Bank mergers and restructuring in Asia

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Introduction

The bank markets in Asia have seen a spate of mergers, acquisitions and major investments over the past 4 or 5 years. The first section of this paper will look at the reasons for the increase in bank mergers in the region and the transaction structures that can be adopted. The second will focus on the key issues that need to be considered when two banks merge or one acquires another and the third will look at bank recapitalisations and rescues in the wake of the Asian financial crisis and the slow down in exports due to recessions affecting many of the major economies worldwide.

Contacts:

Philip Gilligan, Partner +852 2840 5002
philip.gilligan@lovells.com

John Banks, Associate +852 2840 5053
john.banks@lovells.com

Alastair Timblick, Associate +852 2840 5012
alastair.timblick@lovells.com
Although this section is intended to look at issues which will be relevant across the region, certain areas have been focused on as examples, such as Hong Kong and Korea. Similar issues will crop up in most jurisdictions but it should be remembered that local laws in areas such as Thailand, Malaysia and Indonesia may throw up specific issues in relation to matters such as regulatory clearances, property transfers and employment regulations which will need to be dealt with.

**Why are banks merging or being acquired in Asia?**

Banks in Asia are, in many cases, not as profitable as they once were. As a result, many are considering (or being compelled to consider) mergers as a solution. The lack of willingness among corporate borrowers to incur debt, due to the uncertainties in the markets, has led many banks to concentrate on retail banking over wholesale business. Stiff competition in mortgage lending and the recent drops in interest rates have, however, made mortgage lending less profitable, although this has been offset to some extent by drops in the deposit rates being paid. Large write offs and provisions made against bad loans on non- or under-performing loan portfolios have also hit the bottom lines of many banks throughout the region.

Consolidation has already started in Singapore, with the mergers of OUB and UOB, and Keppel Capital Holdings and OCBC. In Thailand, foreign banks have taken control of Thai banks to both rescue them and to gain an entry into the market in the wake of the Asian financial crisis. Examples include UOB's acquisition of Radanasin Bank and Standard Chartered Bank acquiring Nakornthon Bank. In Korea, similar moves have seen foreign entities take sizeable equity stakes in Korean banks, with, for example, Newbridge Capital acquiring a 51% stake in Korea First Bank and a consortium made up of JP Morgan and the Carlyle Group taking a 40.7% stake in Koram Bank.

In particular, the banking markets, both retail and wholesale, in Hong Kong are already well developed and dominated by HSBC, Standard Chartered, Bank of China and Bank of East Asia, with a raft of other local and international banks competing for market share in the same restricted market. Recent developments in the Asian region, such as the financial crisis in 1997 and the spectre of slowing exports due to lower US consumer confidence, have put more pressure on banks (the big four and the other smaller players) to find new ways to increase revenues and market share and to cut costs to increase their profitability.

As the banking markets are becoming more developed and competitive, increasing market share or margins is becoming difficult. In this environment it is becoming more likely that banks will seek to expand and cut costs by way of acquisitions and mergers. Similarly, new players from outside Asia seeking to obtain a foothold are more likely to buy a bank rather than develop a new business from scratch. Examples of these trends
What is a bank merger?

A banking merger is just the same as the merger of any two companies, except that it involves banks. It will likely involve one of the following three basic structures:

(a) the acquiring bank (the purchaser) acquires the shares of the target bank (the target);
(b) the purchaser acquires the business (or part of the business) of the target; or
(c) Bank A and Bank B enter into a joint venture or shareholders’ agreement whereby Bank A and Bank B become shareholders in a new bank, Bank C.

The most significant point in banking mergers is that the banking activities of the participants will almost always be regulated because the institutions use the name ‘bank’, take deposits or transmit money and so the transfer will need to be approved and any new entity licensed as a bank.

Acquisition structures

Universal succession/compulsory transfer

In some jurisdictions, in the case of a sale of a bank’s business, general or universal succession laws or other compulsory transfer methods are used at the same time or immediately following the merger of two banks. This is a common method used in civil law jurisdictions, such as France and Austria, and was used for the mergers of Credit Agricole and Banque Indosuez, and Bank Austria and Credit Anstalt. Such universal succession laws, whilst applicable in the relevant banks’ home jurisdictions, may not be recognised under the laws of certain Asian jurisdictions where they do business and so effect may have to be given to the merger in such Asian jurisdictions by the novation and transfer of one bank’s assets to the other, or of each bank’s assets to a newly created merged entity.

Similar compulsory transfer methods, by which all of the target’s assets and liabilities are transferred to the purchaser, rather than each asset being transferred individually may, however, be available. In Hong Kong, for example, a private ordinance may be used as a compulsory transfer method. This approach was adopted by Bank of Tokyo and Mitsubishi Bank in 1996 when they merged to create Bank of Tokyo-Mitsubishi (‘BoTM’). Here, under the provisions of a private Ordinance, Bank of Tokyo transferred all of its business in Hong Kong to Mitsubishi Bank, which then changed its name to BoTM. More recently the same route has been used for internal reorganisations, such as the merger by the Bank of China Group of certain of its Hong Kong subsidiaries’ businesses into Po Sang Bank and the merger of Bank of East Asia with its subsidiary United Chinese Bank.

This process does have some disadvantages. For example, in Hong Kong, the downsides of effecting a merger or acquisition by private ordinance include:

(a) the preparation of the necessary bill and its guidance through the Legislative Council (Legco) is often complicated and may involve instructing agents, thereby incurring additional costs;
(b) the procedure is public; and
(c) the passage of the bill has to fit into Legco’s legislative timetable (for example, Legco is in summer recess from mid-July to the end of September each year) and this can take a considerable time.
This method may in practice only be worthwhile if there is a considerable business to be transferred and it is possible to get legislative time for the process in the relevant jurisdiction. It is, therefore, just as likely that a merger or acquisition will be given effect by the traditional methods of a straight share purchase or the individual transfer of assets.

Share acquisitions

A share acquisition will involve the purchaser acquiring all or part of the issued share capital of another bank or banks. The overall agreement for the transfer of the shares in the target will be set out in a sale and purchase agreement or, if the target is publicly listed, in a public offer document. The sale and purchase agreement would generally contain various representations and warranties in relation to the business of the bank being sold.

In many ways this is the simplest option and is usually adopted where it is proposed that the target’s assets will not be directly transferred to a new entity.

A share acquisition structure would also be used, for example, where a new top company is to be inserted above two existing banks, but each of those two banks are to retain pre-merger assets; or where one of the original banks acquires the shares in the other but again, each retains its pre-merger assets.

Asset transfers

A much wider range of issues arises where assets are to be transferred. For example, an asset transfer will be needed if all, or part, of the assets of the purchaser and target are to be moved to a new bank (which may be new or which may be one of the existing banks, possibly with a new name) or where, for example, a bank is acquiring only part of the business of an existing bank, as in Standard Chartered’s acquisition of Chase Manhattan’s credit card business.

An "asset transfer" is shorthand for a transfer of the assets and liabilities of the target to the purchaser, together with the right to the future conduct of the applicable banking business as a going concern. The "assets and liabilities" will normally embrace all of the contracts of the target, together (usually) with all legal claims and liabilities.

Specifically, this will normally involve a transfer of all loans (and, if applicable, related security), guarantee obligations, treasury and capital markets contracts (for example: foreign exchange contracts, interbank deposits, options, swaps and other derivatives), certificates of deposit, commercial paper, bonds, other banking contracts such as custody, escrow and agency agreements, forfait paper, operational contracts (including software licences and intellectual property rights), property interests (as freeholder, lessee and lessor), office furniture and machinery, litigation rights and obligations, employee contracts and staff loans and mortgages (including pensions and other arrangements), equities (held as investment), shareholdings in subsidiaries, cash balances, short-term deposits with banks and deposits with central banks, goodwill and so on.

The overall agreement for transfer will be set out in a sale and purchase agreement. This provides for the transfer of the relevant assets and/or the transferor’s right, title and interest in and to them. Part of the consideration is often the acceptance of the related liabilities, the giving of an indemnity for continuing liabilities (for example, guarantees which cannot be removed); and, possibly, the issue of shares or the undertaking of debt. The sale and purchase agreement could also include provisions relating to continuing support, which the target may have to provide following a transfer if it is not being acquired in its entirety.

The process, however, is often costly, administratively intensive and complex. Consents must be obtained from relevant third parties and the relevant paperwork completed. Structures may need to be developed to pass economic risk where counter-parties refuse to give consent to third parties. Fees may be payable to loan agents and security trustees and the registration of transfer documents can be a long and involved process. In addition stamp duty may become payable on the assignment of certain assets.
Notwithstanding the foregoing, an asset transfer is at least not dependent upon a legislative timetable. Any logistical concerns relating to the contacting of the target’s customers might be offset by the ability of the purchaser to put the transfer in a positive light, marketing its existing services and pre-empting any queries in relation to the transfer. In many cases it offers the purchaser a straightforward and relatively quick method of making the transfer.

Joint ventures

A banking joint venture is very similar to a joint venture of any other corporate entity and the issues which arise in relation to a banking merger structured by way of share acquisition are largely the same as will arise in relation to a banking joint venture, with the addition of specific issues on relations between the joint venture partners.

Schemes of arrangements

A scheme of arrangement is another possible compulsory transfer method in some jurisdictions.

For example, Section 166 of the Companies Ordinance in Hong Kong offers a mechanism by which, under a scheme of arrangement, the target's "property" and "liabilities" (which are defined respectively to include "rights" and "duties") can be transferred to a purchaser by operation of law. By this method the shareholders of the target would then be issued shares in the purchaser as compensation for the transfer of the assets of the target. Whilst this mechanism has not been used for a merger or acquisition in Hong Kong as yet, it was used by HSBC when it changed its domicile from Hong Kong to England.
This section will explain some of the key issues to be addressed when an acquisition of a bank is being considered.

**Control and planning**

Whether friendly or hostile, planning is one of the keys to a successful bank acquisition. If an acquisition is made on an agreed basis, the views of the target bank will need to be accommodated from the outset. If the bid is hostile, the target's response (or anticipated response) will affect the transaction. Regulatory provisions will govern the timing and set the terms of the transaction.

Whichever route is taken, planning and advance preparation of documentation is essential. Planning will enable the inevitable shocks and delays of the transaction to be absorbed without any fatal effect, and will enable momentum to be established and maintained. Often the availability of the target becomes known at very short notice, possibly in a competitive situation. Accordingly, there may be value in creating a "war book" in advance. This will include "skeleton" documents, such as timetables, announcements and even a sale and purchase agreement.

**Asset sales**

When a purchaser is acquiring the assets of a target, each group of assets has to be considered individually and the appropriate transfer method must be identified and executed as follows:

- **Delivery:** certain assets (such as cash, chattels and bearer instruments) can be transferred by delivery.

- **Assignment/novation:** although it is possible to assign the benefit of a loan, the burden of a loan agreement can only be novated and it would therefore be necessary to obtain the borrower's consent. In relation to syndicated loans, however, the transfer is effected by completion of the form of transfer certificate in the syndicated loan agreement. A fee is normally payable. Obviously this can add up to a considerable amount. Liabilities (for example, bank-issued guarantees that cannot be assigned) or contracts containing both rights and liabilities (for example a revolving loan), can also only be transferred by way of novation. This involves the cancellation of the existing contract and the creation of a new one, with a substitution of the transferee for the transferor. As novations require the consent of the original counterparty, they are often effected subject to new economic terms.

- **Endorsement:** negotiable instruments, such as bills of exchange and promissory notes, can be transferred by a simple endorsement without notice to or consent of the drawer.

- **Instructions:** transfers of bondholdings in the form of a global note and certain shareholdings can be effected relatively simply by instructions to the relevant clearing system.
Notification/registration: in certain cases, notification or registration will generally be required to be made to a registering authority. For example, in Hong Kong, the Land Registry, in relation to the transfer of an interest in land or the Companies Registry, in relation to the transfer of registered security, must be notified of any change of ownership.

Economic transfer: in cases where novation or assignment are not possible, for example because the counterparty withholds consent, assets are transferred by way of alternative structures whereby the transferor maintains legal ownership and responsibility (in relation to the counterparty) but the economic liability or responsibility and benefit passes to a third party. This may take the form of a simple sub-participation in a syndicated loan, where the borrower has withheld its consent to the assignment of the loan, or more complex arrangements. Similar structures may have to be developed where the target is involved, for example, in tax driven structured finance deals and/or the issue of credit derivatives secured on the target’s assets and revenue streams. The most common forms involve trustee or agency arrangements coupled with undertakings by the transferor to pass on benefits and indemnification by the transferee in respect of liabilities.

All assets and liabilities will need to be dealt with through one or other of the above methods. All contracts will need to be reviewed and the appropriate method of transfer determined and an action plan put in place. This can be a large scale and time consuming task that requires thorough due diligence together with careful planning and management.

It will also be necessary to review whether there are any existing internal arrangements within either of the existing banks that need to be externalised and reflected in binding legal contracts. For example, one division may support or give comfort to another or provide services to it; it may be necessary in future to provide these services across a corporate group between two different entities and so this will need to be reflected in formal agreements.

Share acquisitions

Certain considerations are more likely to be critical in relation to a share acquisition as opposed to an asset sale. The most important of these are:

(a) regulatory and compliance issues, such as the effect of the acquisition on the target’s status as an authorised institution or bank and its membership or registration with banking and securities regulatory organisations;

(b) if the target is listed, compliance with the requirements of the relevant stock exchange on which the shares are registered and those of the takeover code in the relevant jurisdiction;

(c) the effect of the acquisition of the target on change-of-control provisions affecting certain of the target’s assets, for example, such provisions in loan agreements, leases, joint venture agreements (especially in the PRC) and software licences; and

(d) the possible need for the use of assets across the new group produced by the merger or acquisition, such as the sharing of intellectual property, software and customer information.

Key issues

The key issues below are not the only issues which may arise in a banking merger, but are some of the most common ones that may be encountered in either an asset sale or a share acquisition:

Confidentiality

Bankers owe their customers a duty of confidentiality. In the case of a prospective sale, the purchaser of a target’s assets or shares will require detailed information about the business, which will inevitably include details of customers. In many jurisdictions, for example under Hong Kong law, there is no general, implied right to make customer information available to potential purchasers or to transfer such information within the purchaser’s banking group. There are, however, established practices (including the use of generic, statistical information, standard forms and
appropriate confidentiality undertakings) which provide practical solutions to these problems. When dealing with individuals' information, care must also be taken that their rights are not infringed under any personal data protection laws in relevant jurisdictions.

Data protection

As far as data protection is concerned, most jurisdictions will have laws governing how personal data is recorded, stored, transferred and whether it can be processed and stored offshore. Hong Kong's Personal Data (Privacy) Ordinance, for example, provides rules as to the collection, use, security and transfer (even between group companies) of data relating to individuals and the penalties for breaching these rules are severe, ranging from criminal penalties to the payment of compensation to customers. Any intention to use personal data for any non-core purpose, such as marketing, and any intention to disclose data to third parties (including across the group) needs to be identified at the outset, so that appropriate consents can be included in standard form documentation. The move of banks to storing data in other, cheaper, jurisdictions such as China and India may come under more scrutiny as more countries insist that information can only be transferred to jurisdictions with similar data protection legislation to their own.

Licences and registrations

To carry on business as a bank in any jurisdiction, a banking licence will be required. In Hong Kong, for example, if the target, which holds a licence under the Banking Ordinance, is transferring its business to a purchaser it will also be necessary to transfer the banking licence. In some jurisdictions a new licence may have to be applied for by the purchaser itself and the target's old licence cancelled.

The purchaser will usually need regulatory consents or other clearances to carry on a new or expanded financial business or to effect the change of control of the target. The nature and extent of these clearances will depend on the details of the business being conducted. If it is required, the application for approval in respect of the expanded business and/or the change of control is crucial and will be one of the major timing factors of the transaction. Even if bank regulatory approval is not required, other regulatory approvals, for example for dealing in securities, credit broking or providing consumer credit or investment advice, may be relevant. If an authorisation is needed, early discussion with the regulators is the best course.

In Hong Kong, a request for the approval of a transfer of a banking business or the establishment of a new bank would have to be made to the Hong Kong Monetary Authority (HKMA). A new bank, formed by a merger or acquisition or an existing bank not already registered, may also need to apply for registration with, or licences from, the Securities and Futures Commission, depending on its business. Such a new bank may need licences to give investment advice or act as a dealer in securities. Generally, a person with a banking licence will be granted a licence to deal in securities automatically on their application, but this is not necessarily the case in relation to obtaining a licence to give investment advice.

In Hong Kong, under the provisions of the Banking Ordinance, the HKMA must approve any person who acquires control of a bank whether that control is by a majority or minority stake and whether the control is direct or indirect. New management of a bank will also need to be approved. The HKMA will need to satisfy itself that the new controller and management (specifically the chief executive officer and the new directors of the bank) are fit and proper persons to control a bank in Hong Kong. They also need to be satisfied that the interests of depositors will not be threatened by the change of control and that the person taking control will take such steps as are necessary to ensure that the bank's business is conducted prudently, now and in the future.

Contractual clearances

Specific contractual clearance issues may arise, by reason of the past business and existing commercial agreements of the purchaser. Restrictive covenants may have been entered into (perhaps on a previous sale) that are still effective, and these may limit the
expansion of bank operations. The purchaser may also be a party to joint ventures which have such limits; its constitution or the terms of publicly issued debt may impose restrictions on it; and exchanges on which its securities are listed may require public statements to be issued or shareholder approvals obtained. All these issues need to be dealt with early in the transaction to avoid wasted effort and a loss of negotiating position, which can follow if they are left until the last minute.

Consent may, in some cases, only be given subject to disadvantageous new economic terms. For example, certain software suppliers may require higher licence fees to be given as the new arrangements may include use for a wider organisation and, in some cases, premature termination fees may be payable. Counterparties may need to be satisfied that the credit rating of the new or combined entity is at least as good as the credit rating of the original bank they have dealt with. To effect transfers requiring counterparty consent it will, in some cases, be necessary for the new bank created by the merger or acquisition to bear the legal costs of the counterparty.

Stock exchange and takeovers code

If the target is listed on a stock exchange both the purchaser and the target will need to comply with the relevant takeovers code and the requirements of the stock exchange on which the target is listed. Most stock exchange rules will usually require that all documents to be entered into in relation to the acquisition must be reviewed first by the stock exchange and that suitable announcements must be made to the public regarding the transaction. The provisions of the majority of takeovers codes will require that certain announcements and information are made available to shareholders to ensure that all shareholders are treated equally and can make an informed decision in respect of the bid.

Capital and liquidity

The central bank authorities in both the purchaser and target’s home jurisdictions will usually impose capital and liquidity requirements to ensure that banking business is conducted in a prudent manner. The minimum standard for capital adequacy and liquidity is generally derived from the 1988 Basle Accord (described further in the next section) and is monitored by the local central bank or authority. Early discussion will be needed in this area with each relevant central bank authority. This will establish capital cost levels, and raise a number of important issues such as lending policies and large exposures to related customers or groups of companies; the need for comfort letters, relating to the provision of future financial support from major shareholders; and methods of funding capital requirements, as well as the detail of liquidity requirements.

Employment issues

The treatment of employees on the sale of a business (i.e. an asset sale) will be covered by the local labour laws of the jurisdiction(s) in which the target does business. If there is a need to reduce headcount in the new merged entity it will be necessary to abide by these rules as well as the terms of the applicable employment contracts to ensure that the new bank does not start life having to deal with numerous claims from disgruntled ex-employees. Trade union legislation may also be relevant and may set down consultation periods whereby either the purchaser and/or the target may have to enter into lengthy consultation with unions to agree new terms of service or the treatment of staff made redundant by the merger.

Property

The target’s property will usually include freehold or leasehold property from which the target presently operates, and possibly certain residential properties. If these properties are held subject to leases, the leases will need to be reviewed and, in many cases, landlords' approval will be required to transfer any of the leases.
Due diligence

An essential concern is to balance the value of the business acquired with the consideration paid. There are two elements to this. First, investigatory work prior to the acquisition (due diligence) to ensure that the price offered is, so far as practical, commensurate with the business acquired. Second, the negotiation of warranties or other provisions in the purchase agreement that allow post acquisition adjustment through indemnities for breach. This brings price and business value into line, if it emerges in due course that there is a mismatch. One of the oddities of the acquisition procedure is that a public bid for a large, listed company is made without the benefit of detailed information provided specifically to the purchaser or warranties given by the owners of the target. A private company acquisition, on the other hand, has the benefit of full due diligence and wide ranging warranties with indemnities for breach. Due diligence is likely to be an extensive exercise; a difficult one and a fundamental one. Very often the target will have prepared a data room of information and this will be reviewed against a pre-prepared information request of the purchaser. The efficient operation of the data room is a crucial issue for both parties. The vendor or the target must ensure that the data room is, so far as practical, complete and can be supplemented by additional information (whether coming afresh to the notice of the vendor or produced in response to requests from the purchaser) and is clearly indexed, so that new and old information is readily ascertainable. In addition, certain highly sensitive information may be put on a restricted list, on the grounds of confidentiality and made available only at the final stages. The purchaser will need to ensure that reports are prepared on all relevant information, further requests are made when necessary and appropriate warranties drafted to cover risks.

Another difficult area in practice is disclosure letters. The disclosure letter contains the target’s disclosures against warranties. Generally, no claim may subsequently be brought against warranties where the basis of that claim has been disclosed to the purchaser prior to the acquisition being completed.

The rationale for this is that, if the purchaser is concerned about the disclosure, it has the opportunity to reduce the price or, in rather extreme situations, to walk away from the transaction altogether. The purchaser will wish the draft disclosure letter to be produced early and to be specific and fair.

The foreign element

There is often a significant foreign element in a banking merger. Inevitably, it will be necessary to obtain legal advice in a number of overseas jurisdictions, basically wherever the target has overseas offices or branches. The co-ordination of responses from overseas lawyers and regulators (and, perhaps, exchanges) is an essential part of the operation. There may also be competition issues, perhaps in more than one jurisdiction. These will have a bearing on planning and the timetable.

Conclusion

In summary, there are many issues that need to be considered when banks are merging. The most intriguing and relevant to a bank merger, as opposed to any other merger, is the necessity to deal with the banking and regulatory authorities in the relevant jurisdictions to obtain their approval for the newly acquired or created bank to carry on its business.
Restructuring Asia's distressed banks

In this final section, we examine the routes a distressed bank may take to survive as well as looking at some of the more important legal, regulatory and structural issues that need to be considered to achieve this objective.

Since 1997, many banks across Asia have faced either a drastic or sustained deterioration in the quality of their asset base. The resulting effect on a bank's capital adequacy essentially leaves it with three sources of capital support to secure its survival: existing shareholders, the relevant government body or regulator, or a new shareholder through a sale process.

Capital adequacy

Given that the key characteristic of almost all bank rescues is the preservation and/or enhancement of the bank's capital base, it is worth explaining the importance of regulatory capital for a bank.

Regulatory capital requirements are designed to ensure that a bank maintains sufficient capital to absorb any losses incurred while remaining able to pay creditors and depositors. The basic concept is that if a bank has enough of the right type of capital, determined by capital adequacy ratios, then it should be able to repay depositors in full even if there is a run on the bank. Capital for this purpose, covers not only capital in the conventional sense, but also other financial resources and support available to a bank to absorb losses.

The Basle Accord (International Convergence of Capital Measurement and Capital Standards) provides benchmark regulations for banks worldwide. The regulations were issued in July 1988 by the Basle Committee on Banking Supervision. A new accord is in the consultation stage and is expected to be implemented in 2004.

The Basle Accord divides qualifying capital into three tiers:

- **Tier 1**, which includes equity, reserves and current year profits;
- **Tier 2**, which includes revaluation reserves, general provisions and some classes of subordinated debt; and
- **Tier 3**, which includes a greater variety of subordinated debt.

The critical distinguishing features of these different types of capital are their relative ability to absorb losses, their flexibility and their permanence.

Within the framework of the Basle guidelines, individual jurisdictions generally set their own legislative or regulatory capital adequacy requirements. In Hong Kong, the HKMA is the relevant regulatory body and prescribes the relevant capital adequacy requirements. In Thailand and Korea, the Bank of Thailand and the Bank of Korea, respectively, fulfil these roles.
Government support

Banks play a key role in facilitating and providing liquidity for economic growth. Because of the importance of these functions, governments of developing economies across Asia (generally through their central banking systems) have played an important role in providing regulatory capital and other support to domestic distressed banks and in engineering private sector participation through the sale of interests in these banks both to other domestic banks (through mergers) and to foreign banking groups and other foreign investors.

In Korea, the Korea Deposit Insurance Corporation was established to provide capital support (in the interests of depositors) to distressed banks. Similarly, in Thailand the Financial Institutions Development Fund provides financial and other support in the rehabilitation of distressed banks.

In general, the types of the support provided by government include the following:

- acquisition of shares (or other forms of equity participation);
- acquisition of distressed or other assets owned by banks (by establishing special purpose off balance sheet asset management companies to acquire these assets);
- acquisition of subordinated debt and other forms of capital constituting regulatory capital issued by banks; and
- continuing support in respect of distressed assets in the form of (among other things) loss-sharing arrangements and yield guarantees.

In view of the public interest in the provision of such support (ultimately it is paid for by taxpayers) and the terms on which it is provided, a government will generally only provide support in conjunction with a restructuring plan that is likely to involve a consequent bank merger or acquisition by which the management and continuing risk is taken over by a private sector participant. Examples of this two-step approach were evident in Korea with Newbridge Capital’s acquisition of a controlling interest in Korea First Bank and in Thailand with Standard Chartered Bank’s acquisition of Nakornthont Bank. However, there are other examples in the region where initial government support has been provided, but no merger or sale has, to date, come to fruition (e.g. Seoul Bank in Korea and Bank Thai in Thailand).

In view of these risks and concerns, the structure and negotiation of the basis on which government support and private sector participation is to be provided can be very complicated. Some of the more material issues are considered below.

Asset quality

Generally, the first step in the rescue process is to carry out a detailed assessment of the quality of the assets on the bank’s books, to determine the extent of the deterioration in value and to make appropriate adjustments, to arrive at an accurate picture of the bank’s current capital base supporting its liabilities.

Valuation of these assets can sometimes be problematic and generally each jurisdiction’s bank regulators will adopt or require their own particular valuation methodologies in calculating the present value of any distressed assets and the level of provisioning required to be made to the profit and loss account in respect of such deterioration. Although carrying out this exercise will provide a current picture of the bank’s financial position, whether there will be a further deterioration (or improvement) over time is very difficult to accurately assess. This problem will be bought out further, below.

Initial recapitalisation

Once the financial position of the bank is determined, the relevant government agency will often provide initial capital support, generally in the form of a subscription for new shares in the bank (either before or after an initial restructuring of the bank’s assets). The purpose of this initial recapitalisation is two-fold. First, to extinguish or considerably dilute the interests of existing
shareholders, passing control of the bank to the hands of the regulators. Second, to equalise at least the bank’s asset and liability position to provide the foundation on which any prospective purchaser of an interest will invest. Variations of this approach were adopted in both the Korea First Bank and Nakornthon Bank sales.

The consideration paid by the government for any shares usually takes the form of a government-issued or guaranteed note, cash or other securities.

**New shareholder**

Once the bank has been stabilised, a second round of capitalisation is usually considered and carried out in connection with the prospective purchaser. The basis of this further support is generally determined by reference to the risk of further deterioration of the capital base and the future capital requirements of the bank, in order to grow the business.

Generally, the negotiation revolves around the competing interests of new investors and the government. On the one hand, the new investor will want to be insulated against further asset deterioration, which will be determined by a number of factors including the general macro-economic outlook of the relevant economy in which the bank carries out business. The government, on the other hand, will wish to return the operational risk and control of the bank back to the private sector at the lowest cost to taxpayers.

This second round of re-capitalisation may involve only the relevant government body providing additional support, followed by an acquisition of the government’s interest by the purchaser (as seen in the Newbridge deal), or a combination of government and investor support through an issue of new shares to both (as seen in the Nakornthon deal).

Any such recapitalisation will usually be subject to adjustment after completion of the transaction to account for any change in the asset quality during any interim period.

The price paid by the investor will be a function of these negotiations. This can range from being at an effective discount to book value to, in rare cases, a premium. However, it should be noted in this context that the total consideration payable by the investor, or cost to the government, can be significantly increased or decreased depending on whether the government is required, as part of the terms of the acquisition, to continue to provide support for a period following the acquisition. This issue is dealt with below.

**Asset classification**

Given the inherent difficulty in valuing assets of a distressed bank that may have a propensity to further deteriorate over time, financial support of specific assets or classes of assets is usually sought from the government by the investor.

A demarcation process by which assets are separated into different classes determined by the extent of their distressed or impaired nature (and their propensity to deteriorate) will accordingly be embarked on.

The process comprises an examination of the core component of the bank’s assets: loans. This will include all corporate and commercial loans (including loans currently in some form of workout or restructuring process, whether in court or under a regulatory restructuring regime), guarantee payments in subrogation, bills bought, letter of credit bills, privately placed debentures and commercial paper, credit card receivables and other accounts receivable.

These loans will be broken down into various classes by reference to, among other things:

- value;
- class of borrower;
- whether they are performing or not; and
- whether they have been or are undergoing in-court or out-of-court restructuring.
Other assets will be separated into different classes and similarly assessed. In particular, securities will need to be valued based on their liquidity and recovery rate.

**Asset support**

Once the classification exercise has been completed, negotiations between the government and the investor will be undertaken to determine:

- which assets will be stripped out of the bank’s balance sheet (in other words, transferred to an asset management company or other entity), and their transfer value;
- which classes of assets the government is willing to guarantee and the level of guarantee (eg 50%, or all, or a certain class);
- loss or gain sharing arrangements between the government and investor in relation to future deterioration or increased recovery rate of assets;
- duration of any continuing support;
- the mechanics by which any contingent support will be provided (for example, further government notes/cash/other securities);
- the price at which the government’s support will be valued;
- restrictions on the sale or other disposal by the bank of any assets that are the subject of any government guarantee; and
- government contributions to statutory reserves.

Further mechanisms may be adopted by which the bank may "put" selected assets to the government, for example if there is a further deterioration in asset quality.

The purpose of a yield guarantee is to protect the investor from further asset deterioration and it is usually granted by reference to an expected or benchmarked return in relation to a certain class of assets that the investor wishes specifically to preserve. In many cases a deterioration of these selected assets may cause a disproportionate effect on capital risk weighting in determining the bank’s total capital adequacy ratio. Yield guarantees were used in the Korea First Bank acquisition in respect of fixed income securities held by the bank and in the Nakornthon deal in respect of certain classes of highly risk weighted non-performing loans.

The mechanics of yield guarantees vary from deal to deal; however, generally there will be a two to three year period before any calculation of the payment required to be made in respect of the yield is carried out and the guarantee obligation called on, although there are cases when there are much earlier or more regular calculations and payments.

**Dispute resolution**

Given the continuing nature of much of the financial support provided by a government in a bank rescue and its conditionality on a future deterioration or impairment of selected assets, it is crucially important that a clear and transparent dispute resolution mechanic is agreed upon between the government and the investor by which any asset deterioration and its value can be assessed and adjudicated. The independence of any adjudicator will necessarily need to be carefully considered.

**Management control and operation**

Where the government retains an equity stake in the bank post-acquisition, forms of shareholders’ and other agreements will generally be entered into with the investors setting out issues relating to the management and control of the operations of the bank. Even in cases where the government gives up any equity stake, given the continuing financial support obligation placed on the government, it may require control mechanisms and safeguards to protect the government from any further asset deterioration due to poor or imprudent...
management decisions. Conversely, any investor will wish to obtain the greatest freedom possible in managing the acquired bank and reduce the risk of interference or any veto (whether direct or indirect) by the government.

These agreements will typically cover such issues as:

- employees/labour protection;
- voting rights in respect of shares;
- dividend policy;
- directors appointments/removals;
- capital reorganisations, new issues of shares (including under share option plans) and capital reductions;
- sale of assets;
- bankruptcy/dissolution; and
- change of auditor.

Given the public interest, many of these issues will be politically sensitive. However, generally key management and operational control will be passed to the investor and/or their appointed directors.

**Subsequent sale**

Irrespective of whether the government has retained an interest in the bank, an agreement is generally put in place to establish the mechanics that will operate if the bank is sold as a business or either the government or the investor wish to divest of their interests.

The government will usually wish to see the investor locked in for at least an initial period (for example, two or three years) after purchase. Further, both the government and the investor may be granted pre-emption (first right of refusal) rights in respect of a sale by the other and/or there may be drag-along or tag-along rights which will operate to allow shareholders to align themselves in the event that a prospective purchaser wishes to acquire the entire, or a portion of, the issued share capital of the bank. Finally both the government and the investors may provide for exit strategies in relation to their interests in the bank, involving a re-listing of the bank on the equity capital markets.

**Future rescues**

Despite the numerous obstacles to achieving a bank rescue, a number of Asian banks have been saved thanks to successful government and private sector cooperation. Given the uncertain road to economic prosperity in Asia, however, bank rescues may not be a thing of the past.

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