

**Financial and Banking Services Market**

Zoya VASYLCHENKO

**INTERNATIONAL PRACTICE  
OF BANK DOUBTFUL  
ASSETS MANAGEMENT****Abstract**

The paper studies the international practice of doubtful assets management in banking establishments and determines the role of the state in overcoming banking crises.

**Key words:**

Expenses, bank assets, banking crisis, bank doubtful assets management.

**JEL:** F30.

Traditionally, the state plays an active role in averting banking crises and overcoming their consequences. It acts as an organizing force and provides financial resources for settlement of banking challenges. The complex of meas-

---

© Zoya Vasylchenko, 2006.

Vasylchenko Zoya, Doctor of Economic Sciences, Kyiv National T. Shevchenko University, Ukraine.

*Translated by Demchenko H.*

ures that the state can take depends on many factors, and before all, on specific characters or reasons provoking banking crises, likewise on general economic situation in the locations they emerge.

The world practice allowed formulating some basic principles which provide the key to management of doubtful assets in banking establishments, implying cost minimization and optimal cost allocation. As the world practice shows, state expenditures for restructuring bank assets depend upon the intensity of a crisis and usually make 5–15% of GDP [1, 27]. In a number of countries, this index could reach up to 40–50% (Table 1).

Table 1

**Governmental Expenditures Allotted for Overcoming Bank Crisis in Certain Countries**

Country	Bank crisis	Bank assets, % of GDP	Expenditures, % of GDP
Indonesia	1992–1994	62	2
USA	1984–1991	85	2–5
Norway	1987–1989	100	3–4
Sweden	1990–1993	102	4–6
Finland	1991–1993	109	4–6
Venezuela	1994–1995	28	13
Chile	1981–1983	47	32–41
Argentina	1980–1982	39	55

Source: [http:// www.bis.org](http://www.bis.org).

In our opinion, the quality of resources including doubtful and bad debts is a main indicator of bank instability. Therefore, the purchase or transfer of dormant assets, i. e. overdue credits, illiquid securities, losses on real estate, placing them at the disposal of special public institutions, appeared to be a rather effective instrument for doubtful asset management. It should be pointed out that the institutions of this kind were created in the countries with quite different banking systems and different economic developments. Nevertheless, they had a common approach to the concept that rapid growth of doubtful and bad debts in the banks' credit portfolio, decline in real asset value accompanied by increased losses causes mass bank solvency to go down, which, consequently, results in the inability of banks to allocate effectively the available financial resources.

The major part of doubtful (dormant) assets usually includes credits, the management of which is terminated, or non-performing loans. Supervisory authorities regard non-performing credits as doubtful or bad loans. Worth noting is the fact that the criteria of loan categorization are of national peculiarities, although they are mostly oriented at delays in payment terms [2, 21].

The determination of both the crisis depth and prospects for defusing it depends on the approaches to estimation of volume of dormant assets. From the expert point of view, when the ratio of dormant assets exceeds 10%, the challenges in banking system as a whole could be classified as crisis. Worsening of the economic situation in the country, decreased solvency of corporate borrowers, and curtailed production habitually increase the volume of dormant assets in commercial banks. Among other important reasons that cause the increase in doubtful assets, the researches of bank crises specify poor supervision and regulation of the banking system, non-market motivations for credit issuing, low quality of bank management [3, 5].

It is worth noting that many countries have made attempts – within the measures directed at overcoming bank crises – to settle bank insolvency through governmental redemption of dormant assets. In such cases, the banks use the received money to purchase earning assets or settle payments with creditors. With that purpose in view, *centralized* and *decentralized* methods of work were applied.

The *decentralized method* is expedient when rather small number of commercial banks face challenges. The method implies creation of the relevant structure, in or outside the banks, for managing dormant assets. The mentioned method is expedient primarily for settling doubtful credits of enterprises, since the information available in banks about their clients is of great importance. The named approach was taken at the initial stage of bank systems restructuring in Sweden and in Poland.

Swiss government, which plunged into a bank crisis in 1991–1992, adopted a plan directed at separation of regularly managed from doubtful credits through creation of public companies to manage Securum and Retriva's assets. In particular, the Nordbanken's portfolio of doubtful credits amounting to 51 bln. crores was transferred to Securum. The credit portfolio of Retriva Company, received as a result of Gota Bank doubtful loans transfer, was valued at 43 bln. crores. The biggest in volume assets were transferred to public companies. All doubtful credits which amounted to less than 1 mln. dollars remained in Nordbanken and Gota Bank.

As a result of restructuring, the mentioned banks reached the proportion between doubtful and regular assets similar to those available in other Swiss banks. Soon Securum and Retriva companies were transferred under the administration of the *National Agency for Bank Support*. The major task of the newly established asset management companies was to provide maximum payments of doubtful credits. The crediting, ceased because of bankruptcy or other reasons, the asset management companies acquired the realty and shares of participation in big industrial companies. Alienation of the bankrupts' property

proceeded in Stockholm stock exchange tenders, or it was sold to the companies at the street market.

In general, the companies in Sweden are considered to be rather efficient in asset management. Initially, the Swiss government planned the asset sales process to last 10–15 years. In addition, with the improvement of general economic situation in the country, the major part of assets was floated in 1995–1996, and the asset management companies were liquidated in 1997.

During the bank crisis in Poland, asset management companies as legal entities were not established. Instead, credit organizations had to create organizational subdivisions for doubtful credit management.

The *centralized method* implies that the government will set up a specialized corporation for dealing with purchasing and management of all doubtful assets of the banking system. Doubtful assets are to be swapped for debt liabilities or shares of the corporation, or for government debt liabilities. The analysis of the international practice shows that the mentioned method of bank restructuring is more effective as long as there are many banks facing the problems and as long as the purchased assets are rather similar. Doubtful credits can be purchased by Central Banks (Chile, Hungary, Poland) or the Restructuring Agency (Czech Republic, USA, Mexico, South Korea).

We would like to specify the centralized doubtful assets redemption by means of Figure 1 presented below. Depending on the crisis depth, likewise on financial opportunities of the nation, both partial and complete purchase of doubtful assets of the banks under restructuring was done.

For example, in 1984 the Chilean National Bank purchased from commercial banks doubtful and bad loans in amount not exceeding 150% of its own resources. The critical requirement for participation in that program was to keep to timely managing of the credits issued by National Bank at the beginning of the crisis.

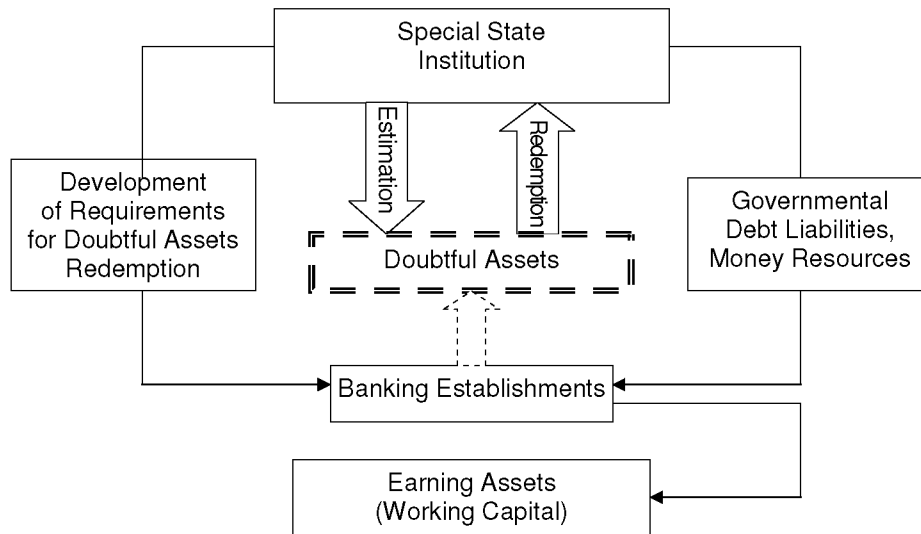
During 1994 crisis, the Mexican Banking Fund for Savings Security (FO-BAPROA) purchased doubtful assets only when the bank augmented its own capital. The ratio of the redeemed credit volume to that, contributed to the equity fund made two to one.

In Hungary the requirements concerning doubtful loans redemption were different for the private and state banks. Thus, the state banks had to swap 100% of main debt and unearned interest, while the private banks – 50% of the doubtful and bad debts made up to 1992, and 80% of nominal value of similar assets in 1992.

It is worth noting that in the restructuring process of banking establishments, one of the key problems is redeemed asset estimation. On the whole, according to common practice, the determination of the stock purchasing price is based on its current discount value. Accordingly, the credits are divided into two categories, i.e. unsecured loans are sold at a larger discount against the secured ones, which are overestimated.

Figure 1.

**Model of Doubtful Assets Redemption**



During 1997 bank crisis in South Korea, the Asset Management Corporation (KAMCO) bought the bank doubtful credits at a price making 45% of secured credits' net value. Unsecured credits were bought at 3% of nominal asset value.

The Czech state financial institution Konsolidachi Banka Praha redeemed the commercial banks' prolonged debts at a fair market price (usually 60% of redeemed nominal asset value).

Malaysia practiced the mechanism of unilateral price adjustment. When the Corporation eventually sold the redeemed asset at a higher price against that paid to the bank, the latter was reimbursed 80% of profit. Nevertheless, the Agencies in a number of countries redeemed doubtful credits at 100% of book value.

For example, the Mexican Bank Fund for Savings Security (FOBAPROA) paid the redeemed assets net-value, i. e. the book value of issued credit minus the created reserve.

We have to point out, that the Corporation could buy doubtful assets both in money facilities and in government secured bonds or bills. It is implied in such cases that the larger part of doubtful assets would be floated before the settlement term, while the earnings would be spent for securities payments.

In Hungary, the commercial banks' doubtful and loss debts were redeemed in exchange of state bonds, denominated on forints for 20 year period. Those instruments yield was pegged to the USA treasury bill profitable capacity.

The Mexican commercial banks in exchange of «bad» debts got the bills of the Banking Savings Security Fund for 10 year term. The yielding capacity of the latter was fixed as minimal, which was equal to the interest rate of short-term treasury 91 day liabilities. The earned interests had to be capitalized with the purpose of saving current budget expenditures and shortening the period of bank capital renewal.

Consequently, we can say that doubtful asset management and salvaging is highly complicated and long-standing. Therefore, the mentioned functions are usually delegated to specially created corporations or just to commercial banks. In our opinion, the advantages of the procedure of asset transfer to bank management are the bank – borrower relations preserved. The named settlement allows to restore credit relations in case of debt repayment.

Mexico can well exemplify where the whole loss debt portfolio redeemed by FOBAPROA from commercial banks was authorised to the latter for management. The total amount of resources gained from the portfolio management had to be directed at settling the debts accountable to FOBAPROA. The imposing of financial sanctions for undue paying back the bills issued in exchange of doubtful debts urged the banks to activate settlement of loss and doubtful debts. So, for example, if the banks were not able to pay back the FOBAPROA bill at the account of doubtful debts portfolio sold till 2005, those banks gained only 20–30% of nominal debt value covered by bill.

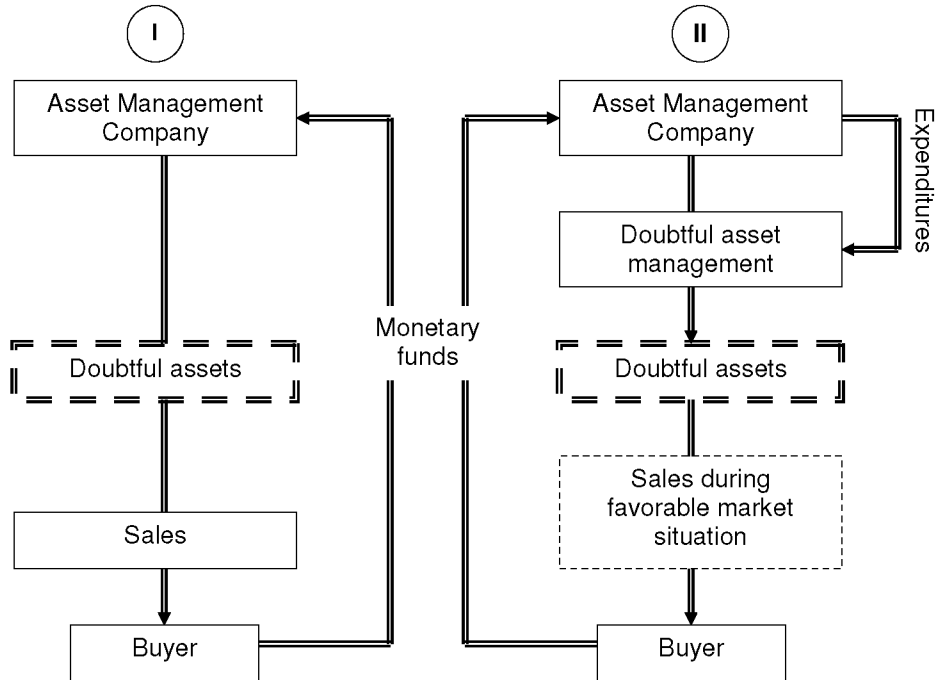
Specialized state corporations managing the redeemed assets were established in the USA, Czech Republic, Thailand, South Korea and a number of other countries.

The generally concluded and systematized practice of those countries allows us to argue that the bank doubtful asset management is of two main strategies (Figure 2). The first one implies prompt asset sales to avoid subsequent value impairing, thus, reducing the national budget loading. At that, we should take into account that when a large volume of impaired assets are sold, they are likely to bring about the marginal value reduction. The alternative approach consists in management of the doubtful assets by specialized state corporations. The latter are gradually selling the debts at maximum market price.

Proceeding from the above, we can state that the option of a strategy or a compromise alternative depends upon the aims and objectives the specialized state corporation is facing, likewise it is determined by economic situation in the country and bank crisis conditions.

Figure 2.

## Strategies of Doubtful Asset Management



For example, the USA *Resolution Trust Corporation (RTC)* was founded in 1989 for redemption and settlement of doubtful debts of credit and saving establishments. Financial Institution Reform, Recovery and Enforcement Act (FIRREA) obliged the Corporation to sell the insolvent credit and saving institutions, as well as their assets by way of marginal receipts provision. The availability of a great number of insolvent organizations resulted in the postponed asset sales, while the amount of the assets managed by the Corporation was continuously increasing. In 1991 the amendments were made to the Recovery and Enforcement Act allowing the Corporation to sell the assets to the account of portfolio sales in full lots.

In Czech Republic the banking reform did not imply immediate sales of redeemed assets. A part of debts and shares of participation in statutory funds of big industrial enterprises, the *Konsolidachi Banka Praha* had redeemed in commercial banks, was transferred to the Rehabilitation Agency founded in 1999. The objective of the Agency was to maximize value of the acquired assets via effective restructuring and rehabilitation of industrial enterprises for subse-

quent sales of the latter to strategic investors. Nevertheless, the Rehabilitation Agency was not legally vested with authorities to manage doubtful assets. In addition, there were political reasons, which hampered the Agency to carry out its functions.

In general, the rehabilitation and subsequent privatization of banking sector in Czech Republic was recognized successful, but the rehabilitation process of powerful enterprises did not reach the expected results.

Proceeding from the analysis of international practice, the asset management corporations applied different procedures to pay back the doubtful debts [4, 38]. In our opinion, the most rational ones are the following: putting out doubtful assets to tenders; bankruptcies of debtors; debt restructuring; attraction of private specialized institutions to management and sales of assets.

Other non-traditional methods were typical to those countries, where specialized corporations were delegated wider legislative powers as for asset sales options.

For example, the USA *Trust Settlement Corporation* in a number of cases provided an opportunity to the buyer to return the assets in exchange for refinancing (usually complete) within the fixed time limit. That format was justified, since the perspective buyers had to spend much time for estimation of the saleable asset packages of intricate structure. Differentiation of returning terms depended on the types of assets, but, on the average the redeemed asset was allowed to be returned within one year. In practice, only one third of aggregate assets, sold after the named matter, was returned by the buyers.

It is worth pointing out, that the Trust Settlement Corporation widely applied securitization of non-traditional assets, like credits on mortgage, for example. Then the pool of homogenous credits was created with its subsequent transfer to Trust Fund for issuing certificates secured by the pool of money resources. In our opinion, the securitization mechanism allows within a limited time to sell a fair volume of credits on mortgage at advanced price against that of single credit sale individually. It is good to note, that within the conditions of national market of credits on mortgage formation ( with adoption of laws «On Mortgage» and «On Mortgage Securities») just the named pattern reflects the potential opportunities of the government to support the market development [5, 128].

Incidentally, the asset management corporations are usually set within the period of banking reforms, which is necessarily accompanied by changes of the parameters of organizational and legal field. The terms of those institutions functioning in different countries differ in principal, but in general they last from three to five years. In some countries, say in South Korea and Thailand, those arrangements were delegated new powers, and they are active so far.

It is worth paying attention to Russian practice of doubtful credit portfolio management by the Agency of Credit Organizations Restructuring. The latter was established in compliance with the federal law «On Restructuring of Credit Organizations» adopted in June 1999. The August-September 1998 bank crisis



in Russia was specified by the state of the then banking system, by the role the banks played in economy, as well as by sharp devaluation of national currency. A group of big banks with about a quarter of the whole volume of assets found themselves in the very epicenter of the crisis.

In this connection, the Russian Government and the Central Bank had to concentrate their efforts on meeting two major challenges, i. e. to increase liquidity of the banking system and restore its intermediary functions; to provide financial rehabilitation to a group of banks the problems of which produced a strong negative effect on general economic situation. In the context of the first task settlement, in particular, the decisions were taken in relation of statutory reserve quotas reduction, and use of substantial part of prescribed reserves for payments of first priority. A number of banks got stabilizing credits from the Russian Bank. To meet the second task, the Credit Organizations Restructuring Agency (ARKO) was established in 1999, and it has been still functioning.

The ARKO objective was to protect the depositors and creditors, primarily those of big banks, which were socially and economically conducive to the country as a whole, and some regions, in particular. The development of the situation in those banks needed to be put under a special state control.

The ARKO's technology of dealing with problem banks was determined by the Federal Act «On Restructuring of Credit Organizations». Unlike the overseas countries, the volume of expenditures for defusing the bank crisis in Russia was stipulated by the tasks, the government was facing, primarily, to preserve the vigorous hub of the banking system, and to determine the quantity and scope of activity of the banks within the system, which needed reformation. Other banks were suggested that their stockholders, managers and interested investors should rehabilitate them. In appliance with the Federal Act «On Restructuring of Credit Organizations», the ARKO had wide authorities in dealing with doubtful debts of the banks under restructuring.

To redeem the doubtful assets of the banks under reformation, the Agency widely applied the method of credit organizations financing on the terms of assigning them claims against their borrowers [6, 48]. The ARKO rather rare bought real estate facilities and banks' shares in the organizations' equity capital. It was explained by the fact that the credits, extended to the borrowers, did not pertain to the banking sector, and composed the main part of the portfolio of restructured banks' doubtful credits. Both the ARKO and restructured banks initiated the Agency redemption of either doubtful asset. The buying price of the offered asset was estimated by independent estimation companies that had already been established and had been successfully functioning at the market. The received from the asset sales money resources were allocated into the earning assets, and thus, the Agency paid back the creditors. The ARKO itself could sale the redeemed assets, having prior studied the market conditions. In addition, the ARKO had right to sell the bank assets, transferred to its management, in advertised biddings. At that, the asset value of the credit organization was also estimated by independent estimation company. The Credit Organiza-

tions Restructuring Agency as an organizer could either hold the biddings itself or delegate it to a special organization.

Proceeding from the above, we will describe (define) the components of economic effect of the bank doubtful asset management. They are as follows:

- 1) Actual opportunities allowing the banks to get delivered from doubtful or loss assets, yield some profit and allow the bank to allocate monetary funds into the earning assets, i.e. into the «working capital».
- 2) Categorization of the assets from doubtful to reliable allows to earn sustained profit within the term of these assets operations.
- 3) Recovery of prior accumulated reserves increases the profit and augments the bank equity capital.
- 4) Release of the personnel from the subdivisions of active transactions for key operations allows concentrating efforts on creating new, safe assets, which improves the economic standards and finance indicators of the bank, thus brightening up the image of the latter as a reliable and skilled partner.

Intensification of aggregate economic effect produced by the reform of commercial banking in relation to doubtful asset management eventually depends upon how efficiently the basic principles will be implemented.

### **Bibliography**

1. Васильченко З. М. Комерційні банки: реструктуризація та реорганізація: Монографія. – К.: Кондор, 2004. – 528 с.
2. Васильченко З. М. Методологічні засади стратегії реорганізації комерційних банків // Фінанси України. – 2004. – № 7. – С. 123–131.
3. Лаврушин О. И. От теории банка к современным проблемам его развития в экономике // Банковское дело. – 2003. – № 6. – С. 5–9.
4. Мельников А. Российский опыт реструктуризации банков: результаты и выводы // Аналитический банковский журнал. – 2004. – № 10. – С. 44–52.
5. Новиков В. Банковские кризисы переходного периода // Аналитический банковский журнал. – 2002. – № 1. – С. 26–30.
6. Трощенко В. Зарубежный опыт законодательного регулирования процедур финансового оздоровления и банкротства // Аналитический банковский журнал. – 2005. – № 2. – С. 36–41.