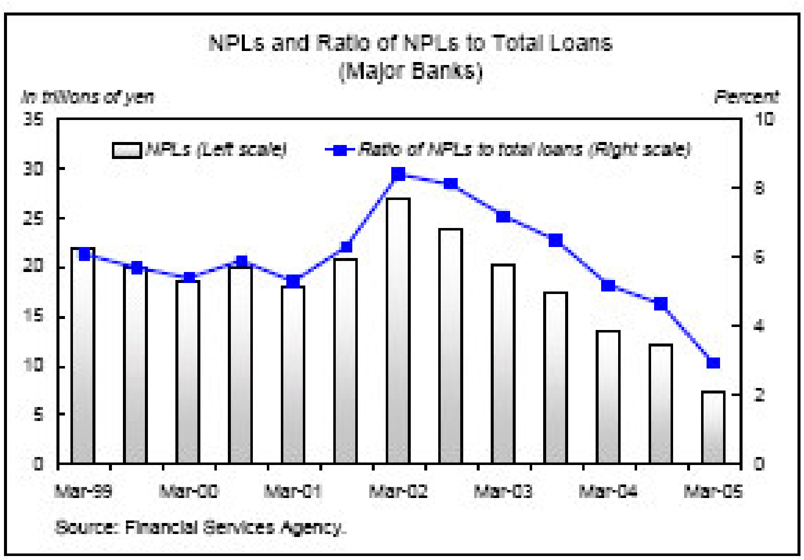


Figure-JP4 demonstrates the result of an improved soundness of bank loans, owing to improvement of some borrowers' business conditions and the progress of corporate revitalization. The total amount of bank loans classified as "special attention" decreased by 5.2 trillion yen, while there has been some newly generated loans due to borrowers' weakened business conditions.

Currently major banks have more than met the PFR's goal of halving the NPL ratio to around 4% by the program's expiration in March 2005. The pace of decline in bank lending has slowed and, according to the Tankan survey, borrowers perceive an increased willingness to lend. In addition, the blanket guarantee on bank deposits was lifted at end-March, with no signs of strain. Regional banks, which have been subject to a less rigorous action plan than major banks, have also made progress, albeit more slowly, in cutting bad loans. Nonetheless, the process of revitalizing the banking system has further to go. The quality of bank capital is weakened by deferred tax assets (DTAs), which have fallen steadily but still account for about a fourth of major banks' Tier 1 capital. Core profitability remains low, leaving banks vulnerable to shocks and ill positioned to perform effective financial intermediation.

4. JAPAN'S CAPITAL MARKET

Since the early 1990s, promotion of the capital market has been one of the major financial policy issues in Japan with the prolonged financial crisis [Sectional Committee on Financial System, Financial System Council, 2003]. The role of a capital market is to link the funding needs of firms and households with the needs of investors, and thus realize efficient fund allocation. Forces of supply and demand in the market determine interest rates, essentially the price of funds. As a market expands, various participants enter and market prices are determined more efficiently, resulting in more efficient fund allocation. Banks should also play a role as financial intermediary between fund-raisers and depositors by accepting deposits and extending loans. Since banks are still saddled with NPLs, the role of capital markets has become especially important [Hayami, 2002].

A report entitled "Japan's Non-performing Loan Problem," published by the Bank of Japan in October 2002, advocated comprehensive measures in order to overcome the NPL problem, including a prompt grasp of the economic value of such loans, the promotion of their prompt disposal, and improvement in the earning power of both borrowing firms and banks. Subsequently, the Financial Services Agency (FSA) formulated its Program for Financial Revival and, on November 29 of the same year FSA announced a timetable. Taking into account such developments with respect to the NPL problem, banks have been vigorously striving to strengthen their management base by focusing on the prompt disposal of NPLs and an improvement in earning power.

Banks and capital markets are complementary - capital markets are expected to substitute for the role of banks in the event banks are faced with problems. In addition to direct funding measures such as corporate debentures and CP, recent developments in financial technology have facilitated the securitization and liquidation of loan assets into forms in line with investor needs [Ibid.].

CAPITAL MARKETS "BIG BANG" PLAN

In November 1996, the Japanese government introduced its Big Bang plan, a major plan that drastically reforms the financial and capital markets through significant revisions to laws such as the Securities and Exchange Law. In April 1998, foreign exchange controls were completely dismantled and at the end of 1998 the Financial System Reform Law was passed. Major elements of the reform program for the financial sector included the liberalization of new products and increased diversity of investment trust schemes, the development of capital markets, the dismantling of barriers between financial sub-sectors, the enhancement of market efficiency, and the creation of rules to prevent unfair transactions.[5]

The capital market reforms consist of five key goals.[6] The first was to provide greater investment opportunities, diversification of investment trust products, allowing banks and insurance companies to market investment trusts over-the-counter, liberalizing trading in securities derivatives, and to make stock investment more attractive. The second key goal of the reforms was to facilitate corporate financing.

A third key goal was to encourage the provision of more diversified services. In order to accomplish this latter, brokerage commissions were liberalized, the licensing of securities companies was replaced by having registration requirements, and other liberalization measures to allow new entrants into securities related businesses. The fourth goal is to make markets more efficient. Stock exchange markets were being reformed, the consolidation requirement for order flows of listed securities was abolished, proprietary trading systems were introduced, and both the repo markets and settlement systems were being reformed.

It was expected that the Japanese Big Bang be completed by the end of March 2001. Unfortunately, system reforms for financial and capital markets are still continuing, including revisions of the Securities and Exchange Law and the taxation system of securities [Ozaki, 2005].

VARIOUS REFORMS IN THE CAPITAL MARKET

Since the Big Bang Program, series of reforms have followed in Japan's capital markets. In May 2000, the Securities and Exchange Law was amended with the stock exchange opened for-profit corporations as well as traditional mutually owned

[5] This information was sourced from the Creative Scientific Research Project 2003–2007.
[6] Sourced from the Roundtable on Capital Market Reforms in Asia Summary Report, 2000.

membership organizations. The process by which a stock exchange could demutualize was also mapped out. The Investment Trust Law was amended to enable new financial products, such as real estate investment trusts (REITs), to be developed. The Financial Services Agency's Program for structural reform of Japan's securities markets followed in August 2001. At this point, it became gradually clear that the capital market reforms that began with Japan's Big Bang were seen as helping to achieve one major historical goal –- redirecting the flow of money in the economy.

In August 2002, as a follow-up to the Structural Reform Program, a Program for Expediting Reform of Japan's Securities Markets was announced. This Program is a basis for a more detailed discussion by the Financial System Council and the drafting of amendments to existing laws. The following year, 2003, more radical reforms transpired such as the introduction of a system of "securities intermediaries" (i.e., stockbroker agents) and the go-ahead for foreign stock exchanges to install trading terminals in Japan.

Finally, in 2004, the enactment of amendments to the Securities and Exchange Law took place. Such enactment will allow banks to act as agents for stockbrokers and at the same time abolished Article 37 of the Securities and Exchange Law[7], require stockbrokers to execute orders on the best terms for their clients, and impose fines for irregular trading activity and inadequate disclosure.

It has been more than four years since Japan's Big Bang program was fully implemented and the country's capital markets appear to have acquired a comprehensive institutional framework. The desired effect will not be achieved unless those in authority discard their authoritarian ways of thinking. To use a well-worn saying, it might be said of Japan's capital markets that, although the field has been ploughed, there is still a risk that the farmer may forget to sow the seed [Ozaki, 2005].

5. JAPAN'S ASSET MANAGEMENT INDUSTRY

Japanese investors have been increasing investments by means of the investment vehicle "funds". Asset flows have been increasing into "hedge funds" and "investment trusts". Regarding hedge funds, financial authorities including central banks have made efforts to comprehend the realities of hedge fund activities because their impacts on financial markets and market participants have become more significant.

INVESTMENT TRUST INDUSTRY IN JAPAN

The Securities Investment Trust Law of 1951 allowed Japanese investment trust business to return from the turmoil of Japan's post-war and, at the same time, created

[7] This requires any stockbroker wishing to execute an order to buy or sell listed shares off the exchange to obtain the express permission of the investor concerned in advance.

the Trust Law, a legal framework for regulated, professional money management for the benefit of small investors. The investment trust industry developed along with the dramatic expansion of the Japanese stock market over the following decades [Brown et.al., 1997].

Japanese investment trusts shares are sold as financial contracts between management companies and individual investors. It falls into two major classifications depending on whether common stocks can or cannot be held in portfolios, comprised of equity funds and bond funds. Each of these funds has another type of classification depending on transaction procedures or possibilities of an open-type and unit-type fund.

UNIT-TYPE AND OPEN-TYPE FUNDS

The Japanese ”unit-type”, does not allow investors to contribute additional funds because of its specific savings-oriented nature. Although these funds offer cancellation and redemption rights in theory, most of them do not allow investors to exercise these rights during certain periods, typically 2 or 3 years after their establishment. Open-type funds, as normally referred to internationally, means open-end investment vehicles. Such investment funds have variable (i.e., fluctuating) capital. UK unit trusts, UCITS in the European Union and most US mutual funds fall into this category. In Japan, on the other hand, although there are certain funds similar to such open-end vehicles, such funds are referred to an ”open-type” in order to directly indicate their nature. Namely, the term”open” is used as a concept in contrast to the”unit” which is peculiar to Japan. In recent years,”open-type” funds have become more common than the ”unit-type” which was previously the principal type of investment trust. Both unit-type and open-type funds may be further divided into stock investment trusts and bond investment trusts based on their investment objectives. Bond investment trusts are limited to investing in bonds while stock investment trusts may invest in both stocks and bonds [Price Water House Coopers, 2002].

PRIVATE-EQUITY FUNDS

Private-equity funds are entities that buy illiquid stakes in privately held companies, sometimes by participating in leveraged buyouts. The vehicles are structured as private investment partnerships in which only qualified investors may participate. Such funds typically charge a management fee of 1.5% to 2.5%, as well as an incentive fee of 25% to 30%. Most private-equity funds employ lock-up periods of five to ten years, longer than those of hedge funds.[8]

Japanese investors in particular among institutional investors are very fond of buyout funds, turnaround funds and other private equity funds. Such funds often use a limited

[8] Taken from http://www.venturejapan.com.

partnership, domestic or foreign, as their vehicle of choice from the perspectives of management, regulations, taxation and others. However, a domestic limited partnership is subject to certain investment restrictions promulgated under its governing law. From December 2004 the interests in such partnerships became securities regulated under the Securities and Exchange Law (SEL), and therefore are usually offered on a private placement basis (to a small number of offerees or limited to institutional investors) if certain requirements are met. The general partner of the fund is deemed as the issuer of partnership interests, and may offer them without a securities broker license under the SEL. In addition, if certain requirements are met, the general partner is exempted from the license requirements under the Securities Investment Advisory Law (SIAL) when it manages the fund investment into securities [Igarashi et.al., 2006].

REAL ESTATE FUNDS

Real estate funds privately placed in Japan are often set up as "tokumei kumiai" (anonymous partnerships) under the commercial code, while real estate funds publicly offered are set up as investment companies under the Investment Trust and Investment Company Law (ITICL). Both funds now face strong demand from investors since investments in commercial buildings and residential real estate are very active in Japan. Private funds do not directly invest in real estate but through trust schemes in order to be exempted from burdensome requirements under real estate fund law. In December 2004, the interests in such funds also constitute securities under the SEL and satisfy private placement requirements for offering [Ibid.].

OFFSHORE FUNDS

In 1972, only Japanese securities investment trust could be sold in Japan. However, in 1973 securities companies were permitted to sell interests in offshore investment trusts. This move resulted from Japan's transformation into a creditor, based on its economic development and accumulation of foreign currencies. Furthermore, many investment trusts were launched abroad to invest in Japanese equities. These offshore investment trusts were launched in foreign countries, mainly Luxembourg, in accordance with their laws. They had been regulated by the SEL in Japan and not by the Securities Investment Trust Law (SITL).

With regard to the sale of offshore investment trusts, the Japan Securities Dealers Association (JSDA) provides rules. These rules provide eligible domiciles and, standards for selection of beneficiary certificates of offshore investment trust and standards for selection of foreign investment securities [Price Water House Coopers, 2002].

Over the last few years, the investment trust business in Japan has grown substantially. Assets of open-type equity funds grew 82% from January 1998 to their maximum value of ¥162 Trillion on May 2000, falling to ¥143 Trillion by the end of

2001, and a net increase of 58% over the entire period of 2001. In the period from January 1998 to January 2000, assets of open-type equity funds grew by 61% [Brown et.al., 2002].

At the end of 2004, the net assets of a publicly offered securities investment trust totaled JPY40.9 trillion. These included stock investment trusts, bond investment trusts, and money market funds (MMFs). Total net assets have recovered to the 1989 level (JPY58.6 trillion), the peak of the bubble economy, but net assets of stock investment trusts have decreased. The total net assets of stock investment trusts reached a high of JPY45.5 trillion at the end of 1989 but then steadily declined, falling to JPY9.9 trillion by the end of 1997. They finally bottomed out in 1998 and rose to JPY27.4 trillion by the end of 2004. In the case of bond investment trusts (excluding MMF), total net asset reached a record high of JPY23.8 trillion at the end of 2000 but fell to JPY9.9 trillion by the end of 2004 due to very low interest rates.

HEDGE FUNDS INDUSTRY OF JAPAN

Hedge fund industry is one of the alternative investment sectors and it has grown rapidly in recent years. According to Casey et.al. [2004], about five years ago, hedge funds gathered virtually all of their assets from wealthy individuals. However, hedge funds at present constitute a main investment vehicle for institutional investors, including endowments and foundations and pension funds as well as for wealthy individuals, particularly among the advanced economies.

The definition of hedge funds is extremely difficult to describe. Hedge funds have no clear definition not only in Japan but also in any other countries and international organizations. One commonly accepted definition of hedge fund is an investment vehicle organized as a private unregistered investment company, most often as a limited partnership, that enjoys considerably flexibility with respect to positions and instruments employed [Sanderson, 2006]. According to the MSCI Hedge Fund Indices, a hedge fund is an investment company that hedges at least 10% of its investment positions.

While in some public data and news source such as Hedge Fund Intelligence defines Asia-Pacific hedge funds as an entity charging performance and either located in the Asia-Pacific investing in any strategy or located outside of the region but investing specifically in Asia-Pacific financial instruments.[9]

For the purpose of this report, the definition of hedge fund was based on the study conducted by the Financial Services Agency (FSA) of Japan. It is a fact-finding survey on hedge funds in Japan and the findings was published in a report titled "Summary of Hedge Fund Survey Results and the Discussion Points" on December 13, 2005 (the English version was released on December 22, 2005). Hedge funds

[9] This was taken from the Hedge Fund Intelligence–Asia Hedge Website.

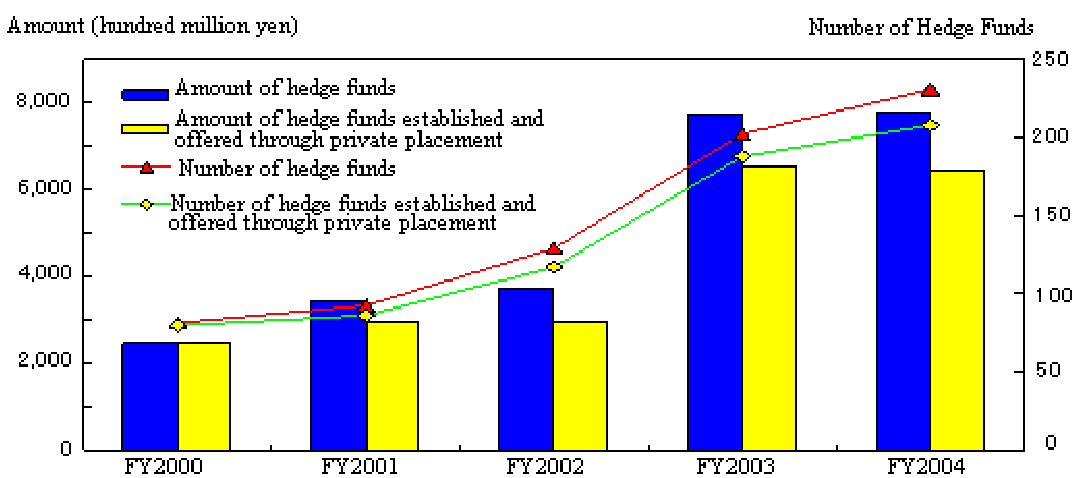
were defined as the funds (including funds of hedge funds or FOF) with the following three components in the Survey for the purpose of identifying the actual state of hedge funds in Japan as broadly as possible: (1) use of leverage; (2) charge of performance fee; and (3) use of hedge fund investment strategies. Considering that the number of publicly offered investment trusts with hedge fund strategies aimed at general (individual) investors established and sold has been increasing recently, FSA-Japan decided to cover both publicly offered funds and privately placed funds in their survey. Likewise, the interpretation of the definition of hedge funds was left to the respondents (financial institutions). As the interpretation might vary between the respondents, it should be noted that such variation might have affected the Survey results.

ESTABLISHMENTS OF HEDGE FUNDS

In fiscal 2003, established hedge funds substantially increased both in number and in amount, approaching ¥1 trillion in amount (as shown in **Figure-JP5**) while those established outside Japan account for approx. 40%. By country of establishment, hedge funds established in Japan accounted for 60% in amount, while those established in foreign countries such as the Cayman Islands and Ireland accounted for the remaining 40%. These countries were chosen because of lower establishment costs, etc. compared to Japan. Hedge funds offered through private placement accounted for more than 80% of all hedge funds in amount.

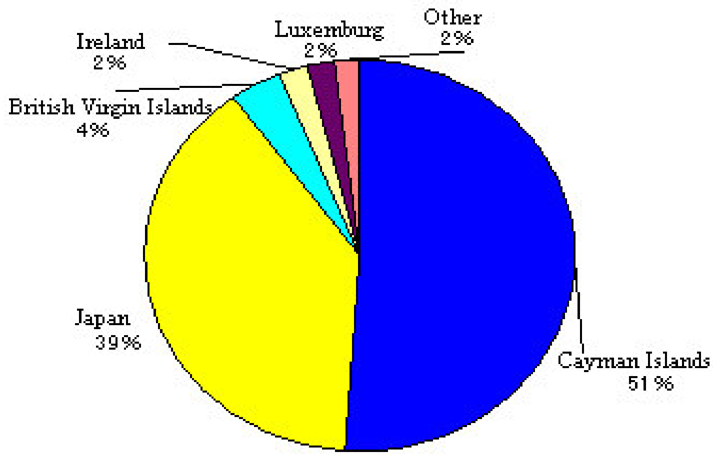
As for the breakdown of sales of hedge funds by country of establishment, **Figure-JP6** shows that approximately 40% of all hedge funds sold in Japan during the survey period were established in Japan, while the remaining 60% were established in foreign countries. In addition, 56% of hedge funds sold by domestic securities companies and 84% of hedge funds sold by foreign securities companies were established outside Japan.

FIGURE-JPY5. NUMBER AND AMOUNT OF HEDGE FUNDS ESTABLISHED



Source: FSA Newsletter 2006 – Summary of Hedge Fund Survey

FIGURE-JPY6. SALES OF HEDGE FUNDS BY COUNTRY OF ESTABLISHMENT



Source: FSA Newsletter 2006 – Summary of Hedge Fund Survey

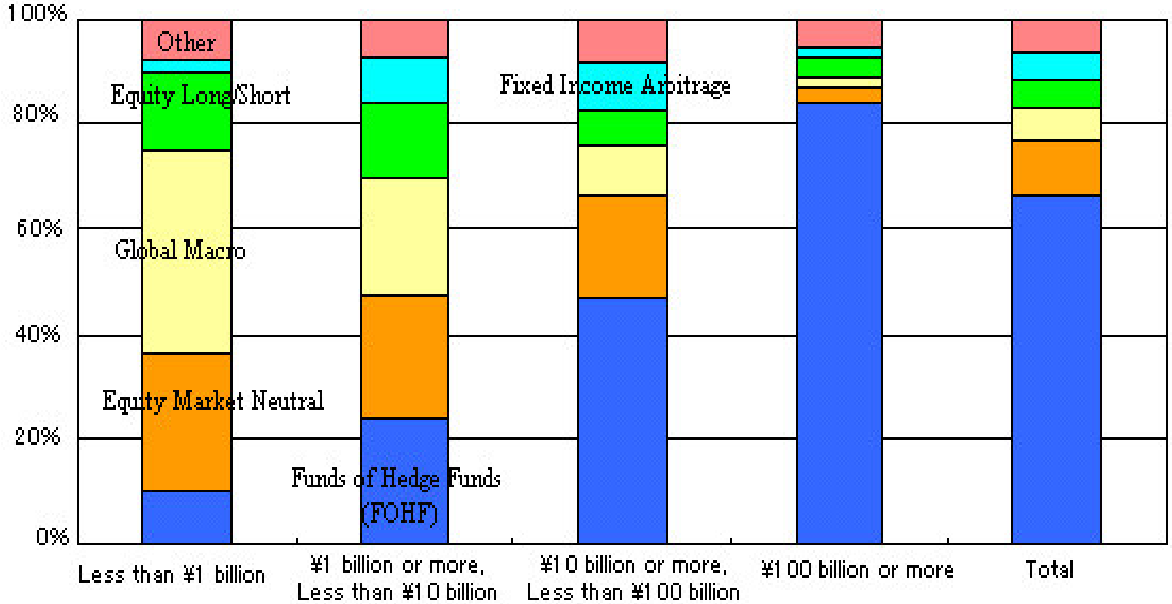
Figure-JP7 presents an important hint on how the FSA should deal with hedge funds. According to FSA-Survey, there will be difficulties involved in directly overseeing the hedge funds or hedge fund arrangers/managers themselves. Also, it will be indispensable to work with foreign authorities to accurately identify their activities to the extent needed. Alternatively, it will be necessary to oversee how financial institutions manage risks.

RISK OF INVESTING IN HEDGE FUNDS

In the past, hedge funds have generally been regarded as high-risk, high-return investment products. Nonetheless, FSA's survey has discovered that many surveyed companies actually recognized middle-risk (middle-return) investment products due to the single-digit risk profile (standard deviation) of hedge funds compared to, for example, the +10% risk profile of TOPIX.

According to the FSA writer's personal opinion, it may be fair to say that hedge funds--which used to offer products with high returns (i.e., high risks) by utilizing excessive leverage back in the day as did the Long Term Capital Management (LTCM)--gradually started providing products aimed at generating stable returns in addition to them. Some analyses point out that such trends are due to hedge funds investors shifting from wealthy individuals to institutional investors seeking stable returns. However, the actual status of risks of hedge funds needs to be identified in greater detail, and it is premature to conclude that "hedge funds = middle risks" at this point.

FIGURE-JPY7. AMOUNT OF INVESTMENT BY HEDGE FUND STRATEGY



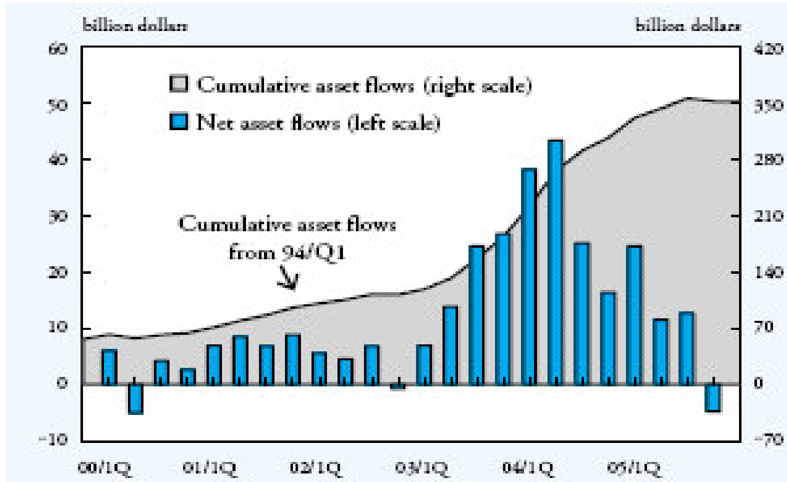
Source: FSA Newsletter 2006 – Summary of Hedge Fund Survey

Figure-JP7 illustrates the investment balance by hedge fund investment strategy. While Funds of Hedge Funds (FOHF) account for 67% of the total, the percentage of FOHF with respect to investment balance is positively correlated with the amount of investment. The findings of this Survey suggest that there is a possibility that investors who invest smaller amounts in hedge funds are investing in funds with risks, considering that FOHF is generally aimed at diversifying risks compared to single funds. However, according to the FSA writer's personal opinion, further fact-finding is still required to analyze the factors behind this.

COMPARISON OF EXPANSION IN MARKETS BETWEEN HEDGE FUNDS AND INVESTMENT TRUSTS

As shown in **Figure-JP8**, hedge fund industry is rapidly increasing. Unlike investment trusts, hedge funds are not strictly defined and it is extremely difficult to study their activities statistically. Given such a difficulty, concerns over impacts of hedge fund activities on markets grew globally during the periods of major shocks such as the Exchange Rate Mechanism (ERM) crisis [1992], the Asian currency crisis [1997], and the Long-Term Capital Management (LTCM) shock in 1998.

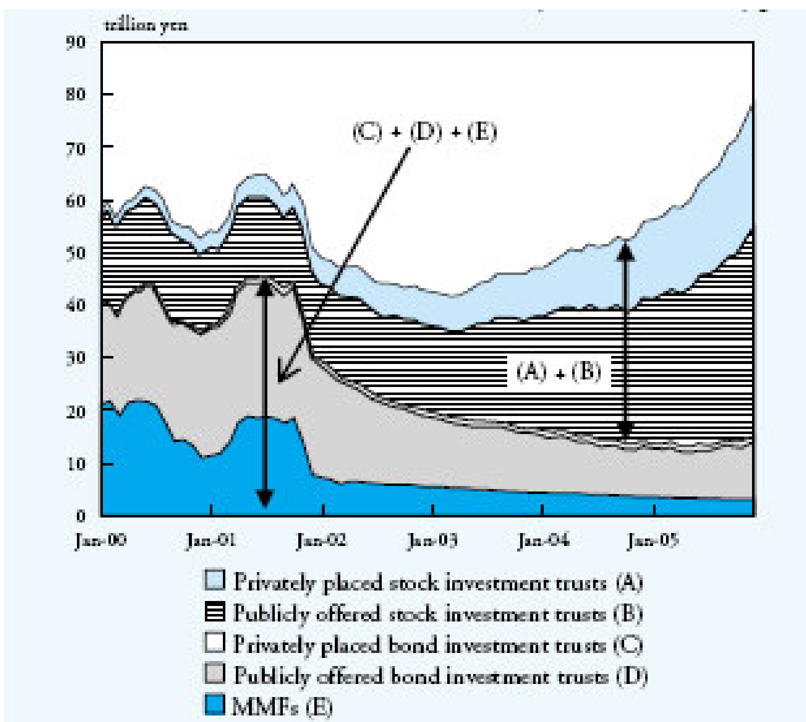
FIGURE-JPY8. NET ASSET FLOWS AND CUMULATIVE ASSET FLOWS INTO HEDGE FUND INDUSTRY



Notes 1: Based on hedge funds registered in Lipper TASS Database
2: The latest figures – as of 05/4Q

Source: Tremont Capital Management

FIGURE-JPY9. NET ASSETS OF JAPANESE INVESTMENT TRUSTS BY CONTRACTUAL TYPE



Source: The Investment Trusts Association, Japan

However, according to the data of Tremont Capital Management, there have been only a few cases that significant asset outflows from the hedge fund industries have been observed since 1994. Nevertheless, hedge fund industries have expanded continuously regardless of some shocks in the markets. Moreover, Japanese investors have also increased investments in hedge funds [Miura, et.al., 2006].

Regarding the Investment Trusts industry, there have been a continuously asset into investment trusts in Japan in the previous years. According to Figure JP10, the amount of net assets of publicly offered and privately placed investment trusts (contractual type) temporarily increased from the end of 2000 through the beginning of 2002, as a result of lower interest rates and changes in the distribution methods for publicly offered bond investment trusts. Until the beginning of 2003, the net assets of the money management funds (MMFs) and the bond investment trusts declined, because of continued redemptions as the value of MMFs fell below par due mainly to accounting scandals in the US, and the lower interest rates impaired the value of bond investment trusts.

Since 2005, due to a rapid increase in asset inflows and good performance in stock markets, the net assets of publicly offered and privately placed investment trusts (contractual type) reached a historical peak of 81 trillion yen at the end of December 2005 [Ibid.].

ASSETS UNDER MANAGEMENT INDUSTRY

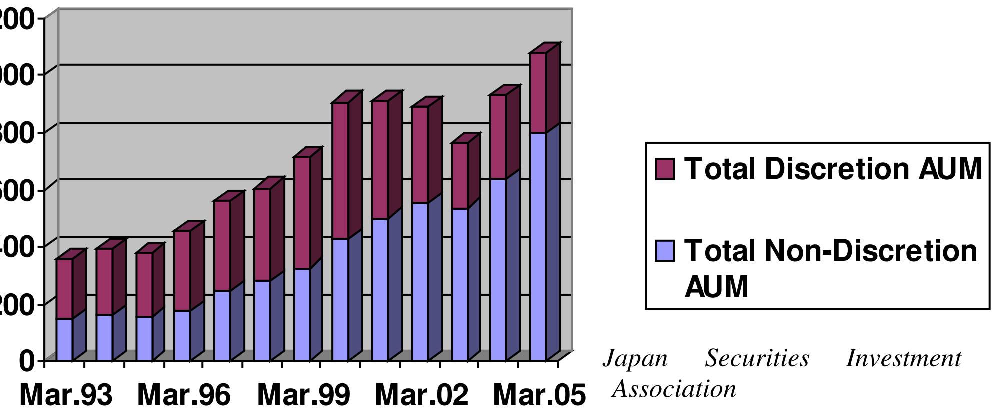
The asset management industry revolves around investment advisory businesses, which in turn entails the provision of investment advice to clients with respect to assessment of the value of securities for compensation. The investment advisory industry in Japan has been growing steadily since the passage of the act in November 1986. The assets under management by discretionary investment advisers reached more than 107.9 trillion yen as of March 31, 2005, indicating that advisors are now key players in the asset management industry.

Recent deregulation has enabled investment advisers to enter other businesses such as investment trust management, securities, and trusts, and have widened the area investment advisers may cover.

The bulk of pooled assets under management are in investment management trusts or contractual-type funds. Investment corporations or corporate-type funds have been permitted since November 1998 but are still very rare. Investment trusts are contracts between the investment trust management company and the trustee banks.

FIGURE- JP10. ASSETS UNDER MANAGEMENT BY DISCRETIONARY INVESTMENT ADVISERS

(Trillion Yen)



Source: Japan Securities Investment Advisers Association

6. CONCLUSIONS AND RECOMMENDATIONS

From the early 1990s through 2002, Japan's economy experienced prolonged adjustment. This period was characterized by declines in asset prices, the risk-taking ability of financial institutions, potential economic growth, and general prices. Various investigations have been carried out to examine which of these factors was the major cause of the stagnation of the economy [Fuchi, 2006].

To date, Japan's economy has regained forward momentum after a pause during the latter part of 2002. After more than a decade of struggle, Japan's financial system has almost overcome the NPL problem, and has entered a new phase of development. The full removal of the blanket guarantee of deposits on April 1, 2005 was a symbolic event of this phase shift [Bank of Japan Financial System Report, 2005].

However, Japan still has to face some challenges. First is fiscal policy. The fiscal situation is not only bad on the books but the problem is that we really don't know what sort of contingent liabilities is off the books: the guarantees extended to third-sector projects, the implicit guarantees that would be extended to the region and other local governments, implicit guarantees to a future bank recapitalization, and the implicit guarantees for pensions. In the long run, Japan needs fiscal consolidation and reduction in spending, probably reneging some commitments, such as social welfare commitments. To date, little action has been witnessed on the fiscal front even though the pressures associated with ageing populations are building up.

Fiscal consolidation is critical not just to restore public finance sustainability but also to recover, ahead of the next downswing, the room for maneuver that was exhausted at the peak of the previous cycle when, in a number of Continental European countries, fiscal authorities exacerbated the upswing by both cutting taxes and increasing spending. In theory, fiscal policy is supposed to help mitigate the vagaries of the business cycle and smooth the tax burden across generations. It is also supposed to reallocate resources in a way that increases the well-being of societies. Unfortunately, in many countries fiscal policy is doing exactly the opposite. Because it often exacerbates problems instead of alleviating them, fiscal policy increasingly turns out to be a problem rather than a useful instrument. Regaining control in the good times is thus urgently needed.[10]

Second is to promote compliance in the asset management industry. Compliance is critical to the firms' reputations and thus ultimately to their ability to grow and prosper. Compliance can be especially difficult in Asia, where rules differ and sometimes conflict from one country to the next. In Japan, regulators demand that each subsidiary and affiliate of a foreign firm must have its own local compliance department or compliance officer, with local control. This approach may make it difficult to develop global compliance processes and achieve economies of scale. Although Japan is trying to harmonize its investment management rules, progress remains slow and the foreign investment management industry is exploring the possibility of having input into the process.

Third is policy formulation. Japan may need to look into policies that would strengthen quality adherence among Suppliers of AMI generated products and services. Similarly this may lead potential entrants in AMI Japan to give focus to its discriminating buyers, as they need to channel excellent efforts in making marketing and distribution more credible and competitive with the AMIs operating in Europe and the United States.

[10] See Economic Outlook No. 79.

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KOREA

1. COUNTRY MACROECONOMIC PERFORMANCE

Since the economic crisis that hit Southeast Asia in 1997, Korea recovered rapidly and recuperated steadily as the government implemented structural reforms to quickly address economic vulnerabilities.

PRE-CRISIS IN 1997-1998

Before the crisis in 1997–98, the Korean corporate sector was characterized by significant conglomeration and concentrated ownership, with complicated cross-ownership linkages between affiliated companies. Back in the 1960s, government policies on conglomeration were designed to promote heavy and chemical industries as development models, with industrial conglomerates *(chaebol)* actively supported by means of directed policy lending at low interest rates. As a result, this model created a culture of risk sharing between the government and the private sector that discouraged the financial sector from improving its risk assessment and monitoring capabilities. This culture was also nourished by a history of government bailouts that created further incentives for risk taking [Jones and Karasulu, 2006].

Various postmortems of the Korean crisis abundantly demonstrated the corporate sector weaknesses that became evident in the aftermath of the crisis. Poor corporate governance, coupled with intense corporate ownership and conglomeration, provided incentives for financial excesses by owners without due attention to profitability and shareholder value. Conglomerates made extensive use of cross-company guarantees, which acted as soft budget constraints in the weaker affiliates and obscured the true financial condition of the affiliated companies and the group. These complex linkages allowed a non-transparent governance culture to flourish, and allowed the owners to exercise control while risking little of their own capital in the process. Inadequate accounting and disclosure rules, in turn, helped mask the magnitude and nature of risks that were being taken [ibid.].

The key financial weaknesses that resulted from this structure relate to the high and increasing level of leveraging and declining profitability. Claessens, Djankov, and Lang [1998] cite that Korea had the highest debt-to-equity ratios and the lowest real return on assets in a cross-country study that included nine Asian countries, Germany, and the United States for 1988–96. The increase in leverage has been ascribed to the financing of rapid investments and the associated acquisitions of fixed assets, especially in 1995–96, which failed to generate sufficient profits and led to increasing servicing cost on accumulated debt. The combination of poor profitability and high leverage made the corporate sector extremely vulnerable to any adverse incident. This form of vulnerability peaked in 1996–97.

ASIAN FINANCIAL CRISIS IN 1997 – 1998

The reasons of the 1997 Korean crisis have been hotly debated especially in the early days of the crisis [Chang, 2000]. Many commentators such as Brittan [1997], Krugman [1998a, 1998b], Frankel [1998], and McKinnon and Pill [1998] argued that fundamental institutional deficiencies of the Korean economy encouraged inefficiencies and excesses by protecting the investors from the adverse consequences of their decisions. However, others like Corden [1998], Furman and Stiglitz [1998], Radelet and Sachs [1998], Stiglitz [1998], and other mainstream economists have argued that the crisis was largely the result of a mixture of the premature and ill-managed financial liberalization (like the dismantling of interventionist policies) and the instability in the international financial market.

During the crisis, gross fixed capital formation fell by 21.2% in 1998 whereas in 1980 it recorded only a 10.7% fall. Exports in 1998 fell by 2.8% (in value terms) for the first time since 1958, whereas they grew at 16.3% in 1980. Unemployment rose from 2.5% just before the 1997 crisis (and from the trough of 2% in 1996) to the height of 8.7% in February 1999 (unemployment is reported to have fallen since March 1999). Income inequality also worsened as never before following the 1997 crisis. The ratio of income of the top quintile to that of the bottom quintile rose from 4.49 before the crisis to 5.38 by 1999 [Joong-ang Daily, 1999]. The ratio of the income of the top 10% to that of the bottom 10% rose from 7.1 in the first quarter of 1995 to 9.8 in the first quarter of 1998 and 10.2 in the first quarter of 1999 [Daehan Maeil News, 1999]. In 1998, Korea's GDP suffered negative growth of 6.7 percent.

POST-CRISIS DEVELOPMENTS

The Korean economy quickly recovered in 1999 to achieve GDP growth of 10.7% with practically nil inflation rate of 0.8 percent. Its recovery from the worst economic crisis in half a century has been truly extraordinary by any measure. For the first three quarters of 2000, the average growth rate was 10.4%, while the rate of inflation has been kept at 2.2 percent. At the end of November 2000, the unemployment rate was lowered to 3.4% from 8.7% at the height of the crisis, while Korea's foreign reserves have increased from US$3.9 billion in late 1997 to US$93.3 billion in 1998 [Sakong, 2000].

Since the crisis, expansionary fiscal policies were easily implemented in Korea. Unlike other countries, fiscal profligacy was not a major problem for this country. Korea's flexible fiscal policy standpoint was a critical factor in the nation's quick recovery. The target for fiscal deficits was gradually adjusted from the initial 0.8% of GDP, immediately after the crisis, to 2.7% of GDP in 1999.

Structural reforms were mainly focused on elimination of accumulated losses from the past. Through its persistent efforts at structural reforms, Koreans are now witnessing stability in growth, prices, interest rates, and exchange rates while its credibility overseas has grown steadily.[11] The downside the restructuring process, as far as the private sector is concerned, is that firms, rather than reducing debt through asset liquidation, focused more on issuing new shares to be purchased, thereby lessening the effectiveness of structural reforms. Furthermore, the financial restructuring efforts have mainly concentrated on capital adequacy and recovering past losses, so that financial institutions are not prepared to enhance profitability and set up a steadfast system to recognize future potential losses on a continued basis. To put an end to this, the government pushed forth a second round of financial and corporate restructuring program [Ibid.].

Efforts at financial reforms have been primarily directed toward, first, eradicating past legacies of non-performing asset problems and restructuring their financial institutions and, second, strengthening institutional bases, i.e., the governance structure of financial and regulatory or supervisory institutions.

In the first quarter of 2006, Korea's economy steamed further ahead driven by rising domestic demand and growing exports. **Table-KR1** shows the increase in real gross domestic product (GDP) by 1.2% compared with the previous quarter. Updated estimates show the increase in real GDP at 1.3 percent.

TABLE- KR1. GROWTH RATES BY KIND OF ECONOMIC ACTIVITY

(At 2000 constant prices, S.A series)

(Percent change from preceding quarter)

	2004				2005^p				2006^p
	1/4	2/4	3/4	4/4	1/4	2/4	3/4	4/4	1/4
Gross Domestic Product	0.8	0.8	0.5	0.9	0.5	1.4	1.6	1.6	1.2
Agriculture, forestry & fishing	8.4	0.6	2.1	3.8	-3.6	0.2	-1.3	0.2	2.2
Manufacturing	2.7	2.1	0.9	1.4	0.6	2.2	3.0	3.9	0.6
Electricity, gas & water	4.1	0.6	-0.1	0.4	6.9	0.1	-0.9	3.7	1.8
Construction	-1.4	-1.2	-0.5	0.2	-1.0	2.6	-0.6	-0.4	0.4
Services[1)]	-0.3	0.5	0.5	0.4	0.8	0.9	1.2	0.9	1.3

Note : 1) Including wholesale & retail trade; restaurants & hotels; transport, storage & communications; financial intermediation; real estate, renting and business activities; public administration, defense & compulsory social security; education; health and social work; and other service activities

Source: BOK Economic Statistic System (http://ecos.bok.or.kr/EIndex_en.jsp)

[11] This was taken from the keynote speech of Jin Nyum, Minister of Finance and Economy in 2000.

The production sector witnessed rising output in the manufacturing industry by 0.6%, led by machinery and equipment, transport equipment, chemical products. Despite contractions in building construction, this sector managed to still post an increase of 0.4% owing to the expansion of civil engineering activity. Production in the services industry rose by 1.3% due to increased output in financial intermediation and business activities.

Table-KR2 shows growth rates in consumption expenditure, with private consumption rising by 1.3%, mainly attributed to increased household spending on semi-durables and services. Gross fixed capital formation increased by 0.3% while facilities investment shifted to negative growth due to the depression in machinery investment, and construction increased by 0.6% driven by civil engineering. Exports of goods increased by 2.6% led by textiles & leather, machinery equipment and transport equipment exports. Exports including services showed 3.2% growth.

TABLE-KR2. GROWTH RATES BY COMPONENT OF EXPENDITURE
(At 2000 constant prices, S.A. series)(Percent change from preceding quarter)

	2004				2005^p				2006^p
	1/4	2/4	3/4	4/4	1/4	2/4	3/4	4/4	1/4
Gross Domestic Product	0.8	0.8	0.5	0.9	0.5	1.4	1.6	1.6	1.2
Final consumption expenditure	-0.1	0.2	0.1	1.0	0.7	1.5	1.0	1.0	1.4
(Private)	-0.4	0.1	0.1	1.0	0.5	1.4	1.0	1.1	1.3
(Government)	1.2	1.0	0.0	0.8	1.4	1.8	1.1	0.6	1.8
Gross fixed capital formation	-0.5	0.4	-0.6	-0.5	1.2	1.8	-0.1	1.7	0.3
(Construction)	-1.3	-1.6	-0.2	-0.7	0.4	1.8	-0.8	0.0	0.6
(Facilities investment)	1.1	3.2	-1.3	-0.9	2.3	2.4	0.8	4.2	-0.4
Exports of goods & services	4.3	2.6	0.0	2.2	2.1	1.2	5.3	1.3	3.2
(Goods)	4.6	2.7	-0.4	2.7	2.4	1.7	5.7	1.0	2.6
Imports of goods & services	2.7	4.2	-0.8	4.5	-2.2	4.5	3.9	-0.9	4.6
(Goods)	2.3	4.8	-1.8	3.1	-2.6	5.4	4.5	-0.4	2.1

Source: BOK Economic Statistic System (http://ecos.bok.or.kr/EIndex_en.jsp)

Many economists are expecting higher growth in 2006, boosted by external and domestic demand; Standard & Poor's Ratings Services expects about 4.5 percent GDP growth this year [Korea Times Print, 2006].

2. NON-PERFORMING LOANS PROBLEM

Nonperforming loans (NPLs) were at the heart of the financial crisis that surrounded the Korean economy during 1997–98. Even before the onset of the currency crisis, the financial system was already in dire straits because of excessive lending to large conglomerates, many of which were already bankrupt.[12]

High levels of NPLs in the Korean financial sector reflected a corporate culture that relished market share rather than profitability and a capital structure that relied heavily on external borrowing. The structural problems in the financial and corporate sectors became apparent in the second half of 1997, when capital inflows were reversed as foreign investors—reeling from losses in other Southeast Asian economies—decided to reduce their exposure to Korea. Intensified withdrawal of credit lines quickly developed into a currency crisis [Balino and Ubide, 1999]. Further, the Korean financial institutions abandoned their original creditor's role of keeping a check on the financial conditions of companies reliant on short-term loans and watching over business investing to keep companies from veering off into diversified fields far from their core business. Consequently, financial institutions were saddled with enormous amounts of NPLs left behind by bankrupt enterprises. These institutions have lost their financial intermediation function [Dohyung, 1999].

In terms of total equity, the five major financial sectors (commercial banks, investment trust companies, non-banks, insurance companies, and securities companies) registered an amount reaching up to 34 trillion won as of September 1997. The combined NPLs of the commercial banks and non-banks, as shown in **Table-KR3**, had climbed to 33 trillion won, reaching a total credit extension of 5.5%, or 7.7% of GDP.

TABLE KR3. SIZE OF NONPERFORMING LOANS

(Trillion won; %)

	Nonperforming Loans (A)	Total Credit Extended (B)	(A)/(B)	% to GDP
Commercial banks[a]	28.5	453.3	6.3	6.8
Merchant banking corporations[b]	3.9	133.5	2.9	0.9
Total	32.4	586.8	5.5	7.7

Source: Ministry of Finance and Economy, April 1998.
[a] As of the end of September 1997.
[b] As of the end of October 1997.

[12] Taken from the keynote speech of Jin Nyum, Minister of Finance and Economy in 2000.

Moreover, the bad debts of financial institutions became all the more enormous when this NPL figure was added in with the 10 trillion won in stock valuation losses (based on a 1996 report) sustained by commercial banks, securities companies, investment trust companies, and insurance companies. As a result, Korea came to a point when it was already losing its creditworthiness. Thus, when foreign creditors began to restrict lending and call in loans, the value of the won and Korean stocks quickly plunged [Ibid.]. At the time only 12 of 26 commercial banks satisfied the required 8 percent capital adequacy ratio [Ji and Park, 1999].

Historical data of NPLs have been subject to upward revisions as loan classification standards were gradually tightened. Prior to the crisis, only loans in arrears of six months or more had been classified as NPLs. However, at the end of March 1998, the government followed internationally acceptable standards and included loans in arrears of three months or more in estimating the "true" magnitude of NPLs. The government arrived at the figure of 118.0 trillion won, based on the new classification, or approximately 28% of Korea's GDP in 1997, twice as large as the estimated NPL total of 59.6 trillion won, based on the old asset classification standards. The government initially estimated that the public cost to complete financial sector restructuring would be around 64 trillion won. In March 2000, the asset classification standards were further strengthened with the introduction of enhanced forward-looking criteria, which classify loans as "nonperforming" when future risks are significant—even if interest payments have been made without a problem up to that point. Based on the enhanced criteria, NPLs would have increased from 66.7 trillion won to 88.0 trillion won at end-1999 [Lim & Hahm, 2006].

3. MEANS OF RESOLVING THE NPL PROBLEM

For Korea, recovery was quite easier compared to other crisis-affected economies due to the deliberate move by the government to manage escalating non-performing loans [Ji and Park, 1999]. Most banks realized the importance of protecting their balance sheet accounts, particularly the quality of their asset portfolios and their operating results to mitigate the possible losses arising from increasing levels of non-performing assets.

NPL RESOLUTION

With the initial task of cleaning up nonperforming loans, the government injected 64 trillion won to acquire nonperforming loans, recapitalize viable financial institutions and support deposit insurance. In the process, a number of financial companies were closed or merged with healthier ones. However, the ratio of nonperforming to performing loans in the system is still unhealthy. Many nonperforming banks still exist [Hilton, 2000].

Immediate resolution of NPLs was deemed a critical component of this strategy. The government announced a program of NPL acquisition as a mechanism for delivering official support for bank restructuring in November 1997. A key component of the program was the establishment of a reorganized and expanded KAMCO, and the creation of the NPA Fund [He, 2004]. In 1998, the government set up a vehicle for acquiring nonperforming loans: the Korea Asset Management Corporation (KAMCO). To monitor the KAMCO, the government created the Financial Supervisory Commission (FSC). This raised the question of how independent a regulatory agency that regulates a government owned banking sector can be when no external constituency exists to demand such independence [Root, 2000].

In December 1999 financial institutions adopted a forward-looking approach in asset classification, taking into account the future performance of borrowers in addition to their track record in debt service. The Ministry of Finance and Economy have introduced and extended forward-looking criteria (FLC) system, which evaluates companies' ability to redeem debt in the future and deal with non-performing loans efficiently. The forward-looking criteria (FLC) required creditors to make a more realistic assessment of loan risks based on borrowers' managerial competence, financial conditions, and future cash flow.

DISPOSAL OF NPLS

KAMCO played an important role in facilitating the restructuring process and to help in developing the financial markets. After Korea's financial crisis, KAMCO was responsible for effectively liquidating non-performing loans. This is a crucial job for at least two reasons. First, the total cost of restructuring is reduced by the income generated from NPL sales. Second, effective disposition of NPLs directly affects the success of both financial and corporate restructuring efforts and the credibility of the financial reform program [U.S. International Trade Commission, 2000]. KAMCO is an exception, as it does not have any sunset date. Its existence was not a result of the financial crisis but dates back to 1962 when it was established as a subsidiary of the Korea Development Bank to assist in the disposition of government-acquired assets. More than four decades of experience in asset disposition and other ancillary services have made KAMCO a model for other Asian countries contemplating on creating a similar outfit for this type of specialized financial service.

In disposing NPLs, KAMCO has remained true to its the principle of quick removal of such loans but at the highest price possible. The NPLs purchased are classified into ordinary loans, restructured corporate loans or Daewoo workout loans for efficient management and disposition. The ordinary loans are further categorized as either secured or unsecured, while the restructured corporate loans are divided into Bankruptcy Court authorized or unauthorized categories, depending on whether the court has approved the company in question to go under court reorganization or composition proceedings. The Daewoo workout loans are managed according to individual group affiliates.[13]

KAMCO disposed of distressed assets through conventional methods such as competitive auctions, collection of rescheduled repayments and recourse to the original seller. In addition, it also developed a number of innovative methods that broadly include bulk (pooled) sales, individual sales, and joint venture partnerships. The choice of a particular method depended on the nature and size of NPLs. Bulk sales typically include the issuance of asset-backed securities (ABS), which launched an important new market in Korea. **Table-KR4** exhibit these varied approaches and were basically responsible for helping to raise the recovery rate and retrieve the NPA Fund as quickly as possible [He, 2004].

TABLE-KR4. NPL RESOLUTION BY METHODS
(as of January 31, 2006, in billions of U.S.dollars)

Resolution Method	Face Value	Purchase Price	Sale Price
International bidding	6.1	1.3	1.6
ABS issuance	8.4	4.4	4.8
Sale to AMC	2.5	0.7	0.9
Sale to CRC	1.9	0.4	0.7
Individual loan sale	3.5	0.8	1.4
Bankruptcy court auction, etc	8.6	2.8	3.5
Collection, etc	15.4	4.9	6.9
Daewoo & Workout loan	7.6	4.5	6.5
Sub Total	54.0	19.8	26.3
Recourse & Cancellation	19.8	10.3	10.3
Total	73.8	30.1	36.6

Source: http://kamco.or.kr/eng.html

[13] This information was sourced from the KAMCO website.

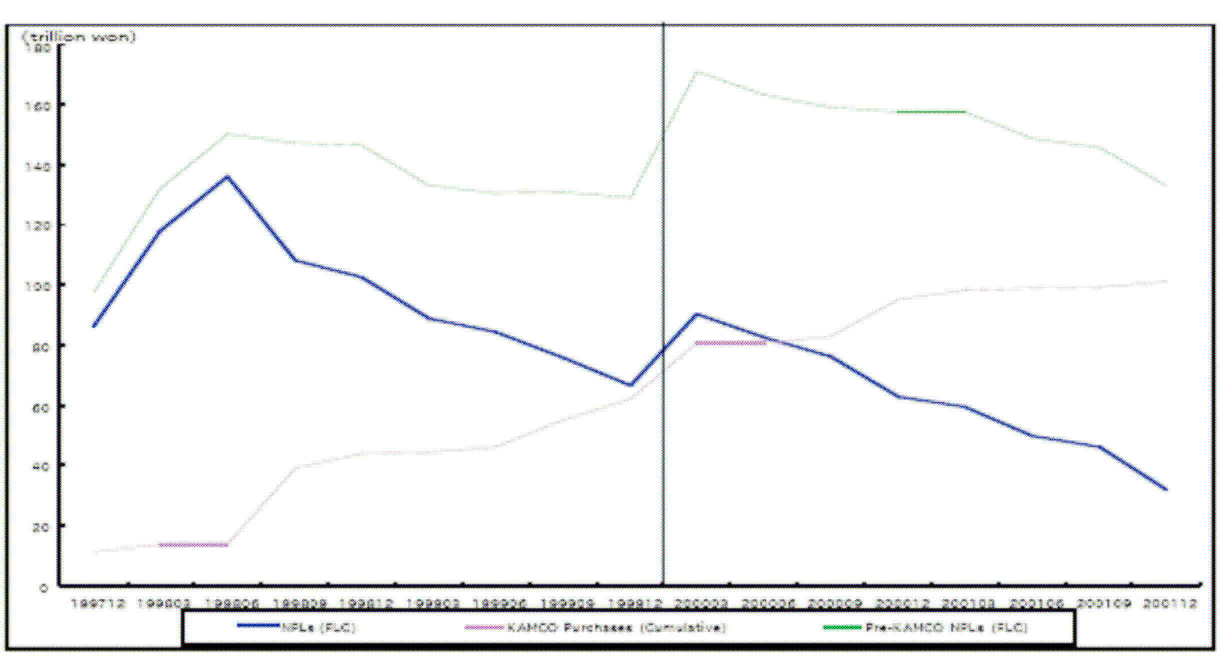
For KAMCO, a majority (about 90%) of funding emanated from bond issuances, with short-term maturities, and the remaining funding requirements were sourced from the central bank, government financial institutions and the Korea Development Bank.

The disposition of asset occurred at a faster rate since Korea has adopted a fair value approach to pricing of NPLs. Korea is way ahead in NPL transfers to AMCs as it had started venturing into overseas acquisition from foreign institutions regarding loans to Daewoo's overseas subsidiaries. Most of the overseas loans were unsecured with the portfolio varying widely from ordinary loans to overdrafts, trade related financing, documents against acceptance and letters of guarantee and overseas issued corporate bonds. The various overseas loans involved 368 different financial institutions in 28 countries [KAMCO Annual Report, 2005]

ACQUISITION OF NPL

Between 1997 and end of 2001, KAMCO purchased 101.2 trillion won of NPLs (face value) for the actual cost of 38.7 trillion won. **Figure-KR1** shows NPLs before and after KAMCO purchases. In the table, the size of NPLs before and after 2000 is re-estimated based on FLC and enhanced FLC, respectively. The spike in the trend line at the beginning of 2000 is due to the change in asset classification standards and the increase in NPLs after the collapse of Daewoo. NPLs before KAMCO purchases have been declining since 2000, due to improved profitability—financial institutions they have been able to dispose of NPLs aggressively since 2001.

FIGURE-KR1. NONPERFORMING LOANS BEFORE AND AFTER KAMCO PURCHASES



Source: MOFE and FSC (2000: 280-286), *White Paper on Public Funds*; MOFE and PFOC (2001: 215), *White Paper on the Oversight of Public Funds*; Korea Asset Management Corporation; Public Fund Oversight Committee

With a large majority of its NPL problems resolved, KAMCO also shifted gear to handle credit card problems in the Korean consumer market. They have also taken a more global outlook to take advantage of expertise built up through the years to provide service to addressing the NPL problems of other countries in Asia.

As of January 2006, KAMCO has acquired closed to USD 110.9 billion of NPLs from various financial institutions. KAMCO acquired mostly bank NPLs because the government was determined to clean up the banks as quickly as possible, given their central role in restructuring corporations. **Table-KR5** shows that NPLs from commercial banks amounted to US$62 trillion (56%) of the total US$110.9 billion worth of NPLs purchased. The total of NPLs purchased from other institutions were only US$22.5 billion (20%) from investment trust companies, US$7.1 billion (7%) from insurance companies, and US$5.1 bllion (5%) from foreign financial institutions, US$3.5 billion (3%) from merchant banks, and US$10.6 trillion (9%) from other institutions.[14]

TABLE-KR5. NPL ACQUISITION WITH NPA FUND
(as of January 31, 2006, in billions of U.S.dollars)

Type of Institution	Face Value	Purchase Price	Purchase Price Ratio(%)
Commercial Banks	62.1	24.7	39.8
Merchant Banks	3.5	1.5	42.9
Insurance Companies	7.1	1.8	25.4
Investment Trust Companies	22.5	8.4	37.3
Foreign Financial Institutions	5.1	2.1	41.2
Others	10.3	1.2	11.3
Total	110.9	39.7	35.8

Source: http://kamco.or.kr/eng.html

4. KOREA'S CAPITAL MARKET

The financial crisis in 1997-1998 and subsequent International Monetary Fund (IMF) bailout program significantly changed the capital market of Korea. The Korean

[14] Data was taken from KAMCO website.

government continue to accelerate overall economic reform aimed at improving the market mechanism and making the economy more transparent.[15]

The most vital changes in the capital market were brought about by the Financial Reform Law of 1997. The "Big Bang" style of financial reform placed the securities supervision function under the jurisdiction of FSC. Most of the supervisory functions of the Ministry of Finance and Economy (MOFE) were also transferred to FSC.

EQUITY MARKET

During the market transition in Korea in 1999, capital market institutions such as the stock exchange, the securities dealers' association, and securities companies have restricted functions. In particular, these institutions do not perform their roles independently or responsibly in the initial public offering (IPO) process. They limit securities companies' business coverage in underwriting and hinder the healthy growth and maturity of a self-regulatory, self-sustaining, and autonomous capital market. FSC should enforce compliance of related institutions in the IPO process. The process of going public and listing in the stock market is still overregulated, especially in the pricing of a new issue. Since the pricing of an IPO issue is the most important function in the securities market, it is recommended that remaining restrictions on IPO pricing be removed or eased [Nam, et al, 1999].

In early 2003, the KSE market experienced depression, which recovered after the end of the war in Iraq. Despite the worries over economic recession in Korea, strong foreign buying kept up market rally. The Korea Composite Stock Price Index (KOSPI) closed at 810.71 in 2003, showing an annual gain of 29.2 percent. Economic recession, higher oil prices and declining semiconductor prices dampened down stock prices. In mid-March, investment sentiment was further aggravated due to the SK Global's accounting fraud scandal and the worries over the problems of credit card companies, thus dragging down the KOSPI to the year low of 515.24 on 17th March. But then, the stock market regained its strength as the Korean financial market stabilized and international oil prices dropped after the end of the war in Iraq. Despite the worries over economic recession, sluggish equipment investment and consumer spending, and the strikes of freight labor unions, the market maintained an uptrend for five consecutive months from April mainly on account of strong net buying of foreign investors. In mid-September, the sharp appreciation of the Korean won against the U.S. dollar and OPEC's decision to cut oil production drove the market lower. However, stock prices rebounded in October due to rising exports and the government measures that were introduced to curb speculative investment in the real estate market. The uptrend continued until the end of 2003 and the number of listed companies at the end of 2003 reached 684 which increased by one from 2002, thus, ending the five consecutive years of decline. The total market capitalization was KRW 355 trillion, a 37 percent increase from KRW 259 trillion in 2002 [KSE Fact Book, 2003].

[15] This information was sourced from the Korea Exchange website.

BOND MARKET

In Korea, a primary market for bonds is the issuing market where money demanders can finance funds by issuing and delivering debt securities to money suppliers while the secondary market is where those securities are traded between investors. For issuers, essentially money demanders, the costs of capital are significantly reduced due to the existence of the secondary market. The bulk of trading takes place in the Korean over-the-counter (OTC) market. In addition, trading activities are largely coming from corporate bonds, financial bonds, and special bonds [An Introduction to KSE Bond Market, 1999].

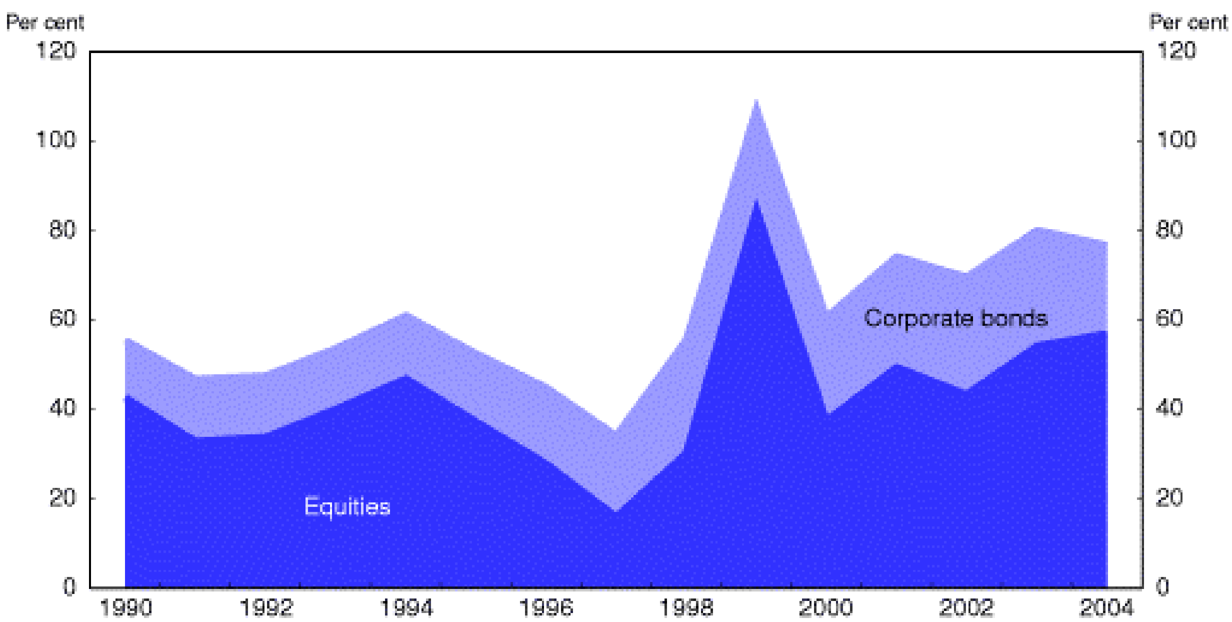
Since April 1998, the Korean bond market has grown rapidly. More than 15,000 bond issues worth over 248 trillion won were listed on the Korean Stock Exchange (KSE). Restrictions on foreign investment were abolished in February 1998 while strong reform measures are urgently needed to make the bond market more efficient and competitive. Many bonds are listed on KSE and traded OTC because investors, including foreigners, prefer them as they are perceived to be quality securities, their traded prices are disclosed to the public, and they are the only bonds that international Trade Commissions (ITCs) may include in their funds. The Government has increased its efforts to issue bonds at interest rates reflecting market rates since November 1993. However, a substantial gap existed between the interest rates on Government bonds in the primary market and the yields in the secondary bond market. As a result, most Government bonds have to be issued by way of forced subscription to individuals or compulsory distribution to underwriting syndicates, further distorting the market mechanism. Government bonds are issued pursuant to the Budget and Finance Law and must be approved by the National Assembly. The Ministry of Finance and Economy (MOFE) is the issuing authority and guarantees the payment of principal and interest on Government bonds [Nam, et.al., 1999].
In August 1998, the Korean government announced the Bond Market Restructuring Plan to restructure the primary and secondary markets. In addition, the KSE opened an Inter-Dealer Market (IDM) in March 1999 to trade government debt securities.

In 2003, the total amount of bond issuance in the primary market was KRW282.6 trillion, an increase of 9.5% from KRW258.0 trillion in 2002. The issuance of the financial and corporate bonds decreased, whereas that of the government and monetary stabilization bonds significantly increased. In the same year, government bonds worth KRW58.7 trillion were issued, a 24% increase from KRW34.6 trillion in 2002, and the monetary stabilization bonds worth KRW89.7 trillion were issued, up 20 percent from KRW69.9 trillion in the previous year. Other issuances include KRW68.0 trillion of financial bonds, KRW50.2 trillion of corporate bonds, and KRW13.9 trillion of agency bonds [KSE Fact Book, 2003].

PROMOTING THE DEVELOPMENT OF THE CAPITAL MARKET

Developments in the capital markets have been less favorable in recent years despite the acceleration of financial-sector liberalization and an opening to international capital flows. A vibrant and strong capital market is important to the development of venture business as well as to provide appropriate long-term saving instruments needed in the context of population ageing. Recent trends in the capital market are encouraging. It is important to promote the further development of the capital market through the issuance of government bonds with long-term maturity, limiting vulnerability to shocks and upgrading the financial infrastructure, including credit rating agencies.[16] **Figure-KR2** illustrates that the size of the capital market has remained relatively constant in Korea during the past few years.

Figure-KR2. Size of Capital Market
(as percent of GDP)



Source: Korea Exchange

In April 2006, the Korean government unveiled its much-anticipated "Capital Market Integration Act" that will combine existing asset management, securities and futures regulations. The proposed bill has the capability to fundamentally transform the financial industry should it pass the National Assembly. The legal framework of the Korean financial market has long been criticized for its out-datedness and rigidity.

[16] Sourced from http://www.oecd.org/

The existing framework, which they refer to as the "positive system", enumerates the financial instruments such as Treasury bond, stock, insurance, security, etc. that can be offered by each financial institution. The system controls financial institutions performing activities (or selling products) not specifically listed within the coverage of certain laws. The new policy direction prescribes that all entities that provide the same financial services will be subject to the unified regulatory regime. And as a result, it allows for the provision of integrated financial services in regard to newly defined "investment products and derivatives" [Korean Times, 2006].

According to Vice Minister of Finance and Economy Kwon Tae-shin (2006) of Korea, the proposed Act has various advantages that would bring many benefits on the improvement of asset management business related regulatory system. First, it will permit the creation of so-called Financial Investment Companies, which can engage in all capital market related businesses including securities, futures, asset management and trust. Second, it will facilitate the restructuring of the capital market and enable the emergence of advanced investment banks. Further, market participants will be allowed to develop any kind of investment instrument and investment business, unless specifically prohibited in the regulations. Third, investor protection will be differentiated based on the level of sophistication of the investors and the risk level of the investment instruments.[17]

5. KOREA'S ASSET MANAGEMENT INDUSTRY

The potential growth of Korea's asset management industry is quite promising with an increasingly aging population and a trend toward low interest rates coupled with deregulation and competition. In particular, the consolidated Indirect Investment Asset Management Business Act (IIAMBA) that was enacted and promulgated in October 2003 is expected to lift investor confidence and contribute to enhanced competition and services in the asset management market by providing a level-playing field for all asset management companies.

The IIAMBA plays vital roles in four ways. First, it advocates effectiveness and fairness by turning from institution-based to function-based regulations. The Korean government had regulated the asset management business based on regulations specific for a financial institution or for a product, leading to an imbalance in regulations with different regulations applied to the same asset management activity. Second, the Act contributes to the development of the Korean capital market by augmenting the range of the investment objects, asset managers, and distributors while strengthening plans for investor protection. Third, the Act has put down the basis for the creation of various products by setting up special purpose indirect investment vehicles, including Exchange Traded Funds, Multi-class Investment Vehicles, Umbrella Indirect Investment Vehicles, Securities Investment Companies

[17] MOFE Website http://english.mofe.go.kr/news.

for Corporate Restructuring, Securities Investment Companies for Corporate Acquisition, Indirect Investment Vehicles for Real Estate, Indirect Investment Vehicles for Commodity Assets, and Private Equity Funds. Fourth, it provides to the promotion of the safe and efficient management of long-term savings vehicles, such as pension funds, by the asset management industry in preparation for an aging society.[18]

The Act, which was enforced in 4th January 2004, put a new face on the asset management industry and allowed investors to opportunities for investment in various indirect investment products. Further, both securities investment trust companies and asset management companies, which had been regulated respectively by the Securities Investment Trust Companies Act and the Securities Investment act, were converted into asset management companies. The main business of such asset management companies is investing capital raised from investors in stocks and bonds and distributing the earning investments. Securities companies are engaged in stock and bond markets either as dealers and/or brokers.

CLASSIFICATION OF FUNDS (BASED ON ADDITIONAL ISSUES OF UNITS)

Investment trusts are divided into two types derived from the allowance for additional issues of units. First is the Open-end Type. This type of investment trust, which can issue and sell additional beneficial certificates at any time, is the most common type of trust. In this case, generally there is no termination date for the investment trust. Second is the Closed-end Type. This type of investment trust cannot make additional issues of units after the initial establishment. With the fixed size of the trust, the assets may be managed more effectively over the long-term and generate higher rates of return than open-end investment trusts. This type of investment trust is preferred when bond yields are expected to decline as the trust will be able to lock in high rates of return. A closed-end investment trust can improve its liquidity by listing on the Korea Stock Exchange (KSE). The life of the trust is determined by the management company at inception and the minimum period is six months [Ibid.].

TYPE OF INVESTMENT TRUSTS

The four main types of investment trusts are (i) equity investment trusts, which invest more than 60% of their total assets in equities or equity related securities such as KOSPI 200 index futures and options; (ii) bond investment trusts, which invest more than 60% of their assets in bonds or interest rate futures; (iii) MMFs, which mainly invest in short-term financial products such as CPs and CDs; and (iv) hybrid investment trusts, which are not classified under any of the above categories.

Equity funds can further be classified as growth-type, growth income-type, and income-type based on their investment plan. The standard trust deed for equity-type

[18] Check out the AMAK website at http://www.amak.or.kr/Eng/

trusts allows these kinds of trusts to invest in KOSPI 200 index futures and options up to an amount equal to the permitted level of stock investment of the trust [Ibid.].

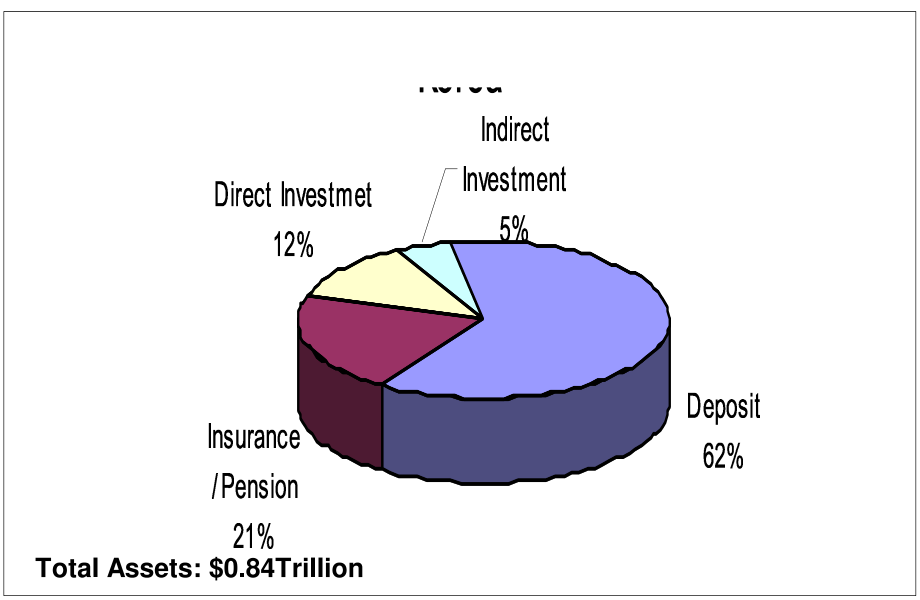
STATUS OF ASSET MANAGEMENT INDUSTRY

In **Figure-KR3**, it illustrates that 62% of personal financial assets in Korea is in some form of deposits. In Korea whether it is an investment product, direct equity or a bond holding type, only 17% (direct and indirect investments) of personal financial assets is invested in the capital market. On the other hand, the equity investment portion of personal financial assets, the combination of direct and indirect is about 8 to 9 percent; 90% of equity investment takes a shape of direct investment.

As for insurance and pension, only 3% of the total 33% is comprised of insurance products and the rest 30% is invested in all kinds of pensions most of which is invested in the capital market. The actual investment by individuals is estimated to represent more than 60%. Consequently, less than 10% of those of the funds is invested in the stock market. This shows there is an extreme tendency of Korean individual investors to be more risk averse.

In Korea, the future growth of the asset investment industry depends on a combination of factors. First is the conversion of deposit assets into investment types driven by sustained low interest rates. Second, inflow of direct investors into indirect investment as the indirect market is refined and the merits of investment are emerged and third, potential expansion of corporate and institutional customers based on expansion of the pension market with introduction of corporate pension schemes.

FIGURE-KR3. AMI STATUS WITHIN THE FINANCIAL INDUSTRY AS OF MARCH 2004



Source: Landmark Investment Management Co., Ltd.

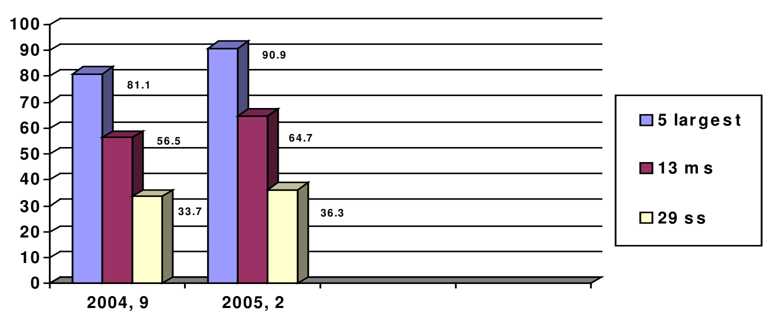
According to the Asset Management Association of Korea (AMAK), asset management firms enjoyed the rising popularity of RSP funds since 2005 by posting a steep rise in earnings. The fiscal year reports of 42 asset management companies from April 2005 to March 2006 found that their net profit surged 72.96 percent to 194.4 billion won from a year ago. Fourteen firms saw their net profit balloon more than two-fold compared to a year ago. One of the biggest winners was KTB Asset Management, which posted a 1,569 percent surge in net gain to total 3.5 million won. Hyundai Wise Asset followed by posting a 719% jump in gains to total 2.2 million won.

In sum, the asset management in Korea has entered the next phase of development and has performed extremely well in the last years. Indeed, Korea's collective investment fund industry has one of the greatest potentials in the region for future growth. The launching of corporate pension funds, then scheduled for launching in January 2006 was expected to add to the upside growth potential of the asset management industry in Korea.

KEY PLAYERS IN THE ASSET MANAGEMENT INDUSTRY

By February 2005, forty-seven (47) asset management companies were in operation in Korea. Nine of these were joint ventures between domestic and foreign financial institutions and 11 companies were foreign owned with controlling shares of over 50 percent; 7 out of 11 companies were 100% owned by foreigners. In fact, the entry of major foreign fund management houses into the Korean market has been significant. For example, Fidelity Asset Management, one of the largest in the world, founded a 100% subsidiary in Korea in December 2004.

FIGURE-KR4. ASSET VALUE UNDER MANAGEMENT BY SIZE OF COMPANIES



Source: Financial Supervisory Service

There are five large management companies, each with assets under management (AUM) of over KRW10 trillion; 13 medium-sized companies with AUM of KRW3 to KRW10 trillion; and 29 small companies with AUM under KRW3 trillion. The total AUM of the five largest companies at the end of February 2005 was KRW90.9 trillion, amounting to 47.7 percent of the industry total. For the 13 medium-sized companies, the net value AUM was KRW64.7 trillion, which was 33.8 percent of the industry total. As for the 29 small companies, the total net value AUM was KRW36.1 trillion, which was 18.8 percent. Therefore, the asset management in Korea is fairly competitive. The market share of the 11 companies at the end of February 2005 was 16.3 percent with AUM of KRW31.2 trillion.

In terms of distribution, 68 financial institutions are distributing funds in the market, the rest are securities companies (41), commercial banks (21); insurance companies (3), futures companies (2), and a merchant bank. Direct sales of funds by management companies will be allowed starting January 2006. As of the end of January 2005, securities companies dominated the fund distribution market with a combined market share of 72 percent; banks accounted for a share of 27.4 percent. Thus, the combined market share of securities companies and banks is 99.4 percent. It is important to note that the market share of banks in fund distribution has, in recent years, sharply increased.

TABLE-KR6. DISTRIBUTION OF FUNDS BY SECURITIES FIRMS AND BANKS
(UNIT IN TRILLION WON, %)

	2003. 12		2004.9		2005.1		
	Sales	Share A	Sales	Share	Sales	Share (B)	
Securities Firm (41)	108.6	81.8	127.4	74.4	134.2	72.0	Δ9.8
Banks (21)	24.2	18.2	43.1	25.1	51.0	27.4	9.2

Source: Financial Supervisory Service

RECENT DEVELOPMENTS IN ASSET MANAGEMENT INDUSTRY

In 2004, Korea Securities Depository (KSD) introduced FundNet, the central investment funds processing platform developed and operated by KSD for the Korean market. FundNet is designed to be the core infrastructure system of the asset management industry in Korea. It supports the handling of investors' orders to buy and sell investment fund shares on one hand, and the proper settlement and custody of each fund's underlying investments on the other hand, assuring full compliance with Korea's new Asset Management Business Act (AMBA) [ISSA Regional Meeting, 2005].

For the purpose of enhancing competitiveness of the asset management industry in Korea, a blueprint for zero-base financial regulatory reforms and the deregulatory measures on asset management business were announced on 23 November 2005 and on 17 June 2005. In reference to those frameworks set out in 2005, part of the revised Presidential Decree on the Indirect Investment Asset Management Business Act was fixed in the Cabinet Council meeting on April 18, 2006 whose key changes aim to deregulate restrictions on the asset management businesses. The government expects to achieve extended autonomy in managing collective investment schemes (CIS) including funds, introduction of legitimate solicitation of indirect investment securities by insurance planners, and relaxation of private equity fund (PEF) related regulations with the revised Decree in effect from 27 April 2006 [Ministry of Finance and Economics Policy Issues, 2006].

6. Conclusion and Recommendation

As a result of aggressive restructuring and bold reform of the past nine years, Korea's economic and financial service industry was able to come out of the 1997 financial crisis wholly revitalized and poised for renewed growth.

Export continues its solid growth, but a more significant development is that private consumption began to recover. Standard & Poor's has recently raised Korea's sovereign credit ratings from A- to A and Fitch Ratings subsequently upgraded the ratings from A to A+.

However, the Korean economy still faces challenges such as the aging of the society and bipolarization issues according to Deputy Prime Minister Han Duck-Soo. The critical point is the government's awareness of these problems and its willingness to take precautionary measures. Regarding the bipolarization issue, the Korean government is promoting 'joint growth' by encouraging 'successful sectors' while boosting 'sectors that are falling behind.' These measures include enforced national basic livelihood security act, improved welfare and self-support system, job training, and expanded social insurance policies.

On the financial market aspect, various achievements were completed to further develop the asset management industry in Korea: restructuring of investment trusts, AUM (asset under management) has recovered its level of KRW200 trillion for the first time since 1999, and the enactment of retirement pension policies in 2005.

The improvement of the market has been encouraged by the Indirect Investment Asset Management Business Act that came into effect on Jan. 4, 2004 for the integrated regulation of the asset management industry. This facilitates financial institutions to maximize investor protection and financial innovation, as the Act was conducive to more efficiently promoting new products in step with the development of the financial industry. In addition, it aims to promote the safe and efficient management of long-term savings vehicles, such as pension funds, by the asset management industry, in response to an aging society.

However, the development of the asset management industry is still is still in its infancy and thus is rather fragile. Recapturing public trust in Korean market is important at this time of recovery and rapid growth. According to Chairman Yoon of AMAK, "This is the time for us to firmly establish the infrastructure needed to support individuals who are turning to long-term indirect forms of investment." He also cited the need for better investor-education, transparency of asset management funds, a stronger practice of disclosure at financial institutions, an expansion of the fund sales network, and strengthening the qualifications of those who solicit funds through more demanding training programs and strict qualification tests.

The fund market is getting bigger, and it is a good investment option because funds are offering better returns during the current times of low interest rates. Understanding the Korean financial market and its products at present apparently is not as important for those selling funds as the market remains rather unattractive with interest rates expected to climb. Above all, public trust remains vital for ensuring stable growth and for the health of our finance industry and should serve as an overall mandate by Korea's central bank and its various government agencies.

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INDONESIA

1. COUNTRY MACROECONOMIC PERFORMANCE

Like most economies in the region, Indonesia experienced relatively high growth rates between 6 to 8 percent in the pre-crisis era, with the country reaping the benefits of major financial and trade reforms (i.e. financial and capital market deregulation and trade liberalization) initiated in the latter part of the 1980s and the early 1990s. Financial reforms included removal of interest rate controls and credit ceiling, reduction of reserve requirements, opening of new banks that encouraged greater competition in the marketplace. As to capital market deregulation, the role of government in the stock market was reduced while allowing greater foreign participation in the buying of stocks. Trade liberalization took the form of tariff reductions, simplification of investment procedures, opening up of more sectors to foreign investment, relaxation of ownership and divestment rules and lifting of minimum capital requirement [Halim, 2000].

Unfortunately, the country seemed to have turned a blind eye, again like most of its neighbors in the ASEAN region, to the impending problems and the growing risk brought forth by growing imbalances, particularly deficits in the current account (the gap being financed by large capital inflows), the rapid expansion of bank lending (coupled with lax credit evaluation and monitoring that led to rising moral hazard problems) and private sector foreign debt (with a substantial portion – about 30% - being short term in nature). The occurrence of the regional currency crisis placed substantial pressure on the rupiah causing the currency to depreciate by as much as 80% only six months into the crisis. This exposed the fragility of the Indonesian financial system and revealed unsound and unregulated banking sector practices on lending. Even prior to the crisis, the banks were already experiencing increasing non-performing loan ratios [ibid.].

The monetary authorities attempted to dampen the pressure on prices and control the movement in the exchange rate by intervening in the market and tightening monetary controls, but these measures proved ineffective as speculative attacks on the currency heightened and inflation rising to double-digit levels of about 13 percent [US State Department, 2002]. With a substantial portion of private sector loans in foreign currency, many banks and corporations were forced to cut down on production activities or close down operations altogether, with a number declaring bankruptcy. The effect of bank failure on corporations and vice-versa was accounted for by the banks being closely related to large corporations, which enjoyed unlimited access to the funds generated by banks. These corporations tend to enjoy higher loan values with higher credit valuation of price-inflated property collateral.

Table-IN1 below presents a bird's eye view of Indonesia's macroeconomic performance.

Table-IN1 Selected Macroeconomic Data

Year	GDP	Expors	Imports	Loan to Deposit Ratio	Real Bank Credit	ROE	D/E
1995	7.8	-	27.60	-	-	-	-
1996	4.7	-	26.40	-	-	-	-
1997	-13.0	-	28.10	1.25	17.16	1.44	2.05
1998	0.3	-	41.70	1.01	-25.38	-5.44	2.56
1999	-	-	26.90	0.88	-56.65	20.96	1.79
2000	-	-	-	1.03	10.21	12.54	2.03
2001	3.8	0.64	4.18	1.02	-1.35	15.69	2.01
2002	4.4	-1.21	-4.25	0.97	7.41	-	-
2003	4.9	8.19	2.73	0.94	15.29	-	-
2004	5.1	8.47	24.95	0.95	18.88	-	-

Source: Various country reports, IMF statistics

After registering negative growth in 1998, the Indonesian economy started showing signs of recovery – in 1998, it grew by 0.3 percent, an extremely modest figure by ASEAN standards. Such growth was led more by consumption expenditures than investments. The financial sector remained in a recession as it grappled with structural and solvency problems. Private and business sector investment, particularly manufacturing, construction and trade began to realize positive growth in 2000 accounting for the major turnaround in Indonesia's economic performance. Tight monetary policies placed a hold on the continued rise in prices. Inflation was controlled at no higher than 3 percent in 2000. Improved revenues from oil exports coupled with decreases in public spending narrowed the budget deficit in 2000 to 1.5 percent of GDP. This is not surprising, as the Indonesian government has historically maintained a balanced budget, although this time the government has placed less reliance on capital inflows to finance the budget gap. Imports for the country clearly exceeded exports and despite the currency crisis in the region that brought most currency values to their lowest levels, Indonesia remained much dependent on imports for its domestic needs. Improvements, however, could be seen in loans-to-deposit ratios and real bank credit as the country tried to address its non-performing loan (NPL) problems subsequently although the real effects of the clean-up still remains to be seen as of the writing of this report.

For much of 2001 to 2003, the economic performance of Indonesia continued to improve, although growth figures remained modest between 3 to 6 percent. Inflation rates remained at low levels and largely controlled, rising to about 10 percent in 2002, but tapering off for the next three years at mid-single digit levels. Such figures were found to be consistent with a floating exchange rate level at the Rp 8000 to Rp 8500 range and low interest rates to spur investments. Stability in the country's macroeconomic conditions has prompted government to wean itself from IMF Extended Fund Facility and replaced it with policy measures contained in the Economic Policy Package, whose goals it is to maintain macroeconomic stability, continuing the restructuring and reforming of the bank financial sector and increase the level of investment, exports and employment creation [A Report on Implementation of EPP, 2003-2004].

Following peaceful elections of the country's new president and vice-president, the economy expanded by 5.1 percent in 2004. The tsunami disaster apparently had minimum effect on Indonesia's 2004 economic performance. The greatest contributor to growth has shifted to consumption-led to investment-led growth. For most of the year, fiscal disciplined was maintained, the deficit remaining at below 2 percent. Bank Indonesia, on the other hand, has kept its inflation target to single digit level, registering 6.8 percent.

2. NON-PERFORMING LOANS PROBLEM

Beginning with the expansion of the financial sector of Indonesia, the government recognized the increase in NPLs and the importance of sound banking management. The first drastic remedy measure taken was the closure of 16 banks and because it was done without provisions for safety nets, the banking system went into turmoil in the years following the crisis. By March 1999, the average NPL ratio of all commercial banks rose to 58.7 percent [Hamada, 2003].

As early as 1991, with the tightening of monetary policies, increasing non-performing loans have already been a problem encountered by state-owned banks. Bank Indonesia started to emphasize the necessity of strengthening the accounting and legal systems for achieving the settlement of NPLs. With the second round of financial reforms in 1992, the number of banks and the amount of total loans and monetary authorities were concerned that the increase would tend to foment speculative investment. Summa Bank was closed as it ran up non-performing loans leading the bank to financial trouble. Subsequently, as more banks faced financial difficulties, Bank Indonesia provided liquidity support to cope with the run on banks as a result of the closure of 16 banks. Banks subjected to recapitalization had their capital adequacy ratio (CAR) increased to 4% and shifted non-collectible accounts to the asset management unit of IBRA. What succeeded bank closures were the mergers and acquisitions and nationalization of banks that cannot maintain the minimum CAR [ibid.].

Indonesia was the most seriously affected of all the countries in ASEAN by the financial crisis. Despite the infusion of public funds, the solution to the NPL problem was found to be the most delayed among the ASEAN countries. IBRA was only established in 1998, given the responsibility to pool NPLs and infuse public funds into institutions worth rehabilitating. Immediately after its establishment, the IBRA introduced restructuring measures such as successive takeovers of ill-performing banks and gaining full control over banks by changing management while supplying liquidity to prospective banks with bigger chances of surviving the crisis [Harado and Ito, 2004]. Indonesia's banking system restructuring has classified banks according to their capital adequacy ratio: A (4% or higher), B (-25% to 4%) and C (-25% or lower). Banks in the A category were considered healthy banks and were allowed to stay in business without government intervention. B banks were obliged to submit business plans and creation of a scheme to boost CAR. C banks were forced to close. Government raised new capital by issuing government bonds, which paved the way for NPLs to be turned into government finances.

Banks in the B category that came under IBRA supervision were made available for sale in 2001, with the full scale of the disposal of these assets intensifying in 2002 and 2003. IBRA was dissolved in 2004 with unsold assets placed under the Ministry of Finance.

As far as the resolution of NPLs is concerned, it was reported that there was scarcely any progress up until 1999. Much of the NPL cases were settled under the Jakarta Initiative and there was no other effective measure to fulfill this goal other than through government initiatives. A year prior to its closure, IBRA has sold almost US$ 22 billion of NPLs .

3. MEANS OF RESOLVING THE NPL PROBLEM

One of the more immediate responses of the Indonesian government to the financial crisis is the creation of the Indonesian Bank Restructuring Agency (IBRA), an ad hoc institution aimed to restore the condition of Indonesia's banking sector and to pay back to the state fund formerly extended to the banking sector.[19]

IBRA is part of a package of restructuring measures designed to regain public confidence in the banking industry. The measures include policies to rebuild the banking system through recapitalization, state bank governance, bank consolidation, improvement of banking regulations and laws, the improvement and enforcement of prudential regulations and the creation of safety nets.[20]

BANK RECAPITALIZATION PROGRAM

The recapitalization program required that BI and international auditors audit affected banks. Audits have been conducted on six banks under the supervision of IBRA and 16 under BI supervision. The audit assisted in determining which banks need to be recapitalized.

[19] Check out official IBRA website.

[20] Taken from IMF Staff Report for the 2005 Article IV Consultation and Third Post-Program Monitoring Discussion, June 21, 2005.

State Bank Governance

A shakeup at the management level in one of the country's major state banks put the issue of corporate governance to the fore in reforms. A report by the IMF discouraged the use of morale suasion for this purpose as it could compromise the soundness of the banking system.

Bank Consolidation

An alternative to recapitalization (which requires significantly lesser amounts of fresh fund infusion) was the creation of incentives for strong banks to serve as core banks for mergers. One of BI's regulations to address this concern was to set a minimum tier-1 level for banks at Rp80 billion by the end of 2007 and Rp100 billion by the end of 2010. Banks unable to meet these criteria can merge with other banks. The scope of operations of those who do not qualify will be curtailed [IMF Staff Report for Indonesia, 2005].

Improvement of Rules and Regulations

Bank licensing was transferred to BI and foreign investors were given greater opportunities to acquire local bank shares. Bank secrecy laws were changed to limit restriction of release of information as they relate only to depositors

Improvements in Prudential Regulation

Such improvements were particularly done on the extension of the leverage of earning asset quality and required loan provisions and guidance on problem loan restructuring. Banks are obliged to fulfill a graduated capital adequacy ratio. Prudential regulations were also established to take stricter legal action against bank owners and management found guilty of violating existing regulations.

Safety Nets

A limited deposit insurance scheme is being put in place with the gradual elimination of the blanket guarantee on deposits. The blanket guarantee policy was an effort to prevent bank runs when 16 banks were declared insolvent and liquidated in the aftermath of the financial crisis. Among the actions taken to expedite the transition away from the blanket guarantee include the issuance of regulations on emergency lending, adoption of joint Ministry of Finance/BI workout procedures for troubled banks, appointment of staff and approval of the budget and operating procedures for the new deposit insurance fund [ibid.].

IBRA was given a level of independence to carry out its mandate. Its governing board was composed of independent professionals, tasked to report to the Financial Sector Policy Committee for the creation of time-bound strategies for the disposition of assets and to the Ministry of Finance on actions taken regarding asset recovery and restructuring. Attached to the board is an independent audit committee.

IBRA's mandate is to drive asset sales and debt restructurings, return assets to the private sector and achieve budgetary collection targets. Collection targets are conducted through a collection arm, an asset management credits (AMC) operations division. IBRA should have achieved most of its responsibilities and would have disposed of all assets by its wrap-up operations in February 2004. The government realizes that one of the most difficult hurdles for the IBRA is in the strong action that needs to be taken against non-cooperative debtors. To this end, an inter-ministerial Committee for Resolving Cases of Recalcitrant Debtors was formed in 2000 which planned out and implemented a coordinated strategy to handle problem cases, covering prosecution, special powers to take over debtors' assets and imposing administrative sanctions. The success of IBRA largely rested on this authority [Jakarta Post, 2000]. Apparently IBRA was closed a year earlier than expected, with settlements with bank owners to have been reported as completed and the majority of the banks taken over by the government either closed or sold to the private sector [World Bank Financial Sector Agenda for Indonesia, n.d.].

The responsibility for the management of free and clear assets formerly under the jurisdiction of IBRA has been transferred to PT Perusahaan Pengelola Aset (PT PPA). This state-owned asset management company is tasked with asset restructuring, cooperate with third parties for enhancing asset value, collection of receivables and asset disposal. Target contribution by the PPA to the state treasury has been exceeded in 2004 as total payments amounted to Rp6 trillion, or Rp3.2 trillion more than the target.

To a certain extent, both the IRBA and the PPA have both been effective instruments in reducing the banking sector's NPL ratios although much still needs to be achieved as new loans are being restructured, with the possibility of joining the ranks of being in arrears.

Table-IN2 presents the values and ratios on NPL from 2001 to the second quarter of 2005.

TABLE-IN2. INDONESIA'S NON-PERFORMING LOANS

YEAR	VALUE (TRILLION)	RATIO
2001	43.40	12.10
2002	33.20	8.09
2003	39.10	8.20
2004	34.24	5.75
As of July 2005	57.80	8.50

Source: Bank Indonesia

The refinancing of Indonesia's debt-ridden banks is considered in the international banking community as the most expensive financial sector bailout in this era. Compared to other affected economies, practically most of the major banks of Indonesia had, in one way or another, been brought under government control. The immediate need to recapitalize these banks led to an upsurge in privatization activities. A number of foreign banks got involved in the purchase of these assets and this increase in foreign ownership forced local banks to shape up, as competition among banks tightened. Best practices among foreign owned banks are testing the capability of fully domestic owned banks to catch up with their foreign counterparts.

With financial reforms firmly put in place, banks are beginning to give out loans to the corporate sector again, following a major restructure of the system and a return to pre-crisis economic growth levels. Bank Indonesia has also managed to maintain interest rates at low levels – with interest rates in 2004 being one of the lowest since the financial crisis. The lowering of interest rates also provided corporations (whose debt problems were linked to the crisis) some reprieve from their own loan obligations. For reputable corporations, the lowering of interest rates affords them the opportunity to tap the capital market by way of bond issuances [The Banker, 2005].

In 2004, the Indonesian government has drawn up 91 private projects with a combined project value of US$22 billion. To complement this, BI has increased the lending limit on infrastructure projects from 20 to 30 per cent, further boosting incentives for these firms to acquire loans from the banking system.

In the same year, Indonesia's Banking Architecture (API) was implemented. API is an overall program that reinforces the reforms already in place in the banking system and improve the quality of bank regulation, supervisory function, bank management and operations, development of banking infrastructure and client (borrowers and lenders) protection. This program strongly adheres to the 25-point Basel core principles for effective banking supervision [Abdullah, 2003].

4. INDONESIA'S CAPITAL MARKET

The Indonesian capital market was reactivated in 1977 with the establishment of BAPEPAM. It is reported to have been less active from 1977 up until the late 1980s, with only about 24 companies participating in this market. The number of firm participants increased quite dramatically to 200 companies in 1992. By end-2003, there were 360 companies, most of which issue shares and/or bonds. The capital market is governed by Law No. 8 Year 1995 and implemented by two government regulations, seven Ministry of Finance Decrees and more than 140 BAPEPAM rules. At present, Indonesia operates two main bourses, the larger one being the Jakarta Stock Exchange (JSX) with a total of 327 listed companies, a number of which are cross-listed in the smaller Surabaya exchange. There are no restrictions on foreign investment in Indonesian stocks and foreign ownership now accounts for over 20 per cent of outstanding equity [Jakarta Stock Exchange, March 2003].

The devaluation of the rupiah in the aftermath of the financial crisis negatively affected the capital market as most issuers had exposures in foreign currency. With a number of these exposures being unhedged, many businesses became insolvent. A crisis of confidence ensued among domestic and foreign investors, who were all the more cautious as Indonesia was classified a high-risk country for investments. The creation of market confidence became a major issue and efforts at reform have since been directed towards this goal.

Various efforts involved in the reconstruction of the capital market are essentially related to internal and external restructuring. For the former, the Indonesian government has drafted the Financial Service Authority (FSA), which proposes to merge BAPEPAM, some functions of the central bank and the Directorate General of Financial Institution. The draft proposal is still under discussion by the House of Representatives. The proposal involving internal restructuring is more organizational in nature. The demutualization of the stock exchange is a proposal in line with external restructuring to make the capital market more globally oriented that could withstand foreign competition. The Indonesian capital market is poised to embrace innovations in information technology to address issues regarding transparency and corporate governance. An improvement in the ownership structure, orientation and management of the stock exchange will hopefully sustain growth in the capital market and improve competitiveness. As service improves and new types of products are introduced, the resulting attraction of the stock market to both foreign and domestic investors would enhance the exchange's liquidity structure. The process of demutualization of the Indonesian stock exchange is in its final phase where its structure might take on an operating holding company, to be owned by majority stockholders of the exchange.[21]

The banking system of Indonesia consists of a central bank, the Bank of Indonesia (BI), state banks, commercial banks and regional credit banks. Under a new act (Act No.23 Year 1999), BI acquired a status and position as an independent central bank, whose main function is to create and administer monetary policies to maintain the stability of the financial and exchange markets. It is also responsible for the administration and regulation of four state banks and banking operation as the lender of last resort. As of December 2003, there were 138 commercial banks and over 8000 regional credit banks, handling basically regional deposits and loans in small amounts.

The non-bank financial institutions are under the supervision of the Ministry of Finance that includes leasing companies, insurance companies, pension funds and other capital market related companies such as securities brokerages and dealers being supervised by the Capital Market Executive Agency (BAPEPAM).

Indonesia's financial sector is generally described as still fragile because of fairly weak capital and loan reserves. Basel II compliance is still at an early stage while accounting disclosures and financial regulations need to be reviewed and strengthened. Calls for stronger implementation, therefore, may be necessary.

A World Bank Financial Sector Agenda Report for Indonesia [2005] identified issues that need to be addressed when developing reform measures. These are:

[21] This was taken from the BAPEPAM Chairman's Speech to the 5th Round of Capital Market Reform in Tokyo, 2003.

- Bank lending has yet to recover with the need to shift focus from consumption to investment. Recapitalization bonds and central bank notes still dominate most of the banks' balance sheets, and credit for productive investment continues to be scarce. Banks generally lack the long-term resources to finance growth – nearly all bank deposits in Indonesia are three months or less in maturity.
- Governance of state banks remains weak. The government, apparently, still continues to pay for the weaknesses of these banks.
- Though BI's role has been redefined to be an independent authority, the central bank seems to have less authority over state-owned banks than private banks.

The capital market, according to the same World Bank report, has its share of challenges and issues the government should likewise heed:

- Non-bank financial institutions (pension funds, insurance, capital markets, mutual funds) remain small, making up less than 30 per cent of Indonesia's financial system. But it is essentially these non-bank institutions that will necessarily have to supply long-term funds for growth and development and for providing a stable source of financing of government deficits and refinancing of debt.
- The private sector needs a more developed equity and debts/bonds market as an alternative source of capital to bank lending. With traded capital concentrated is a small number of listed companies, the size of the exchange can get it expose to easy manipulation.
- Though the primary market for government bonds is doing relatively well, the secondary market needs further development.
- The mutual fund industry has a long way to go in adopting international valuation standards and may be providing a false sense of security to investors.

The sudden upsurge in the flow of investments into mutual funds has generated its own set of concerns that should equally deserve government attention [Kenward, 2003].

- At the macroeconomic level, capital inflows is causing exchange rate appreciation and a drop in interest rates. This poses some serious challenge to other sectors of the Indonesian economy.
- A fragile banking system, just recovering from the adverse effects of the financial crisis, cannot afford a sudden reversal of capital flows that could cause bond prices to drastically drop and interest rates to rise dramatically. This will have negative effects on the capital adequacy ratios of banks since a substantial proportion of their funds are invested in government bonds.
- The rules for the mutual fund industry still appear weak in certain areas, while the enforcement of rules already in place are relatively lax and, therefore, could easily be subject to abuse and manipulation.

5. INDONESIA'S ASSET MANAGEMENT INDUSTRY

Indonesia's funds management industry is at present largely dominated by the mutual fund industry. Mutual funds were first introduced in 1996 and took on center stage in Indonesia's capital market development in 2002. Between 1999 to 2001, an upsurge in investments in mutual funds was experienced by the industry. Funds soared from less than Rp8 trillion at the end of 2001 to almost Rp60 trillion in early 2003. As of end 2003, there were 186 mutual funds registered, valued at Rp69.4 trillion, 60 per cent of which were mobilized by banks (12 banks acting as sales agents), with the bulk of the funds in fixed income securities, mainly government bonds. By September 2004, the number of mutual funds further increased to 215, valued at Rp94.4 trillion. The pace of this expansion has brought about concerns among participants about the fragile state of the financial sector [ibid.].

Table-IN3. Number of Mutual Funds, Total Unit Holders and Net Asset Value

Year	Number of Funds	Total Unit Holders	NAV (Rp billions)
1996	25	2,411	2,782.32
as of 1999	81	24,127	4,974.10
as of 2003	186	171,712	69,477.72
as of September 2004	215	243,247	94,399.08

Source: BAPEPAM

Together with the increasing flow of investments into mutual funds, the number of licenses granted to individual mutual fund sales agent representatives has likewise increased dramatically, outpacing all other securities firms in terms of the number of licensed acquired. **Table-IN3** above shows more than a 12 fold increase in the number of licensed mutual fund sales representatives from 1999 to 2003. In 2004, the figures were nearly double that of the previous year.

Table-IN4. Number of Licensed Representatives in Securities Firms

Year	Dealer-Broker Representatives	Underwriter Representatives	Investment Manager Representatives	Mutual Fund Sales Agent Representatives
1997	1,188	781	449	158
as of 1999	1,929	1,029	651	297
as of 2003	3,458	1,403	1,238	3,798
as of Sept 2004	3,512	1,438	1,382	6,294

Source: BAPEPAM

A combination of favorable regulation and a growing mutual fund industry has created pressure for fund administrators to upgrade their monitoring schemes to international standards. It is believed that this could lead to the consolidation among many custodian banks, serving domestic and overseas investors, as the change makes way for more opportunities for the most competitive of these administrators [Vengayil, 2003].

The regulators, on the other hand, were quick to respond to market needs. Restrictions were eased on ownership limits and investment in overseas securities. The limit on the total number of units in a mutual fund that can be owned by a single investor was doubled to 2 per cent. Mutual funds were also freed to invest up to 15 per cent of their assets offshore whereas previously investments were allowed only in local securities [ibid.].

Banks are generally attracted into the mutual funds industry since it affords them liquidation of government bond holdings and the liability that arises from it are not subject to central bank reserve requirement. Furthermore, the fees to be earned are attractive [Kenward, 2003].

The mutual fund industry is a focus of financial and capital market development in Indonesia as it provides a stable form of financing, boosted by the tax incentives it gets to enjoy from the government.

The monitoring authority over the mutual funds of Indonesia is BAPEPAM. The supervision of Indonesia's mutual funds is reflective of this authority's general philosophy of emphasizing disclosure and self-regulation. Fund managers are required to provide as much information of its operation in its prospectus for which BAPEPAM's inspection would largely depend on the fulfillment of commitment by fund manager as contained therein. Monthly reports serve as monitoring devise for the agency (BAPEPAM). These are supported by on-site inspections once every two years. As a rule, BAPEPAM expects investment managers to manage their portfolio in a manner allowing them to redeem 20 per cent of their daily portfolio [ibid.].

6. CONCLUSIONS AND RECOMMENDATIONS

Since the financial crisis, conditions in the Indonesian financial market have improved remarkably with the implementation of various restructuring programs. But Indonesia's financial market remains fragile and could easily revert to situations experienced during the financial crisis, even with just mild shocks in the system, unless volatility in capital flows can be contained. The government need to work seriously on the basic fundamental infrastructure needs of the system by strengthening prudential regulations, increasing the opportunities for greater participation in the financial sector of foreign reputable bank and non-bank institutions, cut down on preferential treatment of selected sectors that would artificially provide greater returns, and increase the level of transparency in all business dealings. Artificially pushing for greater returns through subsidies and unsustainable incentives would only amount to greater government expense to the detriment of taxpayers. All these boils down to increasing confidence levels among existing and prospective investors in the Indonesian financial and capital markets.

For the mutual fund industry, in particular, the rise in investments were a result of monetary incentives, the goal for which this was adopted has already been achieved. Growth in mutual fund investments should slow down until the necessary monitoring and control mechanisms are put in place. Kenward [2003] has recommended some measures to control the growth of mutual funds. Primary on the list is the elimination of tax exemptions. There is a need to strengthen important aspects of supervision, especially with regards to requirements imposed on custodians and transactions between the mutual fund and their sponsoring banks regarding the market valuation and pricing of the fund. There should be stringent rules and sanctions on incidence of collusion, side agreements and the practice of creative accounting. There is much that a strong political will can achieve in stabilizing the different sub-sectors of Indonesian finance. To the extent that the present administration is willing to subject the finance sector to international scrutiny is a welcome change and one that can provide greater benefits, with spill over effects to the other sectors of the economy.

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MALAYSIA

1. COUNTRY MACROECONOMIC PERFORMANCE

Malaysia is the second most progressive country in the ASEAN region, reported to be second only to Singapore. Its transformation into a rapidly developing nation has been hailed in the international community, by no less than the International Monetary Fund, as one of the most successful economies among its members. From a primary product producing economy with real per capita income of only US$300, Malaysia has recorded dynamic real income growth to its current tenfold level as a result of economic growth of about 7-8 per cent in the 1980s to 1990s. IMF cites this growth to be of the high-quality type, which is essentially sustainable, adheres to macroeconomic stability, benefits most especially the marginalized sector of society, and preserves culture and the arts and has great respect for political freedom [Camdessus, 1996].

Among the reasons for Malaysia's success, the IMF emphasized five sets of policy reforms that this country has effectively implemented [ibid.]:

- Policies have maintained broad macroeconomic stability, which is crucial to the achievement of a continuous cycle of high saving, high investment, and rapid growth that Malaysia has enjoyed;

- Overall strategy has been both outward-oriented and increasingly market-friendly;

- Long-term emphasis on investment in human and physical capital has likewise unlocked another cycle of education spending, productivity, and growth;

- Successful pursuit of deliberate anti-poverty programs has reduced poverty and helped maintain social stability and ensure the political sustainability of the reform process; and

- The cooperative way in which Malaysia has availed itself of the benefits of the Bretton Woods Agreement that has resulted in a permanently open and mutually trustful dialogue.

Selected macroeconomic data given in **Table-MA1** provides a broad picture of the economic performance of Malaysia from 1995 to 2004. GDP figures clearly shows above-average economic performance of the country in the three years prior to the financial crisis.

Table-MA1: Growth Rates on Selected Macroeconomic Data on Malaysia

Year	GDP	Exports	Imports	Loan to Deposit Ratio	Real Bank Credit	ROE	D/E
1995	9.8	18.96	23.70	1.27			
1996	10.0	9.23	4.89	1.32			
1997	7.3	5.49	5.82	1.54	20.18	9.67	2.29
1998	-7.4	0.49	-18.75	1.54	-2.31	-1.82	2.29
1999	6.1	13.16	10.56	1.43	-0.64	4.64	2.35
2000	8.9	16.07	24.37	1.35	4.64	4.64	2.29
2001	0.3	-7.50	-8.61	1.29	3.30	3.44	2.43
2002	4.3	4.49	6.35	1.34	5.04		
2003	5.4	5.70	4.24	1.39	4.63		
2004	7.1	16.31	20.68	1.42	20.51		

Source: Various country reports, IMF statistics

Apparently, Malaysia's strong economic fundamentals were unable to withstand the serious contagion of the financial crisis the year after as the country experienced a significant amount of capital outflow when the crisis erupted in 1997. This resulted in a sudden decline in economic growth to negative levels in 1998. Such outflows comprised mainly of nonresident portfolio investments in the Malaysian stock market. The accompanying decline in prices, as a result of capital outflow, reduced market capitalization to nearly a fourth of its original value. A depreciation of the ringgit (RM), however, contributed to an improvement in the country's external position and exchange reserves stabilized at RM20 billion or the equivalence of almost 4 months' imports. Increase in reserves afforded Malaysia some flexibility in its policy response [Mustapa, 1998]. Prior to the crisis, the Malaysian economy was reported by the Asian Development Bank (ADB) as growing in excess of its underlying potential. Large current account deficits were reflective of domestic resource imbalances, since it was essentially external capital flows that sustained such deficits. Investment growth was accompanied by substantial credit growth, in turn, heightening corporate leverage and asset price inflation [ADB, 1998]. Loan to deposit ratios were likewise on the uptrend, reaching the highest in 1998 and then starting to decline around 1999 onwards. Banks have become more cautious, in fact being excessively cautious right after the crisis as most banks had to put their house in order. The same picture can be gleaned with figures on real bank credit. In 2003, the rise in lending has been a result of government's efforts to jump start the economy and improve on productive capacity.

The effects of the currency crisis of 1997 became strongly felt in Malaysia in 1998. Budget reduction, major adjustments in fiscal measures coupled with tight monetary policies, saw interest rates rise from low single digit levels to nearly 12% and which have caused a deceleration in the country's economic growth. The second Minister of Finance reported that as part of the country's overall strategy of pre-emptive measures to counter the threat of contagion arising, selective administrative controls were introduced in the latter part of 1998. Such measures had more to do with the trading of the ringgit in the offshore market while no restrictions were imposed on the inflow and outflow of foreign exchange. The monetary authorities felt that selective controls were the only way, at the time and given the circumstances, to safeguard the progress the country has already made in terms of economic and financial restructuring. They also felt the strong need to gain monetary independence to enable the implementation of policies to promote economic recovery [Mustapa, 1998].

The policy responses undertaken by Malaysia may be categorized into three phases. The first phase, occurring in the latter part of 1997, involved demand management policies to reduce the current account deficit and address the high leverage exposure of the private sector, in the face of continuous credit growth. Such action ensured that excessive demand would not lead to inflationary pressures and deterioration in the balance of payments resulting from a drop in the value of the ringgit. In the second phase, occurring in the first four months of 1998, fiscal was relaxed to allow for increased spending to strengthen the social safety net of the poorer sector of society. In addition to this, mergers among financing firms were encouraged to strengthen the financial sector. The third phase occurred in mid-1998 when efforts to curb any further deterioration in the currency, while arresting any inflationary pressures on price movements, led to some easing in monetary policy. The rising non-performing loans of banks were addressed by the establishment of: DANAHARTA, whose function was to purchase NPLs from banks and package them for sale to foreign or local investments at discounted prices; and DANAMODAL, which was responsible for recapitalizing banks who have agreed to sell their NPLs to Danaharta [ibid.].

The easing of monetary policy, while providing fiscal stimulus to reactivate domestic demand, contributed to Malaysia's recovery, where the economy quickly picked up beginning 1999. This is evident in the rebound of growth to 6.1 percent two years after the crisis. Efforts at resuscitating the economy seem to have paid off as per capital income in current terms, which declined in 1998, rebounded in 1999, surpassing even the pre-crisis level. Measures have been put in place to increase productivity, like the allocation of more resources to research and development, expansion of education and training and technology improvements [ADB, 2000].

In 2000, the Malaysian government pursued further expansionary fiscal and monetary policies to support efforts taken in 1999 to pump prime the economy, but this led to an increase in fiscal deficit of close to 100% from the previous year's deficit level. Inflation, however, remained subdued and the government is said to have continued its accommodative monetary stance, maintaining low interest rates and its fixed exchange rate regime. Substantial progress was achieved in the banking sector with mergers in domestic banks contributing to a more effective and competitive banking system [ADB, 2001].

Malaysia was affected by the global downturn in the electronics industry in 2001, but the stimulus package initiated by the government's increased public spending subsequently pushing consumption spending and investments upward. Macroeconomic fundamentals remained relatively strong with inflation at low single digit levels, the current account balance in surplus and the banking system remaining resilient [Asian Development Outlook, 2002]. Monetary policies continued to complement fiscal policies in stimulating domestic demand. Bank Negara Malaysia reduced intervention rates contributing to a decline in rates. The merger of 54 banks into so called 10 anchor banks and the successful recapitalization of Danamodal strengthened the banking system even further, making it less vulnerable to problems encountered by the sector during the crisis.

Strong take-off in the economy was experienced in 2003, further accelerating in the first half of 2004. Growth was found to be more broad-based with all sectors registering positive growth. The banking system, particularly, continued to strengthen along with improvements in loan repayments.

2. NON-PERFORMING LOANS PROBLEM

Non-performing loans in Malaysia following the financial crisis seemed to have emanated from critical areas in its banking system, particularly excessive enthusiasm for property based lending, failure to make informed credit evaluations and adequate screening measures, failure to monitor collateral adequacy and over-emphasis on relationship lending [ABD's Insolvency Asia, n.d.].

The currency crisis of 1997 raised concerns over the health of the banking system of Malaysia. Excessive lending without adequate safeguards was identified as a main drawback of financial institutions in Malaysia, resulting in soaring non-performing loans (NPLs) and gross capital inadequacy. Rising NPLs in the banking sector, in turn, gave rise to the fear of systemic bank failures. Malaysia's NPL problems, however, are said to pale in comparison with other countries in the region and similarly pales in comparison with the country's own experience in the mid-1980s crisis when NPLs rose as high as 33 per cent of total loans. During the 1997 crisis, Malaysia's NPL only stood at 14.9 per cent following the three-month classification [Ariff et al, 2001].

The 1997 recession experienced by the region was caused by adverse developments in the regional financial markets following speculative attacks on the currencies of Southeast Asian countries Malaysia was not spared on the contagion effects of such developments despite its relatively strong economic fundamentals.

One of the immediate effects of the crisis on the banking sector was the capitalization problem due to non-performing loans and the ringgit depreciation [Ariff, Setapa and Lin, 2001]. While the NPL problem had a direct influence on the size of operating capital, the ringgit depreciation worsened the situation because of rising costs of international payments. Pre-crisis level of NPLs was low in Malaysia at about 3.5 percent, which nearly doubled within one year alone to 6 percent. Much more remarkable was the growth in loans to what government classified as the less productive sectors of the economy (e.g. property, consumption credit and loans for the purchase of shares of stocks.) In the property sector alone, loan growth was registered at close to 30 percent in 1997 alone [ibid.].

Government-run financial institutions had their own share of the NPL problem. One of these banks, the Bank Pembangunan Malaysia Bhd. (BPMB), has seen an increase in its NPLs arising mainly from the manufacturing sector (55 percent of NPLs), mostly small and medium scale enterprises that are vendors to larger corporations. The Bank Industri Malaysia Bhd (BIMB), another government-owned bank, had the highest NPLs in the maritime sector amounting to RM32 million or about 97 percent of the loans given out to that sector. More that 90 percent of the NPL account holders of BPMB and BIMB are Bumiputra entrepreneurs [National Economic Recovery Plan, n.d.].

BusinessWeek Online (2000) reports that Malaysia is said to be swamped with banks and after the crisis the banking industry was in serious need of a viable system since the smaller banks were in no position to compete as the market was originally set to open to foreign competition by 2003.

Between 1998 and 2005, gross NPLs in Malaysia declined from a high of RM62 billion to RM46 billion. Collective efforts at solving the NPL problem has resulted as well in a decline in the net NPL ratio from 13.6 percent in 1998 down to 6 percent in 2005, although the latter is still considered a high ratio by international standards [Sum, 2006].

3. MEANS OF RESOLVING THE NPL PROBLEM

The Malaysian government took measures to restructure and consolidate the financial and corporate sector with the aim of relieving institutions of their NPLs, strengthening and recapitalizing banking institutions, facilitating corporate debt restructuring and enhancing efficiency within the system. One of the more immediate actions taken by Bank Negara Malaysia was to increase the provisions among banks for bad loans from 1 percent of a bank's assets to 1.5 percent [New York Times, 1997].

Important financial infrastructures were subsequently introduced in mid-1998 to speed financial restructuring of both the banking and corporate sectors. Such infrastructure comprised of three agencies [Rajandram, 1999]:

PENGURUSAN DANAHARTA NASIONAL BERHAD (DANAHARTA)

Danaharta was established in June 1998 under legislation as an asset management company to relieve the banking sector of its non-performing loans with amounts greater than RM 5 million, essentially freeing up management and capital resources of the banking system and refocusing efforts back towards lending and other financial intermediation role. Danaharta's more extensive funding structure allows it greater flexibility in the recovery of NPLs.

DANAMODAL NASIONAL BERHAD (DANAMODAL)

Danamodal was set up in August 1998 as a special purpose company whose essential function was recapitalize and strengthen the banking sector in terms of its main functions.

CORPORATE DEBT RESTRUCTURING COMMITTEE (CDRC)

CDRC is a steering committee where debts are restructured on an informal basis between the concerned companies and their creditors. It restructures loans in excess of RM 50 million. Though its functions are not imposed on companies affected and even if it does not possess legal powers of its own, it has been granted similar powers as that of the central bank of moral suasion in its dealings with financial institutions. CDRC has also been tasked to undertake industry studies of critical sectors (telecom, steel and transport) affected by the financial crisis in search of industry solutions, in addition to individual firm solutions to the debt problem.

MALAYSIA'S ASSET MANAGEMENT COMPANY (DANAHARTA) AND NPLS

Danaharta, a government-owned asset management company (AMC) set up in June 1998, was provided with a specific mandate to resolve the rising problems brought about by NPLs incurred by banks during the financial crisis. This particular AMC is guided by the Danaharta Act of 1998 which essentially provides it with two special powers: one, being given the authority to purchase non-performing assets through statutory vesting and second, the capability to appoint groups of special administrators to manage the companies acquired. All acquisitions by Danaharta are approved for purchase by an oversight committee after evaluation by teams of independent advisors, which also act in behalf of the interests of the creditors. For real estate properties that secure the non-performing loan, Danaharta is guide by the National Land Code of 1998, with its Amended Act facilitating the acquisition of real assets.

To help infuse fresh capital into undercapitalized but viable banks, the Bank Negara Malaysia established Danamodal in 1998 with the specific purpose of injecting new capital into these banks and further rationalize the process of capital infusion. Both Danaharta and Danamodal are obligated to incorporate principles of economizing and rationalizing the proper use of limited public funds, assigned specifically for the acquisitions of NPLs but with a keen eye to searching for the least costly solutions to these problem accounts of the banking system. With NPL problems out of the way, the banks can concentrate on their role of financial intermediation, a function gravely affected by the crisis, as banks took on a very cautious stance in providing funds after the crisis even to borrowers qualified to take on credit.

Danaharta was conceived as a finite life agency. Most AMCs have a projected life span of 10 years. Danaharta is to have a life of only seven and a half years and will cease operations by December 2005, during which time this AMC should have already completed its mandate and would have recovered assets from the resolution of these, either in cash or non-cash. The non-cash assets are comprised of structured loans, properties and securities. The finite life expectancy of Danaharta has been premised on the following reasons [Danaharta Annual Report, 2005]:

- minimize losses to taxpayers considering funds had to be allotted for this purpose
- mitigate the risk of moral hazard
- winding down is a sign of success for this particular AMC
- Malaysia's financial sector has been nursed back to good health as a result of this move and other financial reforms.

An indication of the success of Danaharta can be gleaned from the NPL ratios of the Bank Negara Malaysia, which are currently maintained at a range of 4.7% to 4.9% from its level immediately after the crisis at 8% in 1998. **Table-MA2** provides historical data on Malaysia's NPL ratios. Accounts are classified as NPL when these are in arrears for six months.

Table-MA2 : Non-Performing Loans of Malaysia'a Banking System

Year	Amount (RM million)	NPL Ratio
1998	52,307	8.0
1999	46,828	6.4
2000	49,003	6.3
2001	61,903	8.1
2002	58,885	7.5
2003	54,798	6.8
2004	50,712	5.8
2005 (As of Oct)	45,885	4.7

Source: Bank Negara Malaysia

Other factors that account for the success of Danaharta is traced to their internal performance targets. Danaharta is reported to possibly be the earliest among the region's AMCs to adopt key performance indicators (KPIs) from which the organization is to be evaluated. This AMC went through the four phases of establishment, acquisition of assets, resolutions of NPLs and exit options for more complicated NPLs rather swiftly, with KPIs put in place at every phase. In most of the phases, Danaharta reports meeting if not totally exceeding the benchmark at a speed that does not compromise quality. [Danaharta Final Evaluation Report, 2005].

Furthermore, when benchmarked against key factors identified by the Bank of International Settlements, Danaharta reports to have complied with the following criteria identified for the successful operation of an AMC:

- Strong political will or commitment from government to address the NPL problem;
- Supportive legal infrastructure like laws in bankruptcy and foreclosure backed by legal powers for quicker resolutions and higher recoveries;
- Efficient market environment made possible with the existence of an efficient capital market to facilitate asset sale;
- Clear AMC mandate that covers the types of assets to be acquired and the resolution methods to be utilized;
- Well-defined lifespan to prevent the asset from merely accumulating and preventing incurrence of large losses;
- Adequate governance made possible through systematic internal controls and effective external supervision;
- Transparency through regular reporting of accurate information as backed up by audit reports;
- Realistic asset pricing, following market-based pricing, with proper incentives to facilitate asset transfer; and
- Speedy resolution as well as the speedy disposition of acquired asset regardless of the current economic situation.

4. MALAYSIA'S FINANCIAL AND CAPITAL MARKETS

Among the Southeast Asian countries, Malaysia's financial and capital markets are categorized as one of the more highly developed of the emerging economies. Malaysia's development efforts in this sector is currently at pursuing further growth, consolidation and structural change to address increasing pressures of competition brought about by liberalization and increased international financial integration.

MACROECONOMIC STRUCTURE OF THE FINANCIAL AND CAPITAL MARKET SYSTEM

The financial system of Malaysia is basically comprised of the banking system, a securities market, a commodity futures market and offshore financial services. The Bank Negara Malaysia is the country's central bank tasked with overseeing and supervising the banking system, has seniorage functions of printing the currency, responsible for foreign exchange control regulations and a lender of last resort. The banking system of Malaysia is comprised of licensed domestic commercial banks and their branches, representative offices of foreign banks[22], merchant banks and their branches, an extensive Islamic banking sector, finance companies, discount houses and factoring companies.

The Kuala Lumpur Stock Exchange (KLSE) acts as the main exchange for the buying and selling of equity shares and bonds of Malaysian-listed companies, with a Central Depository System (CDS) serving a clearing and settlement system of the exchange. A separate exchange, the Malaysian Exchange of Securities Dealing and Automated Quotation (MESDAQ), serves as a venue for raising equity capital by technology-based companies with no track record but with substantial growth and strong profit potentials.

Futures contract are traded at the Kuala Lumpur Commodity Exchange (KLCE), with the most active being in crude palm oil futures, palm oil being a leading export. The Malaysian Derivative Clearing House Bhd. (MDCH) serve as the commodity exchange's clearing house. Both the KLSE and KLCE are under the supervision of the Securities Commission (SC). The SC is responsible for capital market development and streamlining of rules and regulations in the securities market [Yusof, 2000].

The Labuan Offshore Financial Services Authority (LOFSA) is a regulatory body responsible for the promotion of Labuan as an offshore financial center. Labuan is a federal territory of Malaysia, an island off the north-west coast of the former British Borneo and Brunei Darusalam.

POST-CRISIS CAPITAL AND FINANCIAL MARKET DEVELOPMENT

Since the financial crisis of 1997, the Malaysian government has further beefed up its efforts at broadening and deepening its capital market. A 10-year Financial Sector Master Plan (FSMP, developed by Bank Negara Malaysia) and a Capital Markets Master Plan (CMMP, developed by the Securities Commission) were drawn up in 2001 to address the government's efforts at capital market development.

The aim of the Financial Sector Master Plan (FSMP) is essentially to build and enhance competitiveness and resiliency among domestic banks in preparation for the introduction of foreign competition in the banking system slated for 2008. The plan, likewise, provides for liberalization in the insurance industry, allowing for some level of foreign participation. The FSMP anticipates public investment to grow by 5.4% per year and private investment by 17.5% over the 10-year period [ibid.].

The Capital Market Master Plan (CMP) likewise aims to prepare domestic players in the market with the entry of foreigners, permitting them to buy into a limited number of existing stock-broking licenses and unit trust management companies. This plan projects the economy will require some RM930 billion in new capital expenditures over this decade, increasing output by a average of 7.3 percent [ibid.]. Government announcements have been made, in the latter part of 2004, on the availability of 10 licenses, divided

[22] Foreign bank representative offices are not permitted to conduct normal banking services.

equally for foreign fund management and stock brokerage firms [US State Department Investment Climate Statement, 2005].

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The Malaysian government continues to maintain most of the barriers to entry in the financial sector. With no new licenses being issued, foreign banks are encouraged to purchase existing financial institutions. Resiliency to external shocks have been reinforced with the consolidation of the banking industry into so called 10 anchor banks, with further consolidation still expected in the years to come. Such consolidation is also viewed as a preparation for the entry of foreign competition towards the latter part of the decade [ibid.].

Malaysia has a fairly large Islamic banking sector, whose asset value comprises 9.6% of the assets of the total banking system, and the Islamic capital market plays a complementary role to this sector. The religion of Islam is the guiding principle for choosing the activities in which Islamic banks and non-bank entities engage in. Some of the leading corporations in Malaysia have issued long-term debt utilising Islamic-based instruments [Yusof, 2000]. Much like other domestic banks, the Islamic banking sector is not spared regarding the efforts of government to open the banking industry to foreign competition, as three new Islamic banking licenses are made available to foreign banks in 2004.

The Malaysian capital market encompasses shares traded in the stock market, government bonds and private debt securities. Other services and products supporting this market include the activities of investment management funds, stockbrokerages and advisory services. Under investment management funds, the unit trust industry grew with the introduction of new investment schemes, new firm entries and regulatory reforms in the 1990s [Yusof, 2000]. Among the new measures introduced to develop the capital market include the strengthening of the stockbrokerage industry through consolidation, promotion of the bonds market with new guidelines and regulations, relaxing rules on the use of proceeds from the issuance of private debt securities, enhancing market mechanism and competitiveness, improving corporate governance and the protection of minority shareholders and promoting the fund management industry.

5. MALAYSIA'S ASSET MANAGEMENT INDUSTRY

DEVELOPMENTS ON THE FUNDS MANAGEMENT INDUSTRY

The beginnings of the Malaysian asset management industry dates back to the 1970, with fund management services concentrated in the hands of merchant banks and largely directed towards large institutional clients. Fund management departments in these merchant banks eventually evolved to become independent entities. Such move minimized the normal problems encountered regarding conflicts of interest. Furthermore, this afforded spun-off entities better monitoring by regulatory authorities while enabling fund managers of these entities to respond more quickly to market sentiments, since this provided avenues, as well, for the entry of other players in the industry.

Economic development, combined with changing investor behavior, provided much of the impetus for growth in the asset management industry in the 1980s and 1990s, dampened only by the onset of the Asian financial crisis. As of June 2005, the asset management industry of Malaysia, then comprised of 76 fund management companies, is a RM116 billion industry, up by 1.3% from the end of 2004. The local unit trust fund continues to be the main source of funds under management by 36 management companies valued at RM88 billion. The rest comprise of funds of charitable bodies, corporate bodies, employees provident fund, government bodies/agencies, insurance companies, private pension funds and wealthy individuals. A breakdown, with comparative figures, is provided in **Table-MA3**. A greater proportion of these funds have consistently, over the years, been invested domestically.

Table-MA3 : Funds Managed by Licensed Fund Management Companies

Source of Fund	Local (RM million)		Foreign (US$ million)	
	2005 (June)	2004 (Dec)	2005 (June)	2004 (Dec)
Charitable bodies	381.56	366.23	1.11	1.00
Corporate bodies	5,804.93	6,127.95	277.15	461.91
Employee Provident Fund	6,070.85	6,385.16		
Government agencies/bodies	4,008.17	3,455.73		
Individuals	1,597.43	1,727.76	28.69	37.65
Insurance Companies	853.59	901.71	36.75	3.41
Private pension funds	1,062.34	1,056.61	1.24	0.72
Unit trust funds	88,450.79	70,757.08	161.84	184.88
Other funds	4,488.14	2,960.12	246.35	301.16
Total	112,717.82	93,738.35	753.13	990.73

Source: Securities Commission of Malaysia

Unit trust funds carry a particularly important position in the development of the asset management industry of Malaysia. The industry has only been in existence for about four decades. With a NAV of RM15.7 billion (or 3.39% share of KLSE market capitalization) in 1992, unit trust investments has grown to RM87.38 billion (or 12.1% share of KLSE) in 2004. Unit trusts are believed to be household products in Malaysia, accounted by the centralization of industry regulation, implementation of the Unit Trust Scheme by the Securities Commission in 1996 and the extensive marketing strategies adopted by well-known financial institutions. After the financial crisis, with new regulations allowing third party distributions, the licensing of tied-agents involved in the distribution and the permit for stockbrokerages to manage unit trusts, there is a continued upward trend in the number of units in circulation as well as unitholders. As reported by the Securities Commission of Malaysia, there are a total of 99.6 billion units in circulation among 10.3 million unitholders.

In a keynote speech delivered by Mr. Saaid on the ‘Development of the Malaysian Capital Market’ in 1999, he mentioned that most industries in Malaysia experienced severe contractions. However, the fund management industry is among those that seemed to have weathered the storm, especially in relation to what he claims is a collective investment scheme that continued to grow, albeit at a slower pace. From a NAV of only RM6.27 million in 1999, the funds management industry has grown to RM114.13 billion in 2004. This amount was a 20% increase from 2003. Unit trust funds continue to be the main source of funds under management, or 77% of total. The five largest fund management companies managed more than half of total funds. The Securities Commission reports that generally favourable economic and market conditions in 2004 is seen responsible for the positive impact on the amounts of funds invested onshore, registering RM110.05 billion.

Most fund management companies still placed relatively greater weight on equities for their asset allocation but recovery in the global markets has encouraged fund managers to seriously consider fixed income securities. A total of 70 funds approved in 2004 comprised of 13 balanced funds, 12 bond funds, 32 equity funds, one conventional equity and bond fund, eight fixed income funds, two conventional money market funds and two conventional guaranteed funds [Securities Commission Annual Report, 2004].

For 2005, the Malaysian government has allowed provisions for the establishment of operations of five foreign fund management companies with 100% equity participation. Among the other significant events benefiting the industry were as follows [ibid.]:

- A review of the 'Guidelines for Fund Managers and Fund Managers' Representatives Under the Securities Industry Act 1983' essentially to introduce additional eligibility criteria for candidates of new fund manager's and future fund manager's licenses;
- Introduction of the 'Guidelines on Online Transactions of and Activities in Relation to Unit Trusts' for the enhancement of distribution channels in the fund by allowing transactions of units to be done electronically;
- Introduction of the 'Securities Commission (Fees and Charges) Amendment Regulation 2004' to speed up the time and rationalize the resources expended on reviewing applications relating to unit trust schemes; and
- The Commission continued to evaluate and examine asset management companies and unit trust management companies for compliance with regulatory requirements. This was done in conjunction with the Malaysian Association of Asset Managers (MAAM), currently comprised of 37 ordinary members. Inclusive of associate members, the industry consists of 76 asset management companies licensed by the Securities Commission.

MAJOR FUND MANAGEMENT PRODUCTS/INSTRUMENTS

The bulk of instruments traded in the market for investment funds generally comprised of unit trusts, open-end and close-end funds.[23]

- Unit Trusts – these funds are pooled vehicles that invest in a variety of assets like fixed income securities, equities and commodities with returns commensurate to the risk to which the fund is exposed to. Unit trust funds are regulated by the

[23] Check out MAAM website.

Securities Commission with operations governed by the Securities Industry Act 1983.

- Open-ended funds – these are usually funds to which unit trust funds are unitized and managed by unit trust management companies.
- Close-end funds – these are companies whose authorized and paid-up capital addresses its single business to invest in designated assets on behalf of its shareholders. Other than being monitored by the Securities Commission, such companies with limited shares are likewise overseen by the Registrar of Companies and the KLSE (if listed). Such companies are governed by the Companies Act of 1965 and KLSE Rules.

Products offered by the industry are by and large not guaranteed which brings to the fore the issue of integrity in operations and investments processes. This accounts for why some unit trust management companies appoint external asset management companies to take care of these matters and they can concentrate on selling units and in product development. This is the seemingly underlying trend, even in this market, where any operation of the organization that does not form part of the organization's core competency is subcontracted to those who are experts in the field.[24]

The most widely traded fund in the Malaysian capital market is the unit trust fund which is valued at RM87.38 billion in 2004 or more than 160% increase since the financial crisis. There are 118 billion units of these trust funds in circulation representing 10.4 million accounts. The development of the unit trust industry within a greater funds management industry was deliberate on the part of the Malaysian government as it was envisioned to facilitate the institutionalization of the domestic market for the fund and creating increased stability, breadth and depth in the securities market.

Table-MA4: Malaysian Unit Trust Industry Number of Accounts and Number of Units in Circulation as at 31 December

Year	No. of Accounts (millions)	Units in Circulation (billions)
1998	8.588	46.539
1999	8.910	52.632
2000	9.582	63.846
2001	9.990	71.392
2002	10.175	84.534
2003	10.221	97.387
2004	10.425	118.620

Source: Securities Commission

[24] Check out the Malaysian Association of Asset Managers website.

Prior to the financial crisis, the share of equity in unit trust funds was more than 70% and though the risk-return trade off in this market provided opportunities for the investing public to earn more, unit trust funds were subject to speculative attacks with portfolio investments flowing in and out more freely from the capital markets. The government's efforts at developing alternative avenues to invest funds positively reflected on the bonds market as long-term funds are made more available. Bond market share in unit trust funds have grown steadily from 2.74% in 1999 to 17.75% in 2004.

Table-MA5: Malaysian Unit Trust Industry - Private Funds
Percentage Allocation of Private Sector Funds as at 31 December

Asset Type	1999	2000	2001	2002	2003	2004
Guaranteed/Protected	0.00	0.00	0.00	0.35	1.30	2.22
Islamic	8.64	10.49	12.54	13.63	14.89	15.81
Asset Allocation	12.50	12.98	12.81	2.87	13.32	10.89
Money Market	1.40	1.17	1.70	12.93	3.25	8.73
Bond	2.74	10.09	11.62	16.06	17.41	17.75
Stock	74.72	65.27	61.33	54.16	49.83	44.60
Total	100.00	100.00	100.00	100.00	100.00	100.00

Source: Lipper Asia Ltd.

The main legal provision for the unit trust industry is the Securities Commission (Unit Trust Scheme) Regulations 1996, which gives power to the Commission over unit trust prospectuses and trust deeds [Saaid, 1999]. The guidelines emanating from this regulation has been reviewed extensively in terms of liberalization of investments and administrative concerns and, more importantly, the disclosure of information, e.g. NAV per unit values are now published in nationally circulated newspapers.

REGULATORY FRAMEWORK OF THE ASSET/FUND MANAGEMENT INDUSTRY

Asset management companies in Malaysia are regulated by the Securities Commission and governed by relevant sections of the Securities Industry Act 1983. Inasmuch as returns are not guaranteed for these industry the guidelines instituted by the Commission revolve around the manner in which asset management companies operate, background on fund managers, compliance, fund management procedures and performance reporting requirements. The companies and their fund managers are required to be licensed. Maintaining the license requires fund managers to attend continuing education courses set by the Securities Industries Development Center (SIDC) of the Securities Commission.

The Commission imposes strict compliance with the semi-annual disclosure of information, particularly on financial balances and liquidity ratios and on important procedural issues. Asset management companies are required to have in their employ a Compliance Officer, reporting to the board of directors and vetted by the Commission. Furthermore, procedure and authority manuals and the codes of conduct of these firms are filed and regularly updated with the Securities Commission.

MALAYSIA'S FUNDS MANAGEMENT INDUSTRY AND RELATED CAPITAL MARKET ISSUES AND CHALLENGES

All of the countries affected by the financial crisis are in one way or another grappling with two important issues, with the underlying theme being the effect of short-term capital flow into emerging markets. These two issues essentially pertain to those of liberalization and corporate governance and transparency. The latter is a major concern of the Malaysian fund management industry, since disclosure preserves market integrity and builds investor confidence in the financial product. Liberalization and deregulation, on the other hand, should encourage exchange of experience and expertise and enhance professionalism within the funds management industry. Foreign participation in existing domestic firms facilitates technology transfer. Though the Malaysian government believes in the benefits to be derived by exposing domestic financial and fund management firms to foreign competition, efforts towards achieving this seem delimiting.

The limited range of product offerings, to this day, remains an issue among market participants. A larger proportion of investments by fund management companies are still in equities. Although the financial crisis has forced fund managers to alter investment strategies towards an increasing share of fixed income instruments. Still, for the Malaysian capital market to be at par with countries like Singapore and Hong Kong, fund managers should provide investors opportunities to get exposed to more sophisticated products that provide higher returns, like financial products emanating from the futures market and in global funds instruments. Investment in futures contract will provide sophisticated investment products with greater returns while fund managers could use this to provide cover against foreign exchange risk. Fund managers can also be benefited with the inclusion of global funds instruments in their portfolio, being a means to diversify country specific risk [Saaid, 1999].

6. CONCLUSIONS AND RECOMMENDATIONS

The Malaysian government's decision to allow the entry of foreign fund managers into the domestic financial market is one way to improve of the credibility and integrity of the Malaysian capital market. However, it should keep a keen eye on the minimum resource or capitalization requirement to effectively compete in the international market and assure the public of the solvency of the institution even in the most challenging of times. In this way, funds will not be much exposed to the vulnerability of the capital market, even regional markets, especially when such foreign institutions have a wider reach in the international market and a solid investment base in different regions in the world. The Malaysian government, on the other hand, can allow mutual fund companies to increase the portion of their assets in non-Malaysian securities and for foreign fund management firms to tap Malaysia's Employee Pension Fund (EPF) assets for investments in markets overseas.

To encourage the diversion of funds into more long-term use, particularly in private and government bonds, greater incentives could be given investors by way of tax incentives through withholding tax and capital gains tax exemptions.

Increasing participation of the unit fund industry in the different types of funds is one way to encourage fund managers to exert pressure on different private and public agencies to facilitate greater levels of transparency in their operations and subject them to continued due diligence in the evaluation of financial performance. Subsequently the standards can be set, with the assistance of the funds management industry, on the types of information that should be made public to afford benchmarking across firms. The financial performance of various funds should likewise be subject to greater levels of transparency and timely release of critical information for enhanced investment decision-making.

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PHILIPPINES

1. COUNTRY MACROECONOMIC PERFORMANCE

One of the goals of a country's monetary policy is to be able to achieve a high rate of non-inflationary economic growth. Particularly in a free market economy where an efficient financial market is warranted, the government must provide a level playing field environment.

For the past decades, Philippines had proven itself to be one of the most progressive economies in Asia. It had boasted itself in various trade related activities. Hence, reversion of its economic performance through the years became apparent.

Prior to the crisis, GDP growth was increasing as institutions and corporations experienced growth particularly in the property sector. As a result of the 1997 currency crisis, the country experienced devaluation of peso against the dollar, along with other crisis-affected economies in Asia, which resulted to divestment of funds. Like Indonesia and Thailand, interest rates also increased sharply (Rana and Lim, 1997)

In what eventually precipitated into a severe economic crisis, the element of contagion spread the region's vulnerability to external shocks and affected other regions outside Asia as well. Most Asian countries' pursuit of financial development was concentrated on financial liberalization; while the concomitant creation of appropriate regulatory structures and supervisory frameworks lagged behind and weak financial systems were produced.

In fact, imports growth rate was even higher than export growth especially during pre-crisis period. A huge drop in GDP growth rate was evident (-0.57%) in 1998, while exports showed -21.03% growth rate compared to imports at -14.7 percent. Unlike Korea and other countries, depletion of the country's gross international reserves was also evident. The post-crisis period (1999-2000) showed increasing reserves but was again adversely hit by the September 11 attack (AEM, 2001).

The Philippines, despite its commitment to liberalize its financial environment, was not greatly affected by the crisis because it had already started instituting reforms in its financial system, particularly in the area of prudential regulations. Unfortunately, even few years after the crisis, the country's financial sector performance continued to lag behind neighboring countries. This was also confirmed by Moreno (2004) where he mentioned that while the country was slightly by the crisis, it was one of the economies that lagged far behind its ASEAN counterparts due to slow growth as a result of the economic and political instability.

2. NON-PERFORMING LOANS PROBLEM

In any crisis, there exists a compromise in the way a country implements its monetary policies. The central bank can either provide low interest rate environment to protect distressed banks or increase interest rates to defend the currency (Rosenberg, 2002). In most cases, governments will end up protecting the banking system as it has primary influence on the economic development of the country and usually comprises the biggest share in most countries' financial system, particularly in Asia.

Like most financial systems in Asia, the country's financial system consists of formal and informal subsystems that are dominated by banks. The informal subsystem comprises the moneylenders and various rotating savings and credit associations ROSCAS, etc., while the formal subsystem is further divided into two major categories - the banking sector and the non-bank financial institutions.

The banking sector is dominated by commercial banks, which comprise 90 percent of the total resources of the Philippine banking system. It is composed of foreign banks, regular commercial banks and expanded commercial banks. From 1995 until June 2005, both the commercial banking and the entire banking sectors' resources grew by approximately 41 percent, with universal banks dominating the industry (www.pdic.gov.ph).

In 1995[25], the banks' total resources comprised 89.1 percent of the total resources of the entire financial system. This indicates that despite the entry of foreign banks (as a result of the Foreign Bank Liberalization Act), there seems to be no significant improvement in the banks' operations. From a share of 6.1 percent by the foreign banks in 1995, significant growth was evident in the total resources held by foreign banks (14.9-81 percent) as of June 2005. Philippine Deposit insurance Corporation's data revealed rural banks comprise a share of 2.78 percent in the entire banking industry's resources (www.pdic.gov.ph). All these institutions are under BSP's (Bangko Sentral ng Pilipinas) supervision with the exception of insurance companies whose operations are supervised and regulated by the Insurance Commission (IC).

Since 1980, the Central Bank introduced various reforms to deepen the financial markets. Interest rate ceilings were removed, the rediscount window was rationalized, interest rates on special credit programs were aligned with market rates, bank branching policy was liberalized and the areas of allowable equity investments of universal banks were expanded (www.bsp.gov.ph).

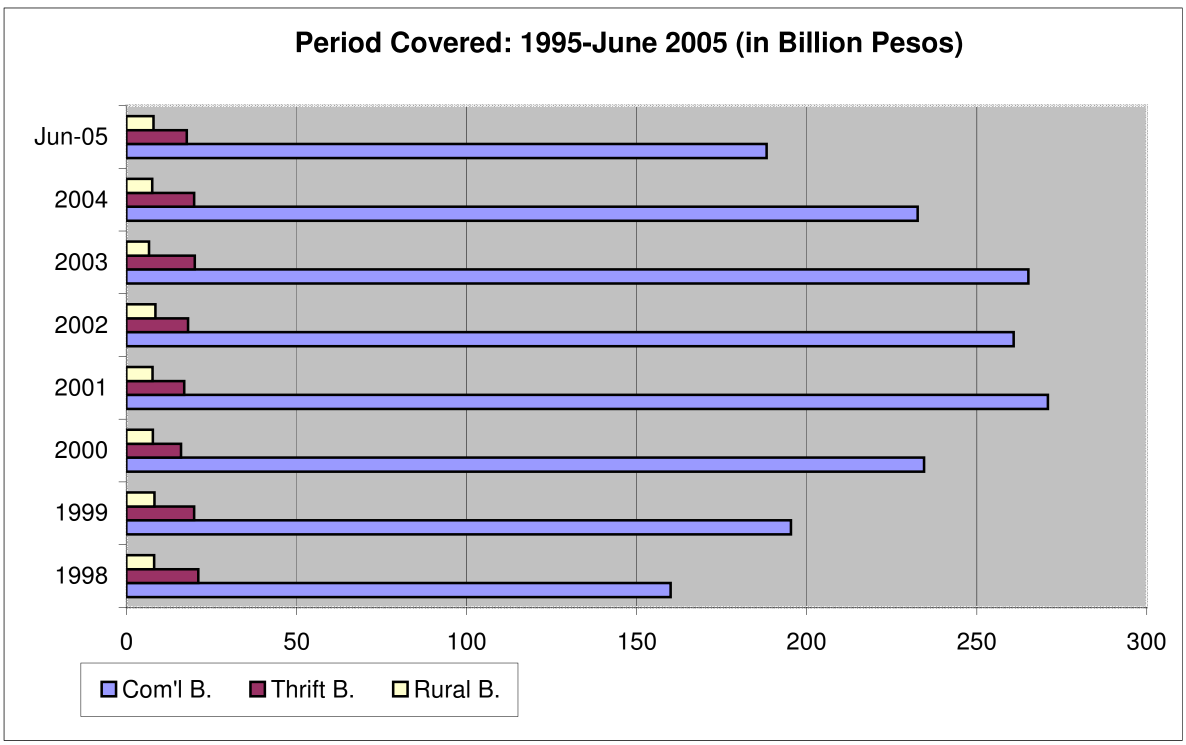
Like any other Asian economies, fast growth was evident but was supported with prudential regulations. Wells (1999) in his findings on the country's regulatory framework cited that corporate governance was not strictly practiced especially before the financial crisis. He reported that majority of the corporations, whether private sectors and financial institutions, are closely held where more than 70% are family owned

[25] Computed by the researcher from the data gathered from PDIC (www.pdic.gov.ph)

corporations especially during its inception or some of these companies are conglomerates.

This exposed both financial institutions and corporate sectors to risk. Given this scenario, banks were exposed to credit risk, as borrowers were not able to pay their debt. Moreover, capital flight in the form of FDI and portfolio outflows caused deterioration in credit quality as a result of the increasing non-performing loan portfolios of banks. However, lending continued to increase but at a slower pace. The country experienced a lending boom in the 1990s similar to neighboring countries such as Thailand, Malaysia, Indonesia and Korea [Milo (2004); Noland (n.d.), Gochoco-Bautista (2000)]. The credit extended to the private sector as a share of GDP more than doubled between 1990 and 1997. By 1997, total loan portfolio increased by 55 percent from the 1995 value of PhP977.87 billion and continued to increase to 121 per cent by June 2005.[26]

FIGURE-PH1. NPLs OF BANKS BY BANK CATEGORY



Source: BSP

Compared to the pre-crisis data where lending activities skyrocketed, commercial banks' lending activities slowed down. Some banks with political affiliations extended loans that eventually turned lemons. The same applied to rural banks and thrift banks, but their

[26] Computations were based on financial data available at the PDIC website: www.pdic.gov.ph).

respective share in the total banking portfolio was relatively small compared to commercial banks.

A review of the lending practices of FIs showed that banking and other lending institutions employ collateral-based credit practice. There were also instances when a clean credit was provided to valued clients. What is surprising is that unlike other East Asian Economies, regulatory framework before and after the crisis remained strong, as BSP had aligned its regulations with international best practices. Hence, implementation of the laws was not so strict, which had eventually exposed the country to the worsening non-performing loans problem.

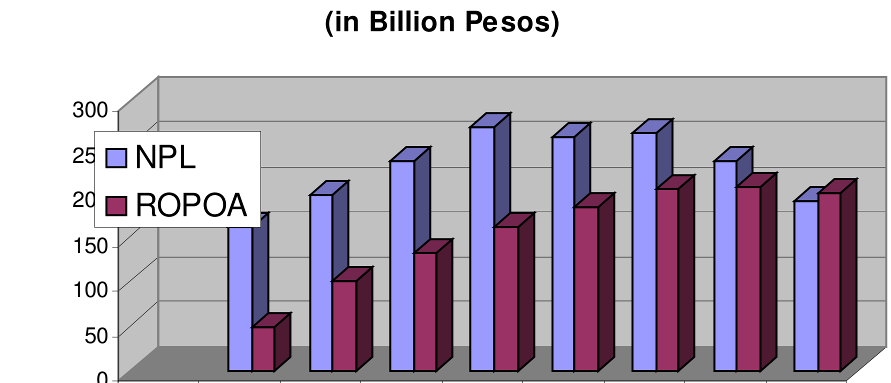
The highest loans to total assets ratio was recorded in 1996 at 64.27 percent (www.pdic.gov.ph); it continued to improve progressively, reaching its lowest ratio at 49.63 percent in June 2005. Even if – the loan portfolio increased after the crisis (from PHP1.522 trillion in 1998 to PHP1.861 trillion in June 2004), - banks were observed to have slowly dis-intermediated by extending loans only - to selected borrowers. More and more banks invested their funds either in -fixed-income securities. Published Statement of Financial Conditions of the banking industry (www.pdic.gov.ph) by PDIC disclose that Investment in Bonds and Other Debt Instruments (IBODI) and Trading Account Securities (TAS) amounted to amounted to PHP370.4 million and PHP34 million in 1998, respectively. As of December 2004, IBODI reached P736.5 million and PHP125.4 million, respectively with growth rates exceeding 100 percent.

The industry's non-performing loans grew by 758.4 percent from the PHP39.99 billion levels in 1995 to PHP295.72 billion in 2001. Majority of the industry's non-performing loans were accounted for by commercial banks' share, which grew progressively from 71.8 percent in 1995 to 91.6 percent in 2001. While many small banks may be vulnerable to the crisis compared to the commercial banks, their share of the total NPLs was very minimal compared to the latter.

What is surprising is that even if non-performing loans slowly deteriorated after 2001 as a result of the rehabilitation of some banks and the deliberate move by the banking sector to restructure their loans, total non-performing assets of the banks continued to grow in the banks' balance sheets (OECD, 2002). The universal banks provided the biggest share in the total loan portfolio and non-performing loans of commercial banks. Even if the foreign banks' share of the total commercial banking industry's value is relatively small compared to universal banks and regular commercial banks, PDIC's data showed that after the crisis, both the loan portfolio and NPL also increased particularly until 2001 (www.pdic.gov.ph).

Shown on FIGURE-PH2 is the level of non-performing loans and real and other properties owned and acquired (ROPOA) by banks for the 11-year period. Until 1998, the share of ROPOA held by commercial banks was relatively small compared to its NPLs.

FIGURE-PH2. NPLs and ROPOAs of COMMERCIAL BANKS



	1998	1999	2000	2001	2002	2003	2004	38504
NPL	160	195.39	234.52	270.95	260.89	265.2	232.61	188.23
ROPOA	48.709	99.942	130.8	159.06	183.03	202.3	205.4	197.19

Source: www.pdic.gov.ph

ROPOA grew significantly because the property market was regarded as a buyers' market, hence, there were some indications that there were reported recoveries in the ROPOAs held by banks. Even if non-performing loans declined starting 2002, the amount of ROPOA continued to increase. Collyns and Senhadji (2002) cited that compared to Malaysia and Thailand, which experienced extreme property price cycles, the Philippines' exposure was moderate. Only extreme capital inflows characterized the country's experience. In fact, real credit growth was also moderate.

In Year 2000, the overall performance of the financial system was stable despite the difficult economic environment brought about by the sluggish asset growth, caused by the contraction in lending activities. Total resources of the banking system amounted to PHP3.3 trillion, with 91 percent share being held by commercial banking industry.

The non-performing loans, continued to rise particularly after 1998 due to additional non-performing loans incurred during those years. NPLs reached a peak in 2001 at P270.9 billion and slightly declined until 2004 as banks continued to increase their non-performing loan portfolios. Any action undertaken by them was not significant to reduce NPAs. The lowest recorded NPLs and ROPOAs in 2005 were due to the implementation of the SPV law, as sale by banks to SPV entities took effect from September 2004 until April 2005. Table-PH1 below records that past due loans of the banking industry were even larger than the NPL and continued to increase. This only proves that when loans remain uncollected, they will end up as NPL.

TABLE-PH1. Selected Asset Quality Indicators on Loan Related Transactions

	1999	2000	2001	2002	2003	Mar-05
Total Loans	1,752.605	1,804.824	1625.05	1639.38	1,961.368	1,995.419
Past Due Loans 2/	225.201	276.916	314.760	287.972	292.248	292.363
Non-performing Loans	221.965	268.688	305.794	269.623	271.398	274.169
Loan Loss Reserves 1/	100.366	117.404	138.595	135.447	139.904	139.862
ROPOA, gross	122.443	158.455	191.418	217.600	230.712	237.961
Restructured Loans, current	56.089	65.766	72.688	83.699	83.548	80.949
Non-performing Assets	344.408	427.143	497.212	487.223	502.110	512.129
Gross Assets 3/	3,057.550	3,356.529	3,406.298	3,622.521	3,816.332	3,951.960

Source: BSP –Prepared by Supervisory Data Center, Supervision and Examination Sector

Above are selected asset quality ratios to measure how banks managed their assets, particularly loan transactions which continued to deteriorate despite deliberate moves by many banks to manage their portfolios. Despite loan restructure moves, a significant portion of the loans remained past due and even exceeded the NPL values. This only proves, banks will still be exposed to credit risks. While pre-Asian financial crisis can be attributed to banks' large exposure to real estate loans, it showed that most of the banks' loans were provided to the manufacturing and retail sectors, and represented roughly 41 to 46 percent of the total loan portfolio. Until 1997, it represented roughly a quarter (26.3%) of the NPL and reached half of the total NPL by 1999. At the onset of 2002, it reached approximately 70 percent until it slightly exceeded the NPL amount of the banking industry during the 1st semester of 2005, a time when banks reduced their NPL levels either through individual sale, *dacion en pago* or through SPV entities. As reported by SEC and TOAP, approximately PhP700 billion pesos were purchased by SPV entities from September 2004 to April 2005 and were not reflected in the banks' balance sheets.[27]

Even if ROPOA increased compared to NPL, they are less costly to maintain in the banks' books as the BSP requires 10 percent loan provisioning every year commencing at the end of the sixth year after its acquisition until the 10th year, for a total of 50 percent of the difference between the excess of the book value over the real estate property. For NPL disposition, the provisioning requirement starts as soon as the loan becomes specially mentioned. Provisioning costs range from 5 percent to 100 percent of the total value of the unpaid portion of the loan, depending on its quality. Thus, banks would

[27] Sourced from http://www.toap.org.ph/industry.html

prefer to dispose NPL prior to ROPOA's disposition until the market for the properties improves.

On the other hand, the industry has high loan loss reserves for these bad assets, which is only reflective of the deliberate move by BSP to reform banking practices regarding credit. Loan loss reserves continued to increase despite fluctuating growth in the loan portfolio as non-performing and past-due loans increased steadily. In fact, banks have successfully restructured credit particularly between 2000 and 2002. Aside from these, some of the non-performing assets, which were restructured for the period, only reflected a small portion of the total NPLs and ROPOAs of banks, representing 14% to 17%, respectively.

3. MEANS OF RESOLVING THE NPL PROBLEM

There are various ways on how NPL problems were addressed by the supervisory bodies. One of the major strategies implemented by the Philippines in improving the banking system is the General Banking Law of 2000, which had amended the existing law and updated the legislative framework for the banks. Tetangco (2003) reported that this law highlights:

- Authority given to the Monetary Board to require banks to adopt internationally accepted capital adequacy standards.
- Stringent rules on bank exposures to directors, officers, stockholders and related interests (DOSRI).
- Strengthening regulations on transparency practices.
- Adoption of fit-and-proper rule tests in the appointment of bank directors and senior bank officers
- Further liberalization of foreign ownership participation of foreign banks in the country's banking system.

Moreover, OECD (2002) reported that prior to the crisis, BSP had undertaken comprehensive financial reforms relating to credit such as central loan origination standards and credit risk rating system. Despite the economic and political problems that plagued the country, it had issued several guidelines to further strengthen credit risk management practices of banks:

- Circular 389 – guidelines on Loans and Other Credit Accommodations
- Circular 414 – Guidelines of Large Exposures and Credit risk Concentration
- Circular 425 – Single Borrower Limits
- Circular 423 – Bank Dealings with any DOSRI
- Circular 439 – Credit Risk Rating Systems for Corporate Exposure

It was cited that BSP had instituted credit risk assessment and management as its first line of defense against shock. Hence, any monetary policy must be aligned not only with the strength of the financial system but also corporate reforms. No matter how sound these policies are, if there are not clear policies for the other, it won't be successful (Ibid).

On the other hand, accounting and auditing standards especially those in compliance with international best practices are governed by the Accounting Standards Council which was created as early as 1981 to respond to the needs of the industry and provide appropriate accounting standards that alleviates the accounting profession to its highest level in line with the other country's standards. While the country adopts the Statement of Financial Accounting Standards, which is the local counterpart of the International Accounting Standards, the same are updated to align local auditors and accountants' practice with that of the world. The advent of cross-border trading, securities and investments prompted the country to harmonize its financial reporting standards (www.sec.gov.ph).

While being one of the least affected during the financial crisis, the country did not immediately set up an Asset Management Companies, as conditions of systemic risks were not prevalent after the crisis. While the other crisis-affected economies acted on it to immediately address the issue and prevent its financial system from any further problem, it was only NPL problems were on the rise at increasing pace that the country considered enacting a Special Purpose Vehicle Act, where a decentralized approach was used (Milo, 2004). Some of the common features of the enabling laws include having special mandates, were time-bound and highly centralized in operation and authority.

Asset Privatization Trust (1987)

Prior to this, a rapid disposition agency was set-up in 1986 to deal with the non-performing assets of banks which accounted for 22 percent of the total assets of the entire financial system and 18 percent of the country's GDP (Klingebiel, 2000). The Asset Privatization Trust (APT) was established as centralized stand-alone agency on a short-term basis where APT's asset value was held in assets (15 percent) and financial claims (75 percent). Its failure in its thrust to liquidate assets of government banks and those that will be privatized accounted to approximately 40%-50% of the assets, which are still held by APT. This was a reflection of the country's lack of political will and enforcements within its designated life. Moreover, Klingebiel (2000) also cited other factors, namely:

1. Weak governance despite temporary extra-judicial power provided to APT.
2. Fraudulent and politically connected assets,
3. Legal problems associated with asset disposition;
4. Lack of full disclosure and transparency of its activities and financial situation.

Special Purpose Vehicle Act and the Asset Management Companies

There are two types of AMCs. The first type is a centralized approach that is either managed by the government or by an agency that will handle the non-performing assets of the financial institutions especially banks. The other type is known as the decentralized approach or privately-led AMCs which the country adopted in the disposition of banks' and financing companies' non-performing assets. Under the sunset provision, it was initially given a five-year period to operate and until now, is still existing (Kingebiel, 2002).

The partial failure of the Asset Privatization Trust in 1986 led the government to adopt a decentralized approach in managing these loans or assets. Unlike Korea, Indonesia, Malaysia and Thailand, the increasing NPL value in the Philippine case could be attributed to the late response by the government in dealing with the problem as there were no sufficient funds or budget for the purchases (Businessworld, 2005). Moreover, BSP considered the NPL problem as non-systemic; thus, it deemed that a decentralized approach could be used to temporarily manage the problem.

SPV Act was passed into law in 2003 by the House of Congress, which approved the purchase and eventual disposition of acquired assets within five (5) years. Aside from being time-bound, the provisions of the Act allowed only loans or assets that were non-performing as of June 30, 2002 to qualify for the fiscal incentives (Pasadilla, 2005). Under the law, an AMC applies with BSP a Certificate of Eligibility which will be reconciled with its master list to verify if the same is a true sale; the bank and the buyer can already use the COE in the application for tax reductions and fee exemptions with the Bureau of Internal Revenue.

Records show that before the crisis and until 1998, the country had single digit NPA/total assets ratios. Confident about the sound monetary policies, the government did nothing much on the problem like other neighboring countries. It was only in 2001 when it realized that the need to set up its own SPV as the NPA ratio reached 14.26 percent in 2001. While waiting for the passage of the SPV Act, the NPA ratio even plunged to as low as 13.26 percent in 2002. The increasing insolvency problem of banks resulted to the big discounts from the face value of the assets and the reluctance of some to participate in this activity.

a. **Market Players**

There are 36 Asset Management Companies operating in the Philippines as of September 2004. Domestic banks own seventeen of these companies (www.sec.gov.ph). These AMCs are also called Special Purpose Vehicle (SPV) entities and are responsible in handling the purchase of the banking industry's non-performing assets (include NPLs and ROPOAs). Despite its approval by the House of Congress in 2003, companies were given until September 2004 to register as AMCs or SPVs to avail of the fiscal incentives.[28]

Unlike the Asset Privatization Trust, the SPV Act is time-bound or temporary, that is, the disposition of the assets is made on a short-term basis. The maximum disposal period will be five years after the acquisition of any NPL or ROPOA. Hence, the law provides additional fiscal benefits such as tax holidays on net interest income arising from new loans that are extended for corporate rehabilitation and payment for documentary stamps.

[28] Check out www.sec.gov.ph

Of the total SPVs, 16 are owned by banks - four owned by Philippine National Bank, two by Export and Industry Bank and another two by Security Bank and Trust Company. Other SPVs are foreign owned while some are owned by individuals and by other non-bank financial institutions.

Under the law, the following are the conditions for the NPLs/ROPOAs to be entitled for fiscal incentives through SPV sale:

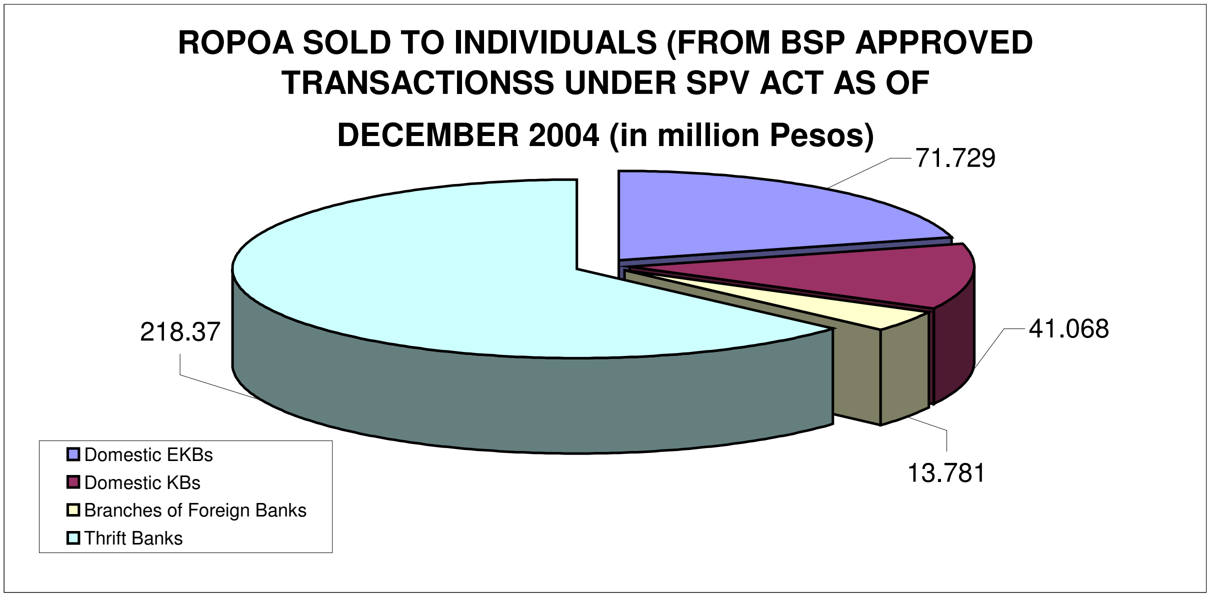
1. It must be a true sale. An asset must have been completely removed from the bank's or debtor's control.
2. The bank has no equity share exceeding 5 per cent in the buying SPV and no direct or indirect management.
3. Originating bank cannot extend credit facility, guarantee or any similar financial transaction to the transferee SPV.
4. Borrower must be notified about the impending transfer of their loans and be given 90-day period for renegotiation and restructuring.
5. For the acquisition of land, foreign investors can only own 40 percent of his/its capital stock.

TABLE-PH2. SALE OF NON-PERFORMING ASSETS

Bank Classification .	**INDIVIDUALS**		**DACION EN PAGO**		**SALE TO SPV**	
	BOOK VALUE	**NO. OF COE ISSUED I**	**BOOK VALUE**	**NO. OF COE ISSUED**	**BOOK VALUE**	**NO. OF COE IISSUED**
Domestic EKBs	71.729	37	7613	30	8510	3
Domestic KBs	41.068	6	301.195	7	36.21	1
Branches of Foreign Banks	13.781	1	409.51	1		
Subsidiaries of Foreign Banks			4.679	1		
Thrift Banks	218.37	38	878.867	12	450.442	1
Government Banks			250	1		
NBQB					1.531	1
Consortium of Banks/Non-banks					11050	2
Total	344.948	82	9457.251	52	20048.2	8

Source: Bangko Sentral ng Pilipinas

FIGURE-PH3. ROPOA SOLD TO INDIVIDUALS



Source: BSP

However, an AMC or SPV entity can issue equity or participation certificates or other forms of Investment Unit Instruments (IUIs) for the purpose of acquiring, managing, mproving, and disposing the NPAs (Hagiwara and Pasadilla, 2004). It must be noted that the banks that had successfully sold NPAs to any SPV entity will not be allowed to purchase IUIs issued by the latter.

The figure shows the BSP approved transactions under the SPV Act as of December 2004. The sale of the assets can either be done thru individual sale or retail sale, *dacion en pago* or through accredited SPV entities. The retail sale or the individual sale by expanded commercial banks reveals a value of PHP71.7 million while thrift banks' retail sales approved by BSP in its master list totaled to PHP218.37 million which is higher than the former.

It is believed that the success of the law can be measured in terms of how well the law had served its purpose. While it is regarded as a temporary disposition of bank's NPAs, it was only able to dispose approximately 26 percent of the industry's total NPL, excluding ROPOAs, as of 2002. If the total NPAs will be considered, then only 16.9 percent of the total were disposed of. Considering the escalating volume of the industry's NPLs after the crisis, the government has a long way to go before achieving its goal of providing stability and soundness in bank's operations. To date, there are still various requests to extend the SPV act.

4. PHILIPPINE'S CAPITAL MARKETS

The Philippine Capital Market

The Bond Market

The Philippine equity market is growing but remains relatively small and underdeveloped compared to the New York Stock Exchange (NYSE). Before the Asian Financial Crisis (AFC), the market capitalization of publicly listed companies had grown to approximately US$89 billion; after the crisis, its performance plummeted due to decreasing investors' confidence. Unlike other primary markets in other developed countries like United Kingdom that is characterized by monopolistic elements, Wells (1999) reported that the Philippine capital market is not hugely inefficient.

Compared to the equity market, the bond market is more developed. The dominance of the Philippine bond market was exemplified in the study of Wells (1999) where he pointed out its development in the ASEAN region primarily because of its diversity; hence few long-term debt instruments are available in the market, which had exposed its later vulnerability to crisis. Most of these debts are government securities to fund budget deficit and major projects, with few municipal and corporate bond issues. For the government bond market, the Bureau of Treasury has regulated the industry effective 1998. It used to be regulated by the Bangko Sentral and its role as bank supervisor is limited to bond issuances of banks. On the other hand, the Securities and Exchange Commission regulates private issues, with BSP approving bank issues on a case-to-case basis.

The private bond market, representing approximately 30 corporations, together with commercial papers comprises the primary and secondary market for debt. Most of these are local issues with few found in the international bond market. Wells observed that asset-backed securities for mortgaged bonds to fund low-cost to middle-class housing. Despite fast growth of debt market, he stressed that for it to work, certain conditions must be satisfied by the issuer, such as repayment sources and real rate of interest.

The Equity Market

Considered an emerging market in the East Asian region, it was rated as the second best performer in the region in 2004. 'The 30-company Index is next only to Indonesia's Jakarta Composite Index, which registered a 44.6% growth. Trailing behind the PSE is Singapore's Straits Times Index, which posted a 17.1% increase. Three exchanges, on the other hand, posted declines in 2004, namely Stock Exchange of Thailand, and Shenzen Stock Exchange and Shanghai Stock Exchange, both in China.'[29]

[29] Sourced from: http://www.pse.org.ph/html/NewsRoom/fullStory.jsp?id=6647

To date, it is composed of 184 trading participants, where 151 companies are local and 33 are foreign. The Philippine Stock Exchange (PSE), both Makati and Ortigas Exchanges, has a total of 235 listed companies whose stocks are classified into 5 major sectors, namely, Banks & Financial Services, Commercial & Industrial, Property, Mining, and Oil. Companies with 23 sub sectors.

Like the stock market, the bond market is also underdeveloped. Approximately 95 percent of the total issues are bond issues of the Bureau of Treasury (BTr), while less than 5 percent are corporate issues. News report cited that Asian Development Bank rated the country's bond market as the poorest performing local currency market in the region because it has the largest bid-ask spread on bond transactions caused by low market liquidity.[30] In 2002, in an attempt to boost the market after the crisis, both BSP and BTr adopted measures to prepare the country to compete in the regional bond market initiative by upgrading its market infrastructures aimed at minimizing settlement risks associated with the trading of equities, fixed income, money and foreign exchange markets.[31]

The Philippine financial system consists of formal and informal subsystems. The informal subsystem comprises the moneylenders and various rotating savings and credit associations ROSCAS, etc., while the formal subsystem is further divided into two major categories - the banking sector and the non-bank financial institutions.

The banking sector is dominated by commercial banks, which comprise 90 percent of the total resources of the Philippine banking system. It is composed of foreign banks, regular commercial banks and expanded commercial banks. From 1995 until June 2005, both the commercial banking and the entire banking sectors' resources grew by approximately 41 percent with universal banks dominating the industry.

In 1995, the banks' total resources comprised 89.1 percent of the total resources of the entire financial system. This indicates that despite the entry of foreign banks (as a result of the Foreign Bank Liberalization Act), there seems to be no significant improvement in the banks' operations. From a share of 6.1 percent by the foreign banks in 1995, significant growth was evident in the total resources held by foreign banks (14.9-81 percent) as of June 2005. Philippine Deposit insurance Corporation's (PDIC) data revealed rural banks comprise a share of 2.78 percent in the entire banking industry's resources. All these institutions are under BSP's (Bangko Sentral ng Pilipinas) supervision with the exception of insurance companies whose operations are supervised and regulated by the Insurance Commission (IC). Since 1980, the Central Bank introduced various reforms to deepen the financial markets. Interest rate ceilings were removed, the rediscount window was rationalized, interest rates on special credit programs were aligned with market rates, bank branching policy was liberalized and the areas of allowable equity investments of universal banks were expanded.

[30] Sourced from: http://money.inq7.net/topstories/view_topstories.php?yyyy=2005&mon=01&dd=05&file=3

[31] Sourced from: http://www.bsp.gov.ph/archive/Speeches_2003/speech_110303.htm

The Philippines was able to withstand the 1997 financial crisis relatively well although ADB sources revealed that the country's financial and corporate structure remain vulnerable to external shocks. This can be traced from what Noland (2002) described as home-grown crisis for the Philippine case.[32]

With the relatively broader powers of expanded commercial/universal banks, their allied and non-allied undertakings had at times exposed some banks to higher risks due to investments on non-profitable businesses. Moreover, the presence of interlocking directorship had resulted in weak corporate governance especially before the Asian crisis.[33]

Nevertheless, while the industry had been fraught by large financial failures from 1980 and onwards, the financial sector had relatively coped well compared to other economies in East Asia (Milo, 2004). The banking sector's institutional framework prior to the crisis rated fairly well compared to other economies in the region. But the different standards of regulation and supervision over financial institutions by other government agencies have intensified the problem. While the introduction of new products and services have helped foster competition and efficiency, the banking industry's level of development is still relatively slow compared to other Asian countries.

With the regulatory changes taking place and the other reforms being proposed in the different financial services sector, there is a need to ensure their consistency and effectiveness especially in dealing with the issue of regulatory arbitrage. Identifying the appropriate level and form of intervention is a challenge to the Philippine government as the regulatory efficiency factors in the overall economic performance and inefficiency resulted in greater burden and costs to the community (ibid.).

5. ASSET MANAGEMENT INDUSTRY IN THE PHILIPPINES

Like most Asian economies, the asset management business in the Philippines is still in its early stage of development. Before the crisis, very few countries in Asia allowed majority or 100 percent foreign ownership of asset management businesses, which

[32] Sourced from http://www.adb.org/printer-friendly.asp?fn=%2FDocuments%2FNews%2F2001%2Fnr2001159.asp.

[33] Sourced from http://www.adb.org/printer-friendly.asp?fn=%2FDocuments%2FNews%2F2001%2Fnr2001159.asp

explained the relatively small stake and limited influence of foreign investors in this industry. In the early 1990s, as the Asian economies expanded and the demand for financial and asset-related products became progressive, privately managed assets or investment businesses began their dramatic growth.

The structure of the asset management industry encompasses significant overlaps between three types of asset pools, namely defined-contribution pension funds, mutual fund industry and trust operations; thereby making them difficult to distinguish. . There is a similar yet limited linkage between private clients' assets and mutual funds, on one hand, and pension funds, on the other. To date, a market for hedge funds in the country has yet to be born (Business World Guide, 2005).

Supervision and Regulation

The asset management industry can be regarded as an emerging business in the Philippine financial market. As mentioned earlier, banks dominate the financial system and non-bank financial institutions only represent one-tenth of the total financial systems resources. While being a formal financial intermediary, it has a long way to go as far as investments are concerned. Fund (mutual, pension funds and trust funds) management business is not different from other non-bank institutions businesses and the degree of intervention and their regulations vary from one another.

The Bangko Sentral ng Pilipinas (formerly known as the Central Bank of the Philippines) was established on 3 July 1993 pursuant to the provisions of the 1987 Philippine Constitution and the New Central Bank Act of 1993. It supervises banks and non-bank financial institutions, while regulating the operations of banks and other non-bank financial institutions. The Securities and Exchange Commission regulates other financial institutions while the Insurance Commission regulates insurance companies.

The Bureau of the Treasury (BTr) helps DOF in formulating policies on borrowing, investments, and capital market development. It formulates adequate operational guidelines for fiscal and financial policies and assists in the preparation by government agencies concerned of an annual program for revenue and expenditure targets, borrowing levels, and cash balances of the National Government (NG). Moreover, it administers the Securities Stabilization Fund and manages contributions to the Bond.

The Securities and Exchange Commission (SEC) was established on 26 October 1936 by virtue of Commonwealth Act 83, otherwise known as the Securities Act. The SEC, aside from BSP's function, is responsible for the activities of other non-bank financial institutions. It acquired additional powers under Presidential Decree 902-A by making it a quasi-judicial body whose orders or decisions when made en banc are appealable only to the Supreme Court for review. Except for Trust Operations that is being regulated and supervised by the BSP, the Securities and Exchange Commission is regulating these institutions' operations.

The Mutual Fund Industry

Mutual funds serve as a catalyst for capital market development because of its nature of pooling savings from thousands of small investors and converting these into long-term sources of investment funds. Mutual funds also provide small investors the opportunity to earn better returns through professional fund management, diversification and economies of scale.

Securities and Exchange Commission (SEC) regulates the mutual fund industry, while trust entities are being regulated and supervised by Bangko Sentral ng Pilipinas, which supervises and regulates bank operations.

The concept of mutual fund was introduced in the country in 1957 with the establishment of Filipinas Mutual Fund through stock market investments. By early 1960s, three other mutual funds were established, namely, People's Mutual Fund, Commercial Mutual Fund and Industrial Mutual Fund. There was only one foreign mutual fund at that time following the establishments of the other three. However, the questionable practices of the European-based company, followed by misguided regulatory policies, disrupted the market for this type of fund (Business World Guide, 2005). This led to the passage of the Investment Company Act of 1960 under Republic Act 2629 followed by the establishment of the Trinity Shares under the then newly implemented Act.

Despite the bullish equity market, mutual fund operations did not last long; as a result, the Securities and Exchange Commission stopped granting licenses within the next 18 years. Thus, the industry was again revived in 1989 and later in 2003, SEC approved the spin-off of the listed shares of FFI into a newly organized open-end investment company called Philippine Index Fund Corporation (PIF).

Valderama and Bautista (2003) cited the findings made by USAID in 1999 that claimed that there was relative disincentive in the mutual fund investments. Wells (1999) also cited that its market are usually high-networth investors who are also clients for bank's CTFs. Unlike other similar investments such as CTFs and pre-need plans, they reported that application of double taxation attached to the instruments made it less popular. The similarities in products or the high degree of substitution do not match the differences in the extent of their regulations (ibid).

Mutual funds product is a close rival or substitute for trust products, particularly, certificate of trust funds as both products cater to small investors for increased income. While trust entities and mutual fund companies are formed as stock corporations, they are separately regulated by different agencies.

Table-PH3. Mutual Fund Industry Statistics by Net Assets, No. of Accounts and Equity Investment per Fund Type

Fund Type	Net Assets	Equity Investments	No. of Accounts	Net Sales
Stock Funds	1,461,302,409	1,028,064,325	7114	106,080,026
Balanced Funds	2,663,605,246	1,479,797,711	14109	36,923,641
Bond Fund	58,532,230,960		46812	3,315,429,283
Money Market Fund	104,335,660		111	8,936,592
Index Fund	508,383,264	509,528,445	8054	49,495,763
Total	**63,269,857,539**	**3,017,390,481**	**76,200**	**3,516,865,305**

Source: Business World Guide, 2005

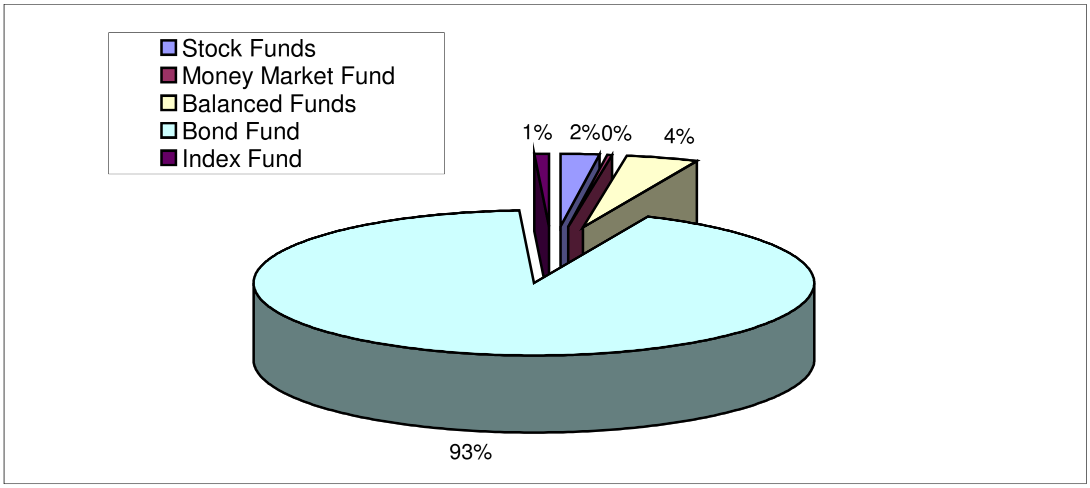
Both industries, trust and mutual funds, are in the same pace of development and the patterns of development are gradually becoming acceptable norms to the investing public. Hence, they must be educated to know how to maximize their investments.

To date, there are 32 mutual funds where sixteen (16) are bond funds, five (5) are equity funds, nine (10) are balanced funds and one (1) each for money market and index funds. The dominance of bond issues in the portfolio, positions the fund to grow faster. As of 2004, net assets held by these fund management institutions represent 92.4 per cent of the total assets of the industry. The sixteen (16)-bond fund managers handle 46,812 accounts totaling to PHP3.3 billion sales net of the total redemptions for the period (Businessworld, 2005).

On the other hand, balanced funds followed the ranking with net assets holdings amounting to PHP2.66 billion compared to stock funds which represents a share of 2.3 percent of the industry's net assets and approximately 55 percent that of the balanced funds. While there are many balanced funds in the market, they are less attractive that is why professional fund managers create value for shareholders by providing superior yields within controlled risk exposures.[34]

[34] Sourced from http://www.icap.com.ph/mf_101.html

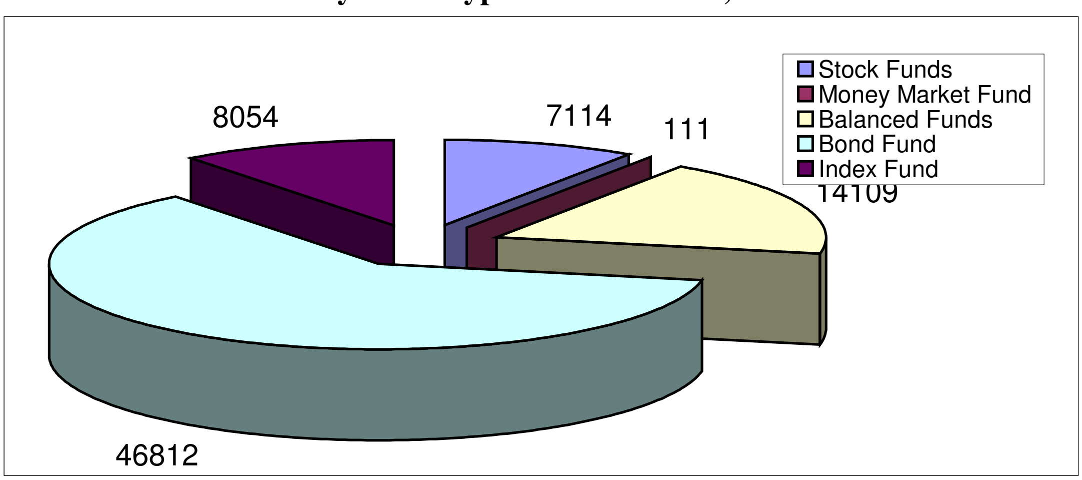
Figure-PH4. Net Assets Held by Fund Companies in the Industry as of March 31, 2005



Source: Business World Guide, 2005

While most investments are long-term fixed income securities, fund managers prefer to focus on fixed-income funds because of the sharp plunge in the stock market following the financial crisis and the BW scam. Likewise, this was as a result of macro-economic problems such as the current-account deficit. Nevertheless, most fund companies failed to achieve their goals due to economic sluggishness, which discourages investors from channeling investments into low-yielding mutual funds. Investors consequently lost confidence in the investments for fear that mutual funds could face financial problems from their investments and deposits with financial institutions in trouble.

Figure-PH5. No. of Accounts Held by Mutual Fund Industry by Fund Type as of March 31, 2005



Source: Business World Guide, 2005

As of 2004, there were 76,200 mutual fund accounts with year-to-date net sales of PHP3.516 billion. While there is a great potential for the industry, it showed that market penetration is still low when one considers the accounts managed. As mentioned by an interviewee from the top bank, the industry is still in its infancy stage education of the investing public is imperative to increase market share.

Table-PH4. List of Major Industry Players

Company	Net Assets	Equity	No. of Accounts	Net Sales
Philam	20,559,144,989	498,193,729	40776	(318,990,248)
Ayala Life	33,332,512,904		10760	3,516,449,884
Sunlife	5,673,218,821	442,997,514	5678	140,647,215
GSIS	1,224,338,677	828,713,979	7506	(2,201,609)
Total	**60,789,215,391**	**1,769,905,222**	**64720**	**3,335,905,242**

Source: Businessworld Guide, 2005; Securities and Exchange Commission

The table above depicts the industry players. The net assets (total resources held less total liabilities) held by the four mutual fund companies represent 96 percent of the industry's net assets. Three companies, namely Philam Life, Ayala Life and Sun life are private insurance companies while GSIS is a government-owned and operated insurance institution for government employees.

Ayala Life holds two bond funds, which are invested either in fixed-income securities or dollar bond fund. Philam Life's funds are distributed in the stock, bond and balanced funds. Like Ayala Life, P30.97 billion are in fixed income bond followed by dollar fund. There are so far many small funds, which are bond funds while others are balanced and equity funds. Only one fund is an index fund where pooled money is invested in stocks of companies based on benchmark index in the Philippines Stock Exchange.

Ayala life generated the highest net sales for the two bond funds offered in the secondary market, representing 84 percent of the industry's net sales. Both bond funds generated positive net sales compared to Philam's four (4) fund products that generated negative net sales of P318.99 million due to the high redemption of its dollar bond fund totaling to P803.07million compared to the gross sales of P294.77million.

Investment solicitors or professional fund managers who are required to obtain a certificate of authority from the Securities and Exchange Commission provide mutual funds. So far, these funds are generally front-end loaded funds with sales ranging from 0.5% to 5.5% depending on the amount of investments. Most of these funds charge redemption fees ranging from 1% to 3% on a graduated scale once the shares are redeemed within specified period (Valderama and Bautista, 2003).

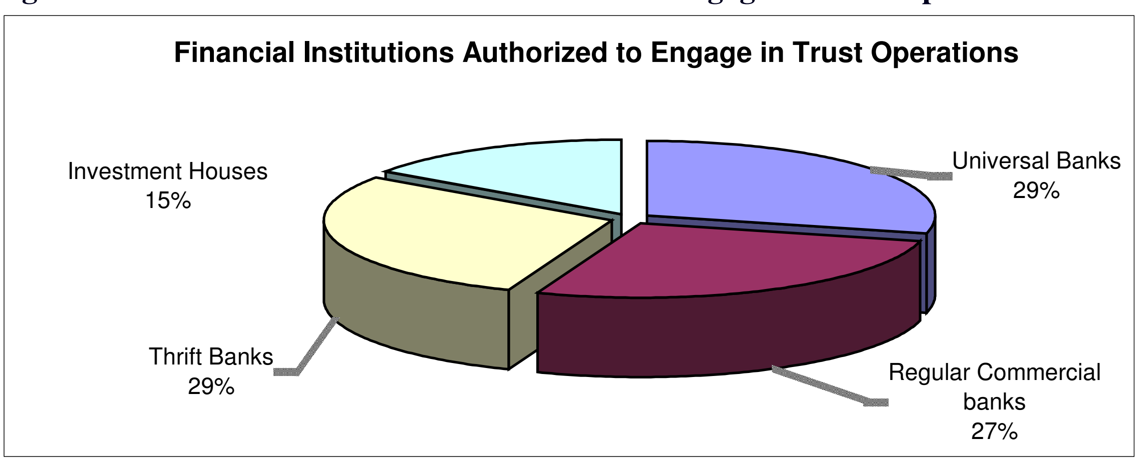
Trust Operations Industry

The trust operations of some financial institutions is supervised and regulated by the Bangko Sentral ng Pilipinas. In the desire of the government to improve the trust activities of banks and non-bank financial institutions, trust activities are embodied in Section IX of the General Banking Law of 2000. An institution that wishes to engage in this type of business may organize as a stock corporation duly authorized by the Monetary Board of BSP to engage in trust business (TOAP, 2005).

Section 83 of the Act defines the powers of the trust entity as follows:

1. To act as trustee on any mortgage or bond issued by any municipality, corporation, or any body politic and to accept and execute any trust consistent with law;
2. To act under the order or appointment of any court as guardian, receiver, trustee, or depositary of the estate of any minor or other incompetent person, and as receiver and depositary of any moneys paid into court by parties to any legal proceedings and of property of any kind which may be brought under the jurisdiction of the court;
3. To act as the executor of any will when it is named the executor thereof;
4. To act as administrator of the estate of any deceased person, with the will annexed, or as administrator of the estate of any deceased person when there is no will;
5. To accept and execute any trust for the holding, management, and administration of any estate, real or personal, and the rents, issues and profits thereof; and
6. To establish and manage common trust funds, subject to such rules and regulations, as may be prescribed by the Monetary Board.

Figure-PH6. Financial Institutions Authorized to Engage in Trust Operations

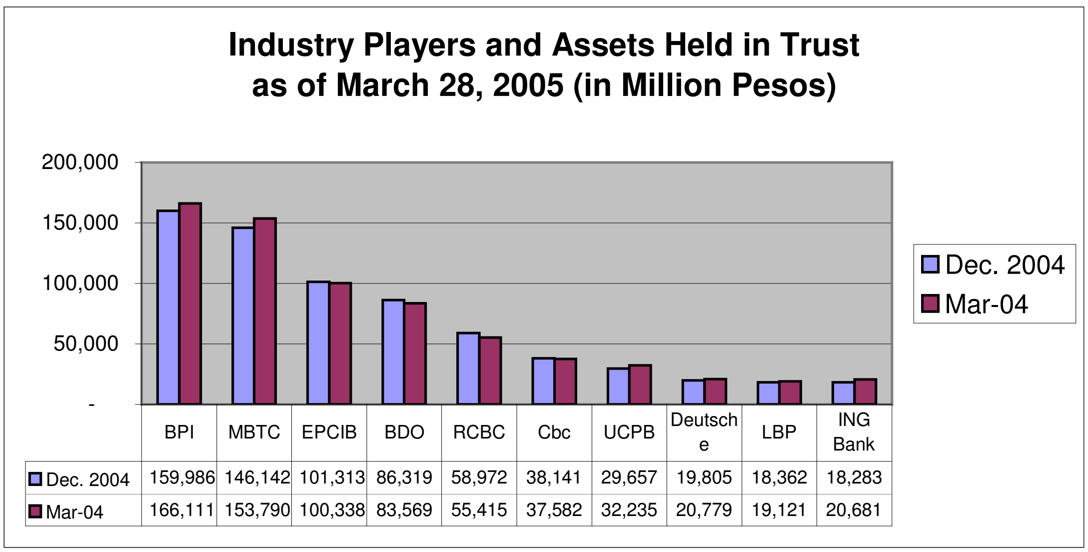


Source: Bangko Sentral ng Pilipinas as of June 2005

Not all financial institutions are allowed to engage in the trust business. As of September 2005, 59 bank and non-bank financial institutions engage in trust operations - 17 are EKBs, 16 are KBs and 17 are thrift banks. On the other hand, there are only 9 non-bank financial institutions, six (6) of which are investment houses with non-quasi banking license while 3 have quasi-banking licenses. Activities undertaken by these institutions are being supervised and regulated by BSP. Thus, BSP's role is not limited to banking activities. It also supervises the activities of non-bank financial institutions except for insurance companies.

The total resources of these institutions as of June 2005 amounted to PHP754 billion Pesos where most of which are held in loans and discounts, and investments in both money market and stock market, which represent 27 percent and 53.4 percent, respectively.[35]

Figure-PH7. Industry Players and Assets Held In Trust



	BPI	MBTC	EPCIB	BDO	RCBC	Cbc	UCPB	Deutsche	LBP	ING Bank
Dec. 2004	159,986	146,142	101,313	86,319	58,972	38,141	29,657	19,805	18,362	18,283
Mar-04	166,111	153,790	100,338	83,569	55,415	37,582	32,235	20,779	19,121	20,681

Source: Businessworld Guide, 2005

The industry, which has over P754 billion assets under management, is currently dominated by the country's leading commercial banks through the operations of their respective trust and asset management departments. Shown below are selected banks' data for 2004. Of the total assets held by the industry, the three biggest banks, namely, Bank of the Philippine Islands, Metropolitan Bank and Trust Company and Equitable-PCIB bank dominated the market.

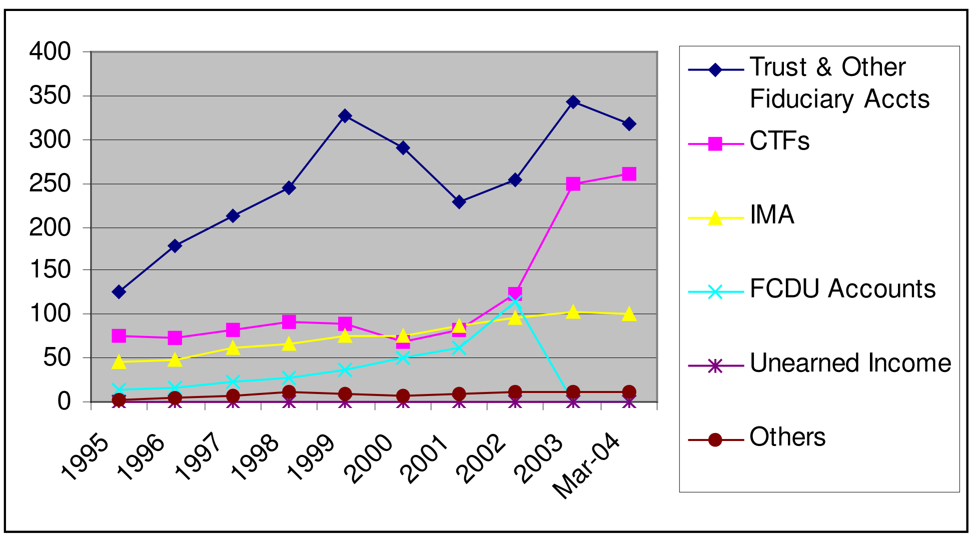
35 Sourced from http://www.bsp.gov.ph/statistics/sipbs/table69.htm.

BPI is leading the ranking with total resources of PHP159.99 billion, compared to previous year's trust portfolio of PHP137.53 billion. This can be attributed to various trust products being offered in the market such as the BPI Premium Fund, BPI Short-Term Fund and BPI Global Philippine Fund. In most of the bank's trust products, investors would have investment P300,000.[36]

On the other hand, MBTC (Metrobank) followed the ranking with over PHP143.14 billion worth of assets held in trust. It was mentioned that on an unconsolidated basis, Metrobank garnered the highest trust holdings in the second quarter worth P125.762 billion of 2005 compared to BPI's unconsolidated trust account of P124.328 billion. Among Metrobank's trust products are Metrofund, MetroDollar Trust Fund, and MetroCapital Fund.

Equitable PCI Bank holds an approximately PHP101.3 billion assets followed by Banco de Oro with total assets holdings of PHP86.3 billion. Other market players are other universal banks.

Figure-PH8. Trust Industry by Product Type



Source: www.toap.org.ph

There are two basic types of trust products, namely trust arrangements and investment arrangements. The following are the services provided by trust entities:[37]

1. Trust and Other Fiduciary Activities. Among these activities involve basic fund management services, employee benefit plans under trust like pension trust, personal living trust, administratorship, bond issues/other obligations under Deeds

[36] See www.toap.org.ph.

[37] Sourced from Businessworld Guide, July 2005.

of Trust or mortgage, custodianship and safekeeping, escrow arrangements, and trusteeship of pre-need plans.

2. Investment Funds

Common Trust Funds

Most of the funds, aside from the money market instruments and deposits, are invested in common trust funds, These are pooled funds that offer yields which are higher than other deposit products. They are not covered by the Philippine Deposit Insurance Corp. (PDIC) (Businesworld, 2005). The trust that is duly established by Trust Entity/ies where the latter exercises full discretionary authority to invest the commingled funds of participating trustors in assets enumerated in the covering agreement. The Trustee Entity is required by the Bangko Sentral to submit for approval the Plan Rules establishing the Fund before the same may be sold to the public. Common Trust Funds are normally sold through the Trust Entity's branches.[38]

Unit Investment Trust Fund (UITF)

In the desire to spearhead trust operations and foster capital market development, the Monetary Board approved the proposed changes to the rules governing trust accounts through the expansion of various investment alternatives. The BSP governor cited that most of the capital requirements of companies, representing 97 percent, are provided by the banking system compared to other countries, which makes it vulnerable to cyclical downturns and economic shock. Thus, capital market development is believed to boost competition among banks and non-bank financial institutions for public funds and at the same time will allow government to implement policies to operate more efficiently.[39]

This was to replace the common trust funds as an investment offered by authorized trust entities that seeks to align the operation of pooled funds with international best practices. This facilitated the introduction of the new product called Unit Investment Trust Funds (UITFs) to clarify misconceptions that pooled funds in CTFs are invested in deposit product. It also separates the risk of a UITF from the bank where the investors are guaranteed that their funds would not be lost in case of a bank folds up.

The Net Asset Value is strictly market-determined based on daily mark-to-market value of the asset pool. Investors can freely join or exit based from the quoted NAV per unit.

[38] Sourced from http://www.toap.org.ph/products.html#5

[39] Sourced from http://tucp-ph.org/pmachine/archives.php?id=A2004071

The new circular on trust funds also requires regular publication of the NAV and limits investments to those that are marketable and tradable.[40]

UITF considers the third party custody of the assets, which prevents price manipulation and double selling of securities by the trustee. Unlike CTF that is subject to reserve requirements, UITFs do not require the same provision and removes single borrowers requirement and DOSRI limitations.[41]

Approximately P250 billion CTFs will be converted into UITFs until its final liquidation where authorized banks and investment houses are given two years transition period (Trust Officers Association of the Philippines, n.d.). This will allow investors to know that their investments are not risk-free, unlike bank deposits, although the returns could turn out higher than those of most deposit instruments.

To ensure proper market valuation of the asset pool at all times, UITFs may only invest in securities with active market and transparent pricing. Trust entities are prohibited from directly extending traditional loans although they may invest in tradable loans in the future once a market is established. They are also prohibited from investing in real estate and other illiquid investments.[42]

Key Industry Players

The industry, which has over P754 billion assets under management, is currently dominated by the country's leading commercial banks through the operations of their respective trust and asset management departments. Shown below are selected banks' data for 2004. Of the total assets held by the industry, the three biggest banks, namely, Bank of the Philippine Islands, Metropolitan Bank and Trust Company and Equitable-PCIB bank dominated the market.

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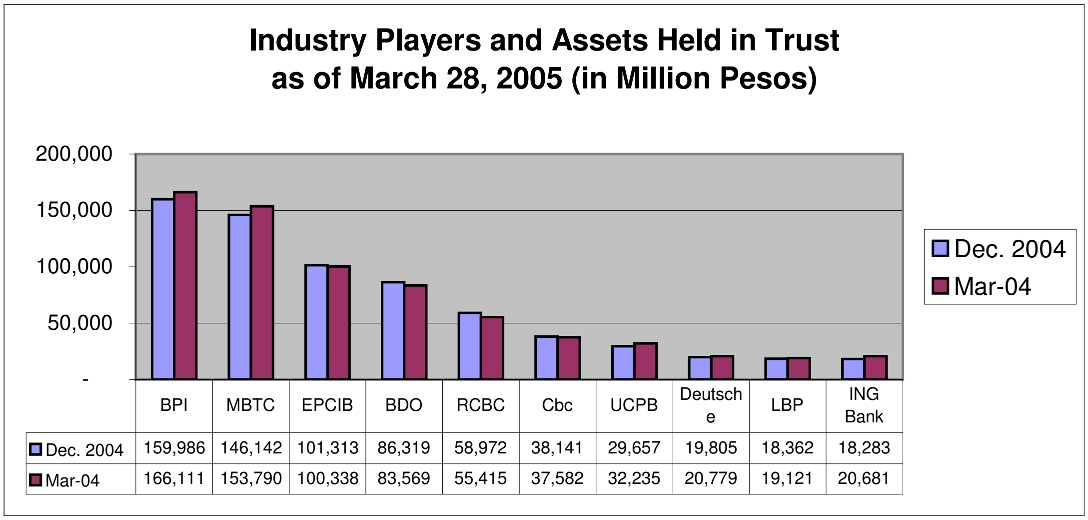
40 Sourced from http://www.iro.bsp.gov.ph/downloads/pressrelease/083004-UITF%20PR.pdf#search='Performance%20of%20UITFs'

41 Sourced from http://www.iro.bsp.gov.ph/downloads/pressrelease/083004-UITF%20PR.pdf#search='Performance%20of%20UITFs'

42 Sourced from www.toap.org.ph.

43 See www.toap.org.ph.

Figure-PH9. Industry Players and Assets Held In Trust



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Reforms in the Asset Management Industry

Among the reforms instituted by the Philippine government before and after the crisis are as follows:

Financial institutions' merger and consolidation during the 1990s marked a major development in the country's financial system following the major developments in the banking sector. This came about as banks and non-banks sought ways to gain financial and marketing strength amid the growing competition in the Philippine financial system. Likewise, there was a growing interest in the government towards micro financing activities by the banks to expand business lines in line with the priority development projects involving lower income groups.[44]

[44] Sourced from http://www.bsp.gov.ph/archive/Publications_2000/srpfs-1s2000.htm

In the desire to improve regulations on capital market, Securities Regulation Code was approved repealing the Revised Securities Act and Sections 2, 4 and 8 of PD 902-A, as amended. This was followed by the reorganization of SEC on December 1, 2000 that focused on capital markets, company registration, enforcement, and support services. This was envisioned to enable SEC to accomplish the policy objectives set by the SRC. Thus, the new organizational structure consists of the Commission, headed by the Chairperson, assisted by two special offices – that of the General Counsel and General Accountant; the 8 Departments which are the operations units that are distributed among four (4) core functions; and the seven (7) extension offices. Moreover, the Bankers Association of the Philippines (BAP), BSP, Bureau of the Treasury (BTr), Money Market Association of the Philippines (MART) and IHAP recently signed a Memorandum of Agreement (MoA) towards the creation of Cash-settled Securities Swap Transactions (CSST) for the temporary exchange of securities for other cash or securities of an equivalent value.

The following recommendations are important to consider in financial services integration (Milo, 2004):

1. Establishment of a consolidated financial sector supervision that will serve as a framework in viewing or positioning new financial reforms or direct future regulatory reforms.
2. Designation of the BSP as the “lead regulator” in the Philippines instead of having independent regulators or supervisors.
3. Creation of a council similar to the U.S. Federal Financial Institutions Examination Council that is composed of the heads of the various regulatory agencies who will establish uniform principles, standards and report forms for the examination of financial institutions.
4. Modernization of the system of supervision and regulation to keep pace with a dynamic financial services industry.

6. Conclusions and Recommendations

There is much to be learned from the 1997 Financial Crisis. The manner by which banks managed their loan portfolios provided an impetus for the government and financial institutions to be more cautious in their credit transactions. Immediately after the crisis, there were evidences of substantially large and prolonged deviations in the prices of financial assets from their current levels. This has threatened the once seemingly strong Philippine financial system. Even if the Philippines was not as adversely affected by the crisis as those of the other crisis-affected economies such as Indonesia, Korea, and Thailand, the problem could not have worsened had the government acted promptly on it. This led to its vulnerability to various risks.

The financial system, particularly banks, has facilitated in the country’s economic development. Over time, it has proven its success particularly in 1990s where government authorities had responded to the demands of the international financial markets. Financial liberalization was considered as a smart move to meet these specific requirements towards globalization.

Compared to other developing countries in Asia, the relatively low level of financial intermediation in the Philippine nonbank sector and the existence of limited alternative funding sources made the business sector dependent on bank financing. This was exacerbated by the fact that there is a concentration of shareholding among banks, other financial institutions or some business conglomerates who were are also major borrowers of banks' funds.

Hence, any monetary policy must be aligned not only with financial reforms but also with corporate reforms. The current status of the financial system, with banks having the biggest share, constrains the development of the capital market and contributed to the rise in the non-performing loans/assets problem. Despite efforts to strengthen supervision and regulation, progress became limited as banks continued to accumulate non-performing loans in their balance sheets, and political and economic instability adversely affected its operations.

While there were various concerns to address the problem on non-performing loans through high loan provisioning mechanism, good credit quality assessments, and stringent credit policies in the monetary policies of BSP, NPAs continued to grow. Hence, it should attempt to reduce this portfolio, together with the non-performing loans, and to provide a well-defined legal framework in revitalizing financially-distressed companies. In line with the monetary policies, financial institutions should also fortify their self-assessment activities and heighten their accountabilities in managing credit.

There should be a venue for the supervision and regulation of the banks and other non-bank financial institution's risk management practices. To do this, there must be a consideration of a number of elements in credit granting, criteria in entering into a contract, and the requirement for board approval for significant amount. This actually reduces high exposure to credit on one industry (credit concentration). Moreover, the maintenance of a credit administration, measurement and maintenance must be undertaken.

Unlike other economies where Deposit Insurance Corporation (DIC) is non-existent, the country is quite successful in its rehabilitation moves and in recapitalizing distressed or insolvent banks. The Monetary Board considered most of the banks that were closed and were not given temporary bailout as having unsound bank practices.

An integral factor to savings mobilization is the development of the capital market and the improvement in financial intermediation that allows various financial instruments to choose from based from the income and risk preferences of savers and investors. To date, the securities market is more active than the capital market. The equities market had proven its vulnerability to shock during the crisis. It is currently recovering from the effects of the crisis and efforts are vigorously undertaken to regain public confidence among investors.

As contrasted to its counterparts in East Asia, mutual fund industry is still in its infancy stage compared to trust. It was only in the early 90s when the industry regained public confidence as a good and alternative source of investments. As a whole, the asset management industry in the Philippines remained underdeveloped because of the absence of a proper legislative framework. Moreover, while there are many players in the industry, few of these players get the significant market share. With this, there is a need to develop the capital market and create awareness among investors through seminars. Moreover, financial infrastructures must be in place including technical capabilities within the system. This is believed to provide various financing schemes for the corporate sector and, at the same time, investment alternatives for investors. This will minimize concentration of funding in the banking system and will allow competition within the finance industry.

However, the country has to work out long-term financial sector development strategies in line with prudential monetary policies that will prevent any financial crises as well as lay a stronger foundation for sustainable development. The need to deepen and modernize capital markets, particularly bond markets, is critical. The country should not only embark in addressing piecemeal short-term solutions to the problem. All these must be achieved in the light of the challenges provided by increasing globalization and heightening liberalization moves.

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SINGAPORE

1. COUNTRY MACROECONOMIC PERFORMANCE

Singapore's strategic location and well-developed infrastructure contributes to this nation state's status as the trade and financial center of the Asian region. The country owes its rapid development to the efforts of government in cultivating an efficient system of financial management among its resident firms and their subsidiaries abroad.

A country study conducted by the US State Department, reveals that conservative fiscal and monetary policies have generated high savings, which, along with high levels of foreign investment, allowed Singapore to grow without accumulating external debt.

The Singapore government identified financial services as early as the 1970s as a key source of growth and drew the appropriate incentives for its development. In the 1980's, the government focused on further diversification, upgrading, and automation of its financial services, emphasizing the development of investment portfolio management, securities trading, capital market activities, foreign exchange and futures trading, and the promotion of more sophisticated and specialized fee-based activities. By the mid-80's, Singapore was the third most important financial center in Asia, after Tokyo and Hong Kong.

Growth in the sector unexpectedly slowed down in 1985, a rare occurrence in this city-state, which prompted stock exchange officials to temporarily stop operations of the exchange for three days to reassess the exchange's position and take remedial measure.

A rebound in global stock market activity also sent Singapore's stock market indices soaring to new heights in 1987, after the unexpected closure of the exchange, dampened only by the October crash in the U.S. This increase was fueled only by bullish sentiments and all gains were wiped out when the crash occurred. By mid-1989, the Singapore stock market would make a substantial recovery.

Singapore has an exceptionally open economy. From 1967 to June 1973, the Singapore dollar was tied to the US dollar and thereafter was allowed to float. Furthermore, a whole range of tax and investment allowances were promoted by the government to attract new investment and for existing businesses to upgrade or expand. Special incentives were given to foreigners and in 1985 extensive tax reductions were introduced to reduce business costs.

Singapore's economic performance since the 1990s was nothing short of being remarkable, dampened only the financial crisis. But the markets have factored in the many years of effort on the part of this nation-state to achieve financial deepening and it is not surprising to find a rebound of the magnitude not experienced by any other country in the region in the aftermath of the external shocks of 1997.

A summary of selected macroeconomic data reveals a rather extremely resilient economy for Singapore prior to and after the financial crisis.

Singapore has generally shown good performance in the trade sector, with exports growing at a steady pace and imports growing at much the same rate as exports. The country's loan-to-deposit ratios have been steady at a range between 1.2 to 1.55, while real bank credit has similarly grown steadily over the same period, taking off in 2004 to reach its pre-crisis level at 20 percent. This may be a good sign that business in the nation-state has achieved some sense of normalcy and is likewise reflective of developments in the external financial markets.

Table-SI1 Selected Macroeconomic Data

Year	GDP	Exports	Imports	Loan to Deposit Ratio	Real Bank Credit	ROE	D/E
1995	9.80	18.96	23.70	1.27	-	-	-
1996	1.00	9.23	4.89	1.32	-	-	-
1997	7.30	5.49	5.82	1.54	20.18	9.67	2.29
1998	-7.40	0.49	-18.75	1.54	-2.31	-1.82	2.29
1999	6.10	13.16	10.56	1.43	-0.64	4.64	2.35
2000	8.90	16.07	24.37	1.35	4.64	4.64	2.29
2001	0.30	-7.50	-8.61	1.29	3.30	3.44	2.43
2002	4.30	4.49	6.35	1.34	5.04	-	-
2003	5.40	5.70	4.24	1.39	4.63	-	-
2004	7.10	16.31	20.68	1.42	20.51	-	-

Source: Various country reports, IMF statistics

2. NON-PERFORMING LOANS PROBLEM OF SINGAPORE AND MEASURES OF NPL RESOLUTION

IMF defined a non-performing loan (NPL) as a loan that is in default or close to being in default, usually after three months. It is also non-performing when payments of interest and principal are past due by 90 days or more, or least 90 days of interest payments have been capitalized, refinanced or delayed by agreement or payments less than 90 days overdue.

When the Asian economic crisis struck in 1997, Singapore was one of the least affected nations. Nevertheless, the contagion effect dragged the Singapore dollar down when demand for exports to those nations, shocked by the fiscal crisis within the region, went on an all-time low. Singapore's capability as a lending center was put on a setback with large expenditures by these crisis-stricken nations on account of the gross debts the rest of the countries in the region owed - in particular the huge costs from loans in Indonesia and Malaysia. Asset prices dwindled from stocks to properties [IMF Country Report, 2004].

Though Singapore's economy was not grossly affected, NPLs still peaked around early 1999, rising to 8% from the slightly lower 7.6% of late 1998. As of June 1998, total domestic NPLs of the six local banking groups amounted to $5.4 billion or 3.9% of the total domestic loans. The number of such loans was 7,913 compared to 6,213 loans six months earlier. About 87% of the domestic NPLs are in the substandard category, with 6% in the doubtful category and 7% in the bad or loss category. The banks made provisions for NPLs in line with MAS guidelines. That is, 10% provision for the unsecured portion of substandard loans, 50% for doubtful accounts and 100% for loss loans. It was likewise observed that 40% of the increase in NPLs is due to the banks adopting stricter criteria for classifying loans. Banks now automatically classify loans as NPLs once the principal or interest payments are three months or more in arrears, compared to the previous rule of six months. Three months is increasingly the international practice. In addition, banks are continuing to treat all loans to borrowers with weak financials as NPL, regardless of whether they are in arrears. The remaining 60% of the increase in NPLs reflects the slowdown in the economy [MAS Parliamentary News 1998].

Unlike other countries in the ASEAN region, Singapore recovered from the crisis with much ease despite its NPL problems, most of which arose from Singapore's banking exposure in its neighboring countries. The market has been able to single out Singapore from the rest of the countries in the region as having a much more strong finance market fundamentals and having achieved advanced levels of financial deepening has convinced the international market that Singapore's NPL problems as temporary and this become visible in its faster recover compared to the rest of the countries in the region.

3. SINGAPORE'S FINANCIAL AND CAPITAL MARKET

Singapore has about 580 local and foreign financial institutions, offering an array of financial products and services. These include trade financing, loan syndication, foreign exchange trading, derivative products, securities trading and underwriting, fund management, and insurance services (IMF, 2004).

In 2002, IMF ranked Singapore as 4th in foreign exchange trading in the world and 6th in over-the-counter derivatives trading. Its equities market has more than 550 reputable listed companies. Its financial sector accounted for 11% of GDP and 5% of total employment (IMF, 2004).

Table-SI2 Structure of the Financial System
(At end-September 2003)

	In billions of Singapore dollars	In percent of total assets in the financial system	In percent of 2002 GDP
Commercial Banks	1,049.6	85.6	674.0
Merchant Banks	58.3	4.8	37.4
Finance Companies	11.1	0.9	7.1
Insurance Companies	71.8	5.9	46.1

Source: Monetary Authority of Singapore

Table-SI2 showed Singapore's financial sector dominated by the banking industry with 85% of total assets in the financial system.

4. SINGAPORE'S ASSET MANAGEMENT INDUSTRY

BACKGROUND OF THE INDUSTRY

Asset management first emerged as an industry in Singapore when the Asian crisis hit the country in the late 1990s. Primarily during the first few years of recession, the country's financial institutions have resorted to numerous recovery programs resulting into the creation and proliferation of asset management companies (AMCs).

Most of the post crisis measures did not necessarily address the underlying behaviors and structural weaknesses in the financial sector. However, the asset management companies formed a crucial part of the emergency measures. These insolvency measures focused on [Miteva, 2003]: (1) creating the legal basis for investment in distressed assets; (2) implementing bulk sales of NPLs; (3) establishing limited life, specialized AMCs; (4) introducing new rescue procedures to insolvency regimes (formal restructuring, often modeled on US Chapter XI); and (5) developing informal workout practices, i.e., informal restructuring or London Approach.

Asset management companies have been used to address the debt overhang – essentially by expediting corporate restructuring or disposing of assets. There is an ongoing debate over the best model for asset management and recovery - should debt restructuring and workout be done by the banks themselves (the decentralized model) or should bad debt be transferred to a centralized publicly owned asset management company (the centralized model) [Klingebiel, 2000]. Styles of responses to banking crisis management have changed over time and there is no unique or optimal blueprint on how to manage systemic banking distress [Dziobeck, 1998].

AMCs tactical goal was therefore to restructure NPLs and contribute to the broader strategic aims of financial and macroeconomic stability. In the case of Singapore, asset management primarily becomes a practice of managing and handling assets through stocks, bonds, or cash equivalents to ensure its proper acquisition, utilization, lease, allocation, or disposal to increase returns on investment.

GROWTH IN THE ASSET MANAGEMENT INDUSTRY

Hagiwara [2005] described how Singapore's asset management business developed. By 1968, Singapore has established an offshore market for non-residents to manage non-resident funds, providing mainly funding and exchange services.

Competition in the late 1980s became more intense as countries attempted to become international finance centers. Singapore undertook a review of its financial sector, realizing the advantages that could be gained by the easing of restrictions and facilitating borderless transactions with advances in telecommunication and technology.

By 1998, Singapore’s Financial Sector Review Group developed a base for the management of domestic and international funds to include non-residents, much like the more advanced London market. Such a move simultaneously boosted the competitive strength of local banks while strengthening the capital market. The Group further believed that the asset management business was important for Singapore for the following reasons:

- European and US investors would sooner or later become positive of investing in Asia after recovering from the crisis, and
- Global investments by the region's emerging wealthy class were expected to become robust.

To supplement the creation of a review group, the government came up with the following measures:

- Entrusting management of government funds to GIC and MAS, set up to manage the government's foreign currency reserves;
- Attracting foreign management companies;
- Fostering domestic boutique fund type fund managers (small scale which would specialize in specific funds); and
- Accepting hedge funds.

The MAS and the Government of Singapore Investment (GIC) Corporation placed a total of $35 billion to external fund managers over three years spanning 1997-2000. This acted as seed money to provide for the development needs of Singapore's fund management industry. To attract more fund managers to operate in Singapore, the minimum fund requirement for an Investment Adviser's license was reduced from $500 million to $100 million. The minimum amount of global funds that the company must manage was lowered from $5 billion to $1 billion. Furthermore, the government introduced tax incentives, which allowed fund management companies tax exemption for fees earned from investment management or advisory services. Singapore currently hosts about 200 asset management firms, most of them being foreign entities (see **Table-SI3**).

Table-SI3 Fund Management Companies in Singapore

Abacus Capital (S) Pte Ltd.	Aberdeen Asset Management Asia Limited
ABN AMRO Asset Management (Singapore)	AIB Govett (Asia) Ltd.
Alliance Capital Management (Singapore) Ltd.	American International Assurance Company, Ltd.
Asia Life Assurance Society Limited	AXA Life Insurance Singapore Pte Ltd
Citicorp Investment Bank (Singapore) Ltd.	CMG First State Singapore
Commerzbank Asset Management Asia Ltd	Credit Agricole Asset Management Singapore Ltd
DBS Asset Management Ltd	Deutsche Asset Management (Asia) Ltd
Dresdner Asset Management Ltd	Eurekahedge Pte Ltd
Goldman Sachs (Singapore) Pte Ltd	Government of Singapore Investment Corporation Pte Ltd
Great Eastern Life Assurance Company Ltd	Henderson Global Investors (Singapore) Ltd
HSBC Asset Management Singapore	Insurance Corporation Singapore Ltd
Invesco Asset Management Pte Ltd	John Hancock Life Assurance Co Ltd
Keppel Insurance Pte Ltd	Keppel Investment Management Ltd
Merrill Lynch Investment Managers Ltd	Morgan Stanley Dean Witter Investment Management Company
Morley Fund Management Ltd	Nikko Global Asset Management (Singapore)
Nomura Asset Management	NTUC Income Insurance Co Ltd
OCBC Asset Management Limited	OUB Asset Management Ltd
OUM Manulife Pte Ltd	OUB Optimix Funds Management Ltd
Overseas Assurance Corporation Ltd	Phillip Capital Management
Prudential Portfolio Managers Singapore Limited	Rothschild Asset Management Limited
Schroder Investment Management Ltd	SG Asset Management (Singapore) Ltd
Singapore Unite Trusts Ltd	Straits Lion Asset Management Pte Ltd
Templeton Asset Management Ltd	UBS Asset Management Ltd
UOB Asset Management Ltd	

Source: www.irasia.com/funds/sg/

The growth of the asset management industry has been quite phenomenal. By June of 1999, there were 189 asset management companies, compared to 169 from the end of 1998 [MAS press release, 1999]. Moreover, total assets managed by Singapore-based financial institutions increased from S$151 billion in 1998 to S$344 billion in 2002 [IMF, 2004]. Of the S$ 183 billion of discretionary assets as of end 2002, 30% came from

Singapore and the rest from abroad – mainly Europe and the United States of America [ibid.].

The IMF attributes the increase to transfers of regional portfolios to Singapore for management and continued expansion of management and advisory activities for the pan-Asian region in light of Singapore's sound legal and tax environment and highly developed infrastructure. Some asset managers also centralized their regional trading and back office functions in Singapore. Fund managers took a greater interest in Asian markets due to economic recovery in Asia, coupled with the continuing commitment of asset management companies to strengthen their activities in Singapore. In addition, the rebound in Asian capital markets has also raised the market value of portfolios under management.

The asset management industry expanded steadily against a backdrop of weak global financial markets after the Asian financial crisis. Total assets managed by Singapore-based financial institutions grew 12.0% in 2002 to S$ 343.8 billion [Asset Management, 1999].

Table-SI4 shows total assets under management in Singapore from 1992 to 2002. There was a 36% increase in the total assets under management in the first half of 1999. As of June 1999, total assets under management was S$204.1 billion compared with S$150.6 billion at year-end of 1998 [MAS press release, 1999]. Total assets under management exhibited double-digit growth in 2004. It was reported that the figure was S$572.6 billion, a 23% growth over S$465.2 billion reported in 2003 [Singapore Asset Management Industry Survey, 2004].

Table-SI4 Assets Under Management

(In S$ Billion)

	Total Discretionary	Total Non-discretionary
1992	37.5	0
1993	61.8	0
1994	65.9	0
1995	86.4	0
1996	125.0	0
1997	124.1	0
1998	111.9	38.7
1999	183.0	90.7
2000	166.4	109.8
2001	180.7	126.3
2002	183.4	160.4

Source: Monetary Authority of Singapore

Singapore is able to retain its role as an international asset management center as 70 % of total assets under management (AUM) have been sourced abroad (see **Table-SI4**). About 46% of total funds came from Asia-Pacific countries, but asset managers appear to have diversified their sources of funds. New high growth markets have emerged such as the Middle East and South Asia. Funds from these regions grew 76% and 53% per annum, respectively, in 2004. Europe and US shares have also increased steadily and accounted for 12% each of total AUM, compared with 7.8% in year 2000 [Singapore Asset Management Industry Survey, 2004].

Table-SI5: Initial Profile of Fund Management Companies in Singapore

Discretionary Assets	$183.4
Non Discretionary Assets (NDA)	160.4
Total	343.8
Sources of Funds:(Region) Discretionary (AUM)	
A. Sources	
Singapore	30%
Europe	25
Others	18
Rest of Asia Pacific	13
North America	14
B. Type of Clients	
Institution	60%
CIS	36
Individuals	4
C. Allocation of Investment of Funds	
Equities	49% $89.8B
Bonds	30 55.7
CIS & others	21
	total $183.4B
D. Investment by Geographical Location	
Rest of Asia Pacific	67%
Singapore	32
F. **Profile of Industry Players**	
Portfolio Managers	695
Investment Analysts	294
Asset Allocators/Economists	23
Total	1,012
E. Investment Professionals by product	
Equity	
Private Equity	54%
Fixed Income % others.	21
	25
F. Collective Investment Schemes(CIS)	
Number of CIS	382
CIS Assets	S$14.1 Billion
G. Popular Investment Choice	
Cash Guaranteed Protected Fund	
Equity	82 Funds
Geographical Location	203
	Asia Pacific

Source: Singapore Asset Management Survey, 2004.

Equities had the largest share in investment funds at 49% of total AUM. Bonds increased in importance from 18.5% in 2000 to 30% in 2004. From negligible levels in 2000, alternative investments, commodities, derivatives and FX products accounted for 21% of total AUM. Cash, deposits and money market products saw their share decline over the same period [Singapore Asset Management Industry Survey, 2004].

The average AUM managed by asset management entities was S$2.3 billion in 2004, up from S$ 2 billion in 2003. Ten asset management entities manage more than S$10 billion in assets, accounting for 31% of total AUM and 56% of discretionary AUM.

Asset managers with less than S$1 billion in AUM numbered 132 in 2004, and accounted for 7% of total AUM. Most of these managers are indigenous companies, which numbered 111, up from 96 in 2003. These companies accounted for 25% and 38% of discretionary AUM and total employment investment of professionals, respectively. The total number of investment professionals in the asset management industry increased by 15%, to 1,135 in 2004 from 86 in 2003 [Singapore Asset Management Industry Survey, 2004].

By end of 2003, Singapore's total assets under management tripled from S$150.6 billion (S$1 = 65yen) to S$465.2 billion. Of this investment, discretionary accounts (investors entrust entire account and management of funds to fund managers) amounted to S$254.6 billion. Non discretionary accounts (where investors specify a particular management policy) amounted to S$210.6 billion. Many of the discretionary accounts are seen as private banking assets catering to the wealthy, 70% mainly coming from Europe and the US. Foreign fund investments are attracted to Singapore for the following reasons:

- In contrast to Hong Kong, Singapore provides strict monitoring from its monetary authorities given a reliable legal framework.
- Competent staff, not only in English but in also in other languages, working to gather inter regional information needed for excellent customer service.
- External factors included redirection of funds from Hong Kong to Singapore after Hong Kong’s return to China.
- A similar redirection from EU happened in response to Switzerland's decision to impose a 15% withholding tax on deposits from EU nationals and to increase tax in stages to 35% by year 2011.

As the private banking industry develops, standards of conduct for trust companies has been tightened and for the first time in 20 years, trustee law and trust company law are being reviewed to prevent malfeasance.

Singapore also established a 5-year program of liberalizing domestic banking and expanding the capabilities of the foreign banks. Domestic banks were encouraged to push for their consolidation. At the same time, this opened the doors to allow more foreign banks into Singapore. Contributing to Singapore as an offshore banking market was the rise of the Asian Dollar Market (ADM).

Moreover, the Singapore government promotes its regulatory environment as one that is business-friendly, with transparent and clear regulations. The rules and regulations are formulated and reviewed with the interests of foreign investors and local enterprises in mind. In April 2003, the Singapore government established a new centralized Internet portal to seek feedback on selected draft legislation and regulations, a process that is being used with increasing frequency.

Singapore's political environment is stable, and there is no history of incidents involving politically motivated damage to foreign investments. Furthermore, the Political and Economic Risk Consultancy ranked Singapore as the least corrupt country in Asia and one of the least corrupt in the world in 2004. Most observers and foreign investors share this view. Singapore has, and actively enforces, strong anti-corruption laws. When cases of corruption are uncovered, whether in public or private sector, the government deals with them firmly, swiftly and publicly, as they do in cases where public officials are involved in dishonest and illegal behavior [Investment Climate – Singapore, 2005].

The IMF has commended Singapore's high degree of observance of international standards and codes and stated that Singapore's financial sector is resilient and robust. Singapore has sought to boost the country's asset management industry by placing with external asset managers a significant portion of government reserves managed by the Monetary Authority of Singapore and the Government of Singapore Investment Corporation. In 2003, some S$465.2 billion in funds were managed in Singapore. The government moved in the late 1990's to develop an AGD debt market. The total issuance of SGD denominated corporate debt in 2003 was s$19.3 billion.

In January 2002, Singapore removed all trading restrictions formerly placed on foreign-owned stockbrokers. Aggregated investment by foreigners may not exceed 70 percent of the paid-up capital of dealers that are members of the Singapore Exchange [Investment Climate, 2005].

The government also provided incentives to indigenous fund management companies to encourage them to grow their businesses, which would enable them to compete in a bigger playing field. The incentive scheme includes exemption from tax on the investment income earned by foreign investors from funds.

Singapore's financial sector has been resilient in the face of major economic downturns in recent years. It has weathered three major shocks: the Asian crisis in 1997-98; a sharp drop in electronics exports in 2000-2001 (resulting in the worst recession since independence); and the outbreak of SARS in early 2003. Sources of the resilience include a long history of sound fiscal and monetary policies, long-standing external current account surpluses, significant external assets and reserve positions, the healthy corporate sector, high household wealth, and conservative financial regulatory and supervisory practices [IMF, 2004].

In 2002, the Council on Corporate Disclosure and Governance was formed to promote good corporate governance and strengthen the framework of disclosure practices and reporting standards, and prescribe accounting standards in Singapore. In the beginning of 2003, companies listed in the SGX have been required to disclose their corporate governance practices and explain any deviations from the Code of Corporate Governance in their annual reports.

Moreover, Singapore has closely followed international best practices in accounting standards and disclosure. All companies with a market capitalization of S$75 million are required to report quarterly financial results and all listed companies will be required by 2006 to change audit partners and locally incorporated banks to change audit firms every five years.

Since 1998, Singapore has implemented changes in their financial sector to enhance its position as a major financial center. Among the significant changes include:

- Opening the financial industry to greater foreign competition
- Bringing regulatory and supervisory practices in line with international best practices on prudential regulation and supervision and disclosure-based regulation.
- Developing deep and liquid fixed-income and equity markets
- Promoting the asset management industry
- Gradually liberalizing the restrictions on the international use of SGD

In 1999, Singapore announced the liberalization of the domestic banking sector, which allowed foreign banks to expand their operation in Singapore and encouraged consolidation of local banks. They also introduced a risk-based capital framework for the insurance industry in late 2004. They were also able to separate financial and non-financial activities by requiring banks to divest non-financial activities, which minimized the contagion risk and conflicts of interest. Furthermore, they introduced the 2nd generation of the MAS Electronic Payment System to further improve the efficiency of the payment system.

As part of the strategy to develop Singapore into a premier financial center, MAS offers tax incentives for financial institutions looking to set up operations in Singapore. These are summarized in **Table-SI6**.

Table-SI6 Monetary Authority of Singapore Tax Incentives for FIs

1. Tax Incentive Scheme for Offshore Insurance Business.	Concessionary Tax rate of 10% on income derived.
2. Tax Incentive Scheme for Commodity Derivatives Trading .	Concessionary Tax rate of 5% on income derived.
3. Tax Incentive Scheme for Approved New Derivative Products traded in Singapore Exchange.	Concessionary Tax rate of 5% on total income derived from transactions in each approved new product.
4. Tax Incentive Scheme for Finance and Treasury Operations.	Concessionary Tax rate of 10% on total income derived from provision of finance and treasury operations.
5. Tax Incentive for the Bond Market.	Concessionary Tax rate of 10% on interest from holding qualified debt instruments.

Source: IMF, 2004.

CURRENT IMPEDIMENTS AND MAJOR ISSUES AND CHALLENGES OF SINGAPORE'S AMI

Despite liberalization, foreign banks in the domestic retail banking sector still face significant restrictions and are not accorded national treatment such as they are not allowed to access local bank's ATM networks. Furthermore, customers of foreign banks are also unable to access their accounts for transfers or bill payments at ATMs operated by banks other than their own [Investment Climate in Singapore, 2005].

In **Table-SI7**, the IMF said that Singapore's financial sector is subject to a number of potential risks, namely:

Table-SI7. IMF Potential Risk For Singapore

1. Negative Shocks in External Demands.
2. Persistent Weakness in the Labor Market.
3. Sharp Increase in Interest Rates.
4. Declines in Asset Prices.

Source: IMF, 2004.

As clients become more sophisticated and learn to invest across the whole spectrum of financial assets, there will be demand for debt instruments. Hence, asset managers should leverage on Singapore's strength in foreign exchange and treasury operations, as clients who want to reduce portfolio risk through currency exposures will find such services attractive. To boost competitiveness, skills must be upgraded, not only through professional qualifications like the Chartered Financial Analysts but also "on the job" training [Koh, 1999].

According to the industry itself, top fund management companies pride themselves on their in-house investment management process and that they guard these processes as this differentiates them from competition in the industry. These companies would prefer well-qualified individuals that can imbibe the investment management culture of the firm [ibid.]. Furthermore, the MAS (Monetary Authority of Singapore) is working to develop a licensing examination for Investment Representatives to provide uniform industry-wide qualifications. This will be structured similarly to that of the Dealer's Representative's Examination.

There is a view that the domestic banking market is mature and so they would like to expand overseas. As they do so, these banks will face new risks. Therefore, local banks should be encouraged to further improve their risk-management capabilities [IMF, 2004].

In 2002, Singapore's financial sector faced the challenges of volatile financial markets and slow economic activity both globally and domestically. As a result, the banking industry was badly affected by weak financial market prices, eroding solvency margins and returns to policy holders, the securities firms have suffered from falling equity market volumes and subdued investor confidence.

5. CONCLUSIONS AND RECOMMENDATIONS

Although the Asian financial crisis caused an outbreak of non-performing loans and non-performing assets, the country's status as a regional financial center remained robust as it implemented reforms in the financial sector.

It is to be noted that liberalization, globalization and the middle-of-the-road approach became for Singapore the target pathways to reach concrete grounds on stability and get past the insecurities of entering the global market. A midway resolution was reached for the regulatory and supervisory policies implemented on the financial and economic sectors. This entails a combination of the strict and firm conditions set by the Japanese and the Europeans and the more open regulatory laws of the Americans were applied to Singapore's own critical financial architecture [Low, 2000]. The system worked by reforming previously existing policies on foreign ownership of banks, commercial establishments, and multinational companies (MNCs). Singapore has emerged as one of the strongest financial markets and appeared to be the safest haven for foreign investments within the Asia Pacific region.

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THAILAND

1. COUNTRY MACROECONOMIC PERFORMANCE

Prior to the Asian financial crisis, Thailand was hailed as the model for East Asia in terms of economic performance. Its economy was growing (between 7 to 10 per cent annually), which triggered overconfidence in the system. The Thai baht was closely tied to the US$ while interest rates were found to be higher than international rates, particularly of the US, causing substantial capital inflows. Sussangkorn [1998] cites capital inflow facilitating liberalization of foreign currency current account transactions and the initiation of the Bangkok International Banking Facility (BIBF) in 1993 to monitor foreign currency inflows and outflows. Subsequently, capital inflows not only bridged the savings-investment gap of Thailand, but also have exceeded it. With capital flows causing a decline in interest rates, Thailand's private sector took every opportunity to finance investments with borrowings. They utilized foreign capital with not much attention given to exchange rate risks. Unlike debt management by the public sector, there was no effective debt management mechanism for private debt imposed by the government on the private sector. This situation in Thailand's financial market, coupled with the loss of competitiveness of its exports, contributed to the adverse effect of the external shock felt as a result of capital flight from the ASEAN region in July of 1997.

The immediate effect of the shock was the inability of the Bank of Thailand to support the baht, which was allowed to float in July 1997, creating a domino effect on the sectors of Thailand largely dependent on foreign currency flows. The property sector was one adversely affected by the crisis where short-term currency inflows financed long term construction needs.

Table-TH1 presents selected macroeconomic data showing the negative effects of the crisis on Thailand's economic performance in 1997-1998 and signs of Thailand's vulnerability to the external shock as seen from the country's export performance. The banking sector suffered the most from the financial crisis and left behind its trail rising non-performing loan problems.

Thailand's economy began to show signs of recovery beginning 1999. Exports and imports took a roller coaster ride over the ten year period 1995-2004, this being more pronounced with imports as the decline occurred beginning 1996 until 1998 as a result of the sudden drop in the value of the Thai baht. Liquidity in the money market was high causing a lowering of domestic interest rates. Loan to deposit ratios continued to decline gradually over the years, the lowest encountered in 2004 for the ten-year period. It seems that banks have become reluctant to beef up lending after the crisis. This is further reinforced by data on real bank credit. Despite this, the level of deposits remained high.

TABLE-TH1: GROWTH RATES ON SELECTED MACROECONOMIC DATA ON THAILAND

Year	GDP	Exports	Imports	Loan to Deposit Ratio	Real Bank Credit	ROE	D/E
1995	9.20	15.44	19.97	1.43	-	-	-
1996	5.90	-5.52	-0.61	1.43	-	-	-
1997	-1.37	7.23	-11.30	1.44	13.57	-31.24	6.83
1998	-10.50	8.24	-21.64	1.41	-11.59	-12.83	6.04
1999	4.40	9.03	10.49	1.34	-6.04	-27.04	5.49
2000	4.75	17.49	27.12	1.28	-17.16	-4.96	5.71
2001	2.20	-4.21	-5.50	1.18	-11.07	7.36	5.34
2002	5.30	11.99	13.70	1.12	14.90	-	-
2003	7.00	7.03	8.47	1.12	4.95	-	-
2004	6.10	9.64	13.48	1.10	2.38	-	-

Source: Various country reports, IMF statistics

Foreign debt repayments were underway, domestic banks concentrated on raising new capital while debt restructuring continued well into 2000. The level of non-performing loans peaked in mid-1999 at around 47% and started its descent with debt restructuring and transfer of loans to asset management companies. Expanded fiscal reform policies to jump start the economy were introduced [Thai Economic Outlook Yearend Review, 1999].

The financial crisis seemed to have ended for Thailand in 2000. Export performance is reported to have reached historic heights with strong growth in global trade, particularly in the durable goods sector. The surge in luxury product imports is reflective of the revival of industrial production, since these comprised largely of industrial raw materials and capital goods. The private sector was more open to refinance foreign obligations to reduce costs and currency risks. The composition of foreign debt saw the public sector with higher debt exposure than the private sector but of longer maturity structures. The effects of the financial crisis lingered in the market as the debt overhang from non-performing loans (NPL) remained strongly felt in the system. Funding of domestic companies was sourced largely through bond issuances and through internal sources and less through bank credit [Thai Economic Outlook Year End Review, 2000].

Credit expansion registered slow growth even into the succeeding years when there was a rise in both consumption expenditures and private investments. Government continued to stimulate domestic demand through expansionary fiscal policies while simultaneously loosening monetary controls. The succeeding years from 2001 to 2004 saw continued economic growth resulting from low interest rates encouraging investments, improved farm income and employment conditions and the implementation of tax measures conducive to private consumption.

2. NON-PERFORMING LOANS PROBLEM

The effect on the corporate sector in the aftermath of the financial crisis was the sudden rise on the incidence of loan defaults and a record number of NPLs in the financial system, whereas it was kept to a minimum prior to 1997. Debt resolution and restructuring proved to be more than a challenge for the system, as Thailand's internal infrastructures were not designed to cope with such problems.

The primary fundamental macroeconomic causes of the crisis were overinvestment, while substantially financed by domestic saving, propelled by low interest rates, and unhedged foreign borrowing. These causes were in turn traced to inappropriate fixed exchange rate policy, capital account liberalization, imprudent bank lending, lax banking supervision and poor corporate and firm governance [Vongvipanond, 2004].

3. MEANS OF RESOLVING THE NPL PROBLEM

During the initial years of the crisis, concerted efforts were directed by the authorities to restructure and consolidate the banking sector through government assisted capital increase. Solutions to the NPL problems of commercial banks in this first phase were substantially through decentralized, market-oriented approach. As far as the organizational mode used in the settlement of debtor-creditor dispute was concerned, roughly equal proportion of debt negotiation and restructuring process took place through some identified channels, particularly,

1. Private bargaining and settlement with or without litigation through civil court procedure;
2. Intermediaries like the Bank of Thailand in cooperation with business organization with managed the Corporate Debt Restructuring Committee (CDRC);
3. Formal bankruptcy and corporate reorganization procedures handled by the Central Bankruptcy Court (CBC).

The crisis brought about many policy and institutional changes. The need for more capital injection necessitated the opening of the banking sector to foreign ownership. The bankruptcy law was revised to include corporate reorganization together with the establishments of CBC in 1998. Civil court procedures, as part of major legislative changes, have been made continuous to speed up NPL resolution. With opposition encountered as to the manner and speed with which changes were made and at a time when these were largely responses to the crisis have partially been addressed with reorganization aspect introduced in the Bankruptcy Act of 1942 [ibid.].

With loan restructuring and the introduction of drastic reforms in Thailand's financial system, the percent of NPLs to total loans continued to decline over time from 47% in 1997 down to 12% in 2004. This was made possible through continued growth in the economy as reflected in growth in business and by the removal of the NPLs from bank system balance sheet and placed into the state-owned Thai Asset Management Corporation (TAMC) as well as private AMCs.

THE CREATION OF THE THAI ASSET MANAGEMENT COMPANY (GOVERNMENT OWNED)

The repercussion of 1997 crisis saw Thailand undergoing changes in its monetary regime involving the conduct of more stringent monetary policies and the internal reorganization and risk management of financial institutions. Commercial banks and central bank regulators gradually learned from the past crisis by changing financial practices, consolidating businesses and introducing new legal institutional infrastructure.

Immediately after the crisis, concerted efforts were directed by the BOT to restructure and consolidate the banking sector. In the first phase, the Thai government's solution to the problem on NPLs of commercial banks was through a decentralized market-oriented approach. It was not until a new government in 2001 that a centralized Thai Asset Management Corp (TAMC) was formed, established by Emergency Decree 2544 [ibid].

TAMC's objectives are to manage impaired assets of financial institutions and asset management companies, debt restructuring, and business reorganization. TAMC is expected to achieve these objectives by taking transfer of impaired assets of financial institutions and asset management companies or by applying any other measure for the purpose of reviving the economy or restoring national stability. However, its actual role toward debt restructuring and economic recovery was marginal since substantial amount of debt owed to financial institutions were already restructured. The NPLs of state owned and private banks transferred to TAMC were of modest amounts. TAMC is empowered to issue 10-year notes guaranteed FIDF to purchase NPLs from qualified state and private financial institutions under prescribed guidelines.[45]

TAMC has been mandated to work around the Bankruptcy Act and use the Central Bankruptcy Court and its processes to force defaulting bank borrowers to accept debt restructuring and business reorganization plans. In October 2001, with obvious objections from the Thai financial and business community, TAMC was eventually cleared of a constitutional hurdle and accepted the first lot of asset transfers on the 15th of October [Kelakos, 2002].

[45] This was sourced from the TAMC website.

MECHANICS OF TAMC

The following items pertain to the requirements for the transfer and restructuring of NPLs from the different Thai commercial banks to TAMC [Pornovalia, 2001].

TRANSFER OF ASSETS

In December 2000, all state-owned financial institutions and asset management companies were required to transfer all NPLs to TAMC falling under the category as loss (required to be written off); doubtful of loss (requiring 100% provisioning); doubtful (requiring 50% provisioning); and sub-standard (requiring 20% provisioning).

To qualify for transfer of NPLs, private financial institutions and asset management companies may transfer NPLs to TAMC only if the following criteria are met: the NPLs are secured by property; the debtor, which is a juristic entity, is indebted to at least two Thai financial institutions; the total value of NPL owed by a debtor is at least Bt5 million; no restructuring agreement in writing has been entered for the NPL by July 9, 2001, and the NPL was not part of a rehabilitation plan approved by the Bankruptcy Court before June 9, 2001.

DEBT RESTRUCTURING

One of the most interesting strengths of the TAMC is its ability to restructure the debt by unilaterally amending loan terms, forcing a debt-equity conversion, taking assignments of debts or assets from the debtor to settle debts, and taking transfer of shares or buy issued shares to increase the debtor's capital. For all these and other measures, only the approval of the TAMC Board is required. Certain procedures required under relevant laws are generally waived.

The TAMC Decree sets the rules and procedures of business reorganization separate from those provided under the Bankruptcy Act. The criteria for business reorganization under the TAMC Decree are as follows:

- The debtor must be a limited company, a public limited company or a registered partnership;
- TAMC is a creditor and is owed more than 50% of the debtor's total debt;
- There is evidence that the business can be carried on and its rehabilitation will benefit the national economy;
- The debtor consents and agrees to be bound by the terms and conditions of business reorganization under the TAMC Decree.

As of September 2004, the TAMC has taken over 15,491 cases with book value of Bt777.2 billion (US$19.4 billion) in bad loans from local financial institutions and asset management companies at the transfer price of Bt266.5 billion or around 34.29 percent of the book value of the total transferred assets. TAMC has successfully restructured 98.11 percent of the total impaired assets transferred to the TAMC [US State Department Investment Climate Statement on Thailand, 2005].

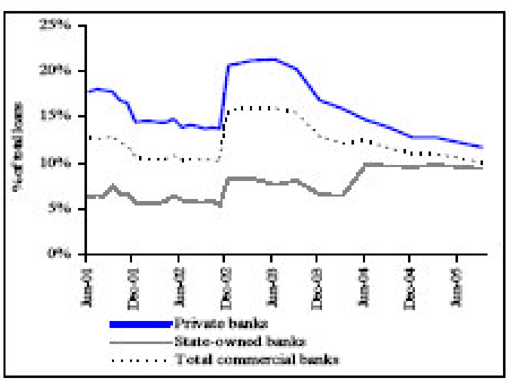
TAMC's special power to foreclose assets is planned for the unresolved cases valued at Bt199 million where it was unable to contact debtors or rejected restructuring proposal submitted by debtors. In June 2005, restructuring was completed and TAMC outsourced the management of the smaller 10,830 accounts (approximately 3 percent of transferred assets) to the largest state bank and one public AMC.

DECLINE IN NON PERFORMING LOANS (NPLS)

Figure-TH1 illustrates that in the first nine months of 2005, NPLs of commercial banks declined by only 2-3 percentage-points from the end of 2004. However, the BOT anticipated substantial declines in financial institutions' NPLs were likely to be removed from the NPL status, given their ability to make payments according to the restructured agreements.

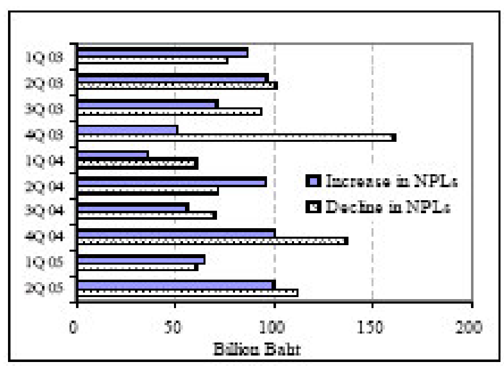
As of September 2005, NPLs of private banks is still in the double-digit range and higher than that of state banks. However NPLs at private banks have been declining faster than those at state banks. In **Figure-TH2**, new and re-entry NPLs increased significantly in the second and fourth quarters of 2004 and the second quarter of 2005 following the enforcement by the BOT of a tightened loan classification since the second quarter 2004. NPLs have been declining as banks were able to increase the level of debt restructuring and economic recovery enabled NPL debtors to make principal repayment [Thailand Economic Monitor, 2005].

Figure-TH1: Non-performing Loans June 2001-September 2005



Source: BOT and World Bank's Estimate

Figure-TH2: Changes in NPLs 1Q2003 - 2Q2005



Source: BOT and World Bank's estimates

BOT assistant governor Krirk Vanikkul is optimistic that the NPLs of banks will fall to 2 percent within the next two years from 2005 and the NPL target could be met in 2007 despite a 10.5 percent rise in the first half of 2005. NPLs have been growing at a slower pace since major restructuring took effect. Bad loans worth Bt158 billion are facing foreclosure; Bt83 billion are in the legal process, Bt206 billion under restructuring and Bt114 billion restructured [Bangkok Post, 2005].

Among Asian countries hit by banking crisis in 1997, Thailand's magnitude of NPLs was the highest for two years. NPLs peaked in mid 1999 at 47 percent of loans, partly attributed to the closure of fifty-six (56) finance companies and the decentralized market based approach taken to restructure affected banks. As of end-2004, bank NPLs have substantially decreased as business activities resumed. **Table-TH2** below reveals a continuous decline in NPL ratios from 1998 to 2004.

TABLE-TH2. YEARLY REPORT ON OVERALL NPLS

Thailand's Development of Non Performing Loans (In million baht)

Year	NPLs	Percent of NPLs to Total Loans
1998	2,674,533	45.02
1999	2,094,424	38.93
2000	863,663	17.73
2001	477,405	10.41
2002	770,282	15.65
2003	641,350	15.69
2004 (March)	617,142	12.02

Source: Bank of Thailand

Debt restructuring in Thailand has been done successfully in and out of court. **Table-TH3** shows the majority of NPLs in legal and court processes, first quarter of 2005 [Nakornthab, 2005].

TABLE –TH3. BREAKDOWN OF FINANCIAL INSTITUTION NPL

Breakdown of financial institution NPLs

	Percent (as of Q1 2005)
In legal and court process	44
Restructuring process	36
Restructured in repayment process	21

Source: Bank of Thailand

The following changes significantly reduced the risk of a systemic crisis among banks, further contributing to improvements in the country's NPL ratios:[46]

MIXED FOREIGN EXCHANGE REGIME HAS BEEN ESTABLISHED SINCE THE 1997 CRISIS**.** The Thai baht has since been floating against other currencies. However, the evolution of the exchange rate is relatively protected against speculative attacks due to substantial market interventions of the central bank and a stricter regulation on capital flows. Transactions, which are not backed by a trade or investment operation, are restricted.

ESTABLISHMENT OF A LOW INTEREST RATE ENVIRONMENT. Since 1998, the monetary policies of the central bank have allowed private operators to redeem their foreign-currency denominated liabilities in baht. This resulted in the decrease in Thailand's external debt from 93% of GDP in 1998 to 38% in late 2003. Debt redemption efforts were particularly carried out by the private sector, making borrowers much less exposed to foreign exchange risk. As part of proclaiming to the international community Thailand's renewed economic health, the government paid back two years in advance US$14 billion loan extended in emergency by the International Monetary Fund (IMF) in 2003.

THE BANKING SECTOR HAS RECOVERED AND IS CONTINUOUSLY IMPROVING**.** A number of affected banks have been foreclosed or merged, limiting the number of major players to 14 commercial banks as of November 2005. **Table-TH5** shows relevant financial figures on Thai commercial banks as a result of the government's recovery program.

With profits returning, further prospects of strategic alliances and mergers are seen in the horizon, as state-owned banks are about to be privatized. Half of the NPLs or about US$16 billion, that has hampered the financial sector up until 2001, were purchased by TAMC. By swapping NPLs for government bonds in bank balance sheets, TAMC ensures a transfer of the accumulated loss of the banking sector to the state budget, with the actual cost spread over 10 years. **Figure-TH3** shows Thai commercial banks' NPL ratios now significantly lower, but still high by overall regional standards. Nevertheless, when debt restructuring is completed, banks affected are relieved from serious financial constraints and allowed to resume normal business.

DIVERSIFIED FINANCING OPTIONS FOR THAI COMPANIES**.** Up until the crisis, Thai companies were virtually using no other financing than standard bank loans. Today they can directly tap capital markets (the stock exchange or the bond market), which have expanded at a fast pace since 1997.

Since the crisis the Thai financial sector appears prepared to undergo further change, influenced by regulatory pressures. Beginning 2005, the introduction of a limited

[46] Sourced from Thailand Focus Business Consultant website.

insurance deposit program will bear its own imprint on the capital market. With bank deposits no longer enjoying blanket guarantees from the government, fund managers anticipate a considerable shift in assets towards the capital market [Bangkok Post Economic Review Year-End, 2004].

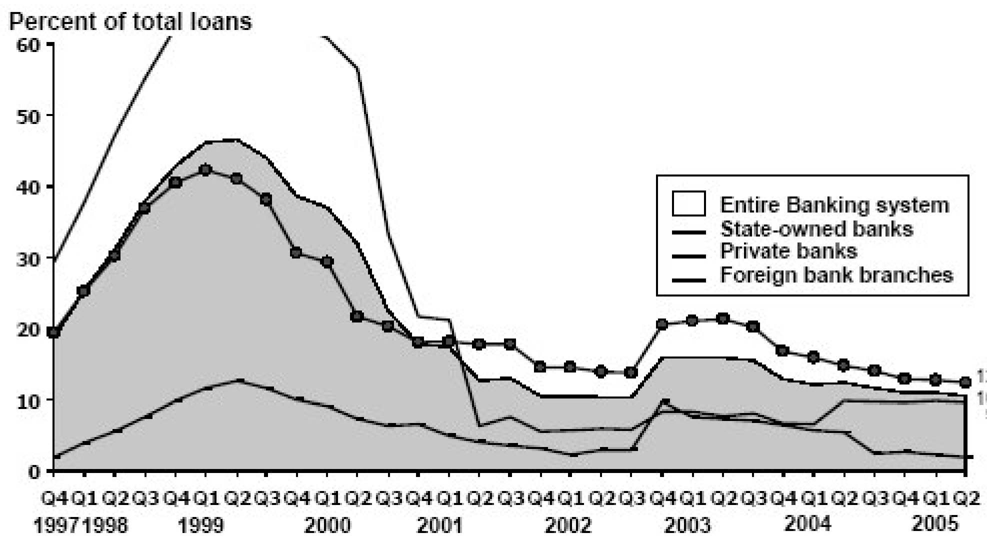
TABLE-TH4. AVERAGE OF FINANCIAL DATA AND RATIO OF THAI COMMERCIAL BANKS, AS OF SEPTEMBER 30, 2005

Average of Financial Data and Ratio of Thai Commercial Banks (Peer Group)
As of September 30, 2005

	Unit : Million Baht			
No. of Banks	Large Bank 5	Medium Bank 3	Small Bank 5	Peer 13
Other				
Loans	731,907	295,632	78,162	379,788
Loan to related parties	32,280	34,125	16,908	24,282
Non - performing loan (NPL)	91,994	20,079	5,247	42,034
Problems assets	102,080	38,455	5,899	50,404
TA plus allowance for possible loan losses	1,038,606	471,700	102,042	547,565
Average net assets (net acceptances)	979,693	437,816	88,969	512,058
Actual allowance for possible loan losses	65,834	21,464	4,595	32,041
Required allowance for possible loan losses	52,938	12,649	3,304	24,551
Tier 1 Capital	69,052	22,883	9,169	35,366
Capital funds	97,217	30,296	10,472	48,179
Risk assets	713,957	279,101	87,114	364,212
Off-balance sheet transaction	583,037	220,500	52,654	295,381
Total income	37,640	14,079	4,373	19,408
Total expenses	22,477	9,918	3,066	12,113
Profit (loss) from operation	15,163	4,161	1,307	7,295
Number of Bank's ATM	1,744	1,162	99	977
Number of Bank's branches	582	319	54	319
Full-branches	449	231	41	242
Sub-branches	133	88	13	77

Peer is based on Total Assets(TA) of Thai Commercial Banks
1. Large Bank : included Thai Commercial Banks with market share of Total Assets ³ 10 %
2. Medium Bank : included Thai Commercial Banks with market share of Total Assets 3 £ x < 10 %
3. Small Bank : included Thai Commercial Banks with market share of Total Assets < 3 %

Source : Dataset BLS, PNL, Consolidated report : Data including IBF operation



Source: Bank of Thailand

FIGURE-TH3: THAI COMMERCIAL BANKS' NPL RATIO

THE CREATION OF PRIVATE ASSET MANAGEMENT COMPANIES

The Asset Management Company (AMC) is a major component of the Thai government's financial reform plan. One of the major factors behind the decline in NPL ratios has been the purchase of NPLs by AMCs, purposely set up as a strategy for banks to specialize in restructuring NPLs that have been separated and transferred from banks. Using AMCs to restructure NPLs does have some disadvantages. Compared to special in-house AMC units or subsidiaries, independent AMCs impose burden on the bank, as the transfers of NPLs have to be treated in bank accounts as losses arising from write-offs. An AMC that is separate from the bank does not have access to information pertaining to debtors, necessary for dealing with claims. However, AMCs also offer some powerful advantages. Transferring NPLs to an AMC improves the balance sheet of the financial institution and allows it to concentrate on its core financial intermediating activities without worrying about managing and recovering NPLs. Subsequently, the AMC is likely to accumulate expertise in disposing of NPLs and even heighten expectations that the development of the secondary market will improve the liquidity of non-performing assets.

The Thai government is encouraging private institutions to establish AMCs, offering preferential treatment in the form of waivers and reductions in taxes and fees. The Bangkok Bank (BBL), Thai Farmers Bank (TFB) and the Siam Commercial Bank (SCB) have already established AMCs while the Bank of Ayudhya (BAY) and others are on there way to establishing the same. The government has taken the initiative in setting up an AMC using public funds, and made the decision to dispose of the NPLs of the Krung Thai Bank, which has played a key role in taking over failed banks.

DIFFERENT MODELS OF THE ASSET MANAGEMENT COMPANY (AMC)

There are different models for asset management companies. Some AMCs are centralized or government-funded and others are decentralized or privately funded. Among the private AMCs, some are independent entities; others are subsidiaries of banks, while others can be workout units or departments within the bank. Each AMC's institutional set-up presents its own advantages and disadvantages.

As **Table-TH6** shows, a centralized AMC is usually effective when the bad loans problem is systemic and the legal infrastructure for debt resolution is weak. At a time when no one would be able to buy loan assets, the centralized AMCs provide the demand for them; and when the legal infrastructure is weak, the centralized AMC can short-cut the legal process in disposing bad loans and thus expedite the cleaning up of financial statements. Moreover, through the government's purchase of bad loans via the AMC, government is able to attach conditions that aid the operational and financial restructuring of banks. For instance, in exchange for government purchase of NPLs, the authorities in crisis-affected countries in Asia were able to ask banks to increase private capital or spin off non-core businesses [Harigawa and Pasadilla, 2004].

The establishment of a centralized AMC requires an enormous amount of money from the government, which explains why some countries are reluctant to establish one. Often, centralized AMCs are prey to political interference and lack administrative flexibility in the management of its assets because of interagency coordination. If not efficiently run, centralized AMCs tend to incur high carrying cost from high operational costs, as well as from the erosion in the value of undisposed and unrestructured assets over time. The lack of trained personnel is another roadblock in establishing centralized AMCs [ibid.].

CHRONOLOGY OF DEVELOPMENTS IN THAI PUBLIC AND PRIVATE ASSET COMPANIES

The Thai experiment on AMCs can be divided into categories—the decentralized and centralized approaches. Furthermore, the decentralized approach can be grouped into private bank AMCs and state-bank AMCs, which operated with different rationales and different susceptibility to what has been claimed as moral hazard behavior. The decentralized approach—encouraging the establishment of individual bank-based AMC took place in 1998 immediately following the financial crisis, while the centralized approach—the establishment of TAMC—took place only in 2001. **Table-TH5** summarizes the characteristics of the three approaches.

Table-TH5. CHARACTERISTICS OF THREE AMC REGIMES

CHARACTERISTICS OF THE THREE AMC REGIMES

	DECENTRALIZED AND MARKET-DRIVEN	DECENTRALIZED AND STATE-LED	CENTRALIZED AND STATE-LED
Type of banks/	Private banks	State-owned banks	All banks
Period	August 1998 (No sunset clauses)	1998 (BBC), 1999 (UOBR), 2000 (KTB), and 2002 (BMB and SCIB)	Second half of 2001-present
Objective and Motivation of establishment	Insufficient skilled human resource in the authorities, and to avoid political interferences	Expedite NPL resolution and provide means to recapitalize the banks	Expedite NPL resolution by bypassing legal and court procedures
Number	12 AMCs in operation	Four AMCs for five state-owned banks (BAM, PAM, SAM, and Radhanasin AMC)	1, TAMC
Average Transfer Pricing (as percent of initial values or book values)	Average 53 percent	Based on political consideration. At 33 percent for BAM, and inflated price for SAM and PAM	Value of collateral used to secure the loans (33.2%)
Transferred NPLs (percent of total NPLs)	Very little	Substantial (e.g., 52 percent, KTB)	All assets in the substandard class and below. Bt 784.378 billion.
Asset Restructuring (percent of transferred NPLs)	Slow restructuring as restructuring not time-bound		73.46% as of June 2003
Incentives/Benefit for NPLs transfer	Not significant since transferring NPLs did not separate the NPLs from the banks' balance sheet. The banks had to maintain capital adequacy against both the NPLs and AMCs issued to purchase the NPLs, resulting in double counting of required assets	Significant since it allows them to meet recapitalization needs	Yes, in a sense that they can separate the bad assets from the balance sheet. Profit and loss sharing arrangement between TAMC and originating financial institution
Moral Hazard Factor	Not significant since there is little benefit for the banks, not much room to exercise moral hazard behavior	Significant since (i) AMCs are fully owned by the FIDF. (ii) Issued bonds are guaranteed by the FIDF to purchase NPLs from the state-owned banks. (iii) Asset selection criteria are generous based on the banks' recapitalization needs. (iv) Not required to publicly disclose information	Muted (?) since any gains from asset recovery will be shared by TAMC and financial institutions. Yes, only if financial institutions have inside information that the assets will eventually result in a loss since majority of the loss will be shouldered by TAMC.

Notes: BAM: Bangkok Commerce Asset Management Company; BBC: Bangkok Bank of Commerce; BMB: Bangkok Metropolitan Bank; FIDF: Financial Institution Development Fund; KTB: Krung Thai Bank; PAM: Petchburi Asset Management Company; SAM: Sukumvit Asset Management Company; SCIB: Siam City Bank; TAMC: Thai Asset Mangement Company; UOBR: United Overseas Bank.
Sources: Santiprabhob (2002) and Fung et al. (2004).

4. THAILAND'S CAPITAL MARKET

Recognizing investors' need for liquidity, the Thai central authorities established a number of secondary markets, while simultaneously undertaking measures to facilitate trading in different types of securities. When first established in 1974, the Stock Exchange of Thailand originally traded in common shares. Subsequently the Bank of Thailand (BOT) introduced the repurchase market in 1979 to accommodate financial institutions' temporary liquidity shortage [Vichyanond, 2002].

The authorized secondary market in Thailand consists of three major markets: the Securities Exchange of Thailand (SET), the Bangkok Stock Dealing Center (BSDC), and the Bond Dealer Club (BDC), all of which are regulated by the Securities and Exchange Commission (SEC). In January 1991 the Securities Exchange of Thailand was officially renamed "The Stock Exchange of Thailand" (SET), with specific function to be the only national exchange, while the BSDC and the BDC served as over-the-counter (OTC) trading networks. There is neither a regional exchange nor an organized derivatives exchange at the time in Thailand. SET lists larger and higher-quality companies when compared to the BSDC. The Securities and Exchange Commission (SEC) of Thailand does not allow dual listing on both national and OTC exchanges [Nittagayasetwat, 1997].

The market capitalization of the Thai stock market is highly concentrated in a small number of companies in only a few sectors in the different industries. For instance, 10 percent of all listed companies account for more than 75 percent of market capitalization. There is likewise a high concentration in specialized industries, like banking, communication, and the energy sectors, whose combined shares traded account for more than 50 percent of overall market capitalization

Two different stock market indices guide Thai investors: the SET Composite and the SET50 Indices. The former is a market-capitalization weighted index based on all stock prices on the main board of SET. It compares the current market value of all listed common stocks with the value on a base date of April 30, 1975, when the SET Index was calculated for the first time and set at 100 points. Its calculation is adjusted in line with new listings, de-listings, and capitalization changes. The SET50 Index is also a market-capitalization-weighted price index but only comprises the top 50 listed companies on the SET with large market capitalization and high liquidity.

The capital market saw many more institutional changes and experienced significant growth beginning the mid 1990s. In 1993, the Thai Rating Information Service Co., Ltd., (TRIS), the first credit rating agency, was established to help investors evaluate bond and share issues. The Bond Dealers' Club (BDC) was put into action in 1994 to facilitate secondary trading of public securities and corporate bonds. Banks were permitted to engage in bond underwriting in 1993. Since then, the banks' role in underwriting has grown from 4% of the total value of bonds registered at BDC in 1995 to 46% in 2000. Banks also became major dealers in the secondary bond markets from 1998 to 2000.

Thailand's capital market is important for economic development for reasons that, in the area of international trade and with increased competition from China and other low wage countries, Thai manufacturers have no choice but to improve on productivity in both the export and import markets. The capital market would also have to address the needs of Thailand's aging population. Current demographics are skewed in favor of a relatively younger population compared to Europeans and Japanese. People in the older age bracket are constantly in search of opportunities to provide for their retirement via income from well-managed investments while minimizing increased reliance on public pension. Capital markets are deemed as channels through which savings can be properly channeled towards productive investments domestically and in the Asian region, thereby contributing to facilitating increased trade and capital market integration [Naranubala, 2004].

The market for government bond was non-existent prior to the Asian financial crisis, as the government was running a budget surplus, which was used to reduce outstanding government debt or build up substantial bank deposits. However, to be able to finance the needs of cash-strapped financial institutions affected by the crisis, the government was forced to issue bonds for the first time in July 1988 and the government bond market has grown rapidly since (see **Table-TH6**). In addition to the new supply of government bonds, other government-related institutions like FIDF, which operates under the Bank of Thailand, also had to rely on issuing bonds with the proceeds used to finance the bailout of banks [Funke and Stadtman, 2001].

Table-TH6. Domestic Bond Values

Outstanding Value of Domestic Bonds

Unit: THB bln.

	1996	1997	1998	1999	2000	2001	2002	2003	2004 p	2005 (Jan-Oct)
Government Bonds	18	13.8	426.9	587.1	658.7	706.4	1,114.60	1,132.20	1,306.50	1,405.94
T-Bills	-	-	-	25	62	110	134	127	168.04	170.2
State enterprise Bonds	278.4	293.8	300.6	356.4	408.8	416.1	395.7	412.2	405.16	473.06
- Guaranteed	239.7	247.3	255.7	309.1	345.3	357.3	343.7	327.3	321.49	333.38
- Non-guaranteed	38.7	46.5	44.9	47.3	63.5	58.8	52.0	84.9	83.67	139.68
BOT/FIDF/PLMO Bonds 1/	40.5	51.6	36.2	18.1	4.1	112.3	112.3	239.3	312.34	595.04
Corporate Bonds	182.4	187.6	177.6	402	501.2	538.1	543.4	607.3	548.3	623.76
Total	**519**	**547**	**941**	**1,388.60**	**1,634.80**	**1,882.90**	**2,300.00**	**2,518.00**	**2,740.34**	**3,268.00**

Source : BoT, PDMO, Registrars (BAY,BBL,BFITSEC,DTDB,IFCT,KGI,SCB,SCIB,TFB,TISCO,TMB,TSD), and SEC
Remark: The Corporate Bonds outstanding is collected from the registrars.
1/ Excluded, THB 455 bln. short-term FIDF bonds traded in the Repo market at the Bank of Thailand
p Preliminary figures

Source: http://www.thaibma.or.th

While total debt outstanding for the whole Thai bond market rose to Bt547 billion at the end of 1997, the market size increased by more than 70 percent in 1998 to Bt941.4 billion. This development was largely attributed to the huge amount of government bonds issued to finance the current budget deficit. Even the most recent figures from 2004 and 2005 (Q3) show a higher growth rate for government debt than for the bond market as a whole. The large amount of new government bonds issued, coupled with the successive decrease of deposit interest rates contributed to a growth in the bond market.

Both the Thai government and corporate issuers are actively using bonds for raising fund and capital. Total bond trading value in October 2005 was at Bt273.37 billion, or 2.31 percent increasing from the previous month. Daily average trading value also rose to Bt13.67 billion from Bt12.15 billion in September. State agency bonds account for 57 percent of the total trading. Amid the trend of rising interest rates, yields of all maturities, especially of medium to long-term bonds, also moved upward, despite more supplies offered by the government and the state oil fund [ADB Asian Bonds Online, 2005].

Table-TH7. Leading Underwriters in the Thai Financial Market

Top Five Underwriter Ranking for Q3 2005				
Rank	Lead Underwriter	Amount (THB mln.)	No. of Issues	% Shares
1	Kasikorn Bank Plc.	8,333.00	6	26.13
2	Standard Chartered Bank	6,608.00	4	20.72
3	Siam Commercial Bank Plc.	5,460.00	7	17.12
4	Bangkok Bank Plc.	3,000.00	4	9.41
5	The Hongkong and Shanghai Banking Corporation Limited	2,320.00	4	7.28

Remark: Ranking criteria are based on:
1. Debt securities registered with ThaiBMA in Apr-Jun 2005 and counted on ThaiBMA registered date
2. The underwriting portion confirmed by the lead underwriters.

Source: Bank of Thailand

5. THAILAND'S ASSET MANAGEMENT INDUSTRY

Thailand's asset/funds management industry's beginnings are traced to the late 1970's with a mutual fund largely invested in the equity's market. The introduction of the pension fund (provident fund) came in 1987 and both the private and public sector firms were encouraged to shift their investments to this form of fund by giving tax waivers as incentives for income earned.

Investments in government bonds are a more recent occurrence in the investment field, beginning in 1988 and taking on a more active role in capital market development after the crisis. Its less than active role prior to the crisis may have aggravated the situation in the financial sector, especially when foreign banks began refraining from lending to Thai banks, depositors took flight and there was not much of an active market that could cushion capital flight by offering alternative investment vehicles. Naranubala [2004] cites the Central Bank of Thailand tried to provide stopgap measures to the immediate shock of the crisis with borrowing from one bank and lending to another, as banks became reluctant to do this most important function of the system. The central bank engaged in excessive lending and was straddled with huge losses. With reforms in the financial market, the bond market slowly acquired depth and is currently highly liquid.

MUTUAL FUNDS

The mutual fund industry has become an investment channel that has grown steadily and is playing a greater role in the country's economic system. The Net Asset Value (NAV) of general mutual funds (including those funds mobilized at home and abroad), in comparison to Thailand's GDP, has risen from 2.1 percent in 1997 to 7.7 percent in 2004. Net asset value (NAV) is usually the first figure investors look at when choosing mutual funds, though at times it may be overrated. The figure is not necessarily a reflection of value, but does offer clues to a fund's performance.

In Thailand, while the decline in stock valuations in 2004 has affected portfolio values, the overall asset management industry continued to rise steadily throughout the year, with assets under management of around Bt330 billion at the end of October, up 6% to 7% from the year before, and is expected to reach Bt400 billion by the end of 2004.

According to Adison Sermchaiwong, head of the Association of Investment Management Companies, with increasing market volatility and risk, upside gains of 5% to 10% on equities were well within reach.

TABLE-TH8. MUTUAL FUND ASSETS

MUTUAL FUND ASSETS						
	2002		2003		Nov-04	
Fund Type	No of Funds	Net assets (bt b)	No of Funds	Net assets (bt b)	No of Funds	Net assets (bt b)
Closed end Funds	72	230.98	114	391.08	119	319.01
Open Ended Funds	261	188.5	301	297.32	375	319.59
Country Funds	13	15.88	14	31.62	14	25.47
Summary	**346**	**435.36**	**429**	**720.02**	**508**	**664.07**

Source: Association of Investment Management Companies

Thailand's mutual fund industry is concentrated within the five largest asset management companies, whose market shares together account for as much as 66.1 percent of the total. There are now only 18 asset management companies in Thailand, fewer than those in other countries. Categorized by their major shareholders, asset management companies consist of five groups, i.e., those whose major shareholders are large commercial banks; medium-sized banks; smaller banks, other financial institutions (non-bank financial institutions) and public agencies. Among them, the asset management companies, whose major shareholders are commercial banks, have always garnered the highest market share, except in late 2003.

TYPES OF MUTUAL FUNDS

The central idea of a mutual fund is to enable investors to pool their money and place it under a professional investment manager. The manager makes the trade, realizing a gain or loss, and collects the dividend or interest income. The investment proceeds are then passed on to individual investors.

With the diverse array of mutual funds available, investors can easily build their portfolio with investments that complement their profile and investment objectives.

FIXED INCOME MUTUAL FUND [47]

In the case of a fixed income mutual fund, the fund manager will invest the pool of money in bank deposits, bonds and other fixed income instruments. The fund will receive interests and gains from these investments, in turn, giving the investor returns in the form of dividends and capital gains.

These funds generally emphasize stable income rather than growth. Since the returns received (in the form of interest income) are stable and market price of these bonds are much less volatile than equity, the overall return from fixed income fund to the investors would be stable and more certain than the equity fund's return.

In Thailand, fixed income mutual funds enjoy tax privileges that retail investors do not have. While banks and bond issuers deduct 15 percent withholding tax when paying interests to individual depositors/investors, fixed income mutual funds give the whole amount to the funds. The funds then turn these tax-free incomes into capital gains, which are also tax-free for individual investors.

There are generally two main types of fixed income mutual funds, open-ended and closed-end. Their features are summarized in **Table-TH9**.

[47] This section was sourced from the website of Ayudhya JF Asset Management.

TABLE-TH9. FEATURES OF CLOSED AND OPEN-ENDED FUNDS

Feature	Closed-end funds	Open-ended funds
Fund size	Fixed. If investors do not invest during the initial period, they need to buy the units from existing unit-holders.	Flexible. Size grows when there is demand for units and shrinks when investors sell.
Life	Usually fixed for 2-10 years	Indefinite
Liquidity	Low; cannot be bought and sold frequently	High; can be easily bought and sold
Where to buy and sell?	Secondary market; i.e. the SET	Asset management company and their agents who are mainly banks and brokers

Source: Ayudhya JF Asset Management

Open-ended funds are more popular because investors can buy or sell the units from asset management companies and bank branches. A number of the funds are available everyday, making them very liquid.

RETIREMENT MUTUAL FUND (RMF)[48]

A retirement mutual fund is an investment instrument that aims to promote long-term personal savings and investment designed especially to accumulate wealth for the retiree.

The prime advantage of RMF are tax benefits from the Internal Revenues Department, where the investor will receive the tax exemption from the investment for a maximum of Bt300,000 per year (including the provident fund portion) or 15% of annual salary income, starting from the first year of investment. This special fund allows investors to use the investment amount as a tax-deductible item in their annual personal income tax filing.

MONEY MARKET FUND

Money market fund is a type of mutual fund that, by law, can only invest in a portfolio of low-risk securities. Money market funds typically invest in government securities, certificates of deposits, and other highly liquid and low-risk securities.

The mutual fund management industry has seen a positive growth in Thailand, following interest rate declines and greater public awareness of long-term savings. As of May 2005, total assets under mutual fund management were Bt578.11 billion, representing an increase of 19.1 percent from the end of 2004.

Recently, the BT Asset Management Co., Ltd. has been granted a license to run mutual fund management business, increasing the total number of mutual fund management

[48] This section was sourced from TISCO Asset Management Co. Ltd website.

companies in the local market to 18, excluding the Thai Trust Fund Management Co., Ltd.[49]

In October 2005, the number of mutual funds rose to 645 with a total NAV of Bt861,281 million. The five asset management companies that held the largest market share comprised of MFC (15%), K-ASSET (14.89%), SCBAM (11.63%), KTAM (11.02%), and ING with 10.36 percent.[50]

TABLE-TH10: ASSETS AND NUMBER OF FUNDS OF DIFFERENT MUTUAL FUNDS

MUTUAL FUND	23-Sep-05	28-Oct-05
Number of Funds	622	645
Total Net Assets (THB mil.)	841,542	861,281
Number of Funds (excluding Resolving Financial Institution Problem Funds and Country Funds)	520	544
Total Net Assets (THB mil.)	643,387	680,277
Foreign Investment Fund	**23-Sep-05**	**28-Oct-05**
Number of Funds	5	5
Total Net Assets (THB mil.)	5,259	5,066
Retirement Mutual Fund	**23-Sep-05**	**28-Oct-05**
Number of Funds	60	61
Total Net Assets (THB mil.)	14,141	14,155
Long-term Equity Fund	**23-Sep-05**	**28-Oct-05**
Number of Funds	25	27
Total Net Assets (THB mil.)	7,841	8,110

Source: ***Association of Investment Management Companies***

6. CONCLUSIONS AND RECOMMENDATIONS

Thailand is a good case of a country that has successfully weathered the financial crisis and has made possible a turnaround in its economic performance in record time. With the size of the NPL Thailand had to address after the crisis, it is fairly remarkable that the country, with determination and despite the lack of infrastructure to address such a problem, went ahead with introducing the necessary reforms and changing those deemed inappropriate for their financial system. Greater adherence to market-oriented reforms made Thailand's recovery more sustainable, as its private sector geared up for increased capacity to compete in the international market.

[49] Sources from Capital Thailand Quarterly Newsletter, July 2005.

[50] See Mavichak (2005).

Though Thailand is on the road to complete recovery, their efforts can further be rewarded with concurrent improvements in the capital market, an alternative source of funds for the private and public sectors and added avenue for long term investments for the consuming public. The mutual fund industry offers opportunities for continued growth and development as the level of savings increases and wealth creation is enhanced. Check and balance in the financial market still need to be strengthened to prevent any reversion to the old system when prudential practice was compromised and capital continued to flow into the system. Financial liberalization and deregulation naturally creates such check and balance and for as long as these reforms as adhered to without fail, Thailand's admirable economic performance can be more assured in the long run.

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BRUNEI DARUSSALAM

1. COUNTRY MACROECONOMIC PERFORMANCE

Brunei Darussalam has experienced economic stagnation as a result of the economic slowdown. While the country is highly dependent on oil and gas exportation, the increasing world prices boost the economy. Being one of the most prosperous economies in East Asia, per capita income averaged $23,000 (Canadian High Commission in Brunei Darussalam, n.d.). Moreover, AEM (2001) reported that the private sector, particularly large construction companies, was greatly affected by the crisis.

As of 2001, GDP growth rate averaged 3.0 per cent due to the weak export demand in Asia, particularly in Japan and Thailand, and the United States. There are no taxes on income or gains from transactions imposed to individuals or businesses. The government's, plans to reduce tariffs on certain commodities such as automobile has threatened its budget surplus for 2001. The biggest problem that confronted the government sector is the domestic private sector's performance. Efforts were geared towards improvement in their business activities thereby increasing employment in the country. For the construction companies that were adversely affected by the crisis, micro-credit financing were made available through nine banks, while unemployment problem was deemed to be solved through apprenticeship training programs and job placements, respectively. As of 2004, growth remained stable as the government continued its momentum in diversifying the economy through medium and long- term development plans (AEM, 2004).

2. BRUNEI'S FINANCIAL SYSTEM AND NON-PERFORMING LOANS PROBLEM

Banks and finance companies dominate the financial system in Brunei. Under the banking system, nine banks operate the commercial banking business, while the Brunei Currency Board manages and issues currency notes and coins. Out of the three domestic banks, the Islamic Bank of Brunei Berhad (created in 1993) provides Islamic banking services and the other two banks are Baiduri Bank Bhd and the Islamic Development Bank of Brunei Bhd. The Banking Act Cap 95 and Emergency (Islamic Bank) Order, 1992 mandate their operations.

The non-bank financial institutions comprise 5 finance companies, 62 moneychanging and remittance companies, 2 securities companies, 23 insurance companies, 1 employees' trust fund company and 1 Islamic trust fund companies. The Government allows foreign companies to establish financial operations in the country, hence the relative dominance of foreign companies in the fields of banking and insurance. Related to this, the government does not seem to disclose financial data on their operations.

With regard to the country's non-performing loans, IMF (1999) showed the ADB Asian Regional Information Center's database on NPLs. Prior to the crisis, the banking system experienced 3.0 percent and 5.0 percent NPL ratios for 1995 and 1996, respectively. On the other hand, the 2001-2003 database showed that NPL ratios were high at 14.9 percent and 15.4 percent in 2001 and 2002, respectively. However, the same eased in 2003 when it reported a ratio of 12.5 percent, which is a slight improvement from the previous year. No reports were provided for the causes and resolutions of these NPL problems.

3. MEANS OF RESOLVING THE NPL PROBLEM

There's a dearth in the literature that deals with the causes of insolvency in Brunei, more so, with the non-performing loan exposures of the banks and their respective resolutions. An article cited that the crisis in its banking system happened in 1998 following the collapse of Amedeo Development Corporation which was suspected to have caused the country to use 50 percent of its foreign exchange reserves.[51]

While there was no asset management company (AMC) organized to deal with the non-performing loan exposures of SOEs or banks, the BIFC provides for operational flexibility particularly in segregating collective investment scheme, private trust company and special purpose vehicle situations, including the commercial deployment of special and purpose trusts. This only means that any related transaction may require the establishment of an AMC to deal with the problem.[52]

4. BRUNEI DARUSSALAM'S CAPITAL MARKET

To date, there is no capital market to speak of, despite the establishment of the securities exchange in 2002. The capital market in Brunei is still new with only two securities companies providing brokerage services. Through the Brunei International Financial Centre (BIFC), the International Brunei Exchange Ltd (a Singapore based company) was granted a license to operate in the country[53] to provide a trading facility for international dealers to trade in conventional equity and derivative products including Shari'ah compliant instruments.

As claimed by the Ministry of Finance (MOF), capital market development remains in its infancy. There were efforts to establish a bond structure via the Brunei International Financial Centre. In September 2002, Brunei made the first venture in the international

[51] Source: http://www.bankintroductions.com/brunei.html).

[52] See http://www.bruneidirect.com/IFC/International_Financial_Centre.htm

[53] Sourced from http://asianbondsonline.adb.org/brunei/market_infrastructure/exchanges_and_trading_platforms.php

debt markets by undertaking a US$250 million syndicated loan. The possible issuance of a sovereign benchmark bond is viewed as the next step.

Sources reveal that the BICF is not operational anymore. It is the Securities Order 2001 that provides rules on financial exchanges, dealers and other persons who provide financial consultancy services with respect to the management and dealership of securities. It also provides for its accounting and auditing, recording and the regulation of investment advisers, penalties and consumer protection.

5. BRUNEI DARUSSALAM'S ASSET MANAGEMENT INDUSTRY

In line with the ASEAN Initiatives to provide prudent international financial practices and standards and in an effort by the Government to make Brunei a leading financial center in Asia, an International Finance Centre (IFC) was established with the following goals:[54]

- To expand the country's financial service sector not only in Brunei but also in the Asia Pacific Region (APR).
- To provide a secure, cost-effective, sensibly regulated IFC facility for corporate and private clients.
- To be able to attract professionals in making IFC operate efficiently.
- To encourage expatriate professionals to providing training and development professionally qualified and trained Bruneians in the International Business Sector.
- To position Brunei as an equal partner in the globalisation of financial and commercial activity.

These initiatives, patterned after Singapore and Bahrain's IFC, will serve as an alternative in servicing existing financial markets' needs and will provide an impetus for Islamic financing in Asia. It will also cover laws pertaining to money laundering, international banking, business companies, trusts and limited partnerships, as well as registered agents and trustees.[55]

[54] Source: BRUNEI DARUSSALAM INTERNATIONAL FINANCIAL CENTRE: THE ABODE OF PEACE, http://www.bruneidirect.com/IFC/International_Financial_Centre.htm

[55] Sourced from http://www.aftaonline.com/aol%20archives/industry/Banking%20&%20Finance%202000.htm

The following lists some of the initiatives highlighted by ADB for ASEAN+3 countries, particularly for Brunei Darussalam:[56]

1. Issuance by the government of short-term government securities following the Government Bond flotation in 2002.

2. Rationalization and expansion of the role of the Brunei Currency and Monetary Board (BCMB) as outlined in the new Currency and Monetary Order where it will be responsible for the trading, discounting and rediscounting of the proposed securities.

3. To align the country's monetary and financial practices with international standards to further develop the Brunei International Financial Center (BIFC).

There is no organized asset management industry in Brunei Darussalam. The Ministry of Finance provides guidelines and rules regarding trust operations and mutual fund activities.

Trust Operations

Any qualified corporation or individual may be given a trust license to establish wholly owned subsidiary of an International Banking Corporation upon which it can act as a trustee, nominee, secretary or director for the international business services. To date, there are 5 companies licensed to operate in Brunei and the law allows them to be involved in all International Limited Partnership (ILP) and qualifying trusts.

Trust activities are regulated by the Registered Agents and Trustees Licensing Order (RATLO) which restricts the provision of International Business Services to companies licensed under the order. Aside from this, the Mutual Fund Order 2000 also covers licensees.[57]

There are three types of trusts, namely, purpose trusts, special trust and charitable trust. Under the International Trust Order 2000, purpose trust is a trust used for the purpose of holding securities or other assets. Special trust is a trust provided by a non-resident upon the establishment of its trust operations in Brunei. Under the modified law, charitable trust includes benefits accruing to the environment, fauna and flora, historical sites and other similar objects.

56

http://asianbondsonline.adb.org/brunei/government_policies_and_initiatives/policy_initiatives_and_reforms.php

57 Source: www.bifc.financegov.bn/Legislation%20Pgs/RATLO.HTM

Mutual Fund

The Mutual Fund is ideally designed to provide the investors realistic, achievable returns with consistent investment returns. While the Mutual Funds Order 2000 provides for the mutual fund operations in the country, no data reveals that there were fund companies that were organized since the law was passed except for the trust companies, which are also covered by the law and are licensed under the Registered Agents and Licensed Trustees Order. Under this provision, companies may establish a public fund, private fund, professional fund and Islamic fund.[58]

6. Conclusions and Recommendations

Brunei Darussalam is one of the richest economies in Asia Pacific region. While the economy is being accelerated through its oil exportation, its domestic performance particularly the private sector was not good, which had slightly affected its overall macroeconomic performance.

Its financial system is classified as simple; yet, the government had exerted efforts in being competitive in the international arena. Regulatory framework and supervision were relatively weak, as information is relatively unavailable or not fully disclosed; which entry barriers more stiff particularly for activities that involved foreign investments. This had safely distance itself from the crisis through its closed banking system and large reservoir of government funds. It can be noted that it was not spared of the non-performing loans problems in the region.

While the government does its best to open itself in the international market, said efforts were seen to be very slow. Hence, it must be able to quickly put regulations and supervision into proper perspective. The financial system's activities are also limited. In an attempt to develop capital market, commercial orientation must be encouraged to allow more competition in the system.

Even if foreign banks were allowed to operate in the country, their operations are still limited as bank supervision is weak and disclosure of information regarding regulatory framework are not available. To date, rules are not enforced strictly as government authorities hardly have requirements related to credit accommodations and provisioning, accounting and auditing standards and other concerns. Disclosure is very important for a regional effort to prosper as this signals willingness to open the market towards a regional integration.

[58] Check out www.bifc.finance.gov.bn/.

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IMF Country Report, 1999

CAMBODIA

1. COUNTRY MACROECONOMIC PERFORMANCE

TABLE-CA1. Selected Macroeconomic Data

Year	GDP Growth Rate	Current Account Balance as % of GDP	Export Growth Rate	Import Growth Rate	Net FDI	Gross Int'l Reserves
1995	6.5	-	34.57	32.67	150.8	192
1996	5.3	-	-19.09	-4.11	293.6	265.8
1997	5.7	-7.3	38.07	6.57	203.7	298.6
1998	4.96	-15.3	-2.32	0.86	223	438.2
1999	12.6	-13	39.42	29.87	223.1	509.5
2000	8.4	-11.8	41.23	32.38	141.9	610.8
2001	5.5	-9.1	18.87	12.91	142.1	697.6
2002	5.2	-8.8	20.75	16.61	139.1	913.7
2003	7.05	-10.1	15.5	-	74.3	981.9
2004	7.7	-9.9	22.1	-	121.2	1118.2

Source: ARIC, Asian Development Bank Website

Cambodia is one of the emerging economies in East Asia, and its progress over the past years had been gradual. From being centrally-planned, it emerged as a market-driven economy with a promise of growth after the late 1980s. It had re-established in 1993 a constitutional monarch to pave way towards a more responsive economy to respond to globalization. As the 1997 crisis proliferated in most Asian countries, Cambodia suffered political instability, which had contracted the business activities in the country (Ear, 1998). In fact, public and private investments were low and spread until Year 2000, as foreign investors remained hesitant and wary about its economic prospects.

Like any other countries in East Asia, it is dependent on agricultural production. Prior to the crisis, the country experienced decelerating growth in its GDP from 6.57% in 1995 to 4.96% in 1998. Its net foreign investment prior to the crisis increased by a hefty of 95% in 1996, only to decline in 1997 by 31%. The growth of export during this period was high compared to the imports growth.

Moreover, the improved performance were attributed to the prudent macroeconomic policies, inflows from foreign aid and the signing by the country with US of the bilateral trade agreement in 1996 (AEM, 2001, 2003 and 2004). Since 1997, GDP growth rate had been very erratic. Moreover, exports growth moved faster since 1999 compared to imports growth rate for 2000. Both exports and imports were affected since 2001, probably because of the 911 attacks.

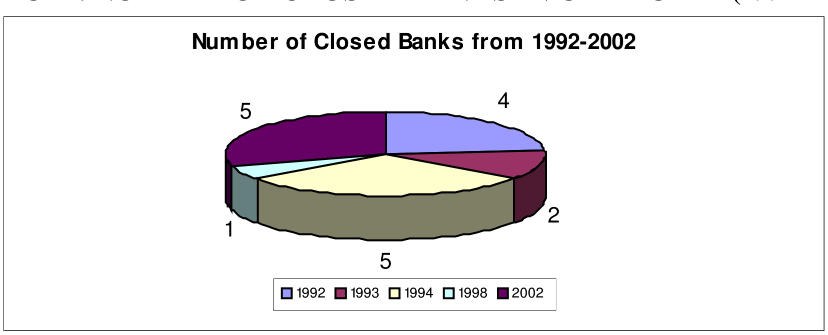
The outbreak of SARS and the riot in Thailand in 2003, had greatly affected the economy of Cambodia as the tourism industry was greatly affected. Prior to this, the country's agricultural production was also adversely affected by the drought; however, garment and textile exportation had facilitated in the rise of its exports of tradable goods. While agriculture had been declining over the past years, it proved that the country is heavily dependent from its industrial and manufacturing sector, which is one of the biggest contributor to the country's GDP (AEM, 2001, 2003, 2004).

Net foreign direct investments grew until 1999 and it suddenly plummeted during the succeeding years. This was understandable considering the political situations. On the other hand, the country gross international reserves rose progressively, especially in 1998 (AEM, 2001). The regional financial crisis exposed Cambodia to risks that resulted to the delay in its financial reform momentum. Aside from the external shocks that affected the country, increasing political uncertainties as a result of the removal of Prime Minister Rannaridh in July 1997 and the governance problems in mobilizing revenues and in controlling public expenditures aggravated the situation. While 35 to 45 percent of the investment activities were affected, its local currency was only slightly affected due to the extensive dollarization of the Cambodian economy. Thus, rising inflation and weakening confidence in the economy affected the banking system.

2. NON-PERFORMING LOANS PROBLEM

Like Lao PDR and Vietnam, the Asian Crisis adversely affected the country's financial system because many banks were heavily exposed to unpaid loans or NPLs of State owned enterprises (SOEs). A review of the country's credit practices revealed that the banks and other lending institutions use directed credit in providing loans. However, there were no comprehensive reports that highlight the level of NPLs of banks in Cambodia. Moreover, AEM (2001) report reveals that the banking system preferred to acquire foreign assets than put the funds in their lending activities.

FIGURE-CA1. NUMBER OF CLOSED BANKS IN CAMBODIA (1992-2002)



Source: IMF's Country Report (Cambodia's Statistical data)

Figure-CA1 summarizes the banks that were ordered closed by NBC from 1992-2002. As of July 2004, a total of 17 commercial banks were ordered closed, five of which were reported insolvent. At the outbreak of the 1997 crisis, six (6) banks were closed, one of which was a domestic bank (IMF).

Analysis of the total assets of banks revealed that as of 2000, it stood at $644 million or 20 percent of the country's GDP (ADB, 2001), while 2001 resources reached approximately 2.132 trillion riel (US$554 million). Loans occupied a share of approximately one-third of the total industry's resources and most of these are predominantly manufacturing and service sectors. As there are no available records regarding the loans of the bank, data on non-performing loan are also unavailable and difficult to estimate. ADB (ibid) also reported that due to the low intermediation activities, lending activities were also low, which affected the quality of the industry's assets.

TABLE-CA2. INTEREST RATES ON DEPOSIT ACCOUNTS, 1998-2003

Interest Rates	1998	1999	2000	2001	2002	2003
Savings Deposits	7.5%	7.3%	5.9%	2.6%	2.5%	2.0%
Foreign Curr. Savings Deposits	2.5%	2.2%	2.3%	1.6%	1.5%	1.4%
Foreign Curr. Term Deposits	3.9%	3.5%	3.7%	2.7%	2.8%	2.8%
Foreign Curr.Loans	17.7%	17.3%	17.4%	15.0%	16.7%	18.4%

Source: Asian Development Bank (National Bank of Cambodia)

The level of interest paid and charged by domestic and/or foreign banks continued to decline over time are shown on **Table-CA2.** Compared to foreign currency savings and term-deposits, riel-denominated savings deposits provide higher interest rates prior to 2001 to exhibit lower rates along with foreign currency denominated deposits despite the higher rates charged on term deposits.

On the other hand, all lending-related transactions are denominated in foreign currencies. Despite the decrease in lending rates in 2001, rates suddenly increased reaching its highest rate of 18.4%, representing a 22.7 percent increase. This only proves the way in which financial intermediation in the system is undertaken considering that foreign banks dominated the commercial banking industry.

Banking activities are embodied in the Law on Banking and Financial Institutions as ratified by the National Assembly on October 19, 1999 and are being administered by the National Bank of Cambodia, which is the central bank. Prior to the promulgation of this law, the Law on Organization and Functions of Bank of Cambodia was established in 1996 which covers matters relating to central banking activities, functions, management, autonomy, budget, financial relations and related issues (ADB, n.d.). Thus, the National Bank of Cambodia, being the central bank, is responsible for the licensing and supervision of banks and non-bank financial institutions that are covered by the law.

Moreover, the problem can also be attributed to the absence of any official accounting and auditing standards in the country (Economic Analytical Unit, 2002). Unlike Vietnam which has a professional organization that actively participate in various international professional organizations (International Federation of Accountants and ASEAN Federation of Accountants), Narayan and Godden (2000) cited that Cambodia does not have a recognized nor regulated accounting profession due to the structure of its market and business activities. Through the technical assistance provided by World Bank and ADB, the Accounting Law is envisioned for the establishment of this professional organization and the accounting regulations. As far as the latter is concerned, the General Accounting Plan sets forth the accounting system adopted in the country. While the initial plan to adopt the International Accounting Standards was initiated in 1995 by the World Bank, the government disallowed the same. Hence, another attempt was made in drafting the accounting and auditing Law (reports on accounting and auditing standards) through World Banks IDF Grant No. TF027305 (Ibid).

A review of the accounting law reveals that it was only in 1993 when the Ministry of Economy and Finance issued the Plan Comptable General, which provided guidelines for the application of accounting system. Hence, the same was not yet formally introduced. Moreover, any law for financial reporting by private corporations was also inexistent pending implementation of the Draft on Corporate Accounts. The Audit and Accounting Profession was envisioned to be formally introduced in the latter part of 2000. The same applies to audit, where under the technical capacity building project of ADB, the draft on the establishment of External and Internal Audit Function in Cambodia was passed together with the National Audit Authority to execute the government's external auditing functions. This only exemplifies of the weak audit and accounting standards in the country despite the establishment by the seven international audit firms to carry out audit of foreign firms or government entities and SOEs. These audit activities are made possible upon the request by the Government, as an audit of local firms is not required (Ibid).

3. MEANS OF RESOLVING THE NPL PROBLEM

Having identified the problem in the industry, it can be noted that the National Bank of Cambodia, has in Year 2000 introduced a bank re-licensing to rationalize its operations and strengthen its capital adequacy requirements, which involves 31 banks. As a result of this, it was found out that 12 banks were nonviable, while the other 13 banks were conditionally viable. Hence, NBC required the banks to infuse additional capital to meet the minimum requirement by end of 2001 as part of its restructuring schemes (AEM, 2001 and 2003).

Some of the pertinent regulations in the financial system include:[59]

[59] These are based on a study by ADB.

1. Maintenance of Required Reserves. This was first implemented in December 1993; banks were required to maintain 8 percent reserves on both foreign and domestic currency denominated. Another round of mandatory requirement of 5 percent for micro-finance was implemented in 2002.

2. Operational Regulations for banks and Financial Institutions. On December 29, 1997, the National Bank of Cambodia implemented the maintenance of bank's net worth to at least equal to their paid-up capital. With regard to credit, they are not allowed to grant insider credit (DOSRI-related) and that demand deposits must not be used to grant long-term credit. This was followed by a new regulation on single borrower's limit of a maximum of 20 percent of their net worth last 17 February 2000.

TABLE-CA3. Provision for Bad Debt

Loan (Bad Debt) Classifications		Minimum Provision
Substandard	Past Due > 90 days	10%
Doubtful	Past Due > 180 days	30%
Loss	Past Due > 360 days	100%

Source: IMF

Aside from reforms in cited above, the National Bank of Cambodia issued guidelines in the provisioning of bad loans in February 2000 (see Table-CA3) in an effort to reduce exposure and restructure banks,.

Bad loans are classified into three major categories, namely, substandard loans, doubtful loans, and loss. A loan can be considered as substandard when it had become unpaid for more than 90 days; hence, a 10 percent provision shall be made. A doubtful loan, which is unpaid for more than 180 days but less than 360 days must have provisions of approximately 30 percent, while a loan is considered as loss when it is unpaid for more than 360 days.

During the same year, it had required banks to maintain a solvency ratio at the minimum level of 20 percent. The same was applied to micro-finance institutions. On October 15, 2001, DOSRI loans were also lowered to 10 percent of the bank's net worth. On 7 January 2000, guidelines for the calculation of said loan exposure excluded placements with head office or Mother Company and shall not exceed 10 percent of the bank's net worth (IMF, 2003).

In a joint venture with IMF, the Cambodian Aid program was established for the rehabilitation or closure of other heavily insolvent SOBs. Moreover, the program established a two-tier banking system that separated the functions of central bank and the commercial banks.[60]

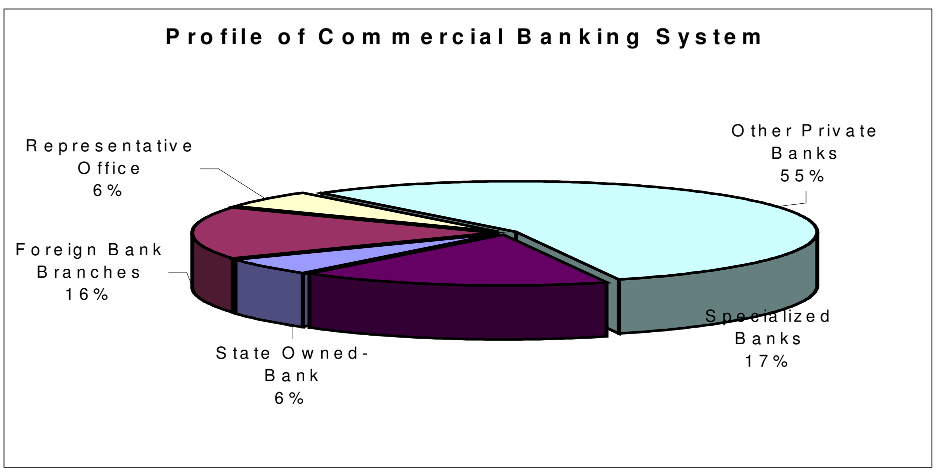
It was cited that under the new law for financial institutions, commercial banks are required to reapply for licenses with the National Bank of Cambodia in line with the latter's thrust to provide reforms on banks' capital adequacy and other prudential requirements. This paved way for the consolidation of some banks to meet new capital requirements.[61]

Foremost among these efforts are the provision for a strong and transparent regulatory, supervisory, and prudential frameworks. Broad reforms are needed over the longer term to improve the economy's competitiveness, given the extensive dollarization of the economy. [62]

4. CAMBODIA'S FINANCIAL SYSTEM

Cambodia's banking sector is still in its infancy, and it will take more efforts on the part of the government to build a strong financial system that underpins market-based development.

FIGURE-CA2. PROFILE OF COMMERCIAL BANKING SYSTEM IN CAMBODIA



[60] Source: IMF, 2002. Survey of the Asian Financial Crisis and Its Implications.

[61] Sourced fromhttp://strategis.ic.gc.ca/epic/internet/inimr-ri.nsf/en/gr104772e.html

[62] See http://www.imf.org/external/pubs/ft/fandd/1999/09/okonjo.htm

Figure-CA2 shows that as of 1999, there were 2 State-owned banks, 7 branches, 1 representative office and 22 local banks. The banking industry has changed due to the closure of some banks and the financial opening to foreign investors (ADB, n.d.). July 2004 record indicates the dominance of some commercial banks in Cambodia in the country's banking system - 10 out of 18 are commercial banks. Of this total, two are subsidiaries of foreign banks, aside from the 3 foreign branches of Asian Banks established in the country. The Foreign Trade Bank is a state owned bank, which had been controlling the financial system in Cambodia since 1979.

The year 1991 saw the opening up of the banking system to private banks and the establishment of Rural Development Bank by the government in 1998. Aside from the state-owned banks and the 5 local banks (wholly-owned or with joint venture with foreign banks), most of them are foreign banks in Asia.

Among the most active government institutions in the financial system are the central bank, Ministry of Commerce and MEF. The central bank, National Bank of Cambodia, oversees the performance of the financial institution. Created in 1982, it was again reorganized in 1992 to respond to the needs of the public. It is also responsible for the establishment and oversight on the operations of the proposed financial markets, which will be implemented in 1997. [63]

The Ministry of Commerce and the Ministry of Economy and Finance played significant roles in initiating key legislation, including the draft laws on Commercial Enterprises and Government Securities and Non-Government Securities Issuance and Trading. While its banking system shifted from being a mono-banking system to a two-tiered system, ADB (2001) reported that it is one of the lowest banking intermediation worldwide, where the latter only accounted to 8%-12% of the country's GDP.

5. CAMBODIA'S CAPITAL MARKET AND ASSET MANAGEMENT INDUSTRY

Cambodia does not have a bond or an equity market to speak of. However, initiatives were undertaken by the government in its Financial Sector Blueprint for 2001-2010 to provide responsive and comprehensive policy reforms, including the establishment of a securities exchange in 2007 and the institutional and regulatory framework for market infrastructure. It also outlines the development of money market instruments, treasury bills, and the need to establish a bond market.[64]

The ADB outlined various laws in line with the Government's move towards capital market development, namely, Insolvency Law, Commercial Contract Law, Law on

[63] See http://www.bigpond.com.kh/council_of_jurists/Banque/bk001g.htm.

[64] For more details on the phases of the financial sector blueprint consult **Government Policies and Initiatives> Master Plans & Blueprints**.

Commercial Enterprises, Law on Secured Transactions, Amended Law on Investment, Civil Code, Law on Commercial Arbitration and Negotiable Instruments Law.[65] Moreover, an agreement between the government and the World Bank had outlined the Financial Sector Blueprint for 2001-2010 that identifies the instruments toward a responsive financial market that involves fixed income securities, interbank/money markets and the capital market (involving three Phases for its implementation)

6. CONCLUSIONS AND RECOMMENDATIONS

Cambodia will heavily rely from its garment and textile industry, as the country's agricultural sector's contribution is low. This is because the country's foundation for sustained growth remained weak. Its financial system can also be characterized as weak due to its limited and inadequate financial infrastructure. Banks are not able to provide various services, as traditional intermediation activities are limited, mostly dollar-denominated and fewer investible products to choose from. Credit transaction is limited and banks had become wary considering that there were many banks that became insolvent and were ordered closed.

The inadequacy of laws and regulations in enhancing a formal credit culture that is market based hampered its development. This has increased risk and cost of intermediation particularly bank's operations. Supervision of these financial institutions must be tightened and regulations pertaining to financial reporting, accounting and auditing standards, among others must be strengthened. While there is an existing capital market, its development is far from being efficient. However, there is room for its development given the opportunities available in the financial system backed by strong regulatory framework.

[65] Sourced from http://asianbondsonline.adb.org/cambodia/government_policies_and_initiatives

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LAO PEOPLE'S DEMOCRATIC REPUBLIC

1. COUNTRY MACROECONOMIC PERFORMANCE

TABLE-LA1. SELECTED MACROECONOMIC DATA

	INDICATORS					
Year	**GDP Growth Rate**	**Inflation Rate**	**Exports**	**Imports**	**FDI**	**GIR**
1995	7.4	25.66	-	-	-	-
1996	6.9	7.28	-	-	-	-
1997	6.9	26.6	-	-	-	-
1998	4	141.97	-	-	-	-
1999	7.3	86.46	342	554	52	106
2000	5.8	30	345	562	31	127
2001	5.8	7.8	334	542	24	134
2002	5.8	-	340	570	60	196
2003	5.8	-	401	618	69	218
2004	6.9	-	-	-	-	-

*Source: GDP Growth Rate – ARIC
Other Source – IMF Country Report 2005

Lao PDR gradually moved from a centrally planned economy to a market-oriented system since the introduction of the New Economic Mechanism in 1986. Its performance before the Asian Crisis was good. It was only in 1998 when GDP growth rate reached 4.0 percent, with inflation rate showing very erratic figures. Bank of Lao, the country's central bank, reported that the average inflation rate reached 25.66 since 1997 and rose to its peak at 141.97 and 86.46 in 1998 and 1999, respectively (www.bol.gov.la). It continued to recover from 2000 to 2004.

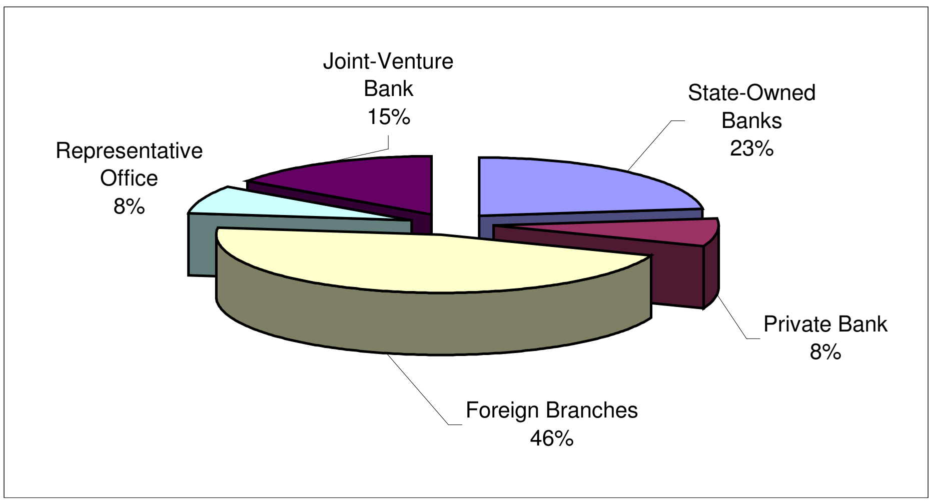
Since the country is dependent on agricultural production, the latter facilitated growth, including its industrial sector. However, revenue collections from its tourism industry declined due to SARS and other health related problems, which plague the East Asian Region during the recent years. The World Bank reported that the outlook for Lao seemed very promising from 2003 to 2005 as the GDP growth had improved given that the country had recovered from drought and almost all sectors' performance improved (http://siteresources.worldbank.org/INTEAPHALFYEARLYUPDATE/Resources/brief-laopdr.pdf).

For the period 2000-2003, the country's GDP growth rate remained steady at 5.8 per cent and recovered in 2004 at 6.9 per cent. Likewise, there was an obvious variation in its fiscal performance particularly in 2002-2003. Given the contraction in revenue collections, it had increased oil prices to beef up tax collections.

Compared to its imports, exports were low as the country is heavily dependent on the importation of materials and machines for its garments industry (World Bank, 2004). The IMF also reported that with the SOCBs' lending experience in early 2000, the government was prompted to improve its credit policies.

2. LAO PDR'S FINANCIAL SYSTEM

FIGURE-LA1. BANKS IN LAO PDR AS OF JUNE 2005



Source: Bank of Lao PDR

Like other financial institutions of emerging countries in East Asia, the banking industry is less diversified. Some banks are privately-owned while others are foreign banks. As of June 2005, there were 13 banks operating in Lao PDR. Banque Pour le Commerce Exterieur Lao used to operate as a specialized branch of the Central Bank of Lao. In 1989, it became a commercial bank. So far, it occupies one-third of the total assets and loan portfolio of the banking industry (www.bol.gov.la).

There are two other state-owned banks (SOBs), namely Lao Development Bank with 18 branches and correspondent banks in other countries and Agriculture Commercial Bank with 17 branches nationwide. The three SOBs own 57 percent of the total resources, 66 percent of the total deposits and 53 percent of the net loans of the banking industry (ibid). What are remarkable in the country's financial system are the merger between two State-Owned Commercial Banks and the changes in the banking sector's laws. These actually created a level playing field for both domestic and foreign banks (Miller, 2006) and provided direction in the financial system.

Other banks are organized as joint venture banks (2), private bank (1), foreign branches (6) and a representative office.

The Bank of Lao PDR (BOL), the country's central bank, supervises the banking system. No other financial institutions are organized or allowed to operate.

2. NON-PERFORMING LOANS PROBLEM

In Lao PDR, there are limited financial products that are available to clients or investors. Like other East Asian Economies that undergoing transition towards a market-oriented economy, credit was rationed through direct controls by the government. These were loans that are classified as non-commercial and were extended mostly to State-Owned Enterprises. To date they are continuously increasing (AEM, 2003) at fast pace.

TABLE-LA2. BANKING SYSTEM PROFILE

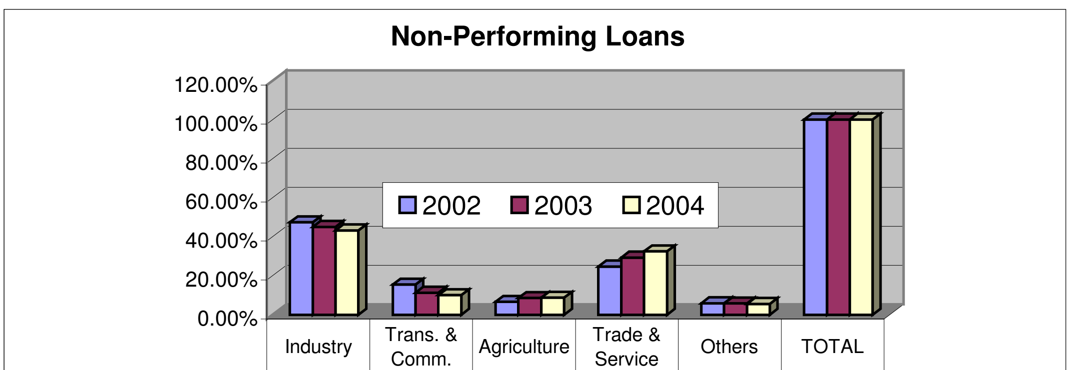
Banks' Name	Assets	Net Loan	NPL	Deposits
Banque Pour Le Commerce Exterieur Lao (BCEL)	36%	34%	58%	40%
Lao Development Bank (LDB)	15%	11%	7%	20%
Agriculture Promotion Bank (APB)	6%	8%	10%	6%
Lao-Viet Bank (LVB)	16%	20%	16%	14%
Joint Development Bank (JDB)	4%	4%	8%	4%
Vientiane Commercial Bank (VCB)	5%	8%	0%	4%
Krungthai Bank Branch (KTB)	2%	1%	0%	1%
Thai Military Bank Branch (TMB)	2%	0%	0%	1%
Siam Commercial Bank Branch (SCB)	3%	0%	0%	2%
Bangkok Bank Branch (BBL)	5%	8%	0%	1%
Ayoudtya Bank ranch (BAY)	2%	3%	0%	1%
Public Bank Branch (PBB)	5%	4%	0%	4%
TOTAL	100%	100%	100%	100%

Source: Bank of Lao Website

As there is no financial data available for the pre-crisis NPLs. Only reports provided by multilateral agencies were used to determine the extent of the country's exposure. The State-Owned Banks, with a total exposure of 75% as of June 2005, account for the two joint-venture banks account for most of the industry's NPLs. Other bank types do not have NPLs. These generally contributed to a drain on the state's annual budget, as the Government had to finance the losses and rehabilitate these banks.[66]

Table-LA2 shows the total assets, net loans, nonperforming loans and deposits of the banking industry. It shows that most if not all of the assets of these banks are in the form of loans. There are also banks whose loans even exceeded their total assets. Hussain, et. al. (2004) reported that net foreign assets of the commercial banks from 2000-2004 were lower compared to domestic assets. Hence, both values were increasing at gradual pace. Still foreign currency deposits still proliferate and are higher than the banks' net assets values. This actually exposes the bank to greater risk. Seven out of twelve (12) banks have non-performing loans in their portfolios. Most of these banks are State-owned Commercial Banks. Moreover, non-performing loans of these banks are even greater than its total loans. This only signifies that these directed credits only impair the bank's ability to maximize their operations and brings them away from commercial orientation. The only banks that drive the economy are the foreign banks whose transactions are also limited.

FIGURE-LA2. NON-PERFORMING LOANS PER SECTOR



	Industry	Trans. & Comm.	Agriculture	Trade & Service	Others	TOTAL
2002	47.35%	15.42%	6.62%	24.71%	5.90%	100%
2003	44.98%	11.30%	8.58%	29.33%	5.81%	100%
2004	43.24%	10.04%	8.74%	32.46%	5.53%	100%

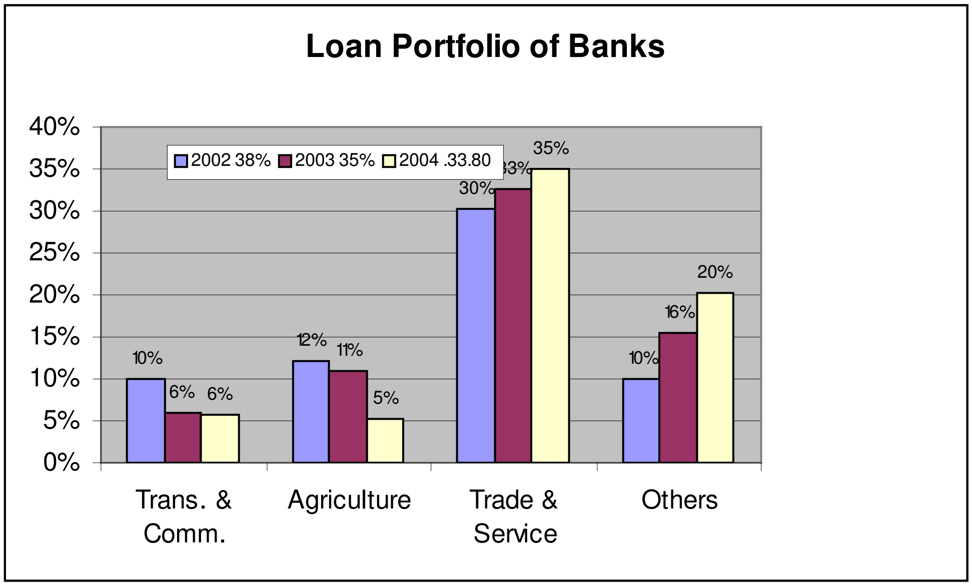
Source: Bank of Lao PDR

Figure-LA2 shows the grouping of the non-performing loans of the banks per sector. NPLs from 2002 to 2004 were high for industry and trade and services sectors. The highest ratio was recorded for industry sector in 2002 at 47.4% while that of the trade and services sector occurred in 2004 at 32.46%. However, there are no available data on the amount of exposure as a percentage of total credit transactions. In 2004, banks' NPL exposure shifted from the industry sector

[66] Check out http://lnweb18.worldbank.org/eap/eap.nsf/Attachments/laocbnov03/$File/laocbnov03.pdf

towards the trade and services sectors. While the country is primarily agriculture, it has the lowest NPL ratios ranging from 6.62% in 2002 to of 8.74% in 2004.

FIGURE-LA3. LOAN PORTFOLIO OF BANKS



Source: Bank of Lao PDR website

Compared to the NPL exposures of the different types of industries, it shows that the loan portfolio represents approximately one third of the total portfolio. **Figure-LA3** reveals that the industry sector still obtained the lion's share in the industry's lending activities; however, its NPL is larger. Trade and services sector occupies one-third of the total portfolio and continuously increased until 2004. Despite the decrease in the share of agricultural sector, non-performing loans were increasing.

Weak SOBs aggravated the problem in the banking system; the ADB, World Bank and IMF helped Bank of Lao in its move to recapitalize deeply insolvent SOBs. However, said assistance was made on the condition an improvement in the financial performance, loan classification and accounting standards/system must be undertaken (Economic Analytical Unit, 2002). As further cited, "the Government is also phasing out directed lending and increasing pressure for state-owned enterprises to repay past loans."

What had contributed to the problem faced by the Government are its weak monetary and fiscal policies. With these macroeconomic fundamentals aggravated by the lengthy consensus building in the decision-making process of the Government, the situation worsened and eventually weakened the banking systems via inadequate regulatory and prudential frameworks. As also cited by Onkonjo-Iweala et.al (1999):

> *Financial sector distress should be addressed in parallel with a broad sector restructuring program to improve the banks' ability to intermediate resources effectively. The Lao PDR will also need to address remaining structural constraints to growth—in*

particular, it will need to improve the climate for investment and business activity to restore external investment flows and boost exports.

3. Means of Resolving the NPL Problem

To date, no asset management companies were organized to clean NPLs in the banking system. The Government only relied from State-Owned budget to restructure SOCBs and from the financial assistance provided by various multilateral agencies. World Bank provided credit as a forum under the Governance Agreements (Ibid).

Immediately after the crisis, the government was unable to clean up the NPLs. BOL's data reveals that as of June 2005, five (5) banks have NPLs in their balance sheets. Of the total loan transactions, Banque Pour le Commerce Exterieur Lao had the largest exposure - 58 percent. Lao Development Bank and Agriculture Promotion Bank had lesser exposure with only 17 percent share of the total NPLs (www.bol.gov.la).

Among the activities undertaken to address credit-related problems under its Governance Agreements, are the restructuring of State-owned Commercial banks and the review of the credit risk assessment and decisions (http://siteresources.worldbank.org/INTEAPHALFYEARLYUPDATE/Resources/brief-laopdr.pdf). This was also cited in the ADB's report (Asian Economic Report, 2003) which mentioned that both the SOCBs and SOE were undergoing restructuring to encourage a commercially-based lending system. Moreover, banks are also encouraged consolidate and as of 2003, two banks merged. Likewise, some of the most prominent resolutions reported by World Bank are the improvements in the classification of loan losses and loss provisioning, amendments to the existing banking laws on entry by private institutions (ibid).

While Lao PDR had been involved with various activities to fund SOEs, the government instituted measures to limit credit for this sector. Economic Analytical Unit (2002) cited that measures were geared towards improving economic reporting and credit management by stopping policy credit provided by Central Bank to this sector and by reducing budgetary deficits. Moreover, internal governance and oversight on the part of Bank of Lao were introduced to strictly monitor the performance of banks and provide level playing field in the financial system. Miller (2006) also mentioned that the government should hasten reform processes in order to improve the country's banking system.

4. Lao PDR's Capital Market

So far, the country has neither equity nor a debt market. The creation of these markets is already part of the country's financial sector reform in 2003. Likewise, three multilateral agencies are actively helping the country in pursuing financial sector reforms, particularly in its banking sector.[67]

As described in a Economic Analytical Unit (1997), the financial sector inhibits and threatens the economic recovery and macroeconomic stability of the country. Among those that were identified as crucial in the financial sector reforms are:

1. Corporate governance of the State-Owned Commercial Bank (SOCB)
2. Upgrading of accounting standards
3. Supervision capacity of Bank of Lao
4. Policy reforms toward a market-driven financial environment with lesser government intervention.

Similar to the Royal Government of Cambodia, Lao People's Democratic Republic (Lao PDR) is currently taking active measures to develop the securities market. Some government agencies, which are involved in making this market operational, are the Bank of Lao, National Treasury of the Ministry of Finance and the Department of Domestic and Foreign Investment. BOL takes an active role by issuing bills and bonds to manage the country's exchange rate and liquidity (www.adbonline.com).

In September 2003, the BOL issued LAK 50 billion of the three-month bills that paid 20 percent annual interest rate to wipe out excess liquidity in the economy and SOBs facilitated the trading of these bills to the public. To date, it can be said that the country's financial system's activities are limited and the capital market, if established formally, can be used as a venue for the private sector's funding requirements. While it may be very small compared to other markets in East Asia, it will facilitate further development in the future.

5. LAO PDR'S ASSET MANAGEMENT INDUSTRY

There are no organized asset management companies that offer various services in the field of finance. Only a government pension fund, whose contribution to capital market development is not quite significant, is operating. Moreover, there is no capital market in the industry. This is understandable considering that the financial system's set-up is very simple and financial transactions are limited.

Currently, the public sector social security scheme in Lao PDR grants comprehensive protection against a broad range of contingencies, including old age, disability (from war), medical care, death, maternity, and sickness. The Social Security Department has been the manager of the social security scheme in Lao PDR since January 1994. Benefits are funded by contributions deducted by the Treasury of the Ministry of Finance for

[67] Source: http://asianbondsonline.adb.org/laos/market_infrastructure/market_overview.php

central organizations and by the provincial treasury offices. Deficits in this fund are covered by the government budget in the form of an open-ended subsidy.

6. CONCLUSIONS AND RECOMMENDATIONS

Lao PDR gradually moved from a centrally planned economy toward a market-oriented system. With the crisis spreading within the region, it was not relieved from its ill effects. The banking sector plays an important macroeconomic role in the country's financial system, that is, the efficient allocation of financial resources aimed at improving economic growth in the country.

Being one of the poorest communist countries in East Asia, its financial activities are very limited and are facilitated mostly by banks. They provide most of the financial transactions. **B**anks were less heavily regulated by the Central Bank and the existence of foreign banks has contributed less in the country's financial system.

State-owned Commercial banks are the most active banks and the State or the government dictates most of their loan transactions. As a result, they have large exposures to SOEs as the government also provides funding. The State Owned banks' non-performing loan exposure had put the financial system into a substantially weak position. Given these problems at the onset, sufficient monetary as well as fiscal policies must be mobilized to be able to support efforts towards addressing problems on nonperforming loans. To do this, the government should be cautious in its efforts to fully open its financial system in the international markets.

Moreover, regulatory framework must be put into proper perspectives to respond to these emerging needs and issues and eventually lead to the establishment of a capital market in the future. Efforts must be vigorously undertaken and it usually takes a political will to do this. As mentioned in the previous discussions, various entities such as the World Bank, ADB, IMF, and the European Union helped the Government to implement financial reforms with special emphasis on bank operations. This includes the strengthening of the operations and supervisory functions of the Bank of the Lao PDR (Central Bank), and the restructuring state-owned commercial banks (SOCBs). It is believed that this will help banks improve their lending decision capabilities and risk management systems.

Looking forward, there are pressures on the financial system in the form of increasing scope of operations and in improving their services to reduce costs.

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MYANMAR

1. COUNTRY MACROECONOMIC PERFORMANCE

TABLE-MY1. Macroeconomic Data

	GDP Growth Rate at constant prices	Export Growth Rate	Import Growth Rate	GIR	NET FDI	AVE. CV
Year	**Percent**	**Percent**	**Percent**	**Millions**	**Millions**	**Percent**
1995	6.9	10.38	51.4	573.2	279.9	12.5
1996	6.4	-13.6	1.7	240.8	313.4	14.25
1997	5.7	18.4	51.1	260.7	390.8	15
1998	5.8	23.2	30	326.3	317.8	15
1999	11	5.4	-13.8	276.5	255.6	12.75
2000	13.7	25	3.4	233.5	258.3	10.5
2001	11.3	62.3	17.8	410.6	210.3	10
2002	12	32.2	-17	481	152.1	10
2003	13.8	-18.5	-11	562.3	251.5	10
2004	13.6	-4.2	5.1	684.7	213.5	10

Source: ARIC

Myanmar posted robust growth before the financial crisis. It slowly dropped at a rate of 5.7 percent during the outbreak of the financial crisis in 1997 (see **Table-MY1**). While export and imports growth were high in 1995, a negative growth rate was evident in 1996. Hence, it bounced back in 1997. Except for 1995 figure, the country's gross international reserves recorded a slight increase until 1997 due to the high foreign direct investments in the manufacturing business (AEM, 2001). Hence, compared to other countries, these are small as its international debts and arrears are continuously increasing, thereby affecting available resources (IMF, n.d.). Aside from the stiff requirements on foreign investments, the slowdown in the global market has also affected the overall economic performance of Myanmar.

While manufacturing sector greatly contributed to the performance of the economy, agricultural sector was affected including the performance of the industrial sector. ADB's AEM (2001) further reports that the increase in the free market exchange rate and the slowdown in investments have contributed to the improvement in the current account balance.

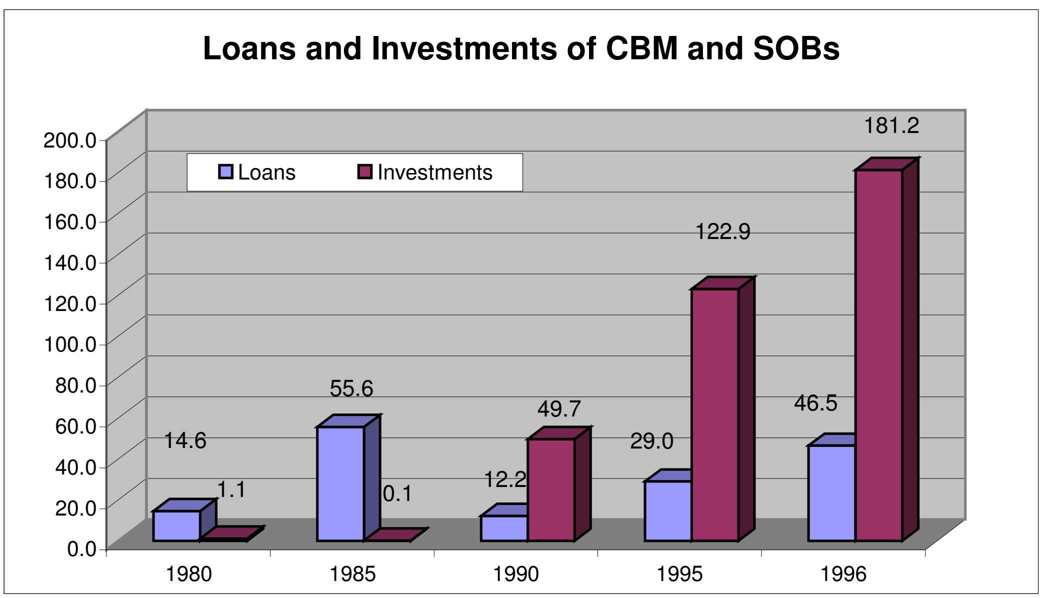
GDP significantly improved by approximately 95% in 1999. This was also followed by improved performance during the succeeding years. IMF (n.d.) reported however that the country's economic growth over the next few years will be hampered by growing macroeconomic imbalances and problems on structural adjustments. Unless reforms will be made, prospects would be bleak.

Despite negative growth rates for imports and exports, the country posted a much stable GDP growth of 13.8% and 13.6% for years 2003 to 2004, respectively. Inflation posted a high rate of 61% in 2003, which according to ADB (AEM, 2003) was attributed to the high growth in the money supply despite slower growth in the country's exports, particularly gas shipment.

The improved performance was accounted for by the various fiscal reforms and structural changes that were undertaken for a sustainable growth. Among these were in the form of privatization of State-owned enterprises, trade liberalization and financial reforms.

2. MYANMAR'S FINANCIAL CRISIS AND NPL PROBLEM

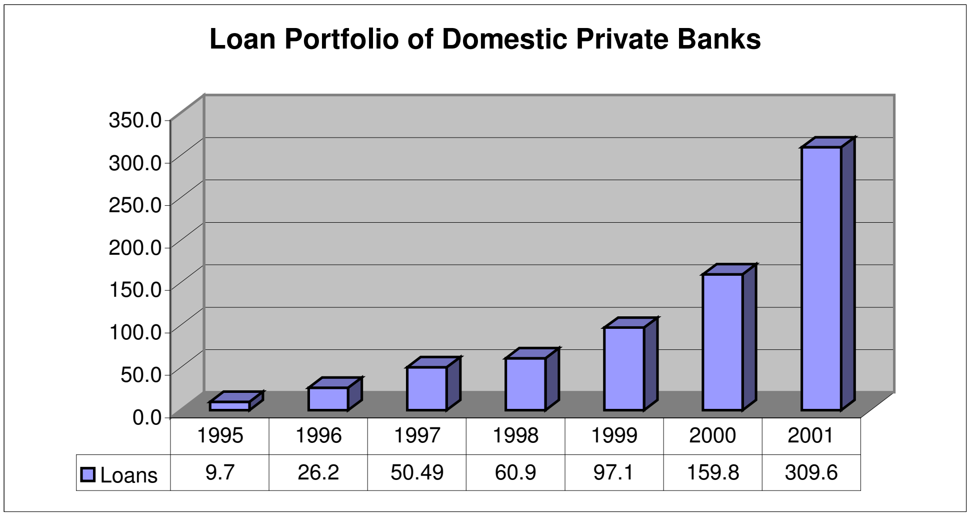
FIGURE-MY1. LOANS AND INVESTMENTS OF CBM AND SOBs



Source: http://www.etrademyanmar.com/STATS/15.htm

Shown above (**Figure-MY1**) are the loans and investment portfolios of the Central Bank of Myanmar and other SOBs. Lending activities were erratic particularly in 1985 when they posted total loans of 55.6 billion kyat. Hence, even if it declined in 1990, it continued to increase at a fast rate from 1995 until the succeeding years. Investments, on the other hand, also exhibited the same trend but reached its peak from 1995-1996.

FIGURE-MY2. LOAN PORTFOLIO OF DOMESTIC PRIVATE BANKS



Source: http://www.etrademyanmar.com/STATS/15.htm

The loan portfolio of private domestic banks exhibit an increasing trend from a low of 9.7 billion in 1995 to 309.6 billion kyat in 2001. It can be noted that the integrity of banking and financial services depends on high legal, professional and ethical standards. However, under the Burmese junta, there are no such standards. Funds from criminal activity can be easily processed through Myanmar's institutions, either because its employees and directors are corrupt or because the institution turns a blind eye to the criminal nature of such funds. Hence, the financial institutions, according to Gutter (2001), have become part of the criminal network itself.

Myanmar is controlled by two groups, namely, the military group and few businessmen, which both treat business and politics as inseparable. This was also confirmed by the findings of Aung Zaw (2005) who claimed unreported yet rampant corrupt practices as common in the market place with either one group bribing the other in exchange for some favors.

To date, there were no reports found on the non-performing loans problem of banks in Myanmar. Asian Tribune (August 2003) reported that more than 10 non-bank FIs were engaged in illegal deposit taking activities to fund drug-related transactions and illegal transactions of Mafias.

High deposit rates that were paid up to a maximum of 60% per annum contributed to their failure, as they were not able to pay off their borrowings. Massive withdrawals of funds were evident, which caused panic among clients. With the President's denial of the problem, the situation worsened and caused more panic withdrawals, until the banks can no longer sustain the withdrawals. Controls were implemented as to the maximum amount of funds that one can withdraw, thereby affecting not only business but also the entire economy as well (Ibid).

3. Means of Resolution

The country is considered as one of the top exporters of drugs/narcotics in the world. 'Cash holdings smuggled into the economy have a high premium because of the rapidly depreciating kyat. Direct-lending options had become attractive in Burma due to the increasing international enforcement of money laundering laws. Informal and illegal credit markets have become very influential. Many credit commitments were unmet, which have encouraged the use of unofficial sources of financing.

There were no asset management companies or special purpose vehicle that were created to resolve the banking crisis in Myanmar. Reports revealed that the Central Bank of Myanmar had imposed ceilings on deposit withdrawals and provided funding to private banks amounting to 25,000 million Kyats (Asian Tribune, 2003). In another article, deposit guarantees provided by the government helped eased the unrest caused by lost of public confidence (Seng and Broadmoor, 2003).

This is a lesson that can be learned from the illegal activities undertaken by banks and other depository institutions in using the banking system for said activities. The issue of money laundering weakened the integrity of Myanmar's financial system (Gutter, 2001; Turnell, n.d.).

4. Myanmar's Financial System

The financial system in Myanmar started in 1969 when the People's Bank of the Union of Burma was organized. Reorganization took place in 1975, which divided the same into 4 institutions, namely Myanmar Economic Bank, Myanmar Foreign Trade Bank, Myanmar Agricultural and Rural Development Bank, and Myanmar Insurance Corporation. By 1988, Myanmar liberalized the financial sector through the State Law and Order Restoration Council to open its market and put into perspective, in 1990, the Financial Institutions of Myanmar Law and the Central Bank of Myanmar Law. This paved way to the establishment of a private bank and a representative office. Even with Phase 3 of the liberalization that allowed foreign banks to operate, none yet had been established (http://www.myanmar.com/gov/trade/fin.html).

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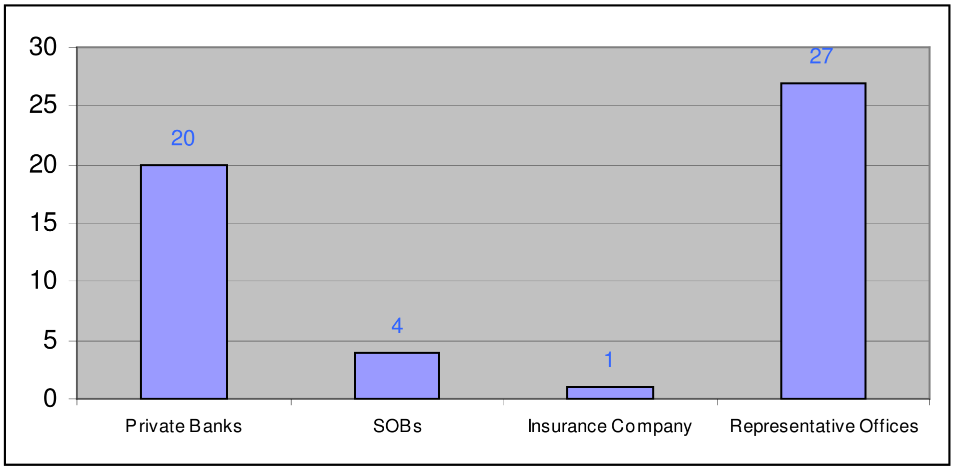
FIGURE-MY3. MYANMAR'S BANKING SYSTEM



Source: Myanmar Website

The financial system in Myanmar was formalized under the Financial Institutions of Myanmar Law of 199027 to streamline its monetary policies and provide guidelines for extending banking services. Under this law, the central bank allows financial institutions to be established for the purpose of providing banking services and "providing intermediation related to money or capital markets through the collection of financial resources from third parties for investment on their own account in credit operations, credit and public debt instruments, securities, or other authorized financial activities" (Gutter, 2001).

Banks dominate the country's financial system. There is only one insurance company, Myanmar Insurance Corporation, which handles all insurance-related activities nationwide. There are 34 branches and offices that provide the specific requirements of the public.[68]

On the other hand, the State Law and Order Restoration Council enacted the Myanmar Insurance Law in July 1993 to replace the Insurance Business Law of 1975 to provide diversified insurance business. Even if there were only four SOBs, they occupy a lion's

[68] Sourced from http://www.myanmar.com/gov/trade/fin.html.

share of the total system's resources while 'total deposits' was seven times as much as the total deposits of private banks.

Aside from its limited banking and insurance set-up, Myanmar Small Loans Enterprise and the Myanmar Investment and Commercial Bank (MICB) were created in 1993 and 1989, respectively, from the Myanmar Economic Bank (MEB) which has the largest banking operations. It has over 300 branches and holds 75% of the total deposits in the system. To date, there are 27 foreign banks out of 46 banks in 2001. Through the central bank, new banking laws enabled the operation of eight domestic private banks. Since 2001, there have been 46 representative offices (with very limited roles) and 20 private banks.

As claimed by Turnell (n.d.), limited information exists regarding Myanmar's financial system as the Government kept information confidential, particularly those related to the state-owned banks' operations. Total deposits grew significantly by 566 percent from its 1995 value of 67.7 billion kyat to 450.9 kyat in 2000. Asia Wealth, a private bank, occupied a total share of 35.5 percent of the total deposits in 2001.

While joint-venture banking is encouraged, no such bank has been established yet due to several restrictive provisions set by the Government.

In June 1996, the Insurance Business Law was enacted to promote foreign and local investments and to encourage participation of the private entrepreneurs in the insurance schemes. A year later, the Insurance Business Rules was issued.

Of the four SOBs, only Myanmar Economic Bank (MEB), Myanmar Investment and Commercial Bank (MICB), and Myanmar Foreign Trade Bank (MFTB) are authorized to deal in foreign exchange transactions. MFTB is in charge of the foreign currency transactions of government organizations, businesses, and individuals while MICB handles companies and joint ventures. MEB, on the other hand, handles foreign currency transactions in border trade regions. Under the Myanmar Foreign Trade Bank's charter, the country has correspondent banking relationship with international banks in 58 countries.[69]

With respect to foreign exchange transactions, restrictions involve the adoption of the dual foreign exchange regime, the prohibition on the conversion of the kyat into foreign currency and the creation of a parallel currency in the form of Foreign Exchange Certification. These restrictions serve as disincentives to foreign investors and were even aggravated by the prohibition of land acquisition or in the lease of land for more than a year. One notable issue is the move to change MFTB from being a specialized bank to a general commercial bank. Even with the establishment of correspondent relationship with 58 international banks, its operational flaws are evident as transactions can be practically made with almost any country in the world.

[69] Sourced from http://www.myanmarsnap.com/banking.asp#4

Yawnghwe (n.d.), reiterating the findings of Collignon (n.d.), specified reasons for the obstacles to foreign investment:

1. Slowdown in the process of economic liberalization since 1993.
2. Requirement among Importers (and received preferential licenses) to import-designated "priority" goods in amounts equivalent to one fourth of their total imports or more.
3. Refusal by the SLORC to comply with the exchange rate regime precondition of an IMF staff monitoring program.
4. As the investment ratio has declined, forced prison labor and uncompensated people's "contributions" to state construction projects have increased (Department of State, 1996).
5. No privatizations efforts were made for large State Economic Enterprises (SEE).
6. Most SEE monopoly privileges continue to dominate Burma's economy.
7. Fundamental macroeconomic disequilibria persist and distort the incentive structure of the private and public sector.

5. MYANMAR'S CAPITAL MARKET AND THE ASSET MANAGEMENT INDUSTRY

There is no fund management industry to speak of due to the protectionist move by the government. Hence, a capital market was initially introduced. Prior to the establishment of Myanmar Securities and Exchange Centre (MSEC), companies were reported to have relied from bank loans for additional funding or capital requirements.

As a policy initiative, a securities exchange law was underway, where Myanmar's Ministry of Finance and Revenue and Attorney General's Office are responsible for the implementing guidelines. This signals an important step toward providing indispensable rules and regulations for securities market activities. During the early 1990s, Myanmar started its financial liberalization efforts by allowing private sector participation in financial activities. A sound capital market, including the market for treasury bonds was proposed and will be implemented soon. In 1996, the Myanmar Economic Bank and Japan's Daiwa Institute Research Ltd. established a joint venture firm, the Myanmar Securities Exchange Centre Co., Ltd. The enactment in 2003 of the Myanmar Companies Act and the Myanmar Companies Rules signaled improvements in the financial infrastructure.

Out of the 16,283 companies registered at the Ministry of Commerce and Ministry of National Planning and Economic Development, only 20 companies went public for fear that their shareholders' rights will limit their ability to run their business. Moreover, since there are very few investors, anomalies were reported in the equity market.

Lim (2004) reported that MSEC's securities market is not a buyers' market but an issuer market whose prices are determined by the issuers. Second, some issuers deceive the investors on the true performance of the stock by manipulating the prices.

Aside from the equity market, Myanmar also initiated the securities market through the initiative of the Central Bank of Myanmar, which is the primary issuer of Treasury Bonds. Since 1993, it had floated 3-year and 5-year bond issues. To date, no corporate bond has been issued. Total issuance until the end of September 2001 was MMK 144.4 billion. The interest rates for the 3- and 5-year bonds are 8.5 percent and 9.0 percent, respectively. Treasury bonds are held mostly by private enterprises.

TABLE-MY2 shows the statistic of the treasury bonds issued in the country from 1995 until 2002.

**TABLE-MY2. GOVERNMENT SECURITIES (3-YEAR, 5-YEAR BONDS)
(in Million Kyatt)**

S.N	Particulars	Year	Total Sales	Discharged	Outstanding	Amount held by Public	Amount held by Private Enterprises
1	Three-year Bonds	1995-1996	823.77	-	907.15	80.15	827
		1996-1997	1898.46	36.01	2769.6	121.6	2648
		1997-1998	2425.3	47.37	5147.53	101.83	5045.7
		1998-1999	10678.2	823.77	15001.96	141.26	14860.7
		1999-2000	5340.45	1898.46	18443.95	136.25	18307.7
		2000-2001	15735.74	2425.3	31754.39	144.39	31610
		2001-2002	6513.14	10678.2	27589.33	171.63	27417.7
2	Five-year Bonds	1995-1996	48.64	-	62.78	22.78	40
		1996-1997	492.04	-	554.82	54.82	500
		1997-1998	1788.23	-	2343.05	154.05	2189
		1998-1999	14974.85	6.81	17311.09	237.09	17074
		1999-2000	36855.04	7.33	54158.8	326.5	53832.3
		2000-2001	44559.91	48.64	98670.07	360.07	98310
		2001-2002	6151.13	492.04	104329.16	365.16	103964

Source: Statistics on Treasury Bonds http://www.etrademyanmar.com/STATS/15.htm

Total issuance to the end of September 2001 was MMK 144.4 billion. The interest rates for the 3-year and 5-year bonds are 8.5% and 9.0% respectively. Its market for said instruments are mostly private enterprises compared t the amount held by the public. For both tenors, 3-year and 5-year bonds, for the past 7 years, only a small percentage of these bonds were discharged while most of them are still outstanding. Most of these bonds are sold to private enterprises. Given this information, it can be noted that there is room for the bond market to flourish in the country. Hence, what is quite alarming is the fact that from 2001-2002, total issuances declined. Hence, for a developing securities market, there must be a continuous supply for the public to choose from as far as alternative investments are concerned, aside from those products being offered by its banking system.

6. Conclusions and Recommendations

The integrity of banking and financial services depends on high legal, professional and ethical standards. Myanmar's financial system can be characterized as very weak with few financial institutions that provide the funding requirements and investments of the public. Most of the institutions including private sectors use it to fund illegal activities or State-owned enterprises' operations. It can be noted that funds from criminal activity can be easily processed through Myanmar's institutions. This makes the financial system vulnerable to various risks and its reputation in the international market will be tarnished.

Given this backdrop, the government must act quickly and promptly to improve the performance of its financial system by strictly monitoring its performance. To do this, regulations must be clear-cut and standards must be aligned for all operations in order to facilitate public confidence. Moreover, supervision must be made closely in order to strictly implement the country's regulatory framework.

Once the financial system's supervisory and regulatory frameworks are in place, a conducive financial environment must be provided to attract more foreign investments (direct and/or portfolio). Moreover, the public must also be assured the availability of investments they can choose from to facilitate savings and investments in the country. This will now then serve as a forum for capital market to prosper.

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http://www.myanmarsnap.com/banking.asp#4

http://www.etrademyanmar.com/STATS/15.htm

VIETNAM

1. COUNTRY MACROECONOMIC PERFORMANCE

TABLE-VN1. Macroeconomic Data

	INDICATORS/VARIABLES				
YEAR	GDP	Exports	Imports*	Inflation Rate	GIR
1995	9.5	-	-	-	1379.09
1996	9.3	41.2	25.5	34.51	1813.78
1997	8.2	24.6	0.2	28.95	2098.1
1998	5.8	2.4	-1.1	21.26	2100.5
1999	4.8	23.2	1.1	17.81	3423.4
2000	6.8	25.2	34.5.	14.06	3509.6
2001	6.9	4.3	2.3	12.82	3765.1
2002	7.1	23.8	22.1	12.01	4231.8
2003	7.3	30.2	29.1	10.84	6359.1
2004	7.69	22.3	25	10.02	7186.1

Source: ADB –ARIC

While other countries were greatly affected by the Asian Crisis, Vietnam remained unaffected. Prior to the crisis, Gross Domestic Product growth was high but at decelerating rates. By the time the crisis occurred, it had maintained a higher growth rate of 8.2% (see **Table-VN1**). International Monetary Fund (1998) mentioned that it was after a few years when Vietnam experienced the problem, which according to him were attributed by the following factors:

- The Vietnam economy has low baseline, is in the process of transition to a market oriented economy; and is open and had integrated in the international market few years back.
- Financial market development in the region can be attributed to the non-convertibility of its currency the stock and portfolio market, the absence of stock market and portfolio investment, the regulated operations of the capital market and exchange rates, and the weak banking system.

Despite its lower GDP growth rate in 1998, it's still high compared to other East Asian countries. A closer look at the table reveals that exports grew faster than imports until 1997; however, Vietnam still experienced trade deficit prior to the crisis, as majority of its imports were in the form of raw materials and capital goods used for investment and production which is determined by its trade policy rather than market-oriented activities. This export growth can be attributed to the increase in oil prices and the country's garment exports, computers and electronics. Hence, it faces stiff competition with China, India and other low labor cost producers of garments. The rising international oil prices have positively affected the country's economy as all sectors' operations have improved at varying levels.

Despite the outbreak of the avian flu, gross domestic product growth rate remained stable since 2000 from a low growth rate experienced in 1999 at 4.8 percent only. Inflation rates continued to decline over the years due to the sustained strength of the commodity prices where Vietnam, is one of the suppliers of oil in the East Asian Region (AEM, 2001). Moreover, the country's international reserves continued to grow at a faster pace from 2002-2004 compared to its growth immediately after the crisis. This was attributed to the increasing world oil prices.

While facing a very stiff competition with that of China, it still was able to boost its economy. IMF (2005) reported that these price hikes were actually offset by the inflows of remittances; tourism receipts and good export performance, which mitigated the adverse impact on the current account balance. The inflationary effects, on the other hand, can be attributed to the sustained strength of world prices and the late adjustments that were made by the government in oil prices. This had actually provided Vietnam an opportunity to reduce poverty rate.

2. NON-PERFORMING LOANS PROBLEM

Vietnam's financial crisis can be attributed to the high NPL exposures by SOCBs to finance some state-owned enterprises' activities (Economic Analytical Unit, 1997; IMF Report, 2004). It was reported that these banks were directed to extend loans to these insolvent SOEs. Moreover, banks were allowed to borrow funds illegally. This problem, together with the presence of a growing yet underdeveloped banking system, had undermined its operations and development (Thien, n.d.). Yu (n.d.) noted that there were no systems of credit risks, transparency in accounting standards and financial reporting in Vietnam's financial system (Yu, n.d.).

Oh (1999) mentioned in her study that non-performing loans are loans whose interest rate are left unpaid up to six months. According to her, there are no adequate requirements for a loan to be classified as non-performing. This poses a problem on the part of the banks and other lending institutions' NPL definition, which may be subjected to bias interpretations. Since there is no clear 'cut-off' as to when loans may be classified as non-performing, this becomes problematic as far as implementation of regulations is concerned.

With the system of recording interest on bad debts as accrued profit by financial institutions, bad financial situation emanating from the loan may not be disclosed. According to Loi (2002), critical in the problem is the ability of the government authorities to separate policy and/or directed credit with that of commercial credit, which were gradually introduced into the system.

Most SOCBs and joint stock banks (i.e., private sector banks with numerous shareholders) are under-capitalized, particularly when NPLs are taken into account. State-directed lending under non-commercial criteria also weakened the financial health of commercial banks in Vietnam, including the four state-owned banks, which hold a large number of NPLs, mainly to SOEs (ibid). As transparent auditing and financial reporting were problematic, the exact proportion of NPLs became difficult to estimate. Sources vary widely, with estimates of bad loans ranging from 4 percent to 30 percent.

The country's financial system is weak and bank-dominated, with the government owning approximately 82 percent of the total system's assets (Doan, 2000). Because of this, the Asian crisis further affected the country's financial and monetary development by putting devaluation pressures on the Vietnam Dong, thereby weakening the banking sector and the balance of payments position and increasing the debt burden. Moreover, the deterioration of the fiscal budget and the financial conditions of the SOEs worsened the problem.

TABLE-VN2. Capital Adequacy of State-Owned Commercial Banks, 1998

	Oct-98		Minimum Legal Capital	Desirable Capital
Capital	Actual	Adjusted		
	(VND Trillion)			
.	6.90%	3.60%	5.50%	9.80%
Capital/Assets	In % of Total Assets at end-October 1998			
.	7.20%	3.80%	5.60%	10.30%

Source: Phuong Lan Doan's Study (data taken from IMF)

Like China, Vietnam's low capital adequacy ratios, averaging 3.5 percent were evident among SOCBs compared to its foreign counterparts whose ratios were in line with Basle's 8 percent (Loi, 2004). The heavy financial burden of these banks led the government to introduce series of compensating measures through the allocation of government funds to these banks, the decrease in income tax rate to 32% and the reduction of reserve requirement from 8% to 5% (Doan, 2000).

Like other Asian countries that were affected by the crisis, Vietnam's problem (which emanated from its constitutional set-up, being a socialist republic country) cannot be regarded in isolation. Cambodia and Lao PDR experienced the same problem regarding the operations of their state-owned operated businesses, which made its banking system vulnerable to financial shocks. This is because the performance of the banking sector is extremely dependent from the strength of state-owned enterprises (SOEs), which are the main customers of SOCBs. This made SOCBs vulnerable to high risk caused by its credit to SOEs, thus making fragile the banks' financial health.

The exposures of commercial banks accounted for 57.4 percent of the total loan portfolio. This made the banks more vulnerable to credit risks and ultimate their insolvencies, as most SOEs were not able to pay off their loans. Their past due accounts rose and their exposure to foreign currency risk was high. SOEs were also suffering from production inefficiencies due to high employment rate, inefficient production technologies and unskilled labor and management (Economic Analytical Unit, 2002) .

Obviously, SOCBs were always expected to absorb over half of the country's formal credit. High banking concentration and sectoral monopoly of SOCBs constrained competition and eliminated the market principles. SOCBs occupy a dominant share in the banking industry; therefore most regulations and policies of the government and SBV favor them. They also gain implicit guarantees from the government for their performance. Moreover, Siregar (1999) confirmed these findings and mentioned that there is lack of transparency in the determination of the loan growth.

TABLE-VN3. Loan structure of SOCBs according to economic sectors, 1998

Enterprises	Agribank	Incombank	Vietcombank	Vietinde bank	Total of SOCBs
1. SOEs	26.5%	50.00%	74.00%	91.20%	57.40%
2. Private enterprises	70.0%	9.20%	3.90%	6.60%	26.80%
3. J.stock and Ltd. E	2.90%	37.70%	17.60%	1.40%	14.00%
4. Cooperatives	0.30%	0.80%	0.10%	0.10%	0.30%
5. Joint Ventures	0.30%	2.40%	4.10%	0.70%	1.50%

Source: Memorandum on the operation of technical assistance group for restructuring Vietnam's banking system-WB&IMF

Aside from this, SOCBs' exposure in real estate triggered structural vulnerabilities of the banking sector in Vietnam. The bullish market on the forefront, as a result of reforms instituted in the early 1990s, led to rising property prices, thereby making property collaterals popular to the banks. Prior to 1997, the lending practice was mainly based on providing collateral. Since SOEs accounted for nearly half of SOCBs lending operations, SOEs borrowings represented 34.1 percent of overdue debt damages to SOCBs, whereas most of the collateral of SOCBs (before 1997) were in property. Similar to Thailand and Indonesia, property sector was highly leveraged. IMF attributed the slow progress in SOCBs reforms due to the fast growth in lending activities, which have contributed to the increasing non-performing loan problems (IMF, 2006).

Although direct subsidies have been largely eliminated, the implicit guarantees from the government on the continuous operations of these SOEs, without being declared as insolvent, increased the loans extended to SOEs and distorted the allocation of financial resources. This was also confirmed in the study of Dufhues (2003) where he also added that these made SOCBs encounter difficulties in meeting their resolution targets due to the delays in SOEs' reforms.

What has worsened the situation is the lack of information on the performance of corporations even as SOCBs were directed by the government to extend more unconditional credit to state corporations. Banks lacked prudent credit assessment policies. Basic accounting, auditing, and disclosure practices were also below international standards; making lenders unable to control the use of loans by their customers, and therefore made them subject to significant liquidity risk.

The NPL levels reached 12.5 percent of the total loan portfolios of the banks by the end of 1998 while the SOCBs' NPL ratios averaged to 30 to 35 percent of their total loan portfolios. Accounting firms sent by World Bank likewise confirmed the problem that caused failure of these banks (Economic Analytical Unit, 2002). Moreover, NPL ratios of non-state banks can be characterized by high exposure to deferred letters of credit.

Poor credit evaluation system, inadequacy of long-term fixed income securities market, inadequate monetary policy, low legal system for collateral banking, poor and underdeveloped accounting and auditing system and severe governance problems aggravated the situation (Loi, 2004). But with the country's slow pace of liberalization, it was able to maintain tight capital controls, which helped soften the major blow of the crisis.

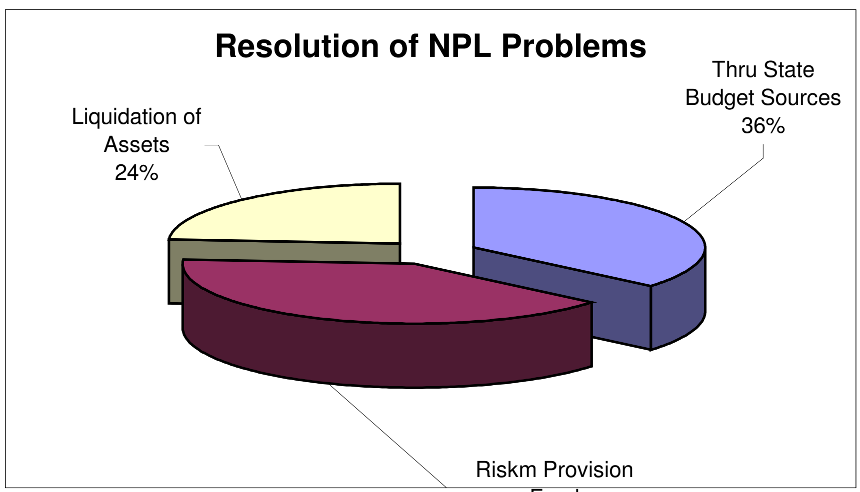
3. MEANS OF RESOLVING THE NPL PROBLEM

Formal resolution to address the NPL problems were undertaken but on a limited basis (ibid.). Two major types of AMCs were established, namely, that which was established by commercial banks (private AMCs), and the Debt and Asset Trading Company (DATC) managed by the Ministry of Finance.

For the decentralized approach, ten commercial banks established their AMCs to deal with and manage mortgaged assets that became non-performing for the time period. In 2003, the DATC was formed to focus on the NPAs of state-owned banks with lifetime being undefined. As of 2004 (start of operations), the historical asset costs of 20 companies to be liquidated amounted to VMD71 Billion. Of the total, only VND17 million was recovered. Only NPAs that remained outstanding for a longer period were considered in the sale (ibid.).

The government dealt with the problem either through State budget allotment, liquidation of assets or risk premium fund. IMF reported that as of 2002, the Government of Vietnam managed to close and merge 7 banks and finalized the move towards the restructuring of other SOCBs.

FIGURE-VN1. RESOLUTION OF NPL PROBLEMS



The following elements were considered essential for the successful recovery of NPAs:

1. The need to rationalize the official definition and classification system of distressed assets;
2. Involvement of foreign investors in NPA resolution such as the purchase of assets is critical.
3. Improvement on the involvement of professionals in NPA resolution must be made.

To deal with the problem, banking reforms continued with the recapitalization of large SOCBs and JSBs as a result of the establishment of the Bank Restructuring Committee in 1999. Initially, financial reforms were undertaken to deal with banks' insolvency, illiquidity and losses relative to capital. Setting up a transparent plan to address both equity and NPL problems was then considered.

Aside from this, World Bank also provided technical assistance to the Government by sending international accounting firms to audit banks' performance, particularly their credit portfolios. As reported by Narayan and Godden (2000), the country's first accounting system was introduced in 1995 as Vietnamese accounting system which is governed by the Ordinance and Accounting Statistics of 1988.under the regulation and supervision of Ministry of Finance. On the other hand, auditing standards was purely manifested in the State of Audit in Vietnam, which was established in 1994 with 18 accredited audit firms. As a result, the Vietnamese Standards on Auditing and the Accounting Standards Board were established through the help of ADB in line with the International Standards on Auditing and the International Accounting Standards.

Despite the existence of the Accounting Standards Board before the crisis, it had not issued any accounting standards yet except for the fact that the existing standards were in accordance with Vietnamese Accounting System (VAS). In another report prepared by by VACO-Deloitte Touche Tohmatsu as of 2003, it compared the new VAS framework with the Current Accounting Regulations (CAR), which was issued by Vietnam MOF in November 1995. While being competitive in the market, 10 standards were initially proposed under VAS in line with IAS. These standards also incorporate financial reporting (Narayan and Godden, 2000) as an enhancement of the existing standards practices in Vietnam. More recently, loan classification and provisioning were tightened including prudential standards that relate to financial statement reporting. This will also be realigned with the recapitalization of SOCBs and the restructuring of the SOEs (IMF, 2005).

4. VIETNAM'S FINANCIAL SYSTEM AND CAPITAL MARKET

The Financial System

The financial sector in Vietnam consists essentially of the banks. Unlike other countries, its banking system is unique because it classifies credit fund system, local credit funds and financial companies as banks. There are approximately 1014 banks, while local credit funds represent 87.6 percent of the total, followed by the representative offices of foreign credit institutions.

Earlier reforms in 1988 included the use of a two-tier system by separating commercial banking from central banking, by creating four state-owned commercial banks (SOCBs) and by considering the State Bank of Vietnam as the central bank. In 1990, the sectoral specialization of SOCBs was removed and entry by foreign banks into the system was liberalized.

TABLE-VN4. FINANCIAL INSTITUTIONS IN VIETNAM

Financial Institutions	No.	%
Banks		
State-Owned Banks	5	0.5%
Social Policy Bank	1	0.1%
Foreign Bank Branches	25	2.5%
Representative Offices	40	3.9%
Foreign Bank Sub-Branches	6	0.6%
Joint Venture Banks	5	0.5%
Domestic Joint-Stock Commercial Banks	36	3.6%
Central People's Credit Fund System	1	0.1%
Local Credit Funds	888	87.6%
Finance Companies	7	0.7%
	1014	
Non-Bank Institutions		
Insurance Companies	18	55%
Finance Leasing Companies	8	24%
Postal Savings System	1	3%
2 Stock Exchange	1	3%
Investment Fund	4	12%
Debt and Asset Trading Company	1	3%
	33	
Informal Financial System		
ROSCAS		
Moneylenders		

Source: State Bank of Vietnam

Vietnam's financial sector had expanded to include a social policy bank, 23 branches of foreign banks, 5 joint-venture banks, 40representative offices of foreign banks, a Central People's Credit Fund System, 36 joint-stock commercial banks and 7 finance companies. There were 888 people's credit funds operating in the system, which are the largest in number but one of the weakest and smallest in terms of resources. The four SOCBs account for 82 percent of total bank assets.

Total bank assets were equivalent to 38 percent, total loans 22 percent, and total deposits 20 percent of the country's GDP by end-1998, signifying a relatively low level of the monetization of the Vietnamese economy. The banking industry is considered small in terms of deposits and loans, as contrasted to the relatively large number of banks operating nationwide, both foreign and domestic (Doang, 2000). This implies weak financial intermediation and low liquidity in the system. In his study, UNIDO, DSI and MPI (2003) reported that the country's financial system is ranked very low. This confirms the claim of Doang in his study. On the other hand, Dufhues (2003) claimed that so far, the banking reforms that were introduced and implemented until 1992 were good contributors to the strong macroeconomic performance of the country.

Eighteen (18) insurance companies and eight (8) leasing companies (three of which have joint venture arrangement with foreign investors, while five are subsidiaries of SOCBs) dominate the non-bank financial system. There are only four investment houses, two stock exchanges and one postal savings bank. The Debt and Asset Trading Company was established by the Ministry of Finance to deal with the NPL problems and insolvency in the country. Aside from the formal financial set-up in the system, there are also moneylenders and rotating savings and credit associations (ROSCAS) that provide special credit facilities to its members and other users of funds.

To date, Vietnam' financial system is in the early stages of reform and may not be considered as an efficient allocator of financial resources yet. At least 50 percent of personal savings are held as cash, gold, or other assets outside the system. However, as part of its World Bank/IMF program (Economic Analytical Unit, 2002), the government initiated a comprehensive banking reform program that relies on market-based action to ensure banking stability and promote better mobilization of domestic resources by improving allocation to commercially viable activities, and by expanding banking services throughout Vietnam. Currently, raising additional capital for its continued growth is a standing priority.

Capital Market Development

Being a centrally planned economy, capital market initiatives were geared toward the development of securities market. Unlike other securities markets in Asia, since its establishment in 2000, the country's capital market did not have any significant contribution to its economic development for the following reasons:[70]

1. It is not closely link to the monetary market.
2. Prices of the securities do not reflect performance of the enterprises.
3. Interest rates are not sensitive to those in monetary market.

Thus, enterprises rely heavily from commercial bank loans, which represent more than 60 percent of their capital requirements. Even if the bond issues were relatively large, their maturities are short and liquidity is low. In general, the corporate bond market is relatively illiquid compared to government bond issues due to lack of diversity in its investor base, market opaqueness, inadequate market microstructures, and limited flows of timely information about issuers (Gyntelberg, Ma and Remolona, 2005).

Earlier observations about the Vietnam securities market was refuted by Tho and Eddie (2003) who observed that two years since its establishment, there had been increasing liquidity for listed companies. A survey conducted among market participants revealed that its development in the Year 2010 is envisioned towards the achievement of priority

[70] This is based on a study conducted by the Ministry of Economic Planning and Central Institute for Economic Management (2004).

solutions such as the promulgation of new securities law, increase in the supply of securities, enhancement of the quality of information disclosure and market transparency and the harmonization of accounting and auditing standards with the International Accounting Standards to attract foreign investments and improve quality of disclosure. Lessons learned from other emerging economies and the current situation of Vietnam's market must likewise be addressed despite social, economic and cultural issues.[71]

There are thirteen licensed securities companies and nine of them are authorized to offer a full range of securities services including underwriting, brokerage, advisory, portfolio management and trading services. Insurance companies, banks, and individuals are the typical players in the bonds market. In line with this, the Capital Market Roadmap to build sophisticated capital markets in Viet Nam was issued by the State Securities Commission in September 2003. Development of the bond market is one of the top priorities in their agenda. To date, the main debt instrument circulating in the market is the government bond, where the Treasury Bond represents 9 percent of the exchange's total listed value; hence, outstanding issues and trading volume are relatively small. Even if the government debt is about 39.4 percent of GDP, foreign debt constitutes 37 percent of GDP.

Nonetheless, the continued lack of financial transparency and noncompliance with internationally accepted standards among Vietnamese firms posed problems in line with the government's plan to expand stock and bond markets.

Despite this reality, there were some impediments to its success:

1. Inadequacy of the legal system on securities. Even if Decree 144/ND-CP issued on November 28, 2003 already provided the legal framework for its development, issuances and dealership of securities are still controlled by many other laws with some regulations not in line with said decree.
2. Existence of entry barriers on foreign companies' participation in the security market. It is believed that more foreign participation will provide equal and transparent business environment in ensuring order in the market and in protecting legal interests of the partners in the market.
3. Lack of coordination between the State Bank and the Ministry of Finance especially in matters related to policy framework and capital market inspection and monitoring.
4. Financial infrastructure is characterized by limited technical and technological infrastructure conditions.
5. Low transparency and linkage between monetary markets.
6. Limited role of commercial banks in the operation of security market
7. Lack of commodities for the efficient operation of the market.

[71] Sourced from http://www.finsia.edu.au/cms/data/live/files/16567.pdf#search='debt%20market%20in%20vietnam

It was observed that Vietnamese investors are not aware of the existence of alternative investment options. The staff in the capital markets' institutions need further education regarding the nature of such investment alternatives (Tho and Eddie, 2003).

The regulatory body can control the market by promoting securities and security investment formation, by improving transactional methods conducive to the investors, by granting tax preferences to listed companies and by attracting more joint-stock companies to list in security market.

TABLE-VN5. Capital Market Trading for 2001-2002

<table>
<tr><th rowspan="3">Year</th><th rowspan="3">Market Cap. (VND Bn)</th><th rowspan="3">Trading Value (VND Bn)</th><th colspan="2">Listed Companies</th><th colspan="4">Listed Bonds</th><th rowspan="3">Market Cap to GDP (5)</th></tr>
<tr><th rowspan="2">No. of Listing</th><th rowspan="2">Value of Shares (VND Bn)</th><th colspan="2">Government Bond</th><th colspan="2">Corporate Bond</th></tr>
<tr><th>No. of Listing</th><th>Value (VND Bn)</th><th>No. of Listing</th><th>Value (VND Bn)</th></tr>
<tr><td>2001</td><td>1596.55</td><td>690</td><td>6</td><td>338.84</td><td>3</td><td>1100</td><td>2</td><td>157.71</td><td>0.37</td></tr>
<tr><td>2002</td><td>4145.04</td><td>1748</td><td>17</td><td>878.63</td><td>25</td><td>3108.7</td><td>2</td><td>157.71</td><td>0.92</td></tr>
</table>

Source: http://www.finsia.edu.au/cms/data/live/files/16567.pdf#search='debt%20market%20in%20vietnam

Prior to 2004, there were 11 securities companies in the Vietnam Securities Market; hence, their role was limited to financial consultancy related services to generate fee-based income (CIEM, 2004). In 2004, there were 13 securities companies and significant profits compared to 2003 level were reported.

Table-VN4 above indicates that market capitalization increased by 160 percent from a VND1.6 trillion in 2001. From a total of 6 listed companies, the listing also increased by 9 companies. In 2004, there were 26 companies listed and seventeen (17) of them reported moderate profits and additional capitalization of VND45 billion through additional stocks issuances.

Shimomoto (1999) reported that some problems can affect the country's bond market. Among these are the absence of a credit rating agency and the trading of privately placed bonds were rating is not required are traded in the stock exchanges and lack of qualified experts in the field such as traders, brokers and etc.

On the other hand, government bonds registered a total turnover of VND3.1 trillion in 2002, a significant volume especially when compared to corporate bond market performance, which represented only 5 percent of the total bond issuances. Since the bond market's capitalization was only 0.37percent of the country's GDP, it is believed that it does not provide significant contribution to the country's economy. But this figure is expected by the State Security Commission (SSC) to double or triple by 2010 in an attempt to boost stock market to mobilize and distribute middle and long-term capital for the country's growth.[72]

Chairman Tran Xuan Ha of the State Securities Committee (SSC) mentioned that the performance of the country's stock market activities in 2004 improved with an increase in the total value amounting to VND12.5 trillion, representing 93.4 percent from 2003 level and additional 20,300 new investment accounts.[73]

To meet the targets, relevant regulatory bodies must help listed companies mobilize capital aside from the measures undertaken to lure major companies to the exchange. The securities market must also lead to the development of corporate bond market. Credit rating agencies need to be established as well. Vietnam's limited stock market activities will also be open for institutional investors including commercial banks, insurance companies, securities companies and investment funds. The VietFund (VF1) has been so far the country's only institutional investor.

CIEM (2004) also suggested that financing development investment must include:

a. Increasing number, types and maturities of government securities both in the wholesale and the retail markets.
b. Enhancing decentralization for managing state budget including the goal of issuing local bonds to mobilize capital for developing socio-economic infrastructures.
c. Allowing Social Policy Bank and Development Assistant Fund to directly mobilize capital in security market.
d. Enhancing Government's capacity in managing debt, in planning state budget and in managing budget revenues and expenditures.
e. Issuing government bonds in international capital market.
f. Encouraging public listing of large enterprises and relevant state agencies to review requirements of announcement of listing information in accordance with Decree 144.

Not all officials, especially those at the provincial and local levels, are fully aware of the new laws and regulations that affect their areas of responsibility. Nor are all laws and regulations readily available to businesses and to the public.

[72] Sourced from http://www.finsia.edu.au/cms/data/live/files/16567.pdf#search='debt%20market%20in%20vietnam

[73] Sourced from http://www.finsia.edu.au/cms/data/live/files/16567.pdf#search='debt%20market%20in%20vietnam

5. VIETNAM'S ASSET MANAGEMENT INDUSTRY

The State Security Commission (SSC) was established in 1996 to regulate the securities market. Decree No. 48/1998/NP-CP was issued to serve as a legal framework for the creation of the securities market and guidelines on securities operations and Decision No. 127/1998/QD-TTg for the establishment of two Securities Trading Centers.

Given this authority, its powers must be expanded so that it can closely monitor the implementation of legal regulations on relevant issues. The SSC should also be allowed to adjust a number of legal regulations on a case-to-case basis or on relevant issues to gradually create liberal mechanism for security market.

Equitisation of some commercial banks and state corporations according to experimental statutes must be addressed soon to eliminate current legal limitations. It is necessary to ease rights of access to and participation in security market by foreign investors.[74] This will enable the government to focus on other important issues once this major activity is undertaken.

SSC's law on the Stock Market would be submitted to the National Assembly in 2006 to rationalize and strengthen its existence and increase bids for bonds of equitized companies. The Government expects to reach its targets through the restructuring of 1,500 State-owned enterprises.[75]

In 1994, the Law on Business Bankruptcy was established to set rules pertaining to Corporate Bankruptcy and provide guidelines to deal thereto. Moreover, Article 20 provides for the reconciliation plan and the solution of business reorganization that constitute:

1. Proposal for debt deferment, debt reduction, debt annulment, debt transfer, debt guarantee and other measures aimed at overcoming the insolvency of the business, commitment of the business on the term, amount and modalities of payment of due debts.
2. The measures to reorganize the business operations of the business include financial measures, reorganization of the apparatus, reorganization of labor, improvement of management, perfecting and renewal of technology and other necessary measures aimed at overcoming the insolvency of the business.

With its failure to address corporate insolvency problems, 2004 provided amendments to the existing law, which includes among others equitisation of State Owned Enterprises (SOE), sale of SOEs, NPL resolution for commercial banks and SOEs and recapitalization of the SOCBs.

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[74] Sourced from http://www.ciem.org.vn/en/asp/InfoDetail.asp?ID=636.

[75] Sourced from http://www.vnstyle.vdc.com.vn/viewDetails.asp?catId=15&PostId=20654

In the same year, the National Assembly passed a revised bankruptcy law and a Law on Competition. MPI also began drafting a Common Investment Law and revisions to the Enterprise Law, and anticipates submitting these to the National Assembly by the end of 2005 to become effective in 2006.

6. Conclusions and Recommendations:

Vietnam has emerged as a developing market in the region. As Vietnam undergoes a transition to a market-oriented economy, its legal system had changed gradually, which made the country competitive in the international arena. To date, it had expanded its financial system to respond to the needs of its people and at the same time, compete in the global market.

The outburst of the Asian Crisis did not leave Vietnam unaffected, particularly its banking system. It is the main source of information, financing and investing activities of corporate clients. A look at the financial system reveals that Vietnamese banks' nonperforming loans were mostly accounted for by State-Owned Banks (SOB). Lending activities were rationed through direct controls by government authorities.

What is sad to note is that banks are unable to compete or focus on their ability to maximize their profits by diversifying and offering more products and services. Both private and government banks NPL problems can be attributed to poor financial infrastructures related to credit, accounting and auditing standards, regulatory and supervisory framework and other factors. The financial viability of these State-Owned Enterprises already must give an impetus for the government to re-evaluate its policy regarding directed lending. Hence, efforts must be redirected towards providing mechanism for growth and stability in the system. Along with this, monetary policies must be reviewed and defined more clearly in the SBV's law. This would also curtail the growth of non-performing loans and improve the current state of the country's financial system.

Substantial progress in the financial system must be introduced towards the development of the capital market, while in its infancy stage. It can emerge as a good forum for financial market or asset management industry's development. Hence, a careful appraisal of the existing capital market and how the country can move forward can be undertaken to pursue its objectives in opening itself in the international markets.

The firm commitment to these measures requires the government and businesses to have a longer-term vision, concentrating the maximum efforts on overcoming short-term challenges, no matter how great they are, the success in this mission is vital for the medium and long-term prospect of the Vietnamese economy.

Strengthening the financial and banking system must be pursued vigorously by allowing state-owned commercial banks, which form the core or are the forerunners of the current banking system, to operate on full market basis, free from the dictates by the government for directed credit and to be more accountable for their own decisions.

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