

# NON-PERFORMING LOANS

## IN EAST ASIA AND THE PACIFIC

Practices and Lessons in Times of COVID-19



**WORLD BANK GROUP**  
Inclusive Growth & Sustainable Finance  
Hub in Malaysia

OCTOBER 2021



Ministry of Economy  
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# Abbreviations and Acronyms

AFC	Asian financial crisis
AMC	asset management company
AQR	asset quality review
ASEAN	Association of Southeast Asian Nations
BCBS	Basel Committee on Banking Supervision
BPS	Business Pulse Survey
CDRAC	Corporate Debt Restructuring Committee
COVID-19	Coronavirus disease 2019
DTI	debt to income
EAP	East Asia and the Pacific
ECB	European Central Bank
FSAP	Financial Sector Assessment Program
FSI	Financial Soundness Indicators
FSM	Federated States of Micronesia
GDP	gross domestic product
GFC	global financial crisis
HAMP	Home Affordable Modification Program
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
KAMCO	Korea Asset Management Corporation
LTV	loan to value
LGFVs	local government financing vehicles
MSMEs	micro, small, and medium enterprises
NPA	non-performing asset
NPL	non-performing loan
PICs	Pacific Island Countries
SBV	State Bank of Vietnam
SFS	Standard Financial Statement
SMEs	small and medium enterprises
SOB	state owned bank
SOE	state owned enterprise
SPV	special purpose vehicle
UTP	unlikeliness to pay
VAMC	Vietnam Asset Management Corporation
VAT	value-added tax
WU	workout unit

Throughout this report, geographic groupings are defined consistently with other World Bank publications, as follows:

**Developing East Asia and the Pacific** consists of Cambodia, China, Indonesia, Lao People's Democratic Republic (PDR), Malaysia, Mongolia, Myanmar, Papua New Guinea, the Philippines, Thailand, Timor-Leste, Vietnam, and the Pacific Island Countries.

**The Pacific Island Countries** comprise Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Nauru, Palau, Samoa, the Solomon Islands, Tonga, Tuvalu, and Vanuatu.

The **ASEAN-5** consists of Indonesia, Malaysia, the Philippines, Thailand, and Vietnam.



# Executive Summary and Key Conclusions

## Executive Summary and Key Conclusions

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**Authorities in East Asia Pacific (EAP) jurisdictions have adopted a battery of fiscal, monetary, and financial measures aimed at mitigating the unprecedented impacts of the COVID-19 pandemic on the economy.** Governments have provided funds and guarantees to borrowers, either directly or by channeling public funds through financial institutions. Authorities provided some degree of regulatory relief to financial institutions to keep the flow of credit to the economy. They have also adjusted elements of the financial infrastructure to better accommodate the challenges arising from the COVID-19 crisis.

**This report discusses the quality of loan portfolios in the banking sector of EAP jurisdictions and the main vulnerabilities surrounding credit markets that may negatively impact the credit quality of banking portfolios and amplify the effects of the COVID-19 crisis.** Non-performing loans (NPLs) came down substantially following the Asian financial crisis (AFC), remaining relatively low in most EAP countries. However, before the outbreak of the pandemic, NPLs in some EAP countries had been increasing slightly, highlighting existing vulnerabilities in banks' credit portfolios. Although EAP financial systems continue to have strong buffers, the pandemic is hitting lenders hard, with market analysts forecasting material credit losses once the full impact of the crisis on the banking sector materializes. Even though much of the data related to borrower relief measures is not public, loans restructured in response to the pandemic represent a significant proportion of segments of banks' loans books. In some jurisdictions, they affect more than half of loans to the hospitality and tourism sector.

**Most EAP countries entered the pandemic with solid capital and liquidity buffers built up following the global financial crisis (GFC).** However, more than one year later, there is a risk that for a significant number of borrowers, short-term payment challenges may become longer-term financial difficulties that translate to higher levels of NPLs. A close monitoring of the credit quality of banking loan portfolios is therefore warranted.

**If NPLs are left unaddressed, they could have harmful feedback effects on the banking system and the real economy.** Increasing credit risk and rising NPLs have become critically important in the context of the COVID-19 crisis, with a significant potential for material negative consequences if these issues are not addressed. Much research has been conducted on the relationship between elevated and unresolved NPLs and the severity of post-crisis recessions, with the literature identifying a set of pre-crisis predictors of NPL problems related to weak macroeconomic, institutional, corporate, and banking sector conditions.<sup>1</sup> The vast majority of crises have been characterized by elevated NPLs, with countries with higher pre-crisis GDP per capita (which may proxy institutional strength) and lower corporate leverage being less likely to experience elevated NPLs during a crisis. Better ex-ante macroeconomic, institutional, corporate, and banking sector conditions and policies can help reduce NPL vulnerabilities during a crisis. Moreover, reliable NPL data are vital for effective monitoring and for the formulation of evidence-based NPL resolution policies.

**Experiences in the aftermath of the AFC, and more recently the GFC, show that many countries were affected by a legacy of high NPLs, which underscores the need for a quick and comprehensive policy response.** While the context under COVID-19 is different, lessons can be learnt from the experience of increased NPLs in some European countries after the GFC. The GFC initially hit the region through a sudden decline in capital flows, exposing the vulnerabilities that had built up in many countries. In the worst-affected countries, credit growth went into reverse, asset and real estate booms went bust, and economic growth stalled. Reflecting widely held views that the downturn would be short-lived and transient losses would be naturally recouped over time, policymakers and bankers were slow off the mark in responding to the rising pressures on asset quality (FinSAC 2021).

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<sup>1</sup> Ari, Chen, and Ratnovski (2019) offer a detailed discussion on available research regarding the role of NPLs in banking crisis.

**In addition, there are risks for countries facing a significant increase in NPLs when there are profound weaknesses in the enabling environment.** Lessons from prior financial crises indicate that potential difficulties can manifest from these weaknesses. For instance, weaknesses in the enforcement of creditor rights can introduce uncertainty regarding ultimate recovery prospects due to unpredictable and time-consuming court decisions. Even if banks were to aggressively initiate legal enforcement measures with non-viable borrowers, the eventual recovery prospects would be low and highly uncertain due to the poor functioning of the overall credit enforcement environment. Rather than forcing such borrowers towards an orderly exit, banks often resorted to questionable loan restructuring practices, keeping non-viable borrowers afloat through a mixture of low interest rates, long grace periods, bullet payments, and frequent rescheduling. While from an individual bank's perspective, this is a rational course of action, at the macro level, it locks up the credit stock in underperforming sectors of the economy at the expense of more dynamic sectors. Put differently, it has the potential to result in a misallocation of capital that could present a serious risk to economic recovery.

**The policy response to the pandemic has visibly intensified the interdependencies between sovereigns, banks, and firms, creating a “sovereign-bank-corporate” nexus (ECB 2021).** Without the forceful responses of fiscal, monetary and prudential authorities, the economic and social costs of the pandemic would have been significantly higher. EAP governments committed to fiscal support equal to nearly 10 percent of GDP in 2020 and a multifaceted array of social protection responses,<sup>2</sup> and have stabilized aggregate demand and incomes by absorbing the economic and financial risks of the private sector as the crisis unfolded. Through the generous issuance of guarantee schemes, governments secured a continuous flow of credit to firms, which supported economic growth and protected financial stability. Monetary policy has complemented these efforts by providing ample liquidity and restoring favorable financing conditions.

**However, some sovereigns are more exposed to the risk of a spike in interest rates, a sudden loss of access to funding, and disappointing GDP growth.** Current benign conditions in the financial markets reflect massive liquidity injections and backstops from central banks, huge fiscal stimulus initiatives to sustain demand, and an assumption of economic recovery from the pandemic next year. A deterioration in market conditions would likely damage comparatively weak sovereigns (S&P Global ratings 2021b). While some pandemic-related fiscal measures will likely expire in 2021, budget deficits are set to remain well above pre-pandemic levels. Although sizeable budget deficits have been essential to tackle the crisis, identifying the appropriate exit strategy could be even more challenging than after the GFC (IIF, 2021). Political and social pressure could limit governments' efforts to reduce deficits and debt, jeopardizing their ability to cope with future crises.

## **NPLs before the COVID-19 pandemic and its effects in EAP**

**In EAP, the private sector credit to GDP ratio is among the highest in the world, with many jurisdictions having experienced continuous credit growth and an expansion of financial systems following the AFC.** Although nominal figures for NPLs rose significantly in many EAP countries, for most of them the NPL ratio decreased after the GFC at least until 2013. Nevertheless, even prior to the COVID-19 crisis, NPL ratios masked material weaknesses in several areas, with the potential to materialize as credit losses. Following the advent of the COVID-19 crisis, NPL ratios in almost all EAP countries increased in 2020 and early 2021, although in many cases, the increase has been cushioned by the special policy measures adopted by many national authorities. Some variations existed across subgroups of countries, noted as follows: High-income economies, such as Korea and Singapore, recorded relatively low NPL ratios while developing economies displayed greater volatility.

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<sup>2</sup> World Bank Group (2021). Uneven Recovery. World Bank East Asia And Pacific Economic Update, April.



- In China, NPLs rose marginally from 1.8 percent in 2019 to 1.9 percent in the third quarter of 2020, and dropped again to 1.8 percent in the first quarter of 2021 contained by the battery of measures adopted by the authorities to deal with the impacts of the pandemic.
- Larger increases were recorded in the Philippines, where NPLs rose from 2.0 percent in December 2019 to 4.2 percent in Q1 2020, among the highest level in ASEAN-5, along with Thailand, where NPLs increased minimally to 3.2 percent in Q1 2021.
- NPL ratios increased sharply in Singapore (from 1.3 percent at the end of 2019 to 2.4 percent in Q1 2021) and Vietnam (from 1.5 percent at the end of 2019 to 2.1 percent in Q3 2020), albeit from a very low base.
- NPL ratios also increased in Papua New Guinea (from 3.8 to 6.1 percent), Palau (0.7 to 1.6 percent), and Tonga (3.2 to 3.7 percent). However, these ratios are still well below those of other Pacific Island Countries (PICs) such as the Solomon Islands and Vanuatu, which had smaller increases over the period but higher overall NPL levels, at 7.9 percent and 17.3 percent respectively.

**Authorities in EAP provided moratoria and temporary relief measures for borrowers to minimize the effects of the pandemic, with the materiality of the banks' portfolios that have been restructured varying across banks and economic sectors.** The amount of loans under moratorium has declined in most markets with the ending of strict lockdowns. In China, at the end of December 2020, while restructured loans accounted for 4 percent of total loans, they constituted 17 percent of loans to micro, small and medium enterprises (MSMEs). In Indonesia, larger corporations experienced more loan restructuring, with more than 31 percent of loans to large corporations having been subject to such measures. In Malaysia, 11 percent of household loans and 17 percent of total business loans have been under repayment assistance, with a significant impact in some economic sectors heavily hit by the pandemic (e.g. 52.8 percent of loans in the hotel and restaurants sector have been restructured).<sup>3</sup>

<sup>3</sup> Data and data sources are detailed in Table 3.

## Recognition of Problem Loans in EAP Countries

**While in some EAP countries, household debt is a key source of vulnerabilities, in others it relates to corporate debt, with the EAP region experiencing the highest level of corporate balance-sheet vulnerabilities of all regions in 2020.** Material vulnerabilities observed before the advent of the COVID-19 crisis in some sectors have the potential to seriously affect NPL ratios. The pandemic has introduced additional pressures and uncertainty on whether such vulnerabilities may materialize, challenging the resilience of the banking sector and its ability to absorb credit losses. Banks' exposure to commercial real estate and to the dynamics of the real estate market more generally is a source of concern in many EAP countries. Low levels of financial development and structural weaknesses influence the NPL ratios in the PICs. Finally, practices in some EAP countries raise questions about the actual amount of NPLs.

**The definition of NPLs is heterogeneous across EAP countries and not necessarily aligned with international standards.** The EAP countries that have asset classification systems set regulatory minimum levels of provisions for each classification. However, provisioning percentages for each past-due classification vary across jurisdictions. Macroprudential tools (such as macro stress testing) are used by many countries in EAP to address vulnerabilities in credit risk.

## The enabling legal environment and instruments for NPL resolution

**The COVID-19 pandemic has challenged the ability of borrowers to service their loans and to meet their obligations, which underscores the need for appropriate and effective tools to manage NPLs and deal with firms that may not survive.** Several instruments, both on and off- balance sheet, are typically employed to resolve NPLs. These instruments can include:

- (i) loan restructuring;
- (ii) legal recovery, including through collateral enforcement and the initiation of insolvency procedures vis-à-vis the borrower;
- (iii) write-offs; and
- (iv) sales to third parties, including selling to investors, securitization, and sales to AMCs.

These channels are not mutually exclusive, and they are often combined and utilized in a specific order (FinSAC 2021, FSI 2017). In selecting the appropriate NPL reduction channel, banks should be guided by the expected net present value for each of these options.

**Effective insolvency regimes are equally essential for NPL resolution.** Efficient procedures to enforce collateral are critical, for instance for the resolution of mortgages, with the need for actions that provide for prompt realization of the rights obtained in secured assets, ensuring the maximum recovery of asset values based on market values. Experience in dealing with crises suggests that a multi-staged approach can be effective in dealing with insolvencies during a crisis. In the first stage of the crisis, it is important to "flatten the curve" of insolvencies and to use relief measures to prevent viable firms from being forced prematurely into insolvency. In the second stage, the challenge is to respond to the growing number of firms that need an insolvency process to survive. Finally, the third stage will require a focus on people coping with personal financial distress in the aftermath of the crisis. However, even in countries with a strong legal framework, there may be considerable challenges in implementation. Given that firm insolvencies are expected to rise, it could put further pressure on already weak implementation capacity.

## Challenges for financial sector policymakers in the context of the COVID-19 crisis

**Financial sector policymakers are faced with an exceptional set of circumstances that underline the need to achieve a balance between micro-prudential objectives of safety and soundness and the macro-prudential goal of system-wide resilience.** Financial sector policymakers in EAP and international standard setters responded quickly to the pandemic, emphasizing flexibility in the application of accounting and regulatory standards for the treatment of potentially impaired loans. This enabled banks to reduce the extent to which non-payments of interest and principal feed through to higher provisioning and higher capital weightings, thereby reducing the adverse impact on regulatory capital ratios. However, these exceptional regulatory relief measures created significant challenges for supervisors in assessing the risk profile of banks and their financial health.

**It is crucial that financial sector policymakers ensure that the extraordinary COVID-19 forbearance measures are used to extend credit to viable businesses and households that are temporarily affected by the pandemic to sustain the economy and to maintain financial stability.** The intention of the COVID-19 forbearance measures is not to promote an environment where banks inappropriately lower their lending standards, resulting in a credit risk buildup in the medium to long term.

**One year after the outbreak of the pandemic, financial sector policymakers face the challenge of unwinding the extraordinary borrower relief measures they implemented.** The general principle should be to unwind them as soon as circumstances permit. In many jurisdictions, this means that the exceptional measures should be wound down in a gradual manner. While the borrower relief measures have helped to reduce pressures on banks' capital, further extensions can be associated with a negative impact on banks' liquidity and profitability, with the relief measures bands translating into a potentially significant reduction on cash flows and overall earnings on banks' loan books.

**Moreover, financial sector policymakers are challenged by the fact that any additional policy response should minimize the extent of moral hazard and maintain adherence to sound credit risk management practices.** Policy responses should be time bound, have clear sunset clauses and exit strategies, and should be targeted to ensure that they only benefit viable borrowers. While loan forbearance is acceptable and within the guidelines set by international standards, forbearance in general is not, given that it has the potential to expose the banking system to significant risk, particularly for jurisdictions with preexisting vulnerabilities.

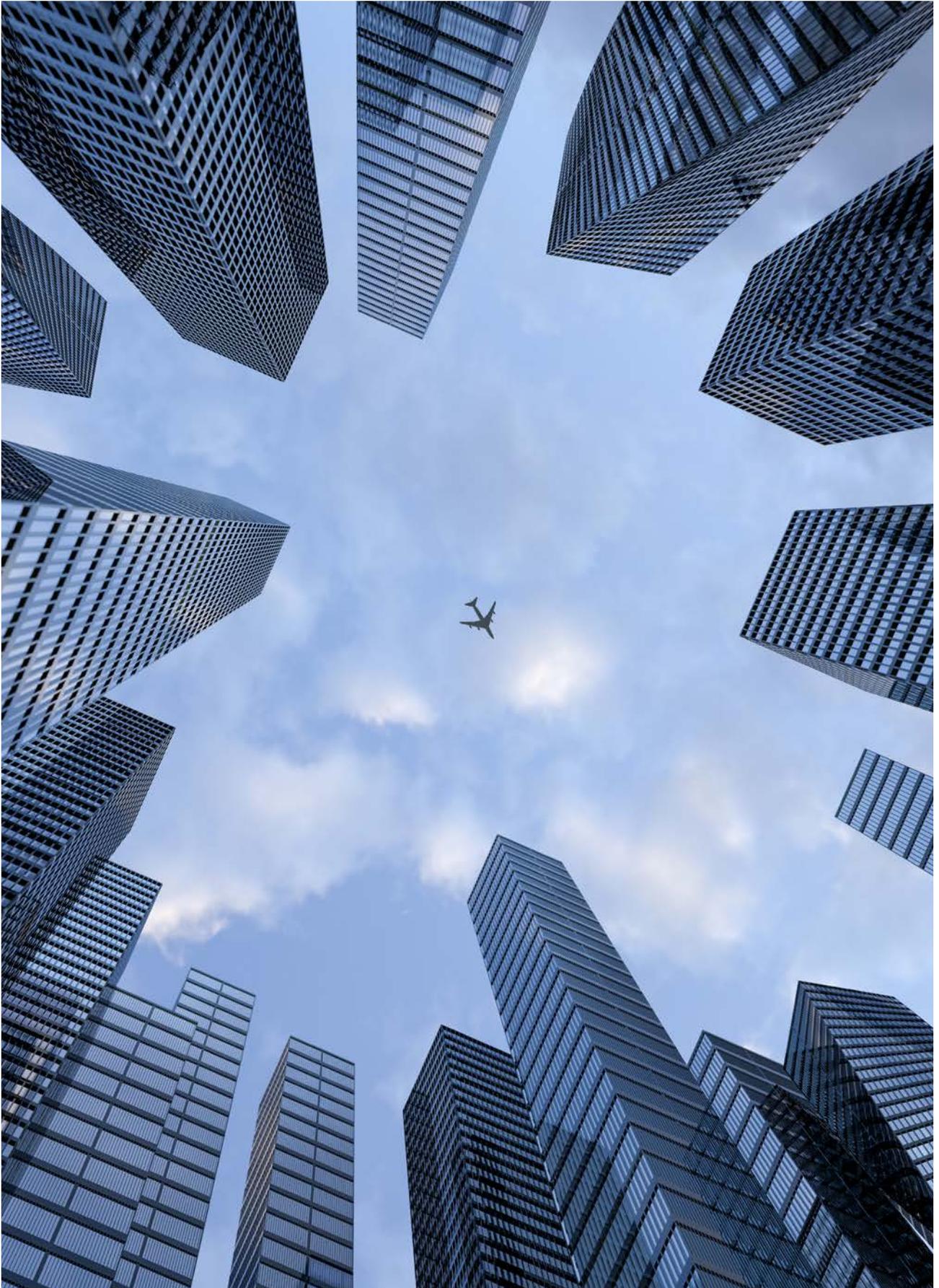
**Supervisors need to understand the implications of the current accounting and regulatory requirements and the interactions between them.** This is not always straightforward, particularly at a time when many countries in EAP are transitioning to IFRS 9 or similar forward-looking approaches to expected credit losses and are seeking to align accounting standards and prudential requirements. Attention is required to address longer-term, more structural challenges, such as the sustainability of banks' business models and the intensified use of new technology in financial services.

## Conclusions and recommended actions for managing NPLs in EAP

**There are three main considerations when looking at NPLs in EAP. First, a meaningful analysis of non-performing exposures in EAP requires considering not only the NPL ratios but also complementary information to address the emerging risks arising from underlying vulnerabilities.** For example, given the existing forbearance measures, it is critical also to closely monitor and perform horizontal reviews of more forward-looking measures of asset quality, including restructured loans and 'loans at risk.' Second, NPL ratios in EAP do not necessarily capture the full spectrum of non-performing exposures because of regulatory arbitrage and poor oversight. Third, trying to compare NPLs across EAP could be misleading, because the internationally accepted guidance for NPLs and forbearance by the Basel Committee on Banking Supervision (BCBS) has not yet been adopted by all countries. Material differences exist across the EAP that call for the adoption of the harmonized definitions of the BCBS. The adoption of the international standards for the definition of problem loans will strengthen national definitions; enhance comparability across countries; and, most importantly, provide policy makers and analysts with more transparent information to take timely and appropriate action.

**Given the magnitude of corporate debt in some EAP countries, a range of policy tools should be in place to deal with firm insolvencies that could materialize due to the COVID-19 crisis, such as adequate frameworks to deal with the firms' restructuring and insolvency.** Similarly, to address asset quality deterioration due to the impact of the crisis on households' debt service capacity, countries could implement mechanisms for consumer bankruptcy. These will guide banks regarding procedures to be followed in such insolvencies and to set realistic expectations regarding potential loan resolution and recoveries. Given that banks in some EAP countries are severely exposed to the real estate market, effective procedures to deal with prompt resolution of real estate collateral are also essential for effective resolution. In the EAP countries where lending to SOEs is material, countries will benefit from removing regulatory incentives that promote an uneven playing field against private firms and that benefit SOEs, such as excessively relying on government implicit guarantees of SOEs.

**Regarding the borrower relief measures adopted in response to COVID-19 in EAP, credible exit strategies are critical and need attention.** Effective and early workout and resolution of NPLs are central to avoid loss of confidence in the banking system and to ensure that bank lending continues to support growth. The framework for AMCs in some of the EAP jurisdictions should be adjusted where necessary by restricting funding to zombie borrowers or to avoid AMCs being just an indefinite warehouse for NPLs.





## CHAPTER 1

# Introduction

# Introduction

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**The global COVID-19 pandemic and its associated impact on economies around the world merits a closer monitoring of the credit quality of banking loan portfolios in East Asia Pacific (EAP) countries.**

Even prior to the pandemic, the international community discussed the potential effects of sluggish gross domestic product (GDP) growth in some EAP economies on the credit quality of banks' portfolios. The cooling of economic growth observed in the EAP in the pre-COVID-19 period, together with material vulnerabilities affecting credit markets, was at the core of the declining credit quality of banks portfolios in the region prior to the outbreak of the pandemic.<sup>4</sup> While the proportion of NPLs in banks' portfolios had declined substantially in the period following the AFC and remained moderate in most of jurisdictions, an upward trend in the proportion of NPLs in some of the EAP economies prior to the pandemic already suggested a need for closer monitoring.

**The relevance of increasing NPLs has become even more pressing in the current context, given that a further increase in NPLs is expected as a consequence of the COVID-19 crisis, based on the lessons of past episodes** (Ari, Chen, and Ratnovski 2019). High and increasing NPL levels typically reflect weak economic conditions and poor health in some dimensions of the banking system. If NPLs are left unaddressed, they could have harmful feedback effects on the banking system and the real economy. Research in EAP countries reveals that both macroeconomic indicators and banking specific variables play a key role in explaining the changes in NPL ratios (Park 2019). A shock to the NPL ratio decreases GDP growth and credit supply and increases unemployment. A buildup in NPLs can result in macro financial feedback effects, with possible spillover effects in increasingly interconnected financial markets.

**In the EAP, the COVID-19 pandemic is hitting lenders hard, leading market analysts to estimate material credit losses.** At the beginning of 2021, the updated market forecast for increases in bank credit losses due to the COVID-19 pandemic stood at US\$ 581 billion for the period 2020-2022. Compared with the credit losses recorded in 2019, which stood at US\$ 329 billion, the potential for credit losses in the current period is significantly higher (S&P Global Ratings Asia 2021). This is contributing to negative pressures for many banks in the region. The provision of fiscal support and regulatory forbearance have contained much of the damage, but downside risks remain, particularly as these programs wind down.

**However, the EAP region's past experiences with the AFC and the implementation of post GFC regulatory reforms (Basel III)<sup>5</sup> has meant that macroeconomic reforms in many countries were accompanied by financial sector strengthening to mitigate the buildup of systemic risk.** Prudential regulatory reforms led to the establishment of higher capital buffers across the system. The reforms improved the quality of bank regulatory capital and increased the minimum capital requirements to ensure banks are sufficiently resilient to withstand losses in times of stress. Hence, most banks in the EAP region entered the pandemic on a strong footing, and EAP supervisors adopted more intrusive supervision for systemically important banks.

**The authorities' provision of support is contributing to the resilience of the banking sector. Fiscal and monetary policy support and regulatory forbearance are providing significant buffers, with many EAP banks having strong earning capacity, which cushions the impact from higher credit losses.** The impact of the COVID-19 crisis on the banking sector has yet to fully materialize. As government support measures, loan moratoria and guarantee schemes begin to expire or are withdrawn, banks will start to feel the full impact of the economic shock. When such measures are phased out, corporate insolvencies are likely to increase, with bank customers finding it more difficult to repay their loans. This is likely to lead to

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4 The topic of NPLs in EAP has been addressed by the World Bank as part of the continuous dialogue with the EAP clients and at the April 2019 regional conference, "Non-Performing Loans Resolution," hosted by the Malaysia Knowledge and Research hub.

5 Basel III is an internationally agreed set of measures developed by the Basel Committee on Banking Supervision in response to the GFC. The measures aim to strengthen the regulation, supervision and risk management of banks.



a higher proportion of NPLs on bank balance sheets. In turn, this will create a need for higher provisions, generate losses, and put pressure on banks' lending capacity and their already structurally low profitability.

**A more severe or prolonged economic impact would intensify the damage on households and businesses, thereby magnifying credit losses.** Moreover, higher corporate and government sector leverage, and anticipated higher corporate defaults in 2021, are also among the most significant risks. Any disorderly asset price correction would heighten asset quality problems (S&P Global Ratings Asia 2021). In addition, many banks in EAP have significant property exposures. Households and businesses may struggle to meet financial their obligations after loan moratoriums and government support end, hitting banks' asset quality. Subdued interest margins remain, given persistently low interest rates.

**While bank earnings are expected to improve after the economic recovery, a return to pre-COVID-19 levels is not expected at least until the end of 2022 for some banking systems, and possibly longer for others** (S&P Global Ratings Asia 2021). In this context, the continued provision of short-term support by public authorities will have a stabilizing effect on bank credit. Further, analysts expect that many systemically important banks would receive extraordinary government support, if it is required.

**The sooner NPLs are identified and provisioned for, the faster and smoother the resolution and disposal process for these NPLs will be, enabling authorities to avert the damaging effects of future debt hangovers.** Targeted forbearance and timely debt restructuring initiatives could maximize value recovery. By contrast, failure to implement these measures is likely to lead to higher bank losses later. Recognizing losses only when public support measures expire increases the possibility of cliff effects, diminishing banks' capacity to create value after the pandemic. Procyclicality will ensue and probably be amplified.

**This report discusses the quality of loan portfolios in the banking sector of EAP countries and the main vulnerabilities surrounding credit markets that, in turn, may impact the credit quality of banking portfolios and amplify the negative effect of the COVID-19 crisis.** By analyzing NPLs, this report identifies the main vulnerabilities existing in certain sectors, market practices, and the legal and regulatory framework, all of which may have significant effects on the NPLs if they materialize. This report also reviews the definitions of NPLs and the provisioning practices in the EAP and the effect they have on the recognition of losses and the amount of reported NPLs. It also provides a concise review of the relief measures for borrowers implemented by the authorities in response to the COVID-19 pandemic in the context of the recommendations of international financial organizations and global standard setters. This report also reviews the legal enabling environment for the resolution of NPLs in the EAP and instruments available to resolve NPLs. Then, it discusses key challenges faced by financial sector policymakers in the context of impaired loans portfolios. Finally, this report provides some key recommendations for the effective management in response to the buildup of NPLs.

**The weaknesses discussed throughout this report related to the identification, recognition, valuation, and provisioning of NPL can be grouped under the common denominator of “implicit credit risk.”**

This denomination refers to the credit risk that may arise and is not captured by reported NPL ratios. The presence of implicit credit risk means that banks may not be provisioning for credit losses to the extent that they should and therefore, that banks’ capital adequacy ratios are not appropriate measures of solvency strength. Failure to recognize this may constrain timely supervisory action in relation to weak banks and could ultimately undermine public trust in the banking system. In addition, it is highly unlikely that major progress will be made in cleaning up NPLs if initiatives to do so are based on asset quality indicators that paint a misleadingly reassuring picture.

**This report is organized as follows:** Section II sets the framework and discusses trends in credit growth and credit quality in EAP in the pre-COVID-19 context and in the months following the outbreak of the pandemic. This section also identifies the key vulnerabilities affecting credit quality in EAP jurisdictions that could potentially result in increased NPLs. Section III discusses the definitions of NPLs and the provisioning practices in the EAP and the exceptional borrower-relief measures implemented by authorities in the EAP in response to the pandemic, comparing them with recommendations based on international good practice. Section IV discusses the enabling legal environment for NPL resolution in EAP, and Section V analyzes the instruments available for NPL resolution. Section VI summarizes the key challenges faced by financial sector policymakers in the context of the pandemic. Finally, Section VII presents the key conclusions, with recommendations for the effective management in response to a buildup of NPLs in the current context and into the future.



**CHAPTER 2**

# **NPLs in EAP: The Pre-COVID-19 Context and the Effects of the Pandemic**

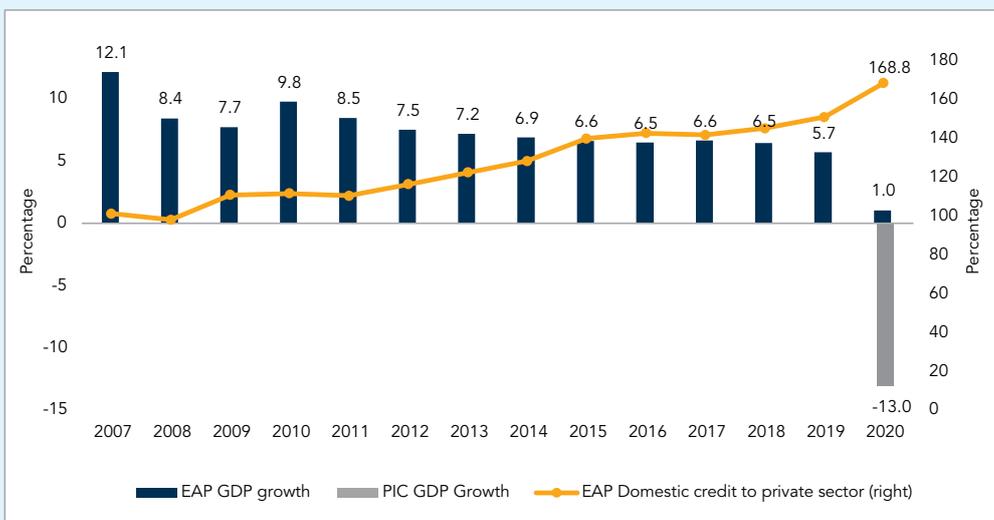


## NPLs in EAP: The pre-COVID-19 context and the effects of the pandemic

### a. Trends in credit growth and credit quality in EAP

The EAP has been one of the key engines of the world economy over the past couple of decades, with strong rates of GDP growth accompanied by growing financial deepening (see Figure 1). Nevertheless, even prior to the outbreak of the COVID-19 pandemic, economic growth had been decelerating, with this deceleration influencing the credit quality of banks portfolios. Conceptually, both strong and weak GDP growth are significant for the quality of banking loan portfolios, for different reasons. On the one hand, weaker macroeconomic conditions may predict higher NPLs as a consequence of their adverse impact on borrowers’ wealth and debt service capacity. On the other hand, when GDP growth is high and accompanied by soaring credit growth, it may reflect a credit boom with lower credit quality, leading also to higher NPLs (Ari, Chen, and Ratnovski 2019).

**FIGURE 1 : Developing EAP’s GDP growth (annual percentage) and credit to GDP (percentage)**

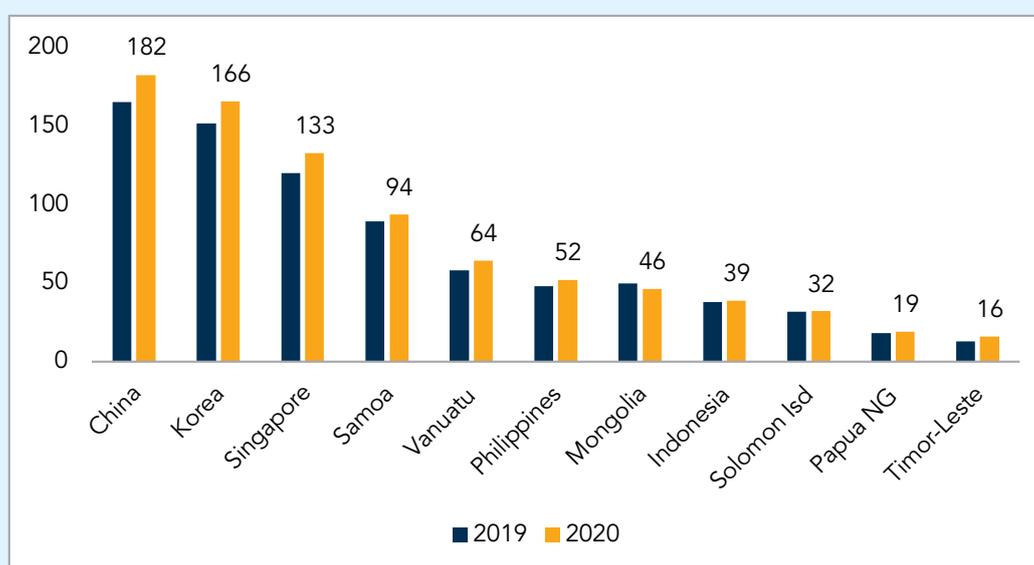


Source: World Bank, World Development Indicators updated June 30, 2021.

Note: EAP = East Asia and the Pacific; PIC= Pacific Island Countries; GDP = gross domestic product.

**The deceleration of GDP growth in the EAP in the years prior to the outbreak of the COVID-19, together with the vulnerabilities observed in some sectors, has raised questions related to the sustainability of credit growth and the quality of loan portfolios.** With the deceleration of GDP growth in recent years, financial deepening measured in terms of the ratio of credit to GDP has been growing slowly. Around the world, the EAP was the first region affected by the COVID-19 pandemic, although with countries within the region affected unevenly. GDP growth in the small PICs, has been hit hard by the COVID-19 crisis, especially due to their dependence on tourism revenue. The developing countries of the EAP (excluding the PICs) are forecast to grow, basically driven by positive GDP growth in China in 2020 (World Bank 2020c). However, pre-existing country-specific vulnerabilities could amplify the effect of the pandemic on both the banking sector and the real economy. In the EAP, the credit-to-GDP ratio has been increasing for years, going up by around 50 percent in the period from 2007 to 2019. Interestingly, the ratio of credit to GDP increased in some EAP jurisdictions in 2020, especially due to exceptional policy measures implemented by authorities to sustain the flow of credit to the private sector (see Figure 2).

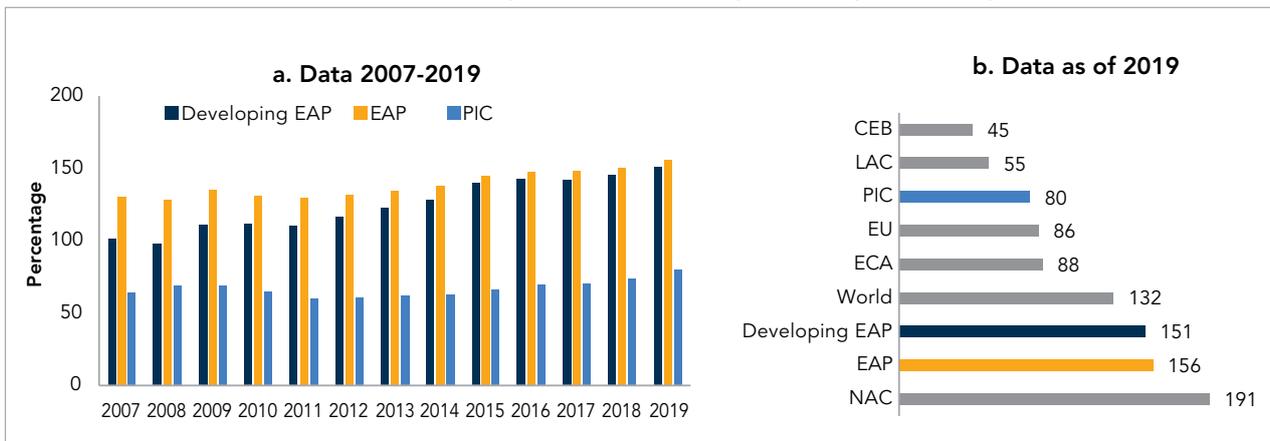
**FIGURE 2 : Credit to GDP ratio post-COVID-19 in selected jurisdictions (percentage)**



Source: World Development Indicators, updated June 30, 2021.

**Given the materiality of the banking sector for the real economy, the credit quality of banks' portfolios is of particular importance in EAP.** Before the outbreak of COVID-19, the ratio of credit to the private sector to GDP in the EAP region reached 156 percent in 2019 (see Figure 3a). In fact, the ratio in both the developing EAP and the EAP were amongst the highest in the world (see Figure 3b). This highlights the importance of preserving a healthy banking sector in these economies, as poor credit quality and banking failures may lead to significant losses for the real economy. Nevertheless, the region is heterogeneous, with diversity in country behavior. Financial deepening was noticeably lower in the PICs, with a ratio of private sector credit to GDP of 80 percent, a consequence of less developed financial systems and the structure of these economies.

**FIGURE 3 : Domestic credit to private sector as percentage of GDP pre-COVID-19**

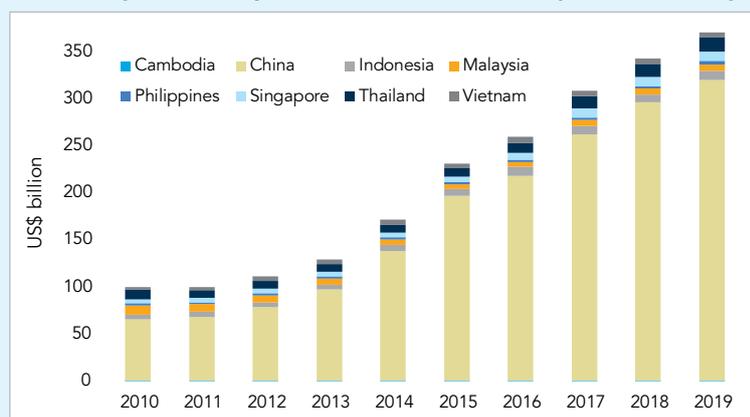


Source: World Bank, World Development Indicators, updated June 30, 2021.

Note: CEB= Central Europe and the Baltics; EAP = East Asia and the Pacific; ECA = Europe Central Asia; EU =European Union; LAC = Latin America and the Caribbean; NAC = North America; PIC =Pacific Island Countries. Developing EAP excludes high-income countries.

**With continuous credit growth and the expansion of financial systems, nominal figures for NPLs have also increased significantly in many of the EAP countries in the years before the outbreak of COVID-19** (see Figure 4). China contributed to by far the greatest proportion of NPLs, accounting for more than 85 percent of the gross NPLs (US\$ 320 billion of US\$ 371 billion) for this group of economies at the end of 2019. The jurisdictions with the highest percentage growth in nominal amounts over the period from 2010 to 2019 are Cambodia and China. Only Malaysia appears to be in a better position in these terms compared to 10 years ago, with a decrease of 31 percent in the nominal amount of NPLs over the period 2010 to 2019. While the nominal value of NPLs is an indicator of the size of distressed assets, it is also important to monitor the NPLs as a ratio to total portfolio, together with the buffers existing to absorb losses, namely provisions and equity.

**FIGURE 4 : Non-performing loans in selected EAP jurisdictions pre-COVID-19**



Source : Bank for International Settlements and World Bank staff calculations.

**In recent years, the growing amount of NPLs in EAP has presented opportunities for investors looking toward global markets.** Following the GFC, while NPL portfolio sales largely focused on the European markets, those markets cooled in 2019 due to measures taken by European banks and regulators to bring NPL levels down. Thus, investors have been looking toward global markets, with the NPL stock held by Asian banks presenting a sizable opportunity (Deloitte 2020). In particular, the continued growth of NPLs in China has provided investors with an opportunity to increase their share in this market (see Box 1). During the first nine months of 2020, 1.73 trillion yuan of NPLs were written off Chinese banks’ balance sheets, mostly through selling to third-party distressed debt managers. As a result, lenders disposed of 2 trillion yuan of NPLs in 2019 (S&P Global 2020).

**Box 1:**

## NPL sales in EAP: An opportunity for global investors

In **China**, foreign investor interest has increased in recent years, with a number of high-profile buyers entering the market. With increased NPL volumes and an improving landscape for overseas investors, there has been an increase in foreign buyer activity. A number of international investors have acquired subsequent portfolios, typically focusing on the coastal provinces of China, particularly Jiangsu, Zhejiang, and Guangdong. Access to an established and experienced domestic servicer has been key to successful NPL investment. Foreign buyers look to establish strong local servicing capabilities to support their expansion. Some investors are establishing their own in-house teams, while others have chosen to develop local partnerships.

The opportunity for international investors basically lies in the secondary market, which represented 44 percent of the total NPL volume transacted in 2018. However, these are predominantly smaller transactions, with 62 percent of assets being sold to local investors in more than 2,700 transactions, with an average deal size of under CN¥90m (US\$ 13 million), compared with the 24 portfolios sold to foreign buyers, worth a total of CN¥17bn (US\$ 2.5bn), with the former representing just 4 percent of the secondary market.

In **Indonesia**, the majority of NPLs are held by the country's state-owned banks, which are restricted in their ability to dispose of NPLs at a discount. This regulation continues to be a key factor limiting the number of loan portfolio sales. Activity has increased since the widely publicized divestment by Permata Bank of an Rp6.5 trillion corporate loan portfolio in 2017 to a consortium of CarVal and Macquarie. While this deal has highlighted the challenges for debt holders to enforce on difficult borrowers, it has also provided a case study for investors, demonstrating that portfolio trades can be executed successfully in the country.

In **Thailand**, the NPL portfolio market is the most mature in South East Asia. The market has been growing over recent years, with regular sales from the largest banks. One of the country's two largest buyers of NPLs estimates over ฿100 billion (US\$ 3.5 billion) is marketed annually. Portfolios coming to market are significantly multi-tranched, catering to the large number of smaller local buyers. However, this is likely to change as the market attracts more foreign investors to its mix of capital providers. With the establishment of servicing operations, larger foreign investors are becoming more active and are taking market share from local incumbents in terms of both portfolio and single asset positions. While residential mortgages continue to represent a significant proportion of the NPLs sold, an increasing number of real estate-backed SMEs NPLs have been brought to market recently.

In **Malaysia**, there has been a steady stream of small-scale clear-outs of legacy unsecured stock, much of which has already been written off. Buyers tend to come from the debt collection or servicing community, including the regional unsecured debt specialist Collectius, which announced three Malaysian acquisitions in 2018. A notable exception to this was AmBank's NPL disposal to Aiqon-controlled SPVs in early 2019. The RM554 million (US\$ 134 million) transaction included both individual and corporate borrowers, separated into two portfolios consisting of Islamic and conventional loans respectively.

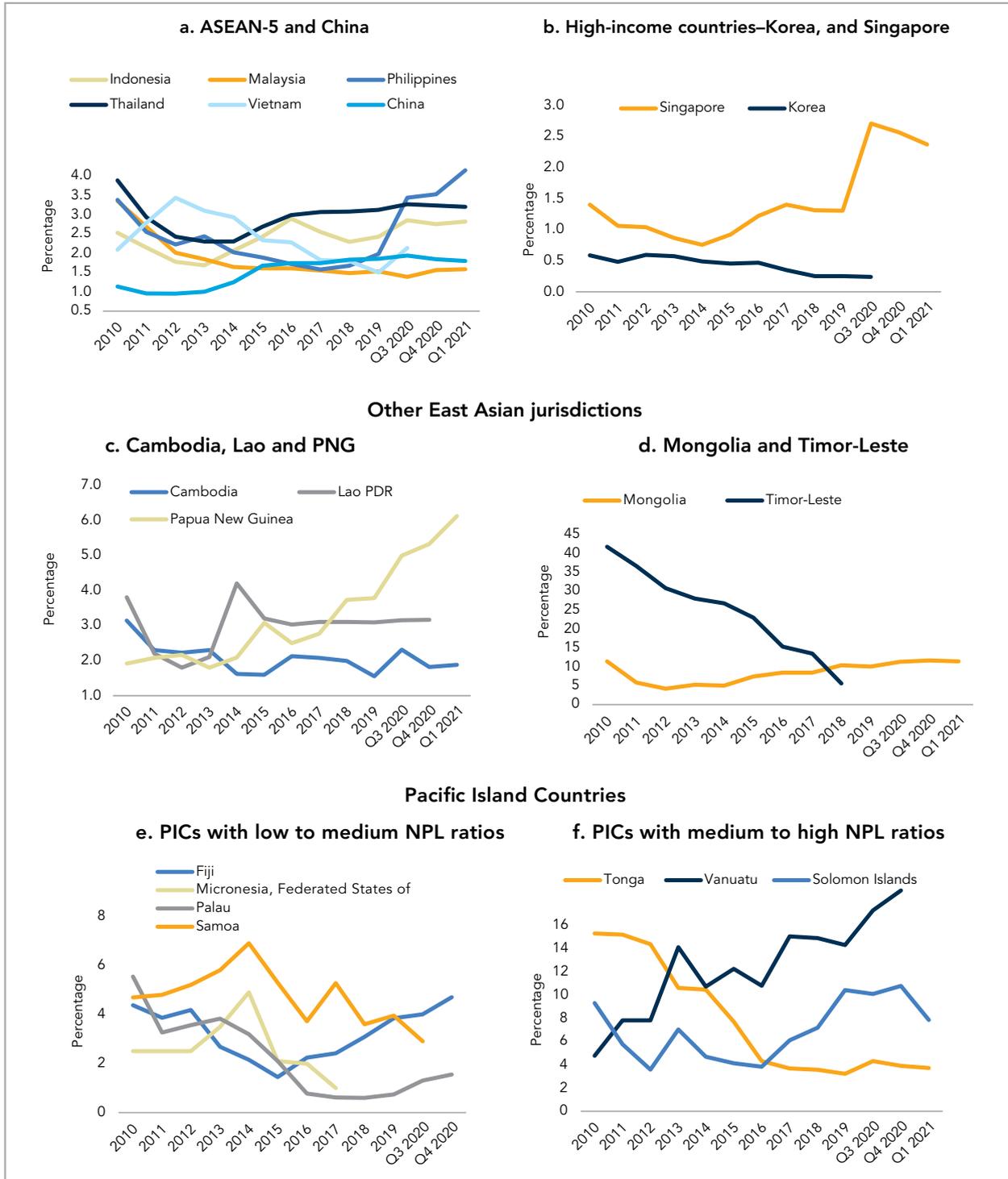
In the **Philippines**, the NPL market originally emerged following the AFC in the late 90's, when the gross NPL ratio of the country's banks skyrocketed to 17.5 percent. Recent portfolio transactions have been predominantly limited to unsecured loans. The sale by Rizal Commercial Banking Corporation (RCBC) and Planters Development Bank to an SPV led by the International Finance Corporation's (IFC) Debt and Asset Recovery Program (DARP) was one of the country's most notable transactions in recent years. In addition, the five M&A deals reported by Mergermarket as being announced in the Philippine financial services sector during 2018, representing a total deal value of US\$ 175 million, would relate to sales of older stocks of NPLs by the banks.

In **Korea**, the NPL market is mature, with portfolios being marketed across a wide range of asset classes, including commercial real estate, residential mortgages, and shipping finance. An estimated US\$ 6 billion outstanding principal balance of NPLs is marketed each year. Buyers are predominantly privately owned investors. Other NPL investors include subsidiaries of larger conglomerates. As would be expected in a mature and competitive market, returns tend to be lower than in other regional markets.

Source: Deloitte 2019.

Figure 5 shows NPLs by country as a percentage of total loan portfolios for the period 2010-Q1 2021, for which comparable and consistent data are available.<sup>6</sup>

**FIGURE 5 : Non-performing loans to total loans (percentage)**



Source: International Monetary Fund, Financial Soundness Indicators; International Monetary Fund Article IV Reports; and public information from national authorities.

Note: Data are Q1 2021 or latest available.

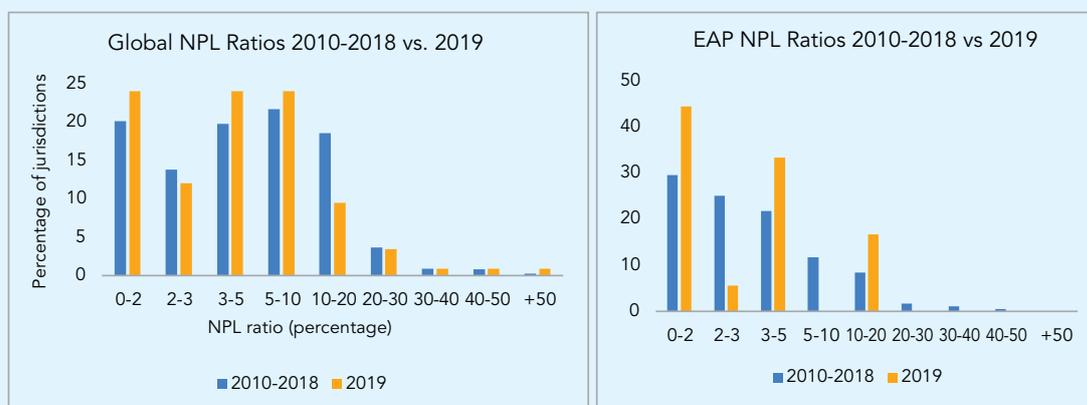
6 Some EAP jurisdictions have not been included because complete and consistent data series for NPLs are not available. Those jurisdictions are Kiribati, Marshall Islands, Myanmar, Nauru, and Tuvalu.

**In the years prior to the outbreak of the COVID-19 pandemic, the dynamics of NPLs in EAP differed across countries.** For most of the jurisdictions in the EAP, the NPL ratio decreased in the years after the GFC until approximately 2013. Following that point, trajectories differed between subgroups of countries. For example, NPLs in the ASEAN-5 economies and China stood in a range of 1 to 4 percent of total loans in the period from 2010 to 2019. The NPL ratios in the high-income economies of Korea and Singapore have been among the lowest in the region, in a range from 1.4 to 0.3 percent. In fact, Korea had the structurally lowest range of NPL ratios among the EAP countries (in a range from 0.6 to 0.3 percent) in 2010–2019. The developing jurisdictions of Cambodia, Lao PDR, and Papua New Guinea show a volatile pattern for their NPL ratios, but nevertheless ranged from 1.6 to 4.2 percent from 2010 to 2019. During the same period, the NPL ratios in Timor-Leste and Mongolia moved in much wider ranges (42.0 to 5.6 percent and 3.6 to 15 percent, respectively). Finally, the NPL ratios for the PICs are relatively volatile, as these jurisdictions are highly vulnerable to natural disasters and external factors, which, in turn, affect the quality of loans.

**In 2020 and early 2021, the NPL ratios in almost all EAP jurisdictions increased due to the impact of the pandemic, although the increase has been cushioned by the special policy measures implemented by national authorities** (see Section IIIb). In China, NPLs rose marginally, from 1.8 percent in 2019 to 1.9 percent in the third quarter of 2020, with the increase basically contained by the battery of measures adopted by the authorities to deal with the pandemic. In fact, in the first quarter of 2021, the NPL ratio decreased again to 1.8 percent. However, the NPL ratio in the Philippines increased from 2.0 to 4.2 percent in the period from the end of 2019 to Q1 2021, with the Philippines' ratio now amongst the highest within the ASEAN-5. In Singapore, NPLs doubled from a low base of 1.3 percent in 2019 to 2.7 percent in the third quarter of 2020, and then dropped to 2.4 percent in the first quarter of 2021.

**In other East Asian economies, Papua New Guinea's NPL ratio increased consistently from 3.8 percent in 2019 to 6.1 percent in Q1 2021** (see Figure 5.c). Among the PICs, NPLs ratios increased in 2020 for almost all jurisdictions for which public NPL ratios are available (Fiji, Palau, Solomon Island, Vanuatu, and Tonga). The NPL ratios of the Solomon Islands and Vanuatu have risen consistently since 2016 for idiosyncratic reasons. In the Solomon Islands, the level of NPL persistency is associated with chronic delays by the central government in releasing payments to its contractors and service providers, who in return rely on these payments to repay loans (IMF 2019d). The NPL ratio has dropped in the first quarter of 2021 to 7.9 percent presumably as consequence of the supporting measures adopted by the government and a partial rebound of the economic activity. In Vanuatu, NPLs increased after Cyclone Pam in 2015, and are basically concentrated in one bank (IMF 2019e). Samoa was the only PIC to report a decreasing NPL ratio in 2020 compared to 2019, with the ratio declining from 4 percent in 2019 to 2.9 percent in Q3 2020 (latest available data).

**FIGURE 6 : Distribution of NPL ratios pre-COVID-19 (percentage of jurisdictions)**



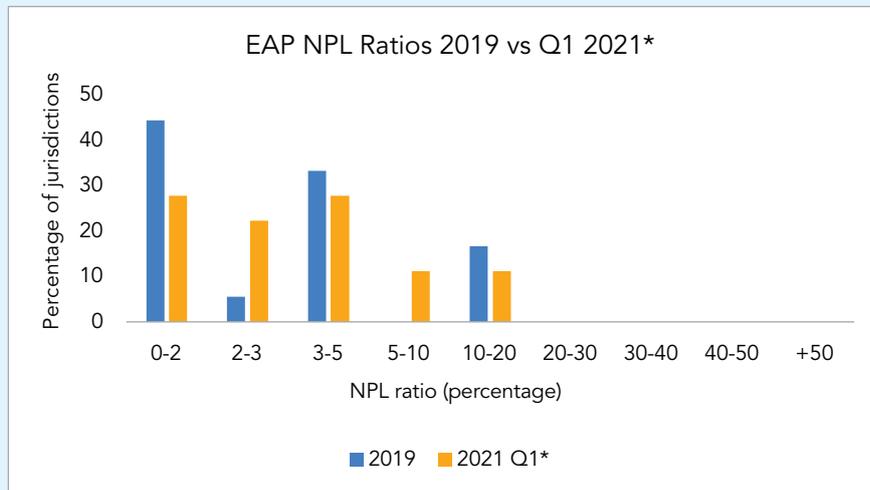
Source: International Monetary Fund, Financial Soundness Indicators, and author's calculations.

Note: NPL = non-performing loan; EAP = East Asia and the Pacific

Although global NPL ratios had been improving in recent years prior to the advent of the COVID-19 pandemic, the same cannot be said for all the EAP countries (see Figure 6). Moreover, in 2019, prior to the pandemic, the frequency distribution of NPLs in EAP became less skewed toward extreme values than in previous years. In 2019, the distribution of NPLs had no outlier ratios above 20 percent, as in 2010-2018, which is explained by the resolution of legacy NPLs in one jurisdiction. Also, in 2019 there was a noticeable decline in ratios in the range of 2 to 3 percent, which evidently has migrated to the range with the highest quality (up to 2 percent) or to higher risk buckets.

It is possible to assess the preliminary effect of the COVID-19 crisis on NPL ratios in the EAP by examining the migration of NPLs ratios across ranges in the period from 2019 to the first quarter of 2021, the latest point for which consistent data are available (see Figure 7). The data shows a clear migration from the lowest range (NPLs from 0 to 2 percent) towards higher risk buckets: in 2019, 45 percent of the EAP jurisdictions recorded NPL ratios in the lowest range, while in Q1 2021, 28 percent of the EAP jurisdictions were within this range. There has been a consistent increase in the number of countries for which NPLs are in the upper ranges, particularly for NPL ratios from 2 to 3 percent (increased from almost 6 to 22 percent of the jurisdictions), and from 5 to 10 percent (from zero percent of jurisdictions to 11 percent of jurisdictions). Marginal decreases are observed in the number of countries for which NPLs ratios are from 3 to 5 percent in the first quarter of 2021 compared to 2019 (from 33 to 28 percent of the jurisdictions), and from 10 to 20 percent (from almost 17 to 11 percent of the jurisdictions). None of the jurisdictions show NPL ratios above 20 percent, because the time needed to assign NPLs to those categories had not yet passed at the time of reporting (for example, when loan classifications are based on arrears) and because of the exceptional measures adopted by the authorities to minimize the impact of the pandemic on NPL ratios in the short term.

**FIGURE 7 : Distribution of NPL ratios in EAP post-COVID-19 (percentage of jurisdictions)**



Source: International Monetary Fund, Financial Soundness Indicators and author’s calculations.

Note: EAP = Data are Q1 2021\* or latest available in 2020; EAP = East Asia and the Pacific; NPL = non-performing loan; Q1 = first quarter.



## b. Vulnerabilities threatening NPL ratios in EAP jurisdictions

**Material vulnerabilities were observed before the COVID-19 crisis in some economic sectors in EAP jurisdictions, with their potential to seriously affect NPL ratios.** The pandemic has resulted in additional pressure and uncertainty related to whether and when such vulnerabilities may materialize, challenging the resilience of the banking sector to absorb credit losses. Therefore, even when NPL ratios may seem structurally low in some jurisdictions, they must be interpreted cautiously. Negative or sluggish GDP growth and its volatility negatively affect NPLs and loans' credit quality more generally. Other structural vulnerabilities arise from exposures to certain types of borrowers (such as corporates and households), economic sectors (real estate), market practices, and the regulatory and legal framework.<sup>7</sup> Furthermore, weaknesses in supervisory frameworks and practices and forbearance granted by financial authorities in some jurisdictions may also hinder the appropriate recognition of NPLs.

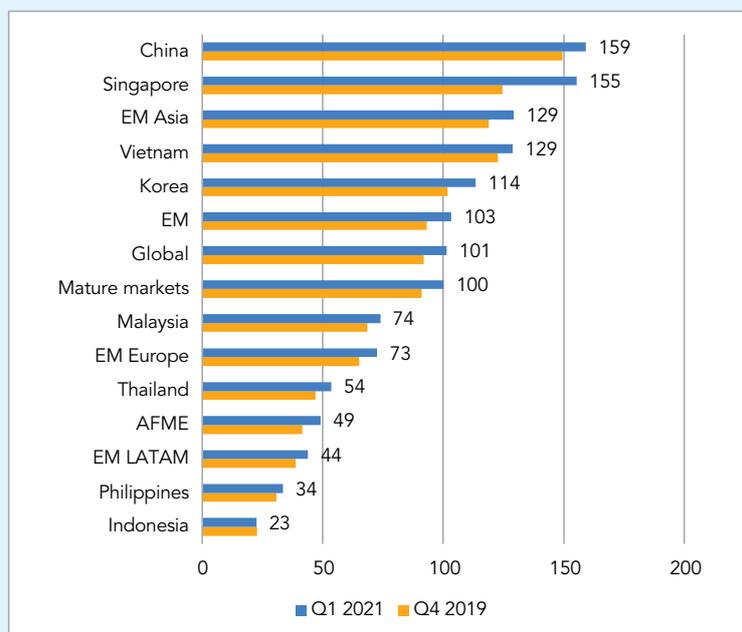
### **Corporate debt in many EAP jurisdictions is among the highest in the world.**

**In 2020, the EAP region experienced the highest level of corporate balance sheet vulnerabilities of all regions across the world (World Bank 2020e).** In all EAP jurisdictions with high ratios for nonfinancial corporate debt to GDP prior to the outbreak of the pandemic, supportive government measures, such as debt moratoria and loan guarantee programs, together with decelerating GDP growth, pushed the ratio upwards in 2020 and early 2021 (see Figure 8). As a result of the massive monetary policy response to the pandemic, while corporate borrowers have been able to lock in lower funding costs, in emerging markets, revenue losses have made the debt service burden much more onerous, despite the benefit from lower borrowing costs (IIF 2021a and 2021b).

<sup>7</sup> Weaknesses from the regulatory framework for NPLs, especially classification and provisioning, are examined in section III.a.

**In China, nonfinancial corporate debt stood at among the highest level in the world both in the pre-COVID-19 period and at the beginning of 2021** (see Figure 8). In 2020, China reported the biggest increase in debt ratios among emerging economies that year (IIF 2021a), and in the first quarter of 2021, debt stood at 159 percent of GDP (up from 149 percent at the end of 2019), which is above the average for both advanced economies and emerging markets (see Figure 8). Prior to the pandemic, corporate leverage was high and credit allocation skewed toward less efficient state-owned enterprises (SOEs) because of their implicit government guarantee. Since 2016, China has adopted de-risking measures. While financial regulatory tightening was needed to support de-risking, analysts assess that this move had the unintended consequence of constraining credit to small and medium enterprises (SMEs), for which shadow banking was an important source of financing. The intended outcome of channeling credit to private corporates through the banking sector did not occur, as banks opted to continue lending to the less risky SOEs. As a result, financing conditions tightened for private corporates, and their default numbers increased prior to the pandemic (IMF, 2019a).

**FIGURE 8 : Corporate Debt to GDP (percentage), Q1 2021 vs Q4 2019**



Source: International Institute of Finance 2021b.

Note: EM = emerging market; AFME = Africa and Middle East; LATAM= Latin America

**The apparent disconnect between Chinese banks' relatively low level of NPLs and the large stock of debt owed by corporations with low prospects of repayment has raised significant questions.** Banks have developed strategies for moving corporate loans out of their loan books, but still retaining some risks, to create capital headroom for new lending. These strategies include trust loans, securitization, asset management plans, entrusted lending, and debt-equity swaps (IMF, 2017).

**In the high-income EAP countries, corporate debt had also reached considerable levels, both in the pre- and post-COVID-19 periods.** In Singapore, corporates experienced a buildup of leverage in the past years, which has been further increased by the measures adopted by the authorities to deal with the COVID-19 crisis. At the end of the first quarter of 2021, the ratio of nonfinancial corporate debt stood at 155 percent of GDP (up from 125 percent at the end of 2019). In the pre-COVID-19 period, this buildup was driven by the property and commerce sectors, which accounted for approximately two-thirds of overall corporate debt growth from 2010 to 2019. Corporates rely heavily on bank loans for financing (90 percent of domestic corporate debt), with a large share of foreign-currency denominated corporate debts (about 64

percent),<sup>8</sup> although hedging is partially used to minimize currency mismatches. In Korea, where the ratio of corporate debt to GDP stood at 114 percent at the end of the first quarter of 2021, the debt of larger firms is concentrated in market-based instruments, mostly bonds, of which only a fifth is denominated in foreign currency. In contrast, SMEs (which account for about 35 percent of total corporate debt) are largely funded by bank credit. SMEs in Korea are creating concerns, as they have taken on substantially more credit in recent years. Smaller businesses tend to become cash-strapped more quickly than larger ones, which poses a macroeconomic risk due to the importance of these SMEs in Korea's economy.

**In Vietnam, lending to SOEs has been one of the key drivers of the rapid credit growth recorded in the pre-COVID-19 years.** The low interest rates and implicit governmental guarantees enjoyed by such firms have squeezed the resources available for other, more productive firms. Lending to connected firms originated a large volume of legacy NPLs in the banking sector, a significant proportion of which was caused by weak SOEs (Katagiri 2019).

**In Thailand, while corporate leverage is relatively low compared with regional peers, it was observed that corporate debt-at-risk and the rollover risk were increasing before the outbreak of the COVID-19 crisis.** There were signs of weaknesses in the SME sector, with NPLs and special mention loans inching up to 8 percent in Q3 2019 (Bank of Thailand, 2020).

**In Indonesia, corporate performance weakened before the advent of the COVID-19 crisis because of the effects of the trade war and falling commodity prices, causing credit demand to decline, with the ensuing credit growth slowdown, and impairments to its quality.** There is a persistently high portion of foreign currency financing in the corporate sector. Bank loans are concentrated in the corporate sector (52 percent are granted to corporates) and they are exposed to foreign exchange risk, while corporate financing remains dominated by bank loans, accounting for 55 percent of total debts. External debt denominated in foreign exchange represents 54 percent of total debt.<sup>9</sup> Corporations mitigate foreign exchange risk by hedging these exposures, in compliance with Bank of Indonesia regulations.

**In other EAP economies, risks from corporate exposures are also material.** In Papua New Guinea, banks may be vulnerable, especially given the poor financial health of their large SOE clients. Several SOEs are essentially bankrupt, and banks will need to be adequately provisioned to deal with insolvencies. In Mongolia, NPLs have remained high, especially in the mining sector, with analysts estimating that at the end of 2019, 36 percent of outstanding loans were non-performing and overdue loans.<sup>10</sup> In Lao PDR, there is a legacy of NPLs related to past infrastructure projects. Over recent years, while private companies have borrowed from commercial banks to finance public infrastructure projects, many of these projects have eventually failed, with loans falling into arrears.

**The 2020 World Bank COVID-19 Business Pulse Surveys show that significant number of firms in several EAP countries are facing liquidity issues and are in arrears on their payments, with a substantial share of SMEs and large firms expecting a cashflow shortage within six months.**<sup>11</sup> Moreover, many corporates in EAP are expected to continue to struggle in the context of an uneven economic recovery, lackluster domestic demand in the next years, and the removal of the exceptional measures implemented by authorities in response to the pandemic (S&P Global Ratings Asia 2021). Credit conditions for corporates in EAP are far from stabilized. About one-fourth of ratings of investment-grade issuers and almost one-third of speculative-grade issuers still had a negative outlook in March 2021. Downside risk was falling in China at the end of 2020, with economies having recovered somewhat faster than elsewhere in the region and with funding conditions mildly improved, even for smaller issuers. Indonesian corporates are at the other end of the spectrum, with about half of outstanding ratings

8 Data are as of 2018.

9 Data are as of June 2019.

10 Economic Policy and Competitiveness Research Center (2019), data as Q2 2019.

11 <https://www.worldbank.org/en/data/interactive/2021/01/19/covid-19-business-pulse-survey-dashboard>

having a negative outlook. Recovery prospects for 2021 are more elusive, with rising COVID-19 cases, a slow vaccine rollout, subdued consumer sentiment, and selective funding by banks. More defaults or restructurings are likely in 2021 after many such events in 2020 among private and state-owned entities.

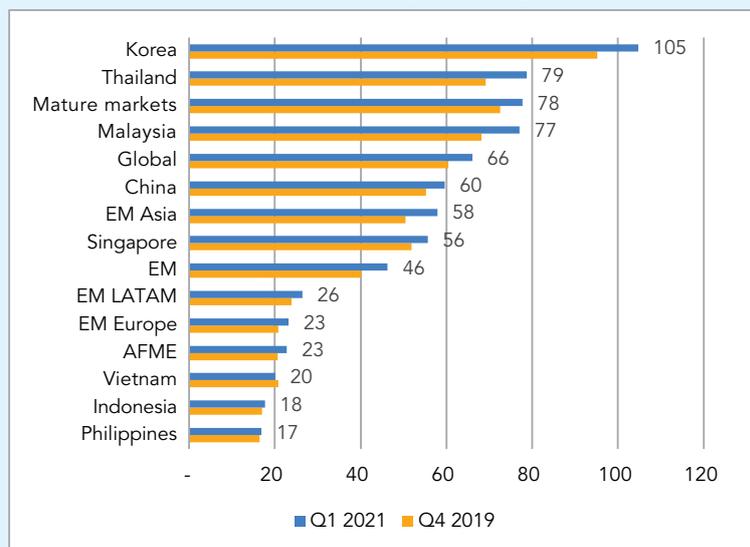
**Access to funding is likely to remain a major credit differentiator in EAP in 2021.** Capital market and bank funding has been ample (and sometimes at all-time lows) for the larger, investment-grade, or more diversified corporates. At the same time, signs are emerging that funding is becoming available once again for some segments. First, this is the case for smaller, more leveraged companies, particularly Chinese real estate developers (despite generally expensive and short tenors). Second, it is also true for weaker companies in Indonesia, which credit access remained mostly closed for most of 2020. Still, funding from domestic banks is predicted to remain selective, potentially even tightening as debt moratoria have ended or are set to end in 2022 in Malaysia, China, Thailand, Indonesia, and India (S&P Global Ratings Asia 2021).

### Household debt is a key source of vulnerabilities in some of the EAP jurisdictions.

**In 2020, with household debt already at a record high in several EAP jurisdictions before the COVID-19 crisis, mounting job losses and reduced working hours have raised concerns regarding household solvency.** The decline in household gross disposable incomes in the context of material job losses has brought household debt ratios to record highs. While much of this is likely to be temporary, already-high household debt levels amplify the adverse impact of the COVID-19 pandemic and exacerbate socio-economic and financial vulnerabilities (IIF 2021).

**Massive government programs have supported the flow of additional credit to households during the pandemic.** Together with reduced or negative GDP growth, this has resulted in a higher household debt to GDP ratio in many jurisdictions (see Figure 9). In some EAP jurisdictions, household debt levels are well above the ratios observed in emerging and mature markets (see Figure 9). Elevated household debt and growing household balance sheet vulnerabilities have the potential to threaten the quality of banks' loan portfolios. In many EAP jurisdictions, elevated household debt is explained by lending related to real estate, particularly mortgages. In the pre-COVID-19 era, the high weight of mortgages in households' total indebtedness, together with rapidly increasing real estate prices and weak underwriting standards, has created a source of instability for banks' portfolios in scenarios in which real estate prices deflate and household incomes are affected by negative shocks.

**FIGURE 9 : Household Debt to GDP (percentage), Q1 2021 vs Q4 2019**



Source: International Institute of Finance 2021b.

Note: EM = emerging market; AFME = Africa and Middle East; LATAM= Latin America

**In Korea, in the first quarter of 2021, the household debt to GDP ratio stood at 105 percent, a ratio higher than that in mature markets** (see Figure 9). With a record-low policy rate, Korea's household debts hit a new record high, with household credit reaching new high of US\$ 1.6 trillion at the end of December 2020 (Bank of Korea, 2021). This marked the biggest yearly increase in four years, since 2016. Household lending growth is primarily related to housing, with approximately 50 percent of household debt reported to be linked to floating interest rates and structured as bullet payments. More than 30 percent of debt has a debt service ratio in excess of 40 percent. Also, around one-quarter of the total stock of debt is held by households whose heads are retired or close to retirement, making them particularly vulnerable to negative income shocks.

**In Thailand, household debt rose to 79 percent of GDP in Q1 2021, especially driven by the government-supported financial assistance programs and a material contraction in GDP.**<sup>12</sup> Prior to the outbreak of the COVID-19 pandemic, households' balance sheets had become financially vulnerable, especially for the younger cohort, as they tend to save less, borrow at an earlier age, bear high debt burdens, and remain so into an old age (Bank of Thailand, 2020). As a consequence, prior to the pandemic, the share of NPLs and special mention loans (that is, 30 to 90 days past due) for households had been on the rise. Banks have been competing intensely in the retail loan market, loosening lending standards to preserve income and market shares. Real estate and auto companies have also engaged in aggressive campaigns to sell inventories, with high loan-to-value (LTV) ratios and extended installment periods.

**High levels of household debt are also a concern in some of the ASEAN-5 countries and China. In China, household debt has risen rapidly since the GFC.** Part of that buildup was attributed to rapid financial development and higher levels financial inclusion, which, combined with rising income, increased the availability of credit. The speed at which households accumulated debt was the highest in the world since the GFC (Han et al., 2019), mostly due to increasing mortgage lending. Housing-related debt accounts for almost two-thirds of all household debt, with the remainder almost evenly split between consumption loans (including credit card debt) and loans to households for business purposes.<sup>13</sup> LTV ratios for mortgages are generally low (on average about 40 percent), but financial innovation has been used to circumvent rules LTV – for instance, by financing down payments with consumer loans (IMF, 2017).

**In Malaysia, household debt was already high in the pre-COVID-19 era, primarily driven by loans for residential properties, with risks concentrated among low-income borrowers and those with variable income.** Signs of easing in underwriting standards were observed in 2019, as evidenced by the higher share of newly-approved loans to borrowers with debt service ratios exceeding 60 percent. Close to two-thirds of these loans were extended to borrowers earning more than RM5,000 per month and about half were credit card and personal financing facilities (Bank Negara Malaysia 2019).

**In Singapore, housing loans account for three-quarters of total household debt and are a key determinant of financial vulnerabilities.** Households are sensitive to house price fluctuations, with about 44 percent of assets comprising residential property (Monetary Authority of Singapore 2019). Government transfers and measures implemented by the authorities and the financial industry in response to the pandemic mitigated the impact of a sharp fall in employment and incomes in 2020. While growth in overall household debt moderated in 2020, leverage risk has edged up, due to an increase in the debt-to-GDP ratio due to the sharp fall in GDP in Q3 2020 (Monetary Authority of Singapore 2020).

**In the Philippines, before the COVID-19 crisis, credit growth was relatively higher in real estate and credit card receivables for a sustained period.** The strong lending growth in the real estate sector (both

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12 The Thai economy was projected to contract in 2020 by 6.6 percent, according to the December 2020 Monetary Policy Report, Bank of Thailand 2020.

13 Data are as of end 2018. See Han et al. (2019).

housing and commercial real estate) coincided with near-boom credit episodes detected between 2014 and early 2018 (International Monetary Fund 2020b). Credit card receivables have grown rapidly and have relatively high NPLs. Residential real estate prices for various types of new housing units in the Philippines contracted by 0.4 percent year-on-year in Q3 2020. The decline in prices may be partly due to the weak consumer demand for houses and lots. NPLs in 2020 have remained numerically low, but this is partially the result of cushioning by the regulatory forbearance measures that were introduced earlier. Incomes have been impaired, both for business entities and for households. Employment figures shifted sharply, as did underlying cashflows (Bangko Sentral ng Pilipinas 2020).

### **Banks' exposure to commercial real estate and to the dynamics of the real estate market more generally is a source of concern in many EAP jurisdictions.**

**Prior to the outbreak of the pandemic, real estate prices in China had recorded bubble-like increases, especially in the big cities.** Real estate-related risks are considered underpriced, given government interventions in the real estate market.<sup>14</sup> Moreover, nonbank credit for commercial real estate has been on the rise, to avoid limits set by regulators on credit from the banking sector. At the end of 2020, the Chinese regulators announced new regulatory caps on banks' exposure to the property sector and mortgage loans. The new regulation came amid an increase in the share of property lending in overall bank loans and signs of overheating in the property markets of some higher-tier cities. Property-related loans accounted for 29 percent of overall outstanding loans, including a record high of almost 20 percent from mortgages, at Q3 2020 (Fitch Ratings 2021).

**In Malaysia, bank credit to the supply of properties (construction and other real estate-related activities) comprises a significant portion of banking system assets and loans in the past years (Bank Negara Malaysia 2019).** A sharp decline in house prices could negatively affect both developers and investors. The number of unsold housing units has remained elevated, with house prices remaining unaffordable due to demand for affordable housing continuing to outstrip supply by a wide margin (Bank Negara Malaysia 2019). Conditions in the Malaysian property market were considerably weaker in 2020, with housing market activity falling and non-residential properties experiencing above-average vacancy rates and depressed rental yields. The pandemic increased risks of a broader decline in house prices due to a deterioration in income and weaker demand conditions. This in turn could increase risks to financial stability, given that loans for the purchase of residential properties account for the bulk of banks' total property-related exposures (Bank Negara Malaysia 2020).

**In the Philippines, strong lending growth has also been reported in the commercial real estate sector (IMF 2020b).** Credit to real estate has continued to outpace that in other sectors, accounting for the largest share in total loans outstanding, at 18 percent. Strong property demand from a few key players, such as those in the online gaming companies operating in the country and those in the business-process outsourcing industry, has driven the real estate credit growth.

**Vietnam recorded an excessive growth of credit for commercial real estate prior to the pandemic.** The central bank sought to constrain this lending by imposing higher risk weights and limiting short-term funding for long-term projects. Rising real estate prices imply that banks have stepped up the resolution of legacy loans. As NPL resolution seems to be partly driven by growing real estate prices, there is a risk that it could be interrupted by a downturn (International Monetary Fund 2019b).

<sup>14</sup> For instance, local governments control the supply of land for development and depend largely on the proceeds for revenue. See International Monetary Fund (2017).

### **Low financial development and structural weaknesses influence the NPLs ratios in the PICs.**

**The PICs have their own unique dynamics, with highly volatile GDP and with NPL ratio and borrowers' credit quality particularly vulnerable to the effect of natural disasters and external factors.** Financial intermediation remains low, and there is a scarcity of bankable projects. The limited ability of businesses to prepare business plans and financial statements also contribute to low access to credit.<sup>15</sup> The remoteness of many of the PIC provided some initial protection from the impacts of the COVID-19 pandemic. Many of these countries effectively closed their borders early in 2020 and began quarantining suspected cases at the preliminary stages of the pandemic. However, the PICs are also some of the most vulnerable in the world to the effects of climate change and disasters (World Bank 2020c).

**The property market is extremely rigid in many of the PICs, with only a limited proportion of land being freehold, making it difficult to use as collateral for banking loans or to be sold in case of default.** This is seen in Samoa and a number of other countries in the region. Moreover, an uneven playing field is observed in property ownership. For example, in Palau, mortgage lending is limited and expensive for foreign-owned banks because of a prohibition on possessing title to fixed property. As locally-owned banks are not subject to such restrictions, they therefore dominate lending for real estate. Similar rigidities are also found in many other of the PICs.

**In Fiji, high household debt level remains under closer monitoring, with a concentration of housing loans and with a continued gradual growth of NPLs even before the pandemic** (Reserve Bank of Fiji, 2019). Banks also have material exposures to agriculture and wholesale, retail, hotels, and restaurants, all of which have been vulnerable to the restrictions imposed by the pandemic. In the Solomon Islands, high levels of NPLs were observed even before the pandemic, with these levels associated with chronic delays by the government in releasing payments to its contractors and service providers, who, in turn, are unable to repay their loans to the banking sector.

### **Practices in some EAP jurisdictions raise questions about the true amount of NPLs.**

**Some practices adopted by the (mainly public) assets management companies (AMCs) during recent years seem to be distorting the true figure of NPLs.**<sup>16</sup> Many jurisdictions in the EAP have extensive experience in using AMCs to resolve NPLs (see Section V). In China, the business model adopted by the AMCs and their balance sheet growth has merited attention over the past few years, with some practices appearing to hinder the effectiveness of measures for a prompt resolution of distressed assets, thus distorting the number of NPLs. In the case of the big four public AMC, bank NPLs only accounted for approximately 16 percent of their assets in 2019, while the asset class "restructured corporate receivables" has been rapidly increasing in pre-COVID-19 years. These so-called bad debt assets have been seen as new credit issuance or corporate bank loan refinancing and bad loan rollover. Through this practice, AMCs are not necessarily taking the risk burden off banks' shoulders but creating a circular movement of funds from banks to AMCs to corporates, given that most of the local AMCs are financed through bank loans. This practice seems to have been contributing to creating gaps between special mention ratios and NPL ratios in banks' balance sheets (Bedford 2017). Thus, the loan refinancing has led to lower levels of NPLs being reported by banks. These practices ultimately continue to inflate the amount of unresolved bad debt in the system and they should be monitored closely now and in the years to come, as NPLs are expected to increase as a result of the COVID-19 crisis.

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15 See, for instance, the case of Micronesia (Asian Development Bank 2019).

16 Zombie borrowers are those that earn just enough money to continue operating and servicing debt but are unable to pay off their debt, thus diverting resources away from healthy, viable firms (World Bank 2020b).

**To obtain a full picture of the total amount of NPLs in the system, NPLs managed by the AMCs have to be considered.** For instance, in Vietnam the overall NPL ratio reported by banks in the pre-COVID-19 era displayed a downward trend since 2012, standing at a minimum level of 1.5 percent in 2019. Nevertheless, in those years, banks have aggressively resolved NPLs through the Vietnam Asset Management Corporation (VAMC), which is a public AMC. A more broadly defined NPL ratio, which includes NPLs sold to VAMC and loans previously restructured, should also be considered to provide a more accurate picture.

**When market practices and/or poor prudential supervision result in banks delaying the identification and recognition of loans as non-performing, broader indicators, such as loans-at-risk and restructured loans, have to be examined to obtain a meaningful indicator of NPLs.** For instance, in Mongolia, market analysts assessed that the official figures for NPLs is likely to understate the true value of bad loans. In another example, in Indonesia, restructured loans increased in proportion to total loans, going up from 13 percent in June 2020 to 18.6 percent in August 2020. In Malaysia, in the period from April to July 2020, banks approved 6.3 times as many applications from businesses to reschedule and restructure loans compared to total outstanding rescheduled and restructured business exposures as at end-2019 (Bank Negara Malaysia 2020).

### **Governments maintain a strong influence in some of the financial sectors in EAP.**

**Some financial systems in the EAP are still characterized by a high degree of government ownership and control.** The presence of governments is important in several areas, particularly through the ownership of state-owned banks (SOBs) and SOEs.

**For example, in China, the government maintains a strong presence in the financial sector.** There are six big SOBs, most of which are among the largest banks in the world. Local governments have important ownership stakes in lower tier banks, in many cases exercising control. In Malaysia and Thailand, the role of development banks in the financial sector, some of them deposit-taking, is also significant.

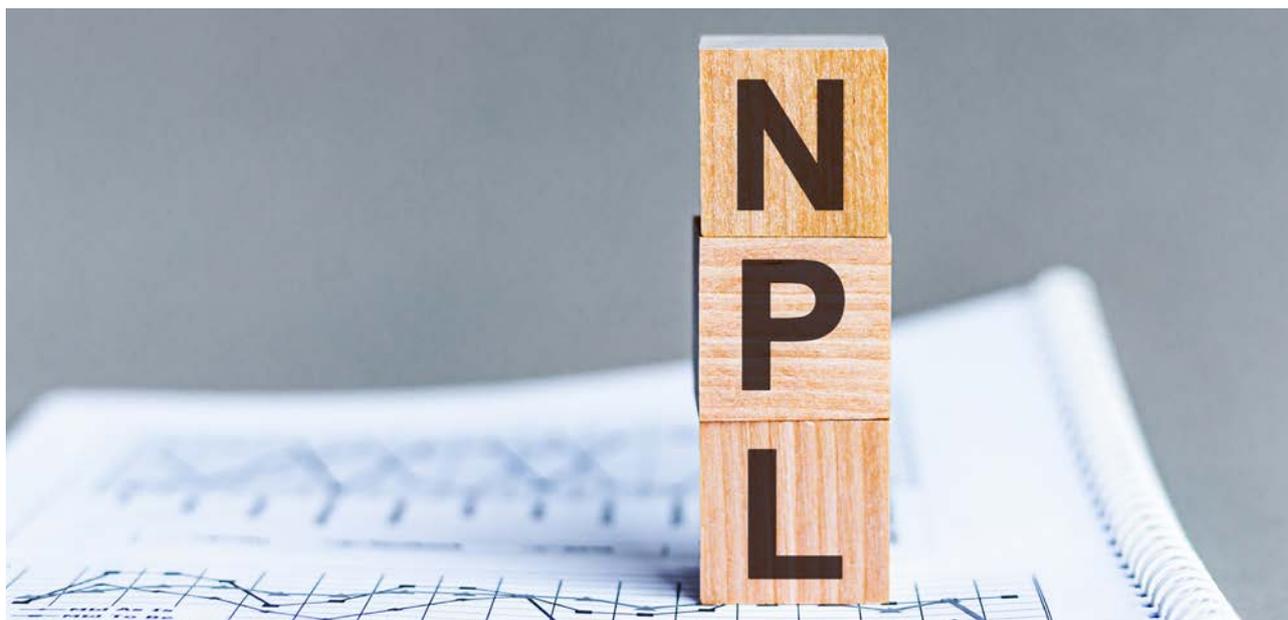
**Indonesian SOEs, like their Chinese counterparts, are likely to remain under the credit spotlight in 2021.** Analysts anticipate more debt restructurings or defaults among smaller entities, given that government support is increasingly turning selective, with leverage keeping on growing. The government's more selective stance is expected to continue in 2021 despite rising defaults, with the government prioritizing vaccine rollouts and support to the wider economy (S&P Global 2021).

**The health of SOEs is also of concern in other countries as well.** For instance, in Papua New Guinea, while NPLs are moderate, banks are exposed to the poor financial health of large SOEs. Several SOEs are essentially bankrupt, banks will need to be adequately provisioned to deal with insolvencies. Banks will need to be well-placed to manage the balance sheet vulnerabilities of such SOEs (IMF 2020c). In addition, in the Solomon Islands, the level of NPL persistency is associated with chronic delays by the central government in releasing payments to the government's contractors and service providers, who in return rely on government payments to repay loans (Bank of Solomon Islands 2020).

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## CHAPTER 3

# Recognition of Problem Loans in EAP Jurisdictions: Practices in the Pre-COVID-19 Era and the Exceptional Measures Adopted in Response to the Pandemic



## Recognition of problem loans in EAP jurisdictions: practices in the pre-COVID-19 era and the exceptional measures adopted in response to the pandemic

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### a. The definition of NPLs, provisioning practices, and macroprudential tools

*The definition of NPLs in EAP is still heterogeneous across jurisdictions and not necessarily aligned with international standards.*

**Most of the jurisdictions in EAP have regulatory asset classification systems that guide the definition of NPLs.** These systems usually comprise five buckets, roughly with the same structure:

- (i) normal/standard;
- (ii) watch/special mention;
- (iii) substandard;
- (iv) doubtful; and
- (v) loss.

The criteria used for classifying exposures into different buckets are driven by the number of days past due and also often include qualitative indicators (Restoy and Zamil 2017).

**At the international level, while BCBS developed harmonized definitions for problem loans, these have not yet been adopted by all jurisdictions in the EAP** (BCBS 2017; D’Hulster 2018). The BCBS definition of NPLs considers both a quantitative and a qualitative component: 90 days past due and unlikeliness to pay (UTP), whichever comes first. The qualitative part of the definition, the UTP trigger, includes that the bank determines the non-accrued status of the credit obligation; makes a charge off or account specific provision resulting from a perceived decline in credit quality; consents to a distressed restructuring; and the obligor is considered bankrupt. In addition, the BCBS guidance includes a definition of loan forbearance. This provides a harmonized view on the modification or refinancing of loans and debt securities that result from a borrower’s financial difficulty. The definition allows forborne exposures to be categorized as performing or non-performing exposures. It also sets the criteria to discontinue

the forbearance categorization and emphasizes the need to ensure a borrower's soundness before the discontinuation.

**In the EAP, the regulatory definitions for “problem assets” differ across jurisdictions and do not necessarily follow the BCBS harmonized definition, constraining comparability across countries.**

The most important differences across countries in EAP have been identified as follows (Restoy and Zamil 2017):

- *Differences in the minimum number of days past due* to place a loan in the buckets with the worst credit quality (watch/special mention, substandard, doubtful, and loss).
- *Uneven application of asset classification guidance*: The degree on which banks rely on past due criteria or more forward-looking qualitative factors when they place a loan in one of the more severe regulatory risk categories varies.
- *Exit criteria for restructured NPLs*: The criteria for upgrading a restructured loan from non-performing to performing status vary across jurisdictions.
- *Varying reported value of an NPL*: Some jurisdictions requiring gross NPL values, while some allowing NPL figures net of provisions.
- *Varying write-off criteria*: In some jurisdictions, banks are not required to write off fully provisioned NPLs, thereby distorting NPL coverage ratios used in assessing the credit risk profile of individual banks.
- *Identification of NPLs on the basis of a transaction or borrower*.

**Moreover, the international database, the Financial Soundness Indicators (FSI) used throughout the report to measure NPL ratios allows jurisdictions to exercise discretion in the treatment of some of the elements affecting the definition of NPLs.** In these cases, different criteria could be applied by the jurisdiction providing the data, which in turn may affect consistency and comparability. Some of the elements for which there is no guidance are:

- (i) the treatment of collateral, the exit criterion (when an NPL exposure becomes a performing exposure again); and
- (ii) whether the definition has to be applied on a transaction or borrower basis.

In addition, the interaction between non-performing status and forbearance is not fully captured in the FSI definition.

### **Most of the EAP jurisdictions set minimum regulatory levels for provisioning.**

**Most EAP jurisdictions that have asset classification systems set regulatory minimum levels of provisions for each bucket.** The provisioning percentages for each past-due bucket vary. Among these jurisdictions, some authorities require banks to follow regulator-prescribed rules as the basis for estimating and recognizing provisions in the profit and loss statement. Other jurisdictions follow the International Financial Reporting Standard 9 (IFRS 9)<sup>17</sup> as the basis for recognizing provisions in earnings, but they still require banks to calculate provisions on the basis of regulatory rules, with any shortfalls (with respect to accounting provisions) being deducted from regulatory capital.

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17 In July 2014, the International Accounting Standards Board issued the IFRS 9, Financial Instruments, which introduced an “expected credit loss” framework for the recognition of impairment. Further, IFRS 9 requires that loans and receivables are classified into three categories: performing (stage 1), underperforming (stage 2), and non-performing (stage 3). Under IFRS 9, banks are expected to cover one year of expected losses for loans at stage 1, but the lifetime of expected losses for loans at stages 2 and 3. See <https://www.bis.org/fsi/fsisummaries/ifrs9.pdf>.

**Some of the EAP jurisdictions have adopted the IFRS 9, although there is some degree of heterogeneity when it comes to the perimeter of application** (see Table 1). In several jurisdictions, IFRS 9 applies only to certain institutions, such as banks of a certain size or dimension, or only for consolidated financial statements, or both. In other countries, IFRS 9 is applied to all banks (Caruso and Kliatskova, 2021). Moreover, EAP supervisors have taken different paths in the degree of adoption of all the elements of IFRS more generally. For instance, Singapore and Korea have fully adopted the IFRS standards, in line with the International Accounting Standards Board timelines. Some other EAP countries have yet to adopt IFRS in full and have instead opted to blend substantial parts of IFRS into their local standards, while providing additional guidance.

**Table 1: Adoption of IFRS 9 in selected EAP jurisdictions**

Jurisdiction	Implementation date	Financial institutions that require IFRS 9	
		All	Subgroup
Cambodia	01/01/2019		X
China	01/01/2018		X
Indonesia	01/01/2020	X	
Lao PDR	2022		
Mongolia	30/06/2022		X
Samoa	31/12/2018	X	
Singapore	01/01/2018	X	
Solomon Islands	30/09/2018	X	
Korea	01/01/2018		X
Thailand	01/01/2020	X	
Timor-Leste	To be decided		X

Source: Caruso, Ezio; D’Hulster, Katia; Kliatskova, Tatsiana; Ortiz, Juan.

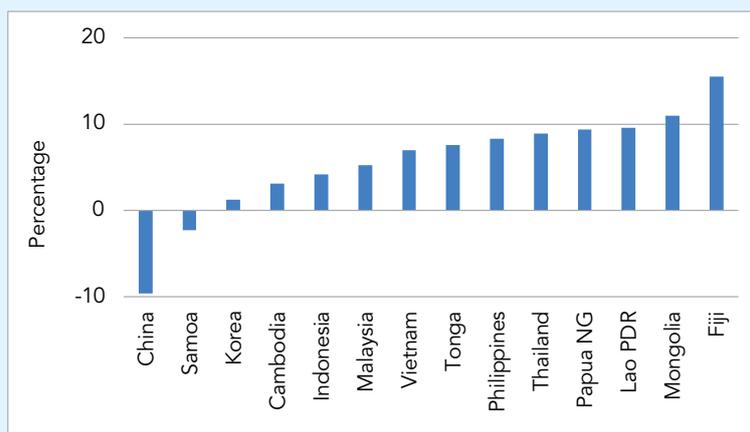
Note: EAP = East Asia and the Pacific; IFRS 9 = International Financial Reporting Standard 9.

**In countries that have implemented IFRS 9, the minimum regulatory provisions interact with the IFRS 9 accounting provisions in different ways.** For some jurisdictions, regulatory provisions are recorded in the financial statements. This method is often the case when prudential regulators also have powers in the area of accounting or are accounting standard setters. Others refer to IFRS for the recognition of provisions for accounting purposes, but still require banks to calculate regulatory provisions and compare them with the IFRS 9 outcome. In case the regulatory provisions exceed the accounting provisions, the deficit has to be taken from regulatory capital. There are variations in this regulatory backstop.

**Differences in the definition of NPLs and in provisioning practices determine the final effect on banks’ financial position.** Apart from differences in the credit quality of banks portfolios, the aforementioned divergent rules and practices regarding the definition of NPLs and provisioning influence how the buffers to absorb losses are measured (the amount of provisions) and how much of the remaining risk has to be absorbed by the capital base.

**Significant variations are observed in the ratio of NPLs net of specific provisions to the capital base in EAP jurisdictions** (see Figure 10). This important indicator measures the capacity of bank capital to withstand losses from NPLs, once specific provisioning has absorbed part of those losses. As seen in Figure 10, the ratio is negative in two jurisdictions, yet in the majority of the other jurisdictions, there would be an impact on the capital base of up to 16 percent. This ratio gives an indication regarding the capital buffers available for NPL absorption. Adequate provisions and capital levels allow for a prompt response when problem loans start to emerge and prevent problems from becoming systemic.

**FIGURE 10 : NPLs Net of Provisions to Capital, Q1 2021 (percentage)**



Source: Financial Soundness Indicators, International Monetary Fund, 2021 Q1 (if not, latest available)

Note: NG = New Guinea; NPL = non-performing loans; Q1 = first quarter

### **Macprudential tools and stress testing are also used by many jurisdictions in EAP to address vulnerabilities in the area of credit risk.**

**Jurisdictions in the EAP are increasingly using macroprudential tools to address the buildup of vulnerabilities affecting credit risk.** A variety of tools are used in the region, with these tools including capital buffers (countercyclical and conservation) and balance sheet instruments such as leverage ratios, limits on debt to income (DTI) and LTV ratios. These tools are intended to address threats to financial stability arising from excessive credit expansion and asset price booms and to limit mechanisms that amplify risks through leverage. To mention a few examples, in Thailand, maximum DTI ratios on credit cards and personal loans from commercial banks were introduced in 2017. The DTI limits appear to have been effective in slowing loan-creating for the riskiest category of loans. While NPL ratios on credit cards reached their highest level in 2016, they have declined following the introduction of the new credit limit. NPL ratios for (unsecured) personal loans provided by banks have also declined (IMF, 2019c). In Korea, caps to LTV ratios were introduced as early as in 2002 to counter risks associated with growth in mortgage loans, with regulatory limits for the DTI ratio introduced in 2005. Both measures are used flexibly, depending on developments in housing prices and mortgage lending (Lee, Gaspar, and Villaruel 2017). In Singapore, macroprudential policies are used to address rapid growth in property prices and loans. These included tightening limits on the ratio of mortgage payments to income; capping the LTV ratio; imposing an additional buyer's stamp duty; and increasing minimum cash-down payments (Lee 2015).

**The role of both supervisory and bank-stress testing has become more prominent in many of the EAP jurisdictions, with this being used to assess the adequacy of the loss absorption capacity in the banking sector.** Many of the supervisors in the EAP require financial institutions to run their own stress test exercises, while some authorities also run supervisory tests. In the case of credit risk, the exercises are typically targeted to assess whether the solvency of the institutions is sufficient to deal with extreme but plausible scenarios. For example, in Malaysia, the central bank has run a stress-testing exercise to assess the effects of vulnerabilities arising from the elevated level of household indebtedness. The central bank simulated the effect of severe stress scenarios on households' debt repayment capacity arising from a house price shock. Under these scenarios, the potential losses to the banking system would be between 43 percent and 68 percent of banks' excess capital buffers (Bank Negara Malaysia 2019). In Thailand, the solvency stress-testing exercise run in the last Financial Sector Assessment Program (FSAP) offered some insights regarding the resilience of the financial sector (IMF, 2019), with the adverse scenario representing a tail-risk event and capturing key macro financial risks. The results have shown that while NPL ratios would increase substantially and most banks would experience significant losses in net income and a decline in capital ratios, banks covered by the exercise were resilient to such an adverse scenario.

## **b. Borrower-related measures adopted in EAP in response to COVID-19**

**Authorities in EAP jurisdictions have adopted a battery of fiscal, monetary, and financial measures aimed at mitigating the effects of the COVID-19 on the real economy.**

**Specifically, the measures implemented by governments in EAP to provide borrower relief can be grouped into three categories.** Firstly, governments have provided funds and guarantees to borrowers, either directly or by channeling public funds through financial institutions. Secondly, authorities have given some degree of regulatory relief to financial institutions so that they are able to keep the flow of credit channeled to the economy. Thirdly, authorities have promoted changes to certain elements of the financial infrastructure so that it better accommodates challenges arising from the COVID-19 crisis.

**Within the first group of measures, the provision of fresh funds to borrowers has been widely used by at least 16 countries in the EAP (see Table 2).** For instance, in Cambodia, the government injected capital to the state-owned Rural Development Bank to grant loans to SMEs in the agricultural sector. In China, policy banks issued COVID-19 bonds at low interest rates to support activities linked to the control of the pandemic and to allocate special-purpose funds to the private sector, particularly SMEs. China has also expanded lending and rediscounting facilities to support manufacturers of medical supplies and daily necessities and to SMEs and operators in the agricultural sector at low interest rates. In Indonesia, SMEs with a good credit record and the capacity to repay are eligible for loans provided through public funds, with the government paying a portion of the loans' interest for certain sectors. Box 2 explores the evolution of NPLs to MSMEs and measures taken to support them in Indonesia and Malaysia.

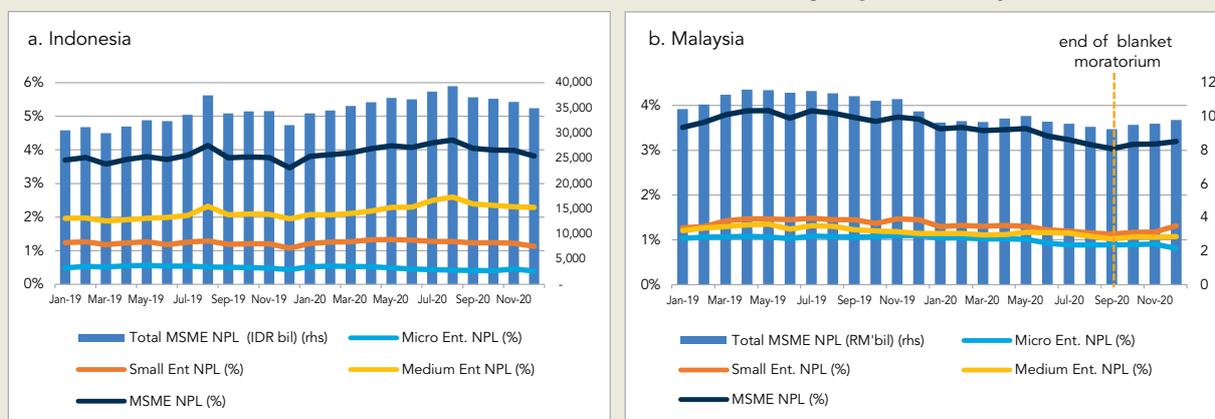
**Box 2:**

## NPLs in MSMEs during COVID-19: The cases of Indonesia and Malaysia

MSMEs are the backbone of many emerging economies, with many of these particularly hard hit by the pandemic. In many countries, governments and central banks have introduced direct and indirect assistance to cushion the impact of the pandemic on SME borrowers. The cases of Indonesia and Malaysia are described below.

The impact of the pandemic on NPLs for MSMEs in **Indonesia** is not yet clear, due to the impact of a loan restructuring program to operate until March 2022. However, to date, the NPL ratio for MSMEs has grown more slowly than the total NPL ratio. The MSME NPL ratio increased from 3.47 percent in December 2019 to 4.29 percent in August 2020, the highest level in 24 months, before declining to 3.81 percent by the end of December 2020 as the loan base expanded and borrower relief measures were extended. As of December 2020, total restructured MSME loans constituted 37.85 percent of total outstanding MSME loans in Indonesia. The NPL ratio for the overall loan portfolio increased more sharply, going up from 2.43 percent to 3.06 percent over the same period. The NPL loan ratio for medium sized enterprises, as defined by their respective countries, accounted for approximately 45 percent of total SME loans and 60 percent of MSME NPLs. The ratio for this category remained stable in Q4 2020, after increasing to 2.6 percent in August 2020. The NPL ratio across all three categories trended downwards in the last three months of 2020. The total MSME loans portfolio has experienced a contraction in loan growth since June 2020, with negative growth of -2.2 percent in December 2020.

**FIGURE 11 : MSME NPL Volume and NPL ratios by Size of Enterprise**



Source: OJK, Statistik Perbankan Indonesia

Source: BNM Financial Inclusion Data

In **Malaysia**, MSME NPLs remained generally stable before inching upward across enterprise sizes in October 2020, following the end of the blanket loans moratorium. MSME borrowers were given a 6-month moratorium that ended in September 2020, followed by targeted relief assistance by banks to enable MSMEs to restructure and reschedule loans and the provision of special relief funds by the authorities. This has cushioned the impact of loan defaults, with the MSME NPL ratio standing at 3.2 percent at the end of December 2020, lower than the figure of 3.7 percent recorded at the end December 2019. Bank Negara Malaysia’s Second Half 2020 Financial Stability Review noted that MSMEs accounted for 90 percent of total loans approved for rescheduling and restructuring. While there are signs of economic recovery, the full impact on the quality of the loan portfolio and potential increase in NPLs may not be seen until later in 2021, and banks have continued to set aside additional provisions as a precaution against future credit losses.

**Public guarantee schemes and other forms of credit enhancements have also been implemented to support the flow of credit.** In Korea, government guarantees for loans to SMEs were available and loans for small merchants were fully guaranteed. In Timor-Leste, the authorities provided access to the Credit Guarantee System to microenterprises, increasing the spectrum of economic activities eligible for the program. In Myanmar, the government guaranteed up to 50 percent of new working capital loans granted by banks to firms on the condition that employment is maintained. Government guarantees were also provided to firms in high-growth sectors that have been negatively affected by the pandemic. In Fiji, public funds were assigned to the SMEs Credit Guarantee Scheme to cover 50 percent of the outstanding loans in case of default.

**Table 2 : Policy measures related to borrower’s relief in EAP**

Area	Policy Measure	Countries
Funding	Fresh funds	Cambodia, China, Indonesia, Korea, Lao PDR, Malaysia, Micronesia, Myanmar, Papua New Guinea, Philippines, Samoa, Singapore, Solomon Islands, Tonga, Timor-Leste, Vietnam
	Guarantees or credit enhancements	China, Fiji, Korea, Malaysia, Myanmar, Timor-Leste
	Capital injection in banks	Cambodia
	Bond issuances	China
Regulatory relief	Capital buffers	Cambodia, Korea, Malaysia, Singapore
	Capital: risk weights	Korea, Philippines
	Liquidity buffers	Cambodia, Korea, Malaysia, Singapore
	Liquidity: reserve requirements	China, Indonesia, Lao PDR, Malaysia, Mongolia, Myanmar, Papua New Guinea, Philippines
	Moratoria, classification and provisioning	Cambodia, China, Fiji, Indonesia, Korea, Lao PDR, Malaysia, Myanmar, Papua New Guinea, Singapore, Solomon Islands, Thailand, Tonga, Vietnam
	Credit reporting	Indonesia, Singapore
Financial infrastructure	AMC Creation	Myanmar
	Insolvency law	Singapore

Source: Author compilation based on World Bank COVID-19 Finance Sector Related Policy Responses, information updated February 2021; International Monetary Fund, Policy Tracker.

Note: AMC= asset management company; EAP = East Asia and the Pacific.

**As for the second group of measures, which involve regulatory relief, some EAP jurisdictions have allowed financial institutions to make use of the flexibility that already exists in the regulatory framework, in line with international recommendations.**<sup>18</sup> The first area where flexibility has been extended is through measures to allow banks to use existing capital and liquidity buffers. By dipping into the buffers, banks are able to make use of the funds to provide additional credit or to absorb losses without the pressure to replenish those cushions immediately. Cambodia, Korea, Malaysia, and Singapore are some of the jurisdictions in which explicit guidance has been issued in this respect. Many jurisdictions have also reduced liquidity reserve requirements, a tool that is traditionally used to relieve short-term liquidity pressures and to expand loan funds. Cambodia, China, Indonesia, Lao PDR, and Timor-Leste, to mention a few, have all used this tool.

18 The use of the flexibility existing in the regulatory framework should be one of the first lines of defense to deal with the COVID-19 consequences (International Monetary Fund and the World Bank 2020).

**In some cases, the authorities have granted regulatory relief by lowering minimum capital requirements for some borrowers, thus deviating from international good practice standards.<sup>19</sup>**

Some jurisdictions have lowered the credit risk weight for loans to SMEs to a level below the ratio required by the Basel Framework. For instance, the Philippines and Korea implemented such reductions in the risk weight until the end of 2020, with this measure intended to support lending to these firms. This regulatory relief granted by lowering internationally agreed minimum requirements has the potential to undermine the credibility of the prudential framework, with potentially severe consequences for transparency, the solvency of individual institutions, and financial stability.

**Moratoria were implemented by at least 14 jurisdictions in the EAP as extraordinary relief measures, with these jurisdictions adopting a range of different designs.** In most of cases, the authorities have tried to limit moral hazard by making the measures time bound and by defining the sectors and loans included in the initiatives. Nevertheless, in some cases, a blanket moratorium has been applied automatically to all borrowers within a certain group. For instance, in Malaysia, an automatic six-month moratorium on loan repayments (principal and interest for individuals and SMEs) was implemented on 1 April 2020, to be replaced by targeted borrower assistance after a six-month period. In other cases, the prudential authorities allowed banks to implement moratoria, with the final decision being left to the discretion of banks and borrowers. Fiji was one such case, where banks were allowed to offer loan repayment holidays on principal and interest for up to six months for businesses and individual customers experiencing difficulties with loan repayments because of the pandemic. In Myanmar, banks could restructure and reschedule existing loans granted to MSMEs that have regularly paid interest and principal on a timely basis for a longer period of up to three years. In Singapore, borrowers may decide to defer the repayment of principal or both principal and interest until 31 December 2020. In Korea, guidelines were issued to extend loan principal payments for SMEs and small merchants hit by the pandemic. Also, the option to postpone principal payments until the end of 2020 was available for vulnerable borrowers.

**Countries implementing moratoria have introduced some degree of forbearance in applying the prudential classification rules and provisions, contrary to international good practice recommendations.<sup>20</sup>** In Lao PDR, financial institutions that implemented debt restructuring and granted new loans to affected borrowers benefited from regulatory forbearance on loan classification and provisioning. In the Philippines, a temporary relaxation of provisioning requirements was allowed, subject to regulatory approval.

**Authorities have also provided regulatory relief on transparency of the exposures subject to moratoria in a manner that does not necessarily promote effective market discipline.** International recommendations require transparency of the exposures subject to moratoria as a precondition for maintaining trust in the system, for market discipline to work effectively, and for limiting moral hazard.<sup>21</sup> In some EAP jurisdictions, banks and regulators do not report the proportion of COVID-19 restructured loans, while in other jurisdictions the authorities require disclosure.

**Still, some authorities in EAP jurisdictions disclose high-level data related to restructured loans or loans subject to moratoria, although the reference portfolio and the details disclosed vary across jurisdictions** (see Table 3). The amount of loans subject to moratoria has declined in most markets, following the end of strict lockdowns. In China, while restructured loans constitute 4 percent of total loans, for loans to MSMEs, the figure stands at 17 percent. In Indonesia, larger corporations experienced more

<sup>19</sup> See guidance provided by International Monetary Fund and the World Bank (2020).

<sup>20</sup> See International Monetary Fund and the World Bank (2020), Recommendations 3, 4, and 5.

<sup>21</sup> See International Monetary Fund and the World Bank (2020), Recommendation 5.

loan restructuring, with more than 31 percent of loans to large corporations having been subject to such measures. In Malaysia, 11 percent of household loans and 17 percent of total business loans have been under repayment assistance, with significant variations between economic sectors and with the figures much higher for economic sectors severely affected by the pandemic (for example, 52.8 percent of loans in the hotel and restaurants sector have been restructured).

**Finally, the COVID-19 crisis has also spurred reforms to some elements of the financial infrastructure in some EAP jurisdictions.** In particular, some jurisdictions have updated elements of the insolvency frameworks to accommodate these frameworks to the current challenges. Thus, in Singapore, a new bill was submitted to the parliament to update some areas of the legal framework for insolvencies. To avoid massive numbers of corporate bankruptcies, Singapore has suspended the obligation on directors to file for bankruptcy. In other jurisdictions, in anticipation of an increase in the amount of NPLs that have to be resolved, the creation of AMCs is under consideration, as in Myanmar, where the government promoted the establishment of an AMC to resolve NPLs.

**Table 3 : The materiality of COVID-19 restructured loans in selected EAP jurisdictions**

Country	COVID-19 Restructured Loans	Source
China	Relief loans amounted to CNY7.3 trillion in 2020, accounting for 4 percent of total loans, but represented around 17 percent of total micro and small enterprise loans	Fitch Ratings, Chinese Banks' Earnings to Stay Resilient in 2021. Wed 31 Mar, 2021.
Fiji	31.3 percent of the commercial banks' gross loans, as of October 2020	Reserve Bank of Fiji. Financial Stability Review 2020
Indonesia	As of June 2020, based on asset size, larger corporations experienced more loan restructuring: 31.3 percent of loans to large corporations, 15.1 percent of medium enterprises and 7.1 percent of small size enterprises	Bank of Indonesia, Financial Stability Review, September 2020.
Malaysia	11.1 percent of the amount of household loans are under repayment assistance. The amount of business loans under repayment assistance accounted for 17 percent of total business loans (52.8 percent of loans in the hotel and restaurants sector). December 2020.	Bank Negara Malaysia, 2021. Financial Stability Report, Second Half 2020.
Philippines	The SME and property loan amounts subject to moratorium constitute about 13.7 percent and 14.1 percent of total outstanding SME and property loans respectively (end of December 2020).	S&P Global Rating. March 2021 Credit Conditions Emerging Markets Q2 2021: Brighter Prospects Prone to Setbacks.
Singapore	The SME and property loan amounts subject to moratorium constitute about 13.7 percent and 14.1 percent of total outstanding SME and property loans respectively (end of December 2020).	Monetary Authority of Singapore, Financial Stability review, December 2020.
Solomon Islands	17.4 percent of gross loans of banks and credit unions loans have been suspended by banks and credit institutions from February 2020 to the end of June 2020 (Principal and interest payments relating to a total of \$448.1 million).	Central Bank of Solomon Islands, Financial Stability Report June 2020.
Thailand	Financial institutions' loans under assistance are 20.5 percent of total loans (4835 billion baht, December 2020).	Bank of Thailand, Performance of the Thai Banking System in 2020, No. 10/2021 and "EC_MB_041, Private credit" (Total loans)

Source: Authors based on the following public sources, Fitch Ratings 2021b, Reserve Bank of Fiji 2020, Bank of Indonesia 2020, Bank Negara Malaysia 2020, S&P Global Ratings 2021, Monetary Authority of Singapore 2020, Central Bank of Solomon Islands 2020, and Bank of Thailand 2021.

### c. Other measures utilized in past crises

**Measures utilized in past crises also provide models for borrower relief efforts in the context of the COVID-19 pandemic.** Two main concerns in some EAP jurisdictions relate to accumulation of unpaid mortgages and credit card debt. In the case of real estate used as collateral, efficient and effective collateral resolution regimes are important for the prompt realization of the rights obtained in secured assets, ensuring the maximum recovery of asset values based on market values (see Section IV.b). However, lessons from prior crises also highlight the importance of early engagement between borrowers and banks to ensure that resolution is achieved before arrears accumulate.

**For instance, in the US, the Home Affordable Modification Program (HAMP) was introduced in 2009 to help financially struggling homeowners avoid foreclosure by modifying loans to a level that was affordable for borrowers and sustainable over the long term.** The program provided consistent loan modification guidelines that could be utilized across the entire mortgage industry. The program included incentives for borrowers, servicers, and investors (see Box 3).

#### Box 3:

### United States: The Home Affordable Modification Program

HAMP was a loan modification program introduced by the US Federal government in 2009 to assist struggling homeowners to avoid foreclosure. HAMP offered reduced monthly mortgage payments to homeowners at risk of foreclosure, with these payments being affordable and sustainable over the long-term. HAMP was designed to enable families who were struggling to remain in their homes and showed documented financial hardship and an ability to make their monthly mortgage payments after the modifications.

HAMP was a voluntary program that supported servicers' efforts to modify mortgages, while at the same time protecting taxpayers' interests. HAMP worked by encouraging participating mortgage servicers to modify mortgages so that struggling homeowners could make lower monthly payments and avoid foreclosure. It had specific eligibility requirements for homeowners and included strict guidelines for servicers. The program included incentives for homeowners, servicers, and investors to encourage successful mortgage modifications.

Before HAMP, there was no standard approach among loan servicers or investors regarding the means by which to assist homeowners who wanted to keep making payments but who needed mortgage assistance. Families in this program reduced their monthly payments by a median of more than US\$ 530 each month. HAMP has also encouraged private lenders to modify mortgages at no expense to taxpayers.

Source: US Department of Treasury

**Early borrower engagement mechanisms played a critical role in the resolution of mortgages in the Irish crisis** (see Box 4). Many borrowers were in deep levels of financial distress, had high debt burdens relative to income, and minimal capacity to save or service debt. For borrowers in such circumstances, there is the need to rapidly produce candid assessments and to apply the appropriate solutions before arrears begin to accumulate. The types of restructuring implemented varied in terms of the depth of payment relief offered, with a correlation between deeper up-front repayment cuts and the likelihood of a successful modification.

#### Box 4:

### Resolving mortgage distress in the Irish crisis

Ireland experienced an extraordinary boom in house prices, followed by a similarly extraordinary bust and a collapse in employment. By 2013, nearly 14 percent of the Irish owner-occupier mortgage market was in arrears of more than 90 days. Widespread loan restructuring was an important feature of the policy response, with repossession much less common. In 2013, the Central Bank of Ireland imposed targets on banks to ensure that most distressed mortgage cases received a “sustainable solution”. By 2016, over one in six owner-occupier mortgage accounts had been restructured.

Borrower engagement is defined as an instance where the borrower contacted the lender because of financial difficulty and completed a Standard Financial Statement (SFS) form. This SFS is a standardized industry-wide template that captures all relevant information on income, expenditure, debt, and demographic factors at the point of distress. Research on borrower engagement based on retail banking data highlights some key facts:

- *Engagement was widespread, despite the relatively low probability of repossession.* More than one-in-five mortgages had an associated SFS completed during the 2012-2020 period.
- *Many borrowers engaged early, before missing payments, stemming the potential flow to arrears.* More than half of engaging mortgage borrowers were engaging before having defaulted.
- *Non-engagement was common among those that accumulated long-dated arrears over the decade.* Close to 40 percent of those in arrears greater than two years past due are determined to be ‘non-engaging’ or ‘non-cooperating’ across different studies. Among those with arrears of ten or more years, ‘non-cooperating’ rates are over 50 percent.

Despite this relative success, the lack of an effective collateral repossession regime led to an accumulation of deep arrears cases representing just over 5 percent of all owner-occupier mortgage balances, suggesting that the ‘last resort’ of a functioning foreclosure regime is an important part of the overall debt resolution architecture.

Across the market, the default rate in recent years has been about five times higher for modified loans compared to performing loans with no such history. Among the reasons are:

- *Even after receiving modification, vulnerabilities remained.* Those with modified mortgages have higher payment-to-income ratios than the general population.
- *Non-mortgage consumer debts were substantial among borrowers engaging to resolve mortgage distress.* Sustainable solutions should take into account the entire indebtedness of borrowers.
- *Repayment relief works.* Re-default rates are lower where the firm has made deeper cuts in monthly repayments as part of the modification.
- *Typical signals are relevant factors to target post-modification.* Re-default rates are lower where the modified loan has a lower loan-to-value ratio and a lower payment-to-income ratio.

Source: McCann and O'Malley, 2020.

**A code of conduct or standardized guidelines set minimum standards for borrower engagement, not only for mortgages in arrears, but also for other target portfolios.** Such codes have been used in Cyprus for all retail and SME loans; in Greece for all retail and commercial loans; and in Ireland, as mentioned above, for mortgages (Aiyar et. al. 2015). The guidelines typically set the processes for borrower engagement and targets for the path of resolution of NPLs of such portfolios. Similar guidelines can be applied specifically for the resolution of credit card debt. In EAP, the experience of the Korean authorities with credit card debt during the Korean crisis episode in 2003 generates some important policy lessons for authorities in other jurisdictions (see Box 5). Preventive measures intended to strengthen the prudential framework for this type of exposure are key to avoiding an excessive buildup of risk. Targeted measures to address distressed credit card borrowers affected by the crisis were useful to try to maximize recoveries once the crisis unfolded.

### Box 5:

## Lessons from the Korean credit card crisis

Korea experienced a credit card crisis in 2003, with a significant impact on its financial system, when a massive credit card lending boom was followed by a wrenching bust. Many credit card issuers were on the brink of collapse as they struggled with deteriorating asset quality and difficult liquidity and solvency challenges, which in turn exposed the banking sector and financial markets to systemic risk, severely affecting the real economy.

Initially, the Korean authorities tightened administrative and regulatory measures. Consultations between the regulators and credit card issuers over best practice guidelines for credit card operations and credit reference agencies were strengthened. The Korean authorities upgraded credit card asset classification standards, strengthening provision requirements, and started applying prompt corrective action to standalone card issuers. They then raised the minimum capital adequacy ratio for card issuers to 8 percent, up from 7 percent. The authorities also banned aggressive marketing practices; established a cap of less than 50 percent of total credit card assets on cash lending, to be introduced by a specified deadline; and pressured credit card companies to lower interest charges. While these measures were probably sound from a longer-term perspective or if deployed before a crisis occurs, in the shorter term, some of them had contractionary effects, thereby exacerbating a credit crunch.

With the turmoil spreading to the bond market, policy interventions veered toward crisis management as policymakers became aware that systemic risks were increasing. Policymakers also changed their tactics over time. They intervened first by providing liquidity support to both the unsettled financial markets in general and to troubled credit card issuers more specifically, then by arranging the rescue of a failing institution. Both these interventions were large-scale operations.

The authorities exercised regulatory forbearance in various forms. The authorities allowed issuers to roll over delinquent credit card loans. This eased, at least temporarily, the burden of provisions and charge-offs on issuers, thereby also providing de facto regulatory forbearance. A credit counselling and recovery service program was established to facilitate debt rescheduling.

The effects of the credit card lending boom-bust on Korea's financial system were determined in part by the initial excesses of the boom and in part by the policy responses to the bust. It is estimated that about one third of the entire card lending book at its peak eventually had to be written off. Credit card balances for both bank and monoline issuers represented as much as one fifth of total bank loans outstanding at the peak of the boom.

The policy implications of Korea's experience may be valuable to policymakers in other Asian markets where credit card lending has expanded rapidly. First, it demonstrates that there is a need to place greater emphasis on detecting early warning signs before the build-up of excessive imbalances persists for too long. Second, it shows that governments can enhance information flows to facilitate the functioning of the consumer credit market. For instance, credit information reporting and sharing may need to be strengthened. Finally, the prudential and supervisory frameworks may also need to be strengthened. This includes both general regulatory rules and guidelines on best practice and prudential rules specific to the credit card business. For instance, there may be a case for more refined and differentiated provisioning requirements for credit card receivables. There should also be an explicit capital requirement to provide firms with a cushion against the retained exposure of, or the contingent liability arising from, off-balance sheet securitization. A case can be made for imposing income tests, credit limits and minimum repayment requirements to cap risk exposure to the less-than-prime segment of the credit card market. Some of these more traditional rules can be helpful safeguards, at least during difficult transition periods involving rapid structural change and financial liberalization, but they need to be deployed pre-emptively or sufficiently early to protect financial stability.

Source: Kang and Ma, 2009.



## CHAPTER 4

# The Enabling Legal Environment for NPL Resolution: Insolvency Frameworks and Collateral Enforcement

## The enabling legal environment for NPL resolution: insolvency frameworks and collateral enforcement

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**An effective legal framework for debt collection and NPL resolution is an essential component for efficient credit markets.** The COVID-19 pandemic has challenged the ability of the borrowers to service their loans and obligations, which underscores the need for appropriate and effective tools to manage NPLs and deal with firms that cannot survive (Annamalai 2020). The enabling legal framework for NPL resolution should include predictable, transparent, and affordable enforcement of both unsecured and secured credit claims through both efficient mechanisms outside of insolvency and a sound insolvency system (FinSAC 2020).

**Efficient and short judicial proceedings support loan restructuring and thereby preserve value. As such, speedy judicial proceedings can help preserve the underlying value of NPLs and reduce bid-ask spreads in NPL pricing.** Uncertainty over the length of the judicial proceedings can hamper loan restructuring and value recovery (FSI 2017). Therefore, it is imperative to address weaknesses in the legal and judicial frameworks for NPL resolution. Legislation to support streamlined court proceedings or out-of-court workouts for corporate debt can help to make debt restructuring more efficient.

### a. Insolvency frameworks

**Effective insolvency regimes are essential for NPL resolution. An effective insolvency regime should provide mechanisms for creditors to enforce their claims in a predictable, speedy, and transparent manner, while at the same time protecting and maximizing value for all parties** (Aiyar et. al 2015). An effective debt enforcement and insolvency framework has, in turn, two pillars: first, it requires an adequate resolution toolkit that provides for the rehabilitation of viable firms and the liquidation of non-viable firms (and, in the case of personal insolvency, a second chance for good-faith entrepreneurs while preserving credit discipline). Secondly, it requires an effective institutional framework that operates in a predictable, efficient, and transparent manner. Strengthening insolvency regimes by enhancing insolvency laws, creating incentives for out-of-court settlement, and institutional reforms such as the establishment of specialized courts have been key elements of strategies for reducing NPLs in a number of countries (Beaton et al. 2018).

**Insolvency frameworks are the rules that determine the manner in which distressed assets are resolved so that business activity can continue or so that assets can be redeployed to more productive uses.** Past crises have shown that acute increases in the insolvency of SMEs and of corporate distress occur. In developing countries, the damage may be amplified by insolvency regimes that disproportionately result in the liquidation of firms, even when they are viable, and that return less than 30 percent on average to creditors. Not only will weak insolvency frameworks promote a destructive wave of premature bankruptcies, they can also leave so-called “zombie” companies limping along, operating but dependent on rolling over credit, unable to invest in new activity and starving healthy businesses of credit (Pazarbasioglu and Garcia Mora 2020). Thus, a staged approach is recommended to deal with insolvencies during a crisis. In the first stage of the crisis, it is important to flatten the curve of insolvencies and use relief measures to prevent viable firms from being forced prematurely into insolvency. Without intervention, even normally effective frameworks may lead to systemic bankruptcy, where a flood of insolvencies could trigger fire-sales and a collapse in asset prices. These relief measures are most useful in emerging markets, where creditors often use the insolvency system as a tool for debt collection. In the second stage, the challenge is to respond to the growing number of firms that need an insolvency process to survive. In this stage, it is vital to ensure the smooth functioning of workouts and debt-restructuring mechanisms. It is critical to minimize the number of

“zombie” firms, whose ongoing presence could starve healthy firms of credit in the post-crisis environment. Finally, the third stage will require a focus on people coping with personal financial distress in the aftermath of the crisis (Pazarbasioglu and García Mora 2020).

**In the EAP, economies experienced a drastic increase in NPLs in the aftermath of the AFC, with financial sector reforms shaping the legal frameworks for NPL resolution.** The AFC promoted reforms to the insolvency and resolution frameworks in many EAP jurisdictions (see Box 6). The COVID-19 pandemic has become a serious test for the framework of insolvency in EAP, given the across-the-board expected increase in NPL volumes.

### Box 6:

## Thailand: Reforms to formal and out-of-court mechanisms in the aftermath of the AFC

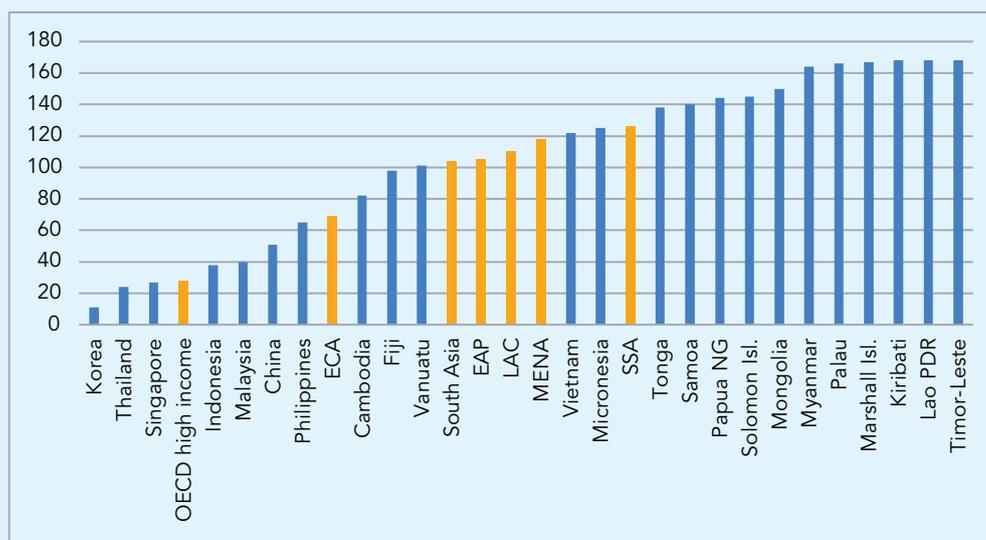
In Thailand, the AFC drove reforms to both formal and out-of-court mechanisms. Formal insolvency mechanisms were reformed in 1998, when the Thai Bankruptcy Act introduced business reorganization procedures to rehabilitate financially distressed but viable businesses. Before this reform, the Thai Bankruptcy Act only dealt with liquidation proceedings. In 1999, further reforms to the Bankruptcy Act resulted in the creation of a specialized Bankruptcy Court that had sole jurisdiction over all liquidation and rehabilitation cases and over all civil cases related to them. Thailand’s corporate reorganization through formal bankruptcy procedures facilitated and speeded up financial recovery for big and medium-sized insolvent firms, especially after 1999.

For out-of-court insolvency resolution mechanisms, the Corporate Debt Restructuring Committee (CDRAC) was established in June 1998 to facilitate debt restructuring between debtors and creditors. CDRAC members identified priority cases; developed a framework of voluntary principles and timelines for voluntary workouts (known as the Bangkok rules); and attempted to resolve legal and regulatory impediments to corporate restructuring. The CDRAC played an important role in the mediation process to reconcile conflicts of interest between various parties and to resolve disputes between the creditors themselves. It was successful in claiming 70 percent of restructured debt. The scheme introduced by the CDRAC was comparable to a pre-packaged out-of-court bankruptcy reorganization procedure, through which creditor-debtor agreements on the debt and business rehabilitation plans were worked out. Enforcement and compliance were conducted through an inter-creditor agreement and a debtor-creditor agreement that specified working rules and penalties in cases of violations by participating members. The scheme gained credibility because it required all the creditors to be involved, with prompt litigation if plans were not agreed upon. A key issue affecting the scheme was that the agreement was not legally binding on creditors who opted not to join it. The role of the CDRAC in at least partially facilitating a decline in NPLs from 38.5 percent in 1999 to 17.9 percent in 2002 has been acknowledged.

Source: Park 2019, DLA Piper 2012.

According to the Doing Business 2020 survey, the EAP region is still heterogeneous in terms of the ease of resolving insolvencies, with the biggest economies and those that reformed their systems in the aftermath of the AFC and the GFC typically generally performing better. The *Resolving Insolvency* index relates to the time, cost and outcome of insolvency proceedings involving domestic legal entities (see Figure 12). Korea, Thailand, and Singapore rank at the top, and even better than some OECD high income jurisdictions, while the average rank for the whole EAP is comparable to that in South Asia, Latin America and the Caribbean.

**FIGURE 12 : Ease of Resolving Insolvency**



Source: World Bank, Doing Business 2020.

Note: EAP= East Asia & Pacific; ECA=Europe & Central Asia; LAC= Latin America & Caribbean; MENA= Middle East & North Africa; SSA=Sub-Saharan Africa. Rank 1 (top) to 168 (bottom)

In recent years, EAP jurisdictions have embarked on a number of reforms to strengthen insolvency procedures. China made resolving insolvency easier by providing rules for post-commencement credit priority and for increasing the participation of creditors in insolvency proceedings. In 2016, Malaysia introduced two new court-sanctioned corporate rescue mechanisms, in addition to the widely used Scheme of Arrangement, while Singapore established a new scheme of arrangement procedures, with features of the debtor-in-possession reorganization regime, and introduced provisions applicable to prepackaged restructurings. In 2019, Thailand made resolving insolvency easier by changing the voting procedures for reorganization plans (World Bank 2020d).

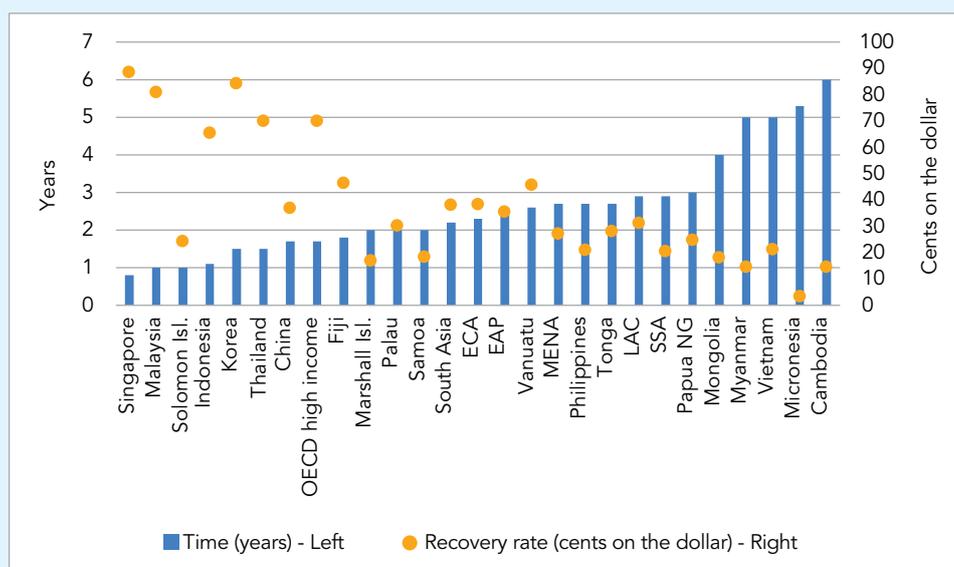
Several PICs, Lao PDR and Timor-Leste face challenges in terms of the ease of resolving insolvencies, with these jurisdictions ranking the bottom of the *Resolving Insolvency* index. Interestingly, in Timor-Leste, Lao PDR, Kiribati and Marshall Islands “there were no foreclosure, liquidation or reorganization proceedings filed in the country in the last 12 months. Due to this circumstance, it is not possible to assess the time, the cost or the outcome associated with the insolvency scenario described in the case study.”<sup>22</sup> In Palau, there is no insolvency legal framework, and foreclosure to enforce security interests must be initiated by filing an application with the Palau Supreme Court. Moreover, some of these jurisdictions do not disclose information related to the NPL ratio, making it even more difficult to assess the influence of the lack of sound insolvency frameworks to resolve NPLs.

22 World Bank, Doing Business (2020).



**In the EAP jurisdictions with more efficient and modern insolvency frameworks, it takes less time to resolve cases and recovery rates are higher** (see Figure 13). In Singapore, Malaysia, the Solomon Islands, Korea, Thailand, and China, completing the process takes from 0.8 to 1.7 years, below the average for OECD high income jurisdictions. With the exception of the Solomon Islands and China, recovery rates in this subgroup of economies are above 50 cents per USD dollar, with the highest rates in Singapore, at 89 cents per dollar. However, even in countries with a strong legal framework, there may be considerable challenges in implementation, including challenges related to an insufficient number of insolvency practitioners. Given that firm insolvencies are expected to increase, it could exert further pressure on already limited implementation capacity.

**FIGURE 13 : Time (years) and Recovery rate (cents on the dollar)**



Source: World Bank, Doing Business 2020.

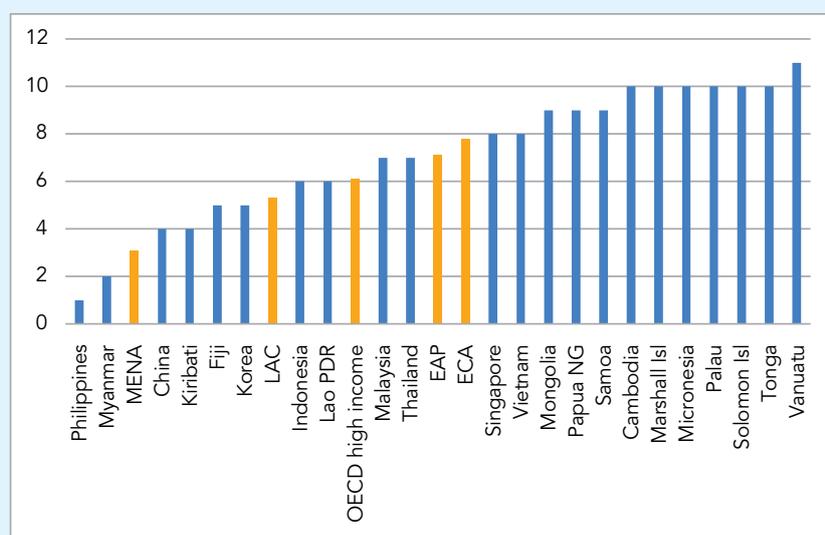
Note: EAP= East Asia & Pacific; ECA=Europe & Central Asia; LAC= Latin America & Caribbean; MENA= Middle East & North Africa; SSA=Sub-Saharan Africa. Rank 1 (top) to 168 (bottom)

## b. Collateral enforcement

Generally, in developing countries, real estate is the preferred form of security due to the lack of credit data and the limited capacity of the legal system to grant relief to unsecured lenders. Thus, lending against collateral is preferred. Enforcement procedures should provide for the prompt realization of the rights obtained through secured assets, ensuring the maximum recovery of asset values based on market values. It must also provide for nonjudicial and judicial enforcement methods. In many developing countries, enforcement of even collateralized debts is challenging. There is cumbersome legal process for enforcement, limited ability to auction property in default without court intervention, delays and prolonged legal processes and procedures, limited ability to enforce court judgement, loss of value of the property while waiting for judgement and auction, and lack of skills and specialization in courts for efficient debt resolution and restructuring (Annamalai 2020).

Several jurisdictions in the EAP rank equally to OECD jurisdictions in terms of the strength of legal rights that supports the enforcement of collateral (see Figure 14). The Doing Business Strength of Legal Rights index measures the degree to which collateral and bankruptcy laws protect the rights of borrowers and lenders and thus facilitate lending. Special emphasis is given to the manner in which the collateral registry operates (if registration of security interests is possible) and on the extent to which difficulties in realizing collateral increase banks' reluctance to address NPLs. The average EAP rank is similar to that for Europe and Central Asia, while several PICs rank in the top buckets of the rank, basically because of the presence of movable collateral laws and credit information systems.

**FIGURE 14 : Strength of legal rights index**



Source: World Bank, Doing Business 2020.

Note: Rank 0 (worst)-12 (best)

Several EAP jurisdictions have introduced changes in recent years to improve the enforcement of collateral. Thailand strengthened access to credit by adopting new legislation that broadens the scope of assets that can be used as collateral. Thailand now allows a general description of assets granted as collateral and allows the security interest to automatically attach to the proceeds of the original asset. It also establishes clear grounds for relief from a stay for secured creditors during reorganization procedures and allows out-of-court enforcement of collateral. In 2018, Vietnam strengthened access to credit by adopting a new civil code that broadens the scope of assets that can be used as collateral. In 2017, Indonesia strengthened access to credit by establishing a modern collateral registry (World Bank 2020d).



**CHAPTER 5**

# **Instruments Available for NPL Resolution and Related Challenges**

# Instruments available for NPL resolution and related challenges

## a. Instruments employed for the resolution of NPLs

A range of instruments are typically employed to resolve NPL and reduce reported NPLs.<sup>23</sup> These instruments can include:

- (i) loan restructuring;
- (ii) legal recovery, including through collateral enforcement and the initiation of insolvency procedures vis-à-vis the borrower;
- (iii) write-offs; and
- (iv) sales to third parties, including selling to investors, securitization, and sales to AMCs, as described in Table 4.

These channels are not mutually exclusive, and they are often combined and utilized in a specific order (FinSAC 2021, FSI 2017). In selecting the appropriate NPL reduction channel, banks should be guided by the expected net present value for each of these options.

**Debtor-focused resolution mechanisms can help to recover the value of banks' assets and can be an important tool in NPL resolution (FSI 2017).** When a bank borrower encounters financial difficulties, debt restructuring can help to preserve the value of the debtor's business. However, as this requires classifying the exposure as non-performing, with the associated higher provisioning requirements and the stigma effect on banks and their clients, banks may tend to postpone this step for as long as possible. A further incentive for delay is the complexity of debt restructuring, especially where lengthy legal processes are expected.

**Table 4 : Instruments available to resolve NPLs**

Instrument	Action
Loan restructuring	Deferment of borrower's debt service obligations to a future date, with or without reduction in the Net Present Value
Legal actions	Collateral enforcement, insolvency processes
Write-offs	Formal recognition in the financial statements that a borrower's asset no longer has value. Loans are transferred to the off-balance sheet records. Partial write-offs are those for which only part of the value of the loan is removed from the balance sheet.
Direct sales	<ul style="list-style-type: none"> <li>a. <b>To private investors:</b> NPLs are sold to private investors in dedicated markets. Investor continues collection efforts.</li> <li>b. <b>To Asset Management Companies (AMCs):</b> dedicated companies buy bad assets from banks. It manages the collection process.</li> <li>c. <b>Securitization:</b> banks, special purpose vehicles, AMCs or private investors pool and tranche loans and sell the securitized product</li> </ul>

Source: FinSAC 2020, Financial Stability Institute 2017.

<sup>23</sup> Throughout this section the term "NPL resolution" includes NPL reduction and NPL work out.

**Loan restructuring is a concession involving modifications to the contractual terms of the loan that otherwise would not be considered by the lender in response to repayment difficulties.**

Debt restructuring is a standard way of restoring a creditor's repayment capacity, as it allows borrowers to reduce and renegotiate NPLs. Short-term restructuring measures are designed to help liquidity-distressed borrowers navigate transient temporary repayment difficulties by allowing the borrower to pay later than originally stated in the contractual terms of the loan. Long-term restructuring measures are meant for borrowers that are facing deeper-rooted solvency difficulties. In such a case, while the borrower is distressed, the expectation is that the borrower can be rehabilitated through the implementation of long-term loan restructuring measures (FinSAC 2020).

**Debtor-focused resolution mechanisms face a number of limitations (FSI 2017).** First, it is important to ensure that debt restructuring is not simply a form of forbearance, which only postpones the problem. Second, debt restructuring is typically used more for corporate loans rather for other types of lending. Finally, fully fledged insolvency proceedings may be harder to implement in crisis times, when banks do not have the capacity to restructure a large volume of NPLs, market pressure is mounting, and courts are dealing with a large number of corporate failures. In those circumstances, out-of-court resolutions may be more effective. Moreover, a key prerequisite for considering loan restructuring is that the borrower is distressed but cooperative and potentially viable. If these conditions are not met, loan restructuring is unlikely to be successful and payment difficulties will most likely recur.

**Legal actions are usually the most suitable instrument for uncooperative or non-viable borrowers.** If financial institutions determine that a distressed borrower is uncooperative or non-viable, the next step is usually the initiation of legal action to recover the debt. This can entail judicial enforcement against the debtor, including collateral enforcement, the enforcement of third-party guarantees, or a petition to request the opening of insolvency proceedings, among other alternatives (FinSAC 2020).

**Write-offs are one means to dispose of NPLs, but banks usually have incentives to postpone them.**

Write-offs help to prevent big backlogs of NPLs building up on banks' balance sheets. They can also be employed in crisis times as an emergency measure, with authorities mandating minimum write-offs on NPLs, recognizing that the expected recovery value will be minimal, and that the economic value of attempting other forms of resolution for these loans will be low at best. Nevertheless, several reasons may delay the writing-off of bad loans. For instance, in some jurisdictions, fully provisioned NPLs are not written off because of fiscal, accounting, or legal impediments. In some jurisdictions, judges' interpretations and ambiguous or restrictive tax rules constrain banks from writing off NPLs. Moreover, banks, and sometimes regulators, affirm that by writing-off a loan, they are relinquishing their enforcement rights this on the borrower (FinSAC 2019).

**Low provisioning and capital levels may influence the write-off of NPLs.** A resolution strategy based on write-offs is, in principle, contingent on banks' capital buffers and provisions being sufficiently high to be able to absorb these losses. Banks may prefer to keep the full value of the loan on the balance sheet, and either count on the passage of time or improving macroeconomic conditions to turn around the loan, or eventually to restructure it. Nevertheless, in some cases, write offs can be conducted without impact on capital and profitability, such as if loans are fully provisioned. It is observed in some jurisdictions that banks have fully provisioned NPLs, but they avoid writing off the loans for legal reasons (for example, the court or the bank judging that write offs involve debt forgiveness) (FinSAC 2019). The borrower still owes money to the bank and therefore, write-offs do not constitute a resolution channel for dealing with NPLs. It has been observed, however, that following a write-off, the momentum for resolving problem loans fades (FinSAC 2020).

**Banks can reduce their exposure to problem assets by selling off portfolios of NPLs to distressed asset investors.** In a direct sale, the bank sells the asset to a counterparty, which is typically another financial institution, possibly a bank, or to other types of investment funds. The selling bank typically provides prospective buyers with the information they need to conduct due diligence.

**The development of secondary markets for NPLs has attracted attention from both investors and policy makers in recent years.** In a bid to diversify the range of NPL disposal channels, policymakers in several regions (e.g., the euro area and some EAP jurisdictions, such as China) have made an effort to develop such markets. NPL sales have played a critical role in reducing NPL ratios in EU countries with serious asset quality problems. Moreover, before the COVID-19 pandemic, investors in NPLs continued to look for new jurisdictions and opportunities to achieve attractive returns on capital. While much of the European NPL market was in a relatively advanced state, investors were looking further afield for NPL opportunities. China was one of the most interesting jurisdictions, given the 1.71 trillion yuan (US \$270 billion) of NPLs held by commercial banks (White and Case 2018).

**Securitization is a more complex means of disposing of NPLs, but it can broaden potential buyers.** Through the securitization process, the cash flows from a number of NPLs are pooled to create a security with senior, mezzanine and subordinate tranches. Each tranche has a different risk-reward profile. The advantage of securitization is that there is some diversification of risk away from a single credit name. Thus, with the use of tranches, investors can choose the risk-reward combination that best reflects their preferences (FSI 2017). Moreover, securitization converts NPLs to marketable securities, which could be of interest to a larger set of buyers, including foreign institutional buyers. Securitization also generally achieves a lower average cost of funding and, if guarantees are provided to the securitized assets, can result in higher NPL prices than direct sales. Finally, when dealing with small NPLs, to households or SMEs, securitization also implies some economies of scale compared to the high transaction costs involved in selling such NPLs individually.

**The ECB has noted that unsecured NPLs, including retail loans and credit card debt, have been actively trading in secondary markets.** The reasons are that these assets are typically straightforward to work out and there is sufficient transparency for investors regarding their value. Due to the unsecured nature of these assets and the resultant high levels of provisioning, sales typically take place at very low prices relative to book value, making it easier for investors to achieve their targeted returns (ECB 2016).

**However, some challenges related to selling and securitizing NPLs should be considered.** The first relates to pricing NPLs. Investors are looking for a return, so pricing will need to reflect this. Often this means that NPLs must be sold below the bank's net book value. Second, there are considerable fixed costs for investors in their assessment of the legal environment in a country. This particularly affects small countries, because they do not have the critical mass of NPLs to cover these one-off costs, while such costs become more affordable for investors in bigger jurisdictions. Finally, if there is no adequate legal protection, there are legal issues related to SOBs selling government assets below book value, as bank staff can be held legally responsible for that action.

**AMCs have been used extensively in NPL resolution, with these entities established in various ways according to countries' needs.** AMCs are companies to which banks can transfer their bad assets, with the AMC taking on the responsibility for resolving the NPLs. The AMCs can be privately or publicly owned, centralized or bank-specific, with the scope of banking assets to be treated under AMCs varying between jurisdictions. All of these options have been implemented, with the choice made by each jurisdiction depending on the nature and extent of the financial crisis at the time their AMCs were established. Typically, single-bank AMCs are set up when the NPL issues are limited to a few individual banks (e.g., during the first phase of the Swedish banking crisis), while sector-wide or centralized AMCs are more suitable for systemic problems (e.g., in Asian countries during the 1990s). In the latter case, it is also far more likely that the AMCs will be established with public funds, as the private sector does not have either the financial or coordination capacity to run these system-wide instruments in times of stress. When AMCs are centralized, they are also better at implementing consistent workout practices across similar types of NPL from different banks. Also, they may have stronger powers to promote legal changes that could help expedite loan recovery and bank restructuring (FSI 2017). In the EAP, financial sector reforms implemented in the aftermath of the AFC have shaped NPL resolution frameworks. As the result of the AFC, NPLs levels rose dramatically from the second half of 1997, persisting even after the economies started forward on a path to stabilization. For instance, NPL ratios rose to 50 percent in Thailand (January 1999); 25 percent in Indonesia (April 1998); and 15 percent in Malaysia (December 1998) (Takayasu and Yokoe 1999).

**Therefore, the NPL resolution took center stage in the East Asian countries hit by the crisis.** The EAP economies that were particularly heavily hit (Thailand, Indonesia, Korea, and Malaysia) developed a framework to support corporate restructuring and deal with the growing stock of NPLs. This was achieved through the use of AMC in a number of countries, including China, Indonesia, of Korea, Malaysia, and Thailand (see Box 7). This strategy took time, with the affected companies and their assets continuing to lose further value over time. Meanwhile, the affected economies paid high fiscal costs to resolve the crisis (ranging from 25 to 50 percent of gross domestic product). EAP jurisdictions also adopted a variety of other policy tools, such as the reforms to the insolvency and resolution frameworks, financial sector restructuring and bailout, and macroprudential tightening, including loan classification and provisioning stringency.

### Box 7:

## AMCs as a Distinctive Feature for the Resolution of NPLs in EAP

*AMCs had a key role during the AFC and shaped the market for resolution of NPLs in EAP*

**China:** China has an active market for the resolution of NPLs. In 1999, four state-owned AMCs were established, and now these together with more than 50 AMCs at city and provincial levels are the major participants in the NPL market. In 2017, a limit that prohibited AMCs from on-selling NPLs to third-party buyers was removed, with a burgeoning private sector–distressed debt market emerging since. Thus, the channels for bad asset disposal have widened for banks, as these private sector investors are more open to buying a wider range of NPLs than the big-four AMCs. This situation has also contributed to creating a more liquid market for the sale of NPLs.

**Korea:** The development of a market for distressed assets was critical to Korea's success in resolving NPLs after the AFC. The government played a leading role in financial and corporate restructuring, including strengthening the legal and regulatory framework, injecting public funds, and setting up new institutions for crisis management, such as the Korea Asset Management Corporation (KAMCO). The political consensus on the need to reduce public debt enabled KAMCO to sharpen its focus on the rapid disposal of acquired assets and the recovery of public funds, rather than simply warehousing the assets, a frequent problem in publicly owned AMCs in other countries.

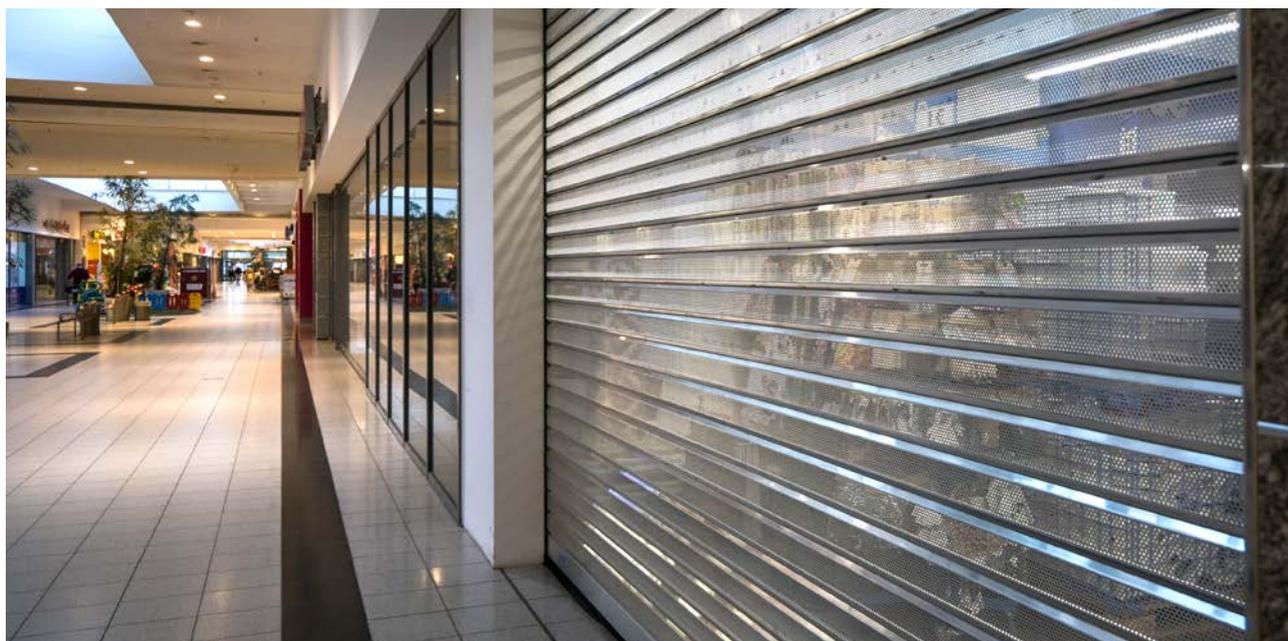
**Indonesia:** A public AMC, the Indonesian Bank Restructuring Agency, was established in 1998, before closing in 2004. Since its closure, there have been no centralized public AMCs, with Indonesian banks relying on private in-house methods to resolve NPLs. In addition, within the Ministry of State-Owned Enterprises, there is a unit that acts as a vehicle to restructure and resolve public debt from state owned banks. Also, in 2004, Indonesia introduced a new bankruptcy law to promote prompt and fair resolution of commercial disputes and to provide a framework to encourage out-of-court settlements.

**Malaysia:** The National AMC Danaharta was established in 1998 to acquire NPLs from banks and to manage them at the account level to maximize recovery value. This entity closed in 2005. The relatively small number of accounts (approximately 3000) and the chunky nature of the majority of the NPLs made such an approach feasible in Malaysia at that time. This case is described in detail in Annex 1 of this report.

**The Philippines:** In the aftermath of the AFC, resolution was centered on private special purpose vehicles (SPV) as the means to acquire NPLs and other assets from bank's balance sheets. The SPV Act incentivized transfers by reducing taxes and fees. By the end of its implementation in 2008, the SPV Act facilitated a massive transfer of NPLs from the banking system, with the NPLs' ratio decreasing from 17.64 percent in 2002 to 4.49 percent in 2008. Currently, private SPVs and multinational debt management companies are engaged in the NPL market.

**Thailand:** In 1998, the AMC Emergency Decree facilitated the establishment of 12 private and four public decentralized AMCs. The Corporate Debt Restructuring Advisory Committee was established in 1998 to facilitate out-of-court restructuring. A public AMC, the Thai Asset Management Company, was established in 2001 and closed in 2013. Following that, one public AMC and two private AMCs took over the Thai Asset Management Company's assets. These entities now dominate Thailand's NPL market, together with other small private AMCs.

Source: Authors' compilation from the following sources: Park 2019; Rosenkranz and Lee 2019; Bedford 2017; He 2004; and Honohan and Klingebiel 2000.



**While public AMC**s may benefit the financial system in a number of ways, a number of preconditions should be in place to ensure their success.<sup>24</sup> The preconditions relate to:

- i. *Commitment to comprehensive reforms*: The political will to recognize and address the relevant issues has been recognized as the most critical precondition. Where credit losses have already occurred but are not recognized, it is usually difficult for the government to face these losses, as it may entail fiscal costs to prevent banks from failing. However, in such a situation, time is of the essence: the longer it takes to recognize the problem, the larger the losses.
- ii. *A systemic problem and public funds at risk*: A high level of NPLs is not a sufficient basis to establish a public AMC. Where banks are well capitalized but experiencing high NPLs, they should be able to withstand higher provisions, set up dedicated workout units, and draw on external expertise to resolve their issues. Likewise, if the problems are confined to one or more smaller banks, they should be addressed either by shareholders or through the bank resolution process. Establishing an AMC is not warranted unless weaknesses in the financial system are systemic and threaten to put public funds at risk.
- iii. *A solid diagnostic and critical mass of impaired assets*: The diagnostic assesses the financial condition of the banks and enables a determination as to whether an AMC may have a critical mass of homogenous assets to manage. This diagnostic is also necessary to determine the mandate of the AMC, either as a bank resolution entity (if many institutions need to exit), or as an asset-purchasing entity (in case most of them can continue operating).
- iv. *A tradition of institutional independence and public accountability*: An AMC is created within a local institutional framework and culture. As its business is prone to interference (it often must collect from politically connected parties), an AMC should enjoy strong protection from any third-party influence. One way to protect an AMC is to require transparency and accountability regarding its performance through its founding statutory basis.

<sup>24</sup> The World Bank has conducted a thorough study of AMCs and designed a toolkit for policy makers and stakeholders considering the establishment of AMCs, see Cerruti and Neyens 2016. This section is based on this document.

- v. *A robust legal framework for bank resolution, debt recovery, and creditors' rights:* The bank resolution framework should be clear regarding the responsibilities of the entities involved, clearly indicating which party bears the cost for bank resolution. An AMC should be designed to absorb a temporary loss in the value of assets, with this loss expected to be offset within its lifetime through active asset management. An AMC builds on a strong legal framework for creditors' rights. In many countries, AMCs were created because the legal framework for creditors' rights, asset securitization, and processes were deficient. As the necessary reforms could not be implemented in a timely manner, a public AMC was given special powers to deal with these constraints.

**As AMCs are costly to set up and to operate, the costs and benefits should be assessed carefully before they are established.** Most of the AMCs created in the wake of the GFC have been structured as entities that purchase assets from open banks (see Box 8). More recently, in Europe, the private sector has participated in the ownership of AMCs to avoid consolidation in the national accounts. This has raised issues regarding transfer price, voluntary versus mandatory participation of financial institutions, and eligibility of assets for purchase. AMCs have been considered to be successful when they managed to repay all their liabilities and some of their initial equity. Some AMCs that did not have high face value returns managed to achieve other results, such as the creation of a vibrant distressed-asset market, or the recovery of misused liquidity support from the shareholders of the failed banks.

#### Box 8:

### Insights from the analysis of AMCs from 1990-2005

- AMCs have been established either to resolve insolvent financial institutions and their assets or to purchase assets from open banks.
- AMCs benefit from a high level of consensus and political will, particularly with respect to a willingness to crystallize, or recognize, the true level of losses within the banking system.
- When AMCs have purchased assets from open banks, defining the transfer price has been the most difficult design issue. Participation from financial institutions was either made mandatory or associated with strong regulatory incentives to participate.
- Most successful AMCs have had a narrow mandate (such as resolving NPLs) with clearly defined goals, a sunset clause, and a commercial focus, including governance, transparency, and disclosure requirements.
- AMCs do not have to be a new institution. Sometimes an existing institution, such as a deposit insurance agency, can be retooled to perform the asset management function.
- Although some AMCs needed special powers when the legal and regulatory framework for debt enforcement was deficient, all benefited from complementary programs to strengthen regulation and supervision, to reform legal and judicial systems, and to improve governance.

Source: Cerruti, Caroline; Neyens, Ruth, 2016.

## b. The influence of taxation on the resolution of NPLs

**Tax policies need to be considered when assessing the feasibility of various resolution options, as different tax treatments have the potential to either hinder or facilitate certain resolution strategies.**

Research on the topic (Haley et al., 2016) classify tax impediments for NPL resolution as:

- (i) those which discourage banks from writing-off and provisioning against NPLs appropriately (e.g., tax treatment of provisions and write-offs, and utilization of tax losses); and
- (ii) impediments impacting the transfer of NPLs from banks to other entities, such as private equity groups or securitization vehicles (e.g., withholding tax on interest payments and transfer taxes, which increase the cost of buying NPLs for investors).

### i. The influence of taxation on NPLs' write-off and utilization of tax losses

**Tax regulations may play an important role in the timing of write-offs.** Tax regulations may require exhausting all possible measures, including legal measures, for loan recovery before the loan is fully provisioned and written off, or they may not recognize write-offs for tax deductibility purposes (for example by introducing caps). The exhaustion of all possible measures to collect a loan may mean obtaining a final ruling of the court, which might take many years. The requirement to undergo the judicial process is particularly burdensome for banks that hold many NPLs with small nominals outstanding. In many instances, the enforcement of borrower's liabilities, involving national judicial systems, takes an excessively long time. Hence, the removal of these impediments is an important precondition for an effective NPL resolution, requiring the involvement of many local authorities.

**Whether banks receive tax deductions for provisions or write-offs on loans can have a bearing on the overall effect of the recording of NPLs.** The conditions that need to be met for the deductions to be allowed can introduce added complexities for banks when booking provisions or writing-off loans. As a result, banks may keep large volumes of NPLs with little or no recovery value on their balance sheets.

**Once banks have been allowed to take tax deductions for provisions and write-offs of NPLs, one of the key points to consider is whether they can derive value from those losses** (i.e., can they offset these losses against current or future taxable income). To the extent that there are restrictions on the utilization of tax losses carried forward, this may create additional difficulties, as banks will not be able to derive value from tax losses through either a decrease in their current year and future cash tax bill, or the recognition of a deferred tax asset on their balance sheet. Restrictions on the future utilization of tax losses carried forward generally come from time limits (i.e., the fact that after a certain number of years, tax losses have to be forfeited) and change of ownership restrictions, whereby tax losses carried forward need to be forfeited upon a change of ownership.

### ii. The influence of taxation on the transfer of NPL to investors and other parties

**Tax rules related to the transfer of NPLs may also inhibit investor demand.** Possible tax impediments on the demand side relate to a number of factors. Withholding taxes on interest payments are usually a key consideration for foreign investors. To the extent that loans are expected to generate interest income, the quantum of potential withholding tax leakage on interest income can be a determinative factor for foreign investors acquiring NPLs.

**Another key tax consideration for investors is whether the transfer will be subject to value-added tax (VAT).** VAT may additionally reduce the value of NPLs for non-bank investors, which do not benefit from exemptions typically available to banks. For example, VAT charged on loan servicing automatically increases the costs borne by servicers for the administration and collection of NPLs, thus making them less competitive than banks.

**Other transfer taxes, such as stamp duty or real estate taxes, may also be of relevance depending on the jurisdiction, type of NPLs being acquired, and the proposed transaction structure.** Depending on how the portfolio is acquired (i.e., whether it is through a share acquisition or an asset purchase), various transfer taxes may be applicable.

**Authorities in some EAP jurisdictions have made explicit use of tax incentives to accelerate the resolution of NPLs following the AFC.** For instance, in 2002, the Philippine Congress enacted the SPV Act, providing tax exemptions and incentives for banks to transfer NPLs to SPVs (see Box 9).

### Box 9:

## Tax Exemptions and the Resolution of NPLs: The Experience of the Philippines

The Philippine NPL market emerged following the AFC. The Philippine Congress enacted the SPV Act of 2002, providing tax exemptions and fee incentives for the parties involved in the transfer of non performing assets (NPA) to SPVs.

The transfer of NPAs from a financial institution to an SPV, and from an SPV to a third party or the payment by the borrower or by a third party in favor of a financial institution or in favor of an SPV, was exempted from the following taxes:

- (i) Documentary stamp tax on the transfer of NPAs and dation in payment (*dacion en pago*);
- (ii) Capital gains tax on the transfer of lands and/or other assets treated as capital assets under the National Revenue Code;
- (iii) Creditable withholding income taxes imposed on the transfer of land and/or buildings treated as ordinary assets pursuant to existing regulations;
- (iv) Value-added tax on the transfer of NPAs or gross receipts tax, as may be imposed under the National Internal Revenue Code.

To provide the right incentives for resolution, transactions were entitled to the privileges for a period of not more than two years from the date of effectivity of the regulations, provided that some conditions were satisfied.

To encourage the infusion of capital and/or financial assistance by the SPV for the purpose of rehabilitating the borrower's business, the SPV was exempted from:

- (i) income tax or net interest income, documentary stamp tax and mortgage registration fees on new loans in excess of existing loans extended to borrowers with NPLs which have been acquired by the SPV.
- (ii) the documentary stamp tax in case of capital infusion by the SPV to the borrower with NPLs.

In addition, losses incurred by the financial institutions as a result of the transfer of NPAs were treated as ordinary loss, provided that some conditions were satisfied, and the tax savings derived by financial institutions was required to be retained as a form of capital build-up.

Source: Deloitte 2019, and Congress of The Philippines 2002.

### c. Banks operational readiness and strategy for the management of NPLs

**Banks need to ensure that they have the operational capacity to address NPLs at an early stage.** The internal capacity includes not only human and financial resources, but also a sound governance framework for the management of NPLs. In that regard, the ECB has identified a number of best practices useful to manage NPLs, which can be used as benchmark for jurisdictions in EAP. These practices are summarized as follows (ECB 2017).

**Banks need to develop an NPL strategy, which establishes strategic objectives for the timebound reduction of NPLs over realistic but ambitious time-bound horizons (NPL reduction targets).** The strategy should define the bank's approach and objectives regarding the effective management and reduction of NPL stocks in a clear, credible and feasible manner for each relevant portfolio. The implementation of the NPL strategy involves some key steps, such as an assessment of the operating environment, including internal capabilities, and the external conditions impacting NPL workout and capital implications (see Figure 15).

**FIGURE 15 : The NPL Strategy and Operational Capacity**



Source: Authors based on European Central Bank, 2017.

**A key step in the formulation and execution of the NPL strategy is for the bank to complete an assessment of its internal capabilities to effectively manage and reduce NPLs over a defined time horizon.** A thorough and realistic self-assessment helps to determine the severity of the situation and the steps that need to be taken internally to address it. Banks should fully understand and examine the scale and drivers of NPLs; the size and evolution of its NPL portfolios on an appropriate level of granularity; the drivers of NPL in-flows and out-flows, by portfolio where relevant; and other potential correlations and causations.

**Banks should have the operational capacity to implement the strategy and to manage NPLs.** This includes the processes, tools, data quality, IT/automation, staff expertise, decision making, internal policies, and any other relevant area for the implementation of the strategy for NPLs.

**Sound governance arrangements should be in place to support the execution of the NPL strategy.**

The bank's board should approve and oversee the institution's strategy (see Table 5). The NPL strategy and operational plan forms a vital part of the overarching strategy and therefore should be approved and steered by the board.

**Table 5: Banks' capabilities to manage NPLs: The role of banks' boards**

The banks' board should
<ul style="list-style-type: none"> <li>• Approve annually and regularly review the NPL strategy, including the operational plan, and oversee the implementation of the NPL strategy</li> </ul>
<ul style="list-style-type: none"> <li>• Define management objectives, including a sufficient number of quantitative ones, and incentives for NPL workout activities</li> </ul>
<ul style="list-style-type: none"> <li>• Periodically (at least quarterly) monitor progress made relative to the targets and milestones defined in the NPL strategy, including the operational plan.</li> </ul>
<ul style="list-style-type: none"> <li>• Define adequate approval processes for NPL workout decisions. For certain large NPL exposures this should involve management body approval.</li> </ul>
<ul style="list-style-type: none"> <li>• Approve NPL-related policies and ensure that they are fully understood by the staff.</li> </ul>
<ul style="list-style-type: none"> <li>• Ensure sufficient internal controls over NPL management processes, with a special focus on activities linked to NPL classifications, provisioning, collateral valuations and sustainability of forbearance solutions.</li> </ul>

Source: European Central Bank (2017).

**International experience indicates that a suitable NPL operating model is based on dedicated NPL workout units (WUs) that are separate from units responsible for loan origination.**

Key rationales for this separation are the elimination of potential conflicts of interest and the use of dedicated NPL expertise from staff through to management level. The implementation of separate and dedicated NPL WUs, ideally should start from the moment of early arrears, but at the latest at the NPL classification of an exposure. This separation of duties should encompass not only client relationship activities (e.g., negotiation of forbearance solutions with clients), but also the decision-making process. Banks should consider implementing dedicated decision-making bodies related to NPL workout (e.g., NPL committee). Where overlaps with the bodies, managers or experts involved in the loan origination process are unavoidable, the institutional framework should ensure that any potential conflicts of interest are mitigated.

**Based on proportionality criteria and the findings of the bank's NPL self-assessment of their capabilities, banks should regularly review the adequacy of their internal and external NPL workout resources and determine their capacity needs.**

Certain benchmarks (e.g., workout accounts per full-time equivalent employee) can be set and monitored. Any staffing gaps should be addressed as quickly as possible. Given the extraordinary nature of the NPL workout activities, banks might choose to use fixed term contracts, internal/external outsourcing, or joint ventures to conduct these activities. In the event that external outsourcing is used, banks should have dedicated experts to closely control and monitor the effectiveness and efficiency of the outsourced activities.





## CHAPTER 6

# Challenges for Financial Sector Policymakers in the Context of the COVID-19 Crisis

## Challenges for Financial Sector Policymakers in the Context of the COVID-19 Crisis

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**Financial sector policymakers are faced with an exceptional set of circumstances that underline the need to achieve a balance between micro-prudential objectives of safety and soundness and the macroprudential goal of system-wide resilience.** Shoring up capital and liquidity to ensure the stability of individual institutions could cut the flow of credit to real-economy sectors when they most need it, thus raising real sector solvency issues and exposing banks with credit exposures to these sectors. However, micro-prudential supervisors might take a cautious view regarding allowing banks to reduce their capital ratios at a time when NPLs and loan losses are increasing (Carstens, Agustin 2020). Policy makers are faced with sometimes conflicting objectives, such as maintaining the safety and soundness of the supervised institutions; ensuring that banks can continue to lend to households and businesses and support the real economy; requiring a robust and consistent market disclosures by banks; and safeguarding the fair treatment of customers (Toronto Center 2020).

**Financial sector policymakers in EAP and international standard setters responded quickly to the pandemic, emphasizing flexibility in the application of accounting and regulatory standards for the treatment of potentially impaired loans** (see Section III). This enabled banks to reduce the extent to which non-payments of interest and principal feed through to higher provisioning and higher capital weightings, thereby reducing the adverse impact on regulatory capital ratios.

**However, these exceptional regulatory relief measures created significant challenges for supervisors in assessing the risk profile of banks and their financial health.** Indeed, most of the relief measures have direct implications for the computation of regulatory capital, risk-weighted assets, and NPLs (see Section III.b). Supervisors are grappling with the trade-off between making judicious use of the flexibility available to them while still maintaining a reasonable level of prudence in supervision of banks.

**The pandemic has increased the overall level of risk for the banking sector, particularly credit risk.** With the economic fallout affecting virtually every segment of banks' credit portfolio, the impact of the crisis on bank balance sheets could be considerable. This is particularly true if government support is withdrawn prematurely, as this could place additional strain on the repayment ability of households and businesses. Other risks, such as market and liquidity risk, have also increased. The pandemic has also heightened the risks to banks' operational resilience. The threat of financial crime has increased as the pandemic leads to an even heavier reliance on technology and third-party service providers.

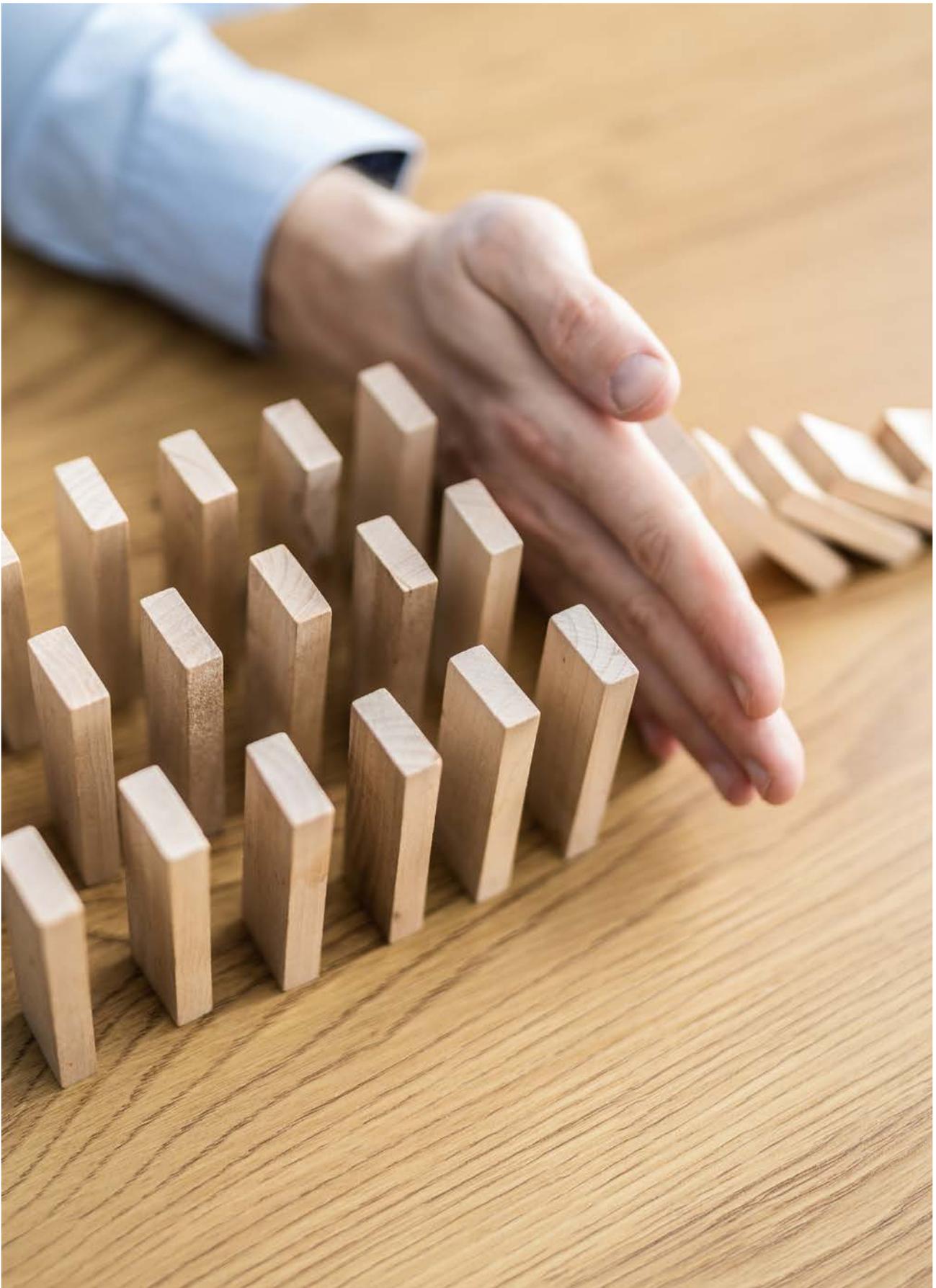
**The pandemic has affected the operations of both financial institutions and supervisors.** With large parts of their workforce working remotely, supervisors have had to adjust their working patterns, putting to the test their IT systems and their institutional agility. Supervisors have had to take a great many extraordinary measures in a relatively short space of time. In the pre-pandemic period, supervisors exercised scrutiny over banks through a combination of off-site monitoring and on-site inspections. With the pandemic, most of the latter became impracticable (Carstens, Agustin 2020).

**One year after the outbreak of the pandemic, financial sector policymakers face the challenge of unwinding the extraordinary borrower relief measures they implemented.** The general principle should be to unwind them as soon as circumstances permit. In many jurisdictions, this means that the exceptional measures should be wound down in a gradual manner (FinSAC 2020). While the borrower relief measures have helped to reduce pressures on banks' capital, further extensions can be associated with a negative impact on banks' liquidity and profitability, with the relief measures bands translating into a potentially significant reduction on cash flows and overall earnings on banks' loan books.

**Moreover, financial sector policymakers are challenged by the fact that any additional policy response should minimize the extent of moral hazard and maintain adherence to sound credit risk management practices.** Policy responses should be time bound, have clear sunset clauses and exit strategies, and should be targeted to ensure that they only benefit viable borrowers. Additionally, as some jurisdictions in the EAP have introduced forbearance measures, authorities should be careful of the unintended consequences of inadequate incentives for sound credit risk management. While loan forbearance is acceptable and within the guidelines set by international standards, forbearance in general is not, given that it has the potential to expose the banking system to significant risk, particularly for jurisdictions with preexisting vulnerabilities.

**Policymakers need to understand the implications of the current accounting and regulatory requirements and the interactions between them.** This is not always straightforward, particularly at a time when many countries in EAP are transitioning to IFRS 9 or similar forward-looking approaches to expected credit losses and are seeking to align accounting standards and prudential requirements. The use of regulatory definitions for NPLs that are aligned with international standards provides a basis for efforts to ensure that standard metrics of asset quality and capital strength are economically meaningful. The use of these definitions by banks and supervisors is critical for monitoring and assessing banks asset quality in a consistent manner (FinSAC 2020). The main objective here is to ensure a sound identification of credit-impaired assets on bank balance sheets. Consistency and comparability in risk metrics is a pre-condition for banks, supervisors, investors, and the public to effectively monitor the impacts of the current crisis in a coherent manner (Toronto Center 2020).

**Attention is required to address longer-term, more structural challenges, such as the sustainability of banks' business models and the intensified use of new technology in financial services.** The digital disruption accelerated by the outbreak of the pandemic poses a formidable challenge to policy makers, who must adapt by balancing measures to facilitate competition and to enable the benefits of innovation with protecting financial stability. The COVID-19 crisis adds to a range of pre-crisis challenges in the traditional banking business model, such as revenue pressure and low profitability (low levels of interest rates and higher levels of capital), tighter international regulation after the GFC, and increasing competition from shadow banks and new digital entrants.





## CHAPTER 7

# Conclusions

## Conclusions

**As result of the COVID-19 crisis, a surge in NPLs is expected in the EAP.** The persistent, long-term presents of bad debt on banks' balance sheets should be avoided and resolved by using the appropriate tools. The analysis conducted in this report allows us to draw conclusions and recommend actions for the management of NPLs and the shaping of the regulatory framework in the EAP region going forward.

### Considerations in analyzing NPL ratios in times of COVID-19

There are three main considerations for those analyzing NPL ratios in the EAP:

1. **A meaningful analysis of non-performing exposures in EAP requires looking not only at NPL ratios, but also of the environment in which emerging risks arising from underlying vulnerabilities are addressed.** Before the COVID-19 crisis, while NPL ratios were relatively low for most of the countries in the EAP region, some sectors displayed critical vulnerabilities that had the potential to significantly impair the quality of credit portfolios. These include the high levels of household and corporate debt, the exposures to the real estate market, and the exposure to SOEs in some jurisdictions. In fact, those risk factors underscore the importance of stress testing NPLs ratios in normal times to assess their potential effect. Furthermore, it also highlights the relevance of having in place macroprudential policies to help contain the buildup of such vulnerabilities. In the aftermath of the COVID-19 crisis, there is a higher potential for some of these vulnerabilities to materialize, which in turn will further affect the NPL ratios.
2. **NPL ratios in EAP do not necessarily capture the full spectrum of non-performing exposures because of regulatory arbitrage and poor prudential oversight.** In countries where traditional regulatory classification and provisioning systems are still used, the special mention, past due, or forbore exposure categories should be considered. These practices call for enhancements in the regulatory and supervisory frameworks to close gaps, to identify the borrowers, and to classify them properly. Given the existing forbearance measures, it is critical to also monitor forward-looking measures to determine asset quality, including restructured loans and 'loans at risk' to the extent that data are available.
3. **Attempts to compare NPLs across EAP can be misleading, because the internationally accepted guidance for NPLs and forbearance provided by the BCBS has not yet been adopted by all countries in the region.** Material differences exist across the EAP that call for the more widespread adoption of the harmonized definitions established by the BCBS. The adoption of the international standards for the definition of problem loans and forbearance would strengthen national definitions and enhance comparability across jurisdictions.



## Options to address NPLs in times of COVID-19

**In order to effectively address all the dimensions involved in the identification, management and resolution of NPLs, authorities will need to sequence short-term and long-term measures.** While some policy measures should be adopted in the short term, such as those related to exiting from extraordinary policies, other reforms will require more time and should be addressed over the medium to long term, such as those related to regulatory and supervisory policies and reforms to the enabling environment. Recommendations for each of the areas are provided below.

### (i) Exiting from extraordinary policies

**Exit strategies for borrower relief measures:** Regarding the borrower relief measures adopted in response to the COVID-19 crisis in the EAP, credible exit strategies are critically important and require urgent attention, following the recommendations that have been agreed upon internationally (IMF and the World Bank 2020; FSB 2021). The sudden removal of these measures could cause a sharp rise in NPLs, with a significant negative effect on banks' financial health. Therefore, the authorities must implement careful planning. Moreover, as recommended by the IMF and the World Bank (2020), any additional policy response should minimize opportunities for moral hazard and maintain adherence to sound credit risk management practices. Policy responses have to be time bound, with clear sunset clauses and exit strategies, and targeted to ensure that only viable borrowers will benefit. Additionally, as many EAP countries have introduced forbearance, jurisdictions should be careful of the unintended consequences of inadequate incentives for sound credit risk management. These solutions expose the banking system to significant risk, particularly for jurisdictions with preexisting vulnerabilities.

**International recommendations targeted to the local circumstances:** The implementation of the exit strategies and any additional exceptional measures would benefit from the adoption of the international recommendations in a manner appropriate to the local circumstances. Policymakers in the EAP can benefit from the FSB recommendations regarding the design of the exit policies (FSB 2021). Authorities may follow a flexible, state-contingent approach, adjusting and withdrawing gradually, by:

- (i) ensuring that measures are targeted, rather than based on broad and large-scale support as at the beginning of the pandemic;
- (ii) requiring beneficiaries to opt in, as this may help to ensure that support goes only to those who need it, as well as being a means to elicit information relating to the financial health of the beneficiary;
- (iii) making the terms on which support is provided progressively less generous; and
- (iv) sequencing the withdrawal of support measures.

**Disclosure of exposures subject to the exceptional measures related to the COVID-19 crisis:** In order to promote market discipline, authorities should establish tailored risk indicators for credit exposures covered by the COVID-19 exceptional measures. The lack of sufficient information regarding the application of payment moratoria and the public guarantees necessitates both the additional collection of specific information from the institutions for supervisory purposes and public disclosure for the purposes of ensuring market discipline and transparency for investors and in the wider public interest. In this regard, the guidelines set by the European Banking Authority constitutes a sound benchmark for those EAP jurisdictions that do not require institutions to disclose the exposures that have been subject to the special measures (see EBA 2021).

## (ii) Regulatory and supervisory policies

**Adoption of internationally agreed definitions for NPLs and forborne exposures:** Supervisors in the EAP should work towards the adoption of the international standards for the definition of NPLs and forborne exposures. That will help to strengthen regulatory definitions and to promote the harmonization of definitions and practices across jurisdictions. The use of regulatory definitions aligned with international good practice underpins efforts to ensure that standard metrics for asset quality and capital strength are economically meaningful. The use of these definitions by banks and supervisors is critical for monitoring and assessing asset quality in a consistent manner, both within and across jurisdictions, and to facilitate timely action to address rising asset quality problems.

**Sound valuation of collateral used by banks:** A conservative approach should be adopted for the valuation of collateral, reflecting various constraints in valuing, accessing and disposing of collateral. In particular, the value of collateral should reflect changes in market conditions, the costs of sale, and delays in realizing proceeds. Furthermore, collateral should be periodically valued by reliable and independent third parties and subject to enhanced supervisory scrutiny. In the case of real estate, banks should obtain sound appraisals of the current fair value of the collateral from qualified professionals.<sup>25</sup> This item is particularly sensitive in jurisdictions where banks are heavily exposed to real estate collateral.

**Ensure banks make proper use of the UTP criteria:** Banks should be required to assess exposures as performing or non-performing based solely upon the DPD and the UTP criteria, but not on the collateral, as recommended by the 2017 BCBS guidelines on NPLs. This principle is of utmost importance in jurisdictions that face material difficulties related to collateral valuation and debt enforcement mechanisms.

**Ensure appropriate incentive frameworks for SOEs:** In the EAP jurisdictions where lending to SOEs is material, countries will benefit from removing regulatory incentives that promote an uneven playing field to benefit SOEs at the expense of private firms, such as excessively reliance on government implicit guarantees of SOEs. The credit quality of SOEs must be evaluated and assessed on the basis of their own ability to maintain sustainable cash flows, as with any other private firm. Any uneven privilege should be removed from the regulatory framework to avoid crowding out resources from the private sector.

## (iii) Enabling environment

**Tools to manage firm insolvencies:** Given the magnitude of corporate debt in some EAP jurisdictions, a range of tools should be in place to deal with firm insolvencies that could materialize due to the COVID-19 crisis in order to minimize the negative effects on the financial sector. In countries where firms were heavily indebted before the crisis, many of them have been under considerable financial stress. In addition, their viability may be threatened, which in turn affects the repayment of banking loans. Revising insolvency frameworks is one of the main elements that authorities should consider in this context (Pazarbasioglu and García Mora 2020). It is recommended that during the first stages of the crisis, authorities across jurisdictions should use relief measures to prevent viable firms from being forced into premature insolvency. In a second stage, when a growing number of firms will need insolvency processes to survive, it is vital to ensure the smooth functioning of workouts and debt restructuring mechanisms.

<sup>25</sup> See Aiyar et. al (2015) for the experience in Europe.

**Mechanisms for consumer bankruptcy:** As the materiality of household debt in some of the EAP jurisdictions could create serious issues and negatively affect the quality of banks' portfolio, these jurisdictions would benefit from implementing mechanisms for consumer bankruptcy. It is recommended that countries put in place modern consumer bankruptcy frameworks, ensuring that there are flexible options for debt rescheduling and repayment plans (World Bank 2020b; Pazarbasioglu and García Mora 2020). Such mechanisms would help to resolve banking loans to individuals and households in a more ordered manner. Further, they would help to provide more certainty to banks regarding the procedures to be implemented in such insolvencies and to set realistic expectations related to potential loan recoveries.

**Resolution of collateral:** Given that banks in some EAP jurisdictions are severely exposed to the dynamics of the real estate market, effective procedures to facilitate the prompt resolution of real estate collateral are required. In particular, mechanisms to resolve mortgages are necessary in anticipation of an escalation in defaults. To address this challenge, the implementation of standardized procedures for the engagement of borrowers at banks could help to speed the process of restructuring such loans if they have prospects for long-term sustainability. Moreover, in the current low interest rate environment, borrowers have incentives to refinance or even repay their loans, which introduces a source of interest rate risk for banks. The review and reform of the legal framework for the enforcement of collateral and mortgages should be conducted when needed to promote efficient, rapid repossessions by banks.

**Effective workout and resolution of NPLs:** NPLs are expected to continue to grow in the aftermath of the COVID-19 crisis, with experience showing that NPL-related problems are best addressed proactively. Reducing NPLs through deliberate policies is associated with significant growth dividends when compared with countries where high NPL ratios have persisted over long periods (Balgova and Plekhanov 2016). The effective and early workout and resolution of NPLs are central to avoid loss of confidence in the banking system and to ensure that bank lending continues to support growth.

**Adjustments to AMC frameworks:** The framework for AMCs in some EAP jurisdictions should be adjusted where necessary by restricting funding to zombie borrowers and to avoid them functioning as an indefinite warehouse for NPLs. This crisis creates an opportunity to review recent international experience with AMCs and to introduce the necessary adjustments in the legal, regulatory, and operational framework to increase their efficiency. AMCs can be instrumental in developing a liquid and agile private market for NPLs (for example, by linking buyers and sellers of NPLs). For AMCs to be able to deliver according to their mandate, clear rules and sound governance practices are required. Moreover, AMCs may also serve as key actors in financial safety nets to avert the massive cost of crisis resolution.

**Preconditions for the entry of private investors in the market for NPLs:** The entry of private investors in the market for NPLs may play an important role in NPL resolution as a means to clean banks' balance sheets, although some preconditions must be satisfied. China is one example where including additional market participants has helped to complete the spectrum of risk appetite for NPLs. These private investors are willing to invest in distressed assets that are not of interest to AMCs. In cases where banks do not have internal capacity to work out NPLs or have exhausted internal restructuring opportunities, the sale of NPLs is a viable option for the bank. The necessary preconditions for this include the presence of sound accounting and valuation frameworks and the rights of foreign investors to own property, which are still binding limitations in some jurisdictions.

**Taxation and the resolution of NPLs:** Countries in the EAP should review the tax regime applicable to all parties involved in the resolution of NPLs to streamline the process and eliminate any perverse incentive deterring NPL resolution. Tax impediments are often constraints on effective NPL resolution. As a result, tailored local tax measures are key to supporting banks' ability to write off NPLs and to attract investors to acquire distressed debt from banks.

It is important to recognize that the EAP consists of a diverse set of countries with a range of NPL levels, leading to difficulties in prescribing any one set of policy measures to cope with the impacts of the COVID-19 crisis. Regulators and policymakers can review the practices and lessons identified in this report to devise a prioritized action plan to address issues such as the identification of problem assets, to assess measures to be taken (including phase out), to establish guidelines, and to formulate policy statements to communicate the way forward.

**Finally, this report is an overview paper, intended to provide a broad contextual examination of the important issues.** There are many areas for future work that derive from its key findings and recommendations. One of the areas refers to the empirical analysis of the relationship between NPLs and macroeconomic stability, NPLs and investment and GDP growth, and assessing NPL trends and scenarios. This will require detailed and granular data on past due, migration rates, and cure rates from the prudential supervisor, preferably at the bank level. Another area of interest is an assessment by country of the implementation of harmonized NPL definitions, relative to international standards. Further work is necessary on the effectiveness of insolvency processes (including out-of-court workouts), especially to assess whether the reforms introduced after the AFC are sufficient to deal with the challenges created by the COVID-19 crisis and to identify areas for further reform under different time horizons. Finally, a cross-country review of taxation practices that hinder the resolution of NPLs would be useful to identify potential areas for improvement.

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# Annex 1:

## NPL Resolution: Malaysia’s Experience during the Asian Financial Crisis<sup>26</sup>

The thrust of Malaysia’s financial sector reforms introduced during the AFC was twofold, namely:

- (i) to stabilize the banking system in the immediate term; and
- (ii) to strengthen the financial sector over the medium to long term.

Short-term stabilization measures such as reductions in the statutory reserve requirement were introduced to help invigorate lending activity in the banking system. At the same time, the Government instituted a suite of complementary recovery measures through a merger programme for finance companies and the establishment of *Pengurusan Danaharta Nasional Berhad*, *Danamodal Nasional Berhad* and, the Corporate Debt Restructuring Committee. These instruments were implemented to ensure efficient functioning of the intermediation process while creating an environment that was conducive for business activities to operate (Table 6).

**Table 6 : Instruments created to support NPL resolution in Malaysia**

Instrument	Functions
<b>Pengurusan Danaharta Nasional Berhad (Danaharta)</b>	An asset management company. It was set up to purchase NPLs from banks to enable them to recommence their lending activity.
<b>Danamodal Nasional Berhad (Danamodal)</b>	It was a special purpose vehicle to help recapitalize affected banks that were unable to raise additional capital to meet their capital adequacy requirements.  Danamodal also served to facilitate the consolidation of the banking sector and revamp banks’ management where necessary.
<b>Corporate Debt Restructuring Committee (CDRC)</b>	The CDRC was formed to provide a mechanism for both banks and debtors to work out voluntary debt restructuring solutions without resorting to legal proceedings.  Rehabilitation units were also established in individual banks to manage distressed loans involving smaller amounts.

While Danaharta, Danamodal and CDRC were governed by their respective operational frameworks, a Steering Committee, chaired by the Governor of Bank Negara Malaysia, was established to oversee and monitor the policies, operations and progress of these entities to ensure that they operate in a cohesive and coordinated manner. The committee was also responsible to ensure that the strategies implemented:

- (i) minimized the use of public funds;
- (ii) promoted transparency;
- (iii) adopted commercial and market-oriented principles; and
- (iv) ensured equitable burden-sharing among stakeholders.

26 Based on a Policy Brief prepared by Nik Ahmad Rusydan Nik Hafizi and Allison Loke Yen San, Bank Negara Malaysia.

## Danaharta: Key characteristics and operational strategies from its initiation phase (June 1998) through to its closure (December 2005)

The main objective of the AMC was to acquire NPLs from banks, and NPLs were managed at the account level to maximise recovery value. This was necessary as a significant portion of the NPLs suffered from structural issues such as fundamental problems of the business or the industry in which the companies operated. The relatively small number of accounts (approximately 3000) and the chunky nature of majority of the NPLs made such an approach feasible in Malaysia at that time.

### The legal framework

The Pengurusan Danaharta Nasional Berhad Act 1998 (Danaharta Act) was enacted to provide the legislative framework for Danaharta's operations. Existing laws, although sufficient, normally involved legal proceedings, which could be time-consuming. The Danaharta Act conferred upon Danaharta the ability to:

- (i) buy assets through statutory vesting, allowing Danaharta to acquire assets with certainty of title and maximised value;
- (ii) appoint Special Administrators to manage the affairs of distressed companies and develop workout proposals; and
- (iii) carry out foreclosure, under the amended National Land Code,<sup>27</sup> without going through the judicial process.

With the ability to acquire assets through statutory vesting, Danaharta was able to 'step into the shoes' of the selling banks, thereby preserving essential third-party rights or interests.<sup>28</sup> Combined with the option to appoint a Special Administrator, without which banks might have opted for liquidation, Danaharta was able to extract maximum recovery from the NPLs while preserving the value of viable, growth-enhancing businesses.

### NPL acquisition

Danaharta acquired NPLs via a market mechanism. A simple yet transparent and attractive valuation method was formulated. For secured loans, the purchase price was determined by referring to the fair value of the underlying collateral of the NPL, with only shares and property accepted as eligible collateral.<sup>29</sup> Danaharta paid 10 percent of the principal amount outstanding for the unsecured loans.

As the acquisition of NPLs was market-driven, not all Danaharta's offers were initially accepted. Banks held back on selling their NPLs, particularly given that the sale would be at a discounted price, which would result in banks incurring valuation losses and possibly lead to a significant erosion of their shareholders' capital.

<sup>27</sup> The National Land Code (Amendment) Act 1998 allowed Danaharta to buy NPLs that were secured by land by clarifying that existing registered interests will not prevent the transfer of the security to Danaharta.

<sup>28</sup> For instance, if the selling bank had a first charge over land as security for the NPL, Danaharta would also have a first charge over the land. If a second charge had been registered over the land by another bank, such second charge would continue to exist without any change in priority.

<sup>29</sup> In the case of NPLs collateralized by property, the fair value was set at 95% of the market value of the property as determined by a licensed independent professional valuer. For quoted shares, the fair value was dependent on the size of the shareholding in the company that was pledged as collateral – a larger stake that offered influence or control over a company would attract a higher premium.

Faced with rising NPLs in the system, Danaharta devised a “carrot and stick” approach to expedite the acquisition process: it proposed to share any surplus recovery from the NPLs with the selling banks on an 80:20 basis, in favour of the banks. At the same time, banks were allowed to amortise any shortfall arising from the sale of NPLs over a period of up to five years to smoothen out the effect of the reduction in the value of their loan portfolios, which could only be enjoyed if they chose to sell their NPLs.

To finance its purchase, Danaharta sourced its funding from the private sector by issuing bonds directly to the selling banks.

### **NPL resolution**

Danaharta analyzed each NPL account in its portfolio to determine the appropriate strategy to elicit maximum recovery. For businesses that were viable, Danaharta employed a ‘soft approach’, which involved rescheduling and restructuring of loans, early settlement, and formulation of voluntary schemes to restructure the loans. For businesses that were deemed non-viable or if a borrower failed to comply with the loan restructuring guidelines, a ‘hard approach’ was used. This approach would include the appointment of Special Administrators and the sale of the borrowers’ business and assets, or the underlying collateral of the NPLs. Generally, the ‘soft approach’ yielded better recovery and legal action was considered only after all the other strategies had been exhausted, as it was lengthy, costlier, and typically generated minimal recovery.

### **Performance and closure**

From inception, Danaharta was committed to adopting strong corporate governance and maintaining a high level of commercial focus, with different key performance indicators (KPIs) set throughout its lifecycle. During the initiation phase, Danaharta commenced operations within just three months of its announcement, exceeding the benchmark of five months that was set based on the experience of AMCAs in other countries. In terms of NPL acquisitions, Danaharta met its KPIs both in terms of the time taken to complete the acquisition of NPLs and the amount that was carved out. More importantly, Danaharta managed to accomplish its primary goal of relieving the pressure on the banking system as NPLs began to decline at a steady rate of around 5 percent every month following the carve-out exercises. This contributed significantly to mitigating the effect of the crisis and consequently reducing the output loss during the AFC. Danaharta’s lifetime Loan Recovery Rate<sup>30</sup> of 58 percent surpassed the 20 – 50 percent range experienced by similar agencies internationally.

As with most national AMCAs, Danaharta was by design a finite-life agency. Danaharta closed in December 2005 upon achieving its KPIs. Adoption and publication of KPIs to direct organisational efforts was proven a critical component to instil discipline and ensure commercial focus in Danaharta’s operations. Consequently, this also prevented the “warehousing” problem and reduced moral hazard typically inherent in public AMCAs.

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30 An indicator used to gauge an NPL resolution agency’s recovery performance, calculated by comparing the actual amount recovered against the amount owed.



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