MANAGING TURBULENT TIMES, A MALAYSIAN EXPERIENCE

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"Bulls and bears make money; but pigs get slaughtered" - Edwin Lefevre

The 1997 Asian economic crisis almost crippled the Malaysian banking system, which was until then enjoying an unprecedented growth . Set up by the government as a hopeful solution to the catastrophe , Danaharta, together with Danamodal, succeeded in averting the collapse of the financial system, and helped spur the economy. The Malaysian banking system survived and grew in strength, a testament to the efforts of the two agencies.

The nineties were a phenomenal period for the South East Asian economies. Malaysians, were beginning to enjoy an unprecedented economic growth with many "firsts". Highways, hotels, office towers, high rise apartments, their administrative capital, Putrajaya, Kuala Lumpur International Airport and of course the KLCC Twin Towers that had begun changing the landscape of their many cities.

It was the vision their earlier Premier, the forceful visionary Tun Dr. Mahathir had initiated and like their many neighbors, Malaysia enjoyed the competitive advantage with reasonably low wages, an educated work force and an adequate infrastructure. Malaysia was thus able to move from a basic exporter into an exporter of more complex products: semiconductors, computers and a wide array of high tech goods that yield a high value–added in the international market place. These efforts pushed Malaysia into a developed-economy income and status.

The euphoria of growth brought about with it an unending appetite to amass wealth. The local stock market was booming, sidestepping fundamentals. Many were quick to forget earlier experiences, placing life savings into the equity market. In Edwin Lefevre's book, "Reminiscences of a Stock Operator", he wrote of a 1920's speculator by the name of Jessie Livermore, called "Boy Plunger of Wall Street", who legend has it, made $100 million by short selling on the eve of the 1920 Wall Street crash. He got rich and went broke three times before committing suicide in 1940. Such, to Edwin Lefevre, was human nature.Malaysia was a popular investment destination, and this was reflected in the activity of Kuala Lampur Stock Exchange which was regularly the most active stock exchange in the world. At the start of 1997, the KLSE Composite index was above 1,200, the ringgit was trading above 2.50 to the dollar, and the overnight rate was below 7%.

Corporate borrowers enjoyed more than required borrowings from eager bankers. The growth of credit to the private sector grew from 12% p.a during 1990 -1994 to over 26% p.a during 1994 to 1996. Many borrowers ventured into property development, a quick money earning avenue in the nineties. By the end of 1996, total credit to the property sector accounted for 40% of total outstanding bank credit. The increased exposure led to a property glut in the market with lettable space outpacing demand.

Sadly, banks were willing to fund property ventures despite the fact that these were not core areas of such borrowers. Two such companies that I remember dealing with whilst in Danaharta involved a watch retailer and a trophy manufacturer, both listed and presumably impatient with the slower returns that came with their retail operations. Both ventured heavily into property development, taking on liabilities that far outweighed their income generated from their core operations. Both companies like many others failed quickly in the crisis.

With a fixed exchange rate against the dollar, U.S. Dollars were also borrowed to finance local investments but with exchange rates floating, the risks of such investments also rose sharply.

In July 1997, within days of the Thai baht devaluation, the overnight rate jumped from under 8% to over 40%. This led to rating downgrades and sell off on the stock and currency markets. By end 1997, ratings of many companies had fallen several notches, the KLSE had lost more than 50% from above 1,200 to under 600, and the ringgit lost 50% of its value, falling from 2.50 to under 3.80 to the dollar.

In 1998, the construction sector contracted 23.5%, manufacturing shrank 9% and the agriculture sector 5.9%. Overall, the country's GDP plunged 6.2% in 1998. In September, measures were taken to move the ringgit from a free float to a fixed exchange rate regime. The Central Bank fixed the ringgit at 3.8 to the dollar.

The confidence among banks, Corporate and consumers fell drastically with plummeting demand for goods and services. Wealth was halved, significantly quicker than it was gained and the country plunged into recession.

Non performing loans (NPLs) rose to a high of 13.6% and there were fears that the banking system faced the risk of a systemic failure. In addition, the collapse in the value of both equity and property asset values reduced the collateral of the banks. Larger provisions were required and with relatively minimal or "no growth", the banks faced losses and erosion of capital which restrained further lending.

The rising NPLs had two significant effects on the banks; first they tightened their lending making it virtually impossible for any viable business to help generate the much needed economic growth and secondly, banks became solely focused on recovery through any means possible. These measures left unattended would have thrown the economy into chaos.

The set-up

In January, 1998, the Malaysian government set up the National Economic Action Council (NEAC) as a consultative body to guide the country out of the crisis. The primary objective of the NEAC, chaired by the then premier Tun Dr. Mahathir, was to deal with the economic problems and to revive the economy. The NEAC prepared the National Economic Recovery Plan (NERP) which contained measures to guide the country towards economic recovery and maintain financial market stability.

To deal with the rising NPLs, the NERP recommended to the Ministry of Finance to set up both an Asset Management Company (AMC) with the objective of dealing with the NPLs from the financial institutions and a Special Purpose Vehicle (SPV) to recapitalize the financial institutions.

This led to the incorporation of Pengurusan Danaharta Nasional Berhad (Danaharta), the AMC and Danamodal Nasional Berhad (Danamodal), the SPV in June and August of 1998 respectively. Danamodal was entrusted with the task of injecting fresh capital into the financial institutions which required additional capital to meet the Capital Adequacy Ratio requirements but were unable to do so, due to the drastic changes in the market conditions. Danamodal's exit was through the sale of their stake when the market improved.

Danaharta's goal on the other hand was to remove the NPLs from the banking system so as to allow banks to concentrate on their core business of lending to viable borrowers and to maximize recovery from its NPL portfolio. Danaharta sought to actively manage the NPLs in its portfolio on an account by account basis with a view to maximizing the recovery on each. This was in contrast to the rapid disposition strategy adopted by Resolution Trust Corporation of US and the warehousing agency structure, which held on to assets, waiting for the market to recover.

The Danaharta Act

Having decided on the approach to address the threat in the banking system, it was imperative that Danaharta possessed the necessary legislative powers to undertake its objectives in an efficient, effective and expeditious manner. Determined to shut its operations within 7 years so as to minimize tax payers loss, the agency could not rely on the available but sometimes protracted Court avenues for recovery. The answer to this was the drafting of a new legislation, the Pengurusan Danaharta Nasional Berhad Act or more fondly known as the Danaharta Act in 1998.

The Act, which some deemed draconian, provided within it, three special powers that would help define the Agency's success in the following years.

The first power was the "Statutory Vesting" which essentially allowed Danaharta to acquire a loan by stepping into the shoes of the seller, financial institution. The NPLs acquired would vest in Danaharta on the vesting date specified in a "Vesting Certificate" issued by Danaharta. The Certificate was conclusive evidence that the asset has been vested in Danaharta and from the vesting date, Danaharta acquired all the seller's rights, title and interests in the NPL subject only to registered interests and claims disclosed before the vesting date.

The effect of vesting was to preclude any person from raising any claim in respect of the asset unless the claim is a disclosed claim. This Act proved vital in years to come, preventing borrowers from attempting to frustrate the recovery process by frivolous claims in the Courts.

The second power was the "Appointment of a Special Administrator" by Danaharta over a Corporate borrower, or a subsidiary, or a security provider, or a company whose shares were charged to Danaharta if the borrower was unable to pay its debts. To ensure transparency in such appointments, the decision to appoint a Special Administrator rests with an Oversight Committee whose members are represented by officers from the Regulatory authorities, namely the Central Bank, Securities Commission and the Ministry of Finance. The foremost criteria for an appointment of a Special Administrator is that it must enhance the value of recovery from the borrower.

Once appointed, the Special Administrator takes control over the assets and affairs of the affected company. A 12 months moratorium takes immediate effect during which time no creditor can take any action against the borrower company. The Special Administrator is then entrusted to draw up a workout proposal or a Scheme of Arrangement, to be implemented upon approval by creditors.

The distinct advantage with the appointment of the Special Administrator (principally a qualified accountant) is its ability to derive maximum value by disposing of all assets including the "listed status" of a public listed company through a carefully managed tender process. Without this option, creditors would pursue a liquidation approach which only serves to erode any recovery value. This Act proved extremely useful in maximizing recoveries from listed Corporate borrowers, to whom lending were largely on a clean basis.

The third power involved an amendment to the Malaysian National Land Code for Danaharta to carry out "Foreclosure" on a loan's underlying property collateral without having to go through a court process. The latter is time consuming with banks having to obtain an Order for Sale to dispose charged properties. Collateral properties could be disposed once borrower fails to comply with Danaharta's notice to remedy any breach of the loan agreement within 30 days.

This Act also allowed Danaharta to dispose of properties via private treaty, as compared to the financial institutions which could only dispose via a public auction. This helped ensure an expeditious recovery on property collaterals through disposal at market values.

Buying the NPLs

Acquisition of the NPLs from the financial institutions was next on the agenda. It was agreed that all acquisitions would be premised on a willing buyer-willing seller approach. Since a failure in any of the financial institutions, be it a finance company or a development or commercial bank, would have further affected confidence and halted any possibility of growth, Danaharta embarked on a system-wide carve-out and made offers to all financial institutions in Malaysia including locally incorporated foreign banks.

Since all financial institutions could manage a certain amount of NPLs in its Balance sheet, it was decided that only NPLs above Ringgit Malaysia (RM) 5.0 mil would be acquired. As the accounts were non performing, investment premised models such as discounted cashflow could not be used to determine the purchase price. Danaharta then applied the following pricing mechanism for these loans.

For secured loans, the price was determined by referring to the underlying tangible collateral value of the loan. For property collateral, the fair value was set at 95% of the market value of the property as determined by an independent professional valuer whilst for shares, the price was determined between the market and net tangible asset value of the shares, the price being higher if the stake was a controlling size.

For unsecured loans, purchase price was based at 10% of the loan outstanding, an arbitrary figure (South Korea had used 3% as value in purchasing NPLs). Although all parties agreed with the approach, financial institutions were still unwilling to sell as they would have had to make major losses in selling the loans at a discount. To address this issue, Danaharta agreed to share any surplus recovery with the selling institution should recovery be in excess of the purchase price plus holding costs.

Typically, the surplus recovery is shared, net of holding costs, on an 80 (financial institution): 20 (Danaharta) basis and the amount receivable by the financial institution is capped at the shortfall value. On realizing its acquisition costs (plus holding costs) in cash, Danaharta distributes the surplus recovery to the financial institution in the form of cash or a combination of cash and instruments.

Further pressure was initiated by the Central Bank, which required that all financial institutions with NPLs above 10%, sell their NPLs to Danaharta. As a carrot, the Central Bank allowed all institutions selling NPLs to Danaharta to amortize their losses on the loans over a 5 year period as against an immediate write down by 80% of Danaharta's valuation should the Bank opt to not sell the loan.

In total, Danaharta acquired loans of about RM50.0 billion in loan outstanding, comprising 2,902 borrowers. The acquisition phase was completed in March 2001. The purchase of the NPLs was to be financed by the issuance of zero coupon bonds guaranteed by the government. Although the initial intention was to have an international bond issue, the fall of the ringgit and the downgrade in Malaysia's sovereign credit ratings made this an expensive option.

Setting the path

The organizational structure of Danaharta was similar to that of a bank. Operations Division undertook the core activities of asset acquisition, management and its subsequent disposition whilst the support functions were undertaken by Internal Audit, Property, Corporate Services, Finance, Legal Affairs & Risk Management and Communications and Human Resources.

A key factor in the success of Danaharta was the people it employed. In addition to bankers, the agency had on its payroll a core team with expertise in corporate finance, property and legal. Where expertise could not be found within, external resources were sought and the best was obtained. For much of the early period in Danaharta, I remember spending much time with three lawyers, Tommy Thomas, Sitpah and Vinayagar of a reputable law firm, Skrine & Co, running through the files of the larger NPLs and establishing recovery strategies based on the facts of the file and the type of collateral we had. Tommy & Sitpah subsequently set up a firm of their own and we engaged them for many of our legal cases where the Danaharta Act was contested. All service providers were monitored and their performances evaluated, to ensue that only the best were retained for subsequent appointments.

We viewed it very necessary to act early in all cases, as a drawn-out solution to the NPL problems would have been costly to the Government. Loan recovery policies were established to address the issue of moral hazards whilst loan restructuring principles and guidelines were also formulated in consideration of the following objectives:

- maximizing the overall recovery value and returns to Danaharta;
- minimizing the involvement of taxpayers' money;
- ensuring fair treatment of all stakeholders;
- utilizing where appropriate Danaharta's special powers to leverage and benefit the banking system as a whole.

Danaharta adopted an enterprise wide risk management approach. Risks were identified relating to the objectives and the critical success factors that were necessary to provide success. There was a continuous review of the risk management policy by the Management to ensure its relevance to the overall business plans.

During the latter part of my years in the agency, I headed the Risk Management Unit. Having been involved in the Operations division prior to that, I enjoyed the constant debates with the Operation Heads at the various Committees on addressing the risk areas in their proposed solution for the various NPLs. Their openness and single mindedness to achieve the best solution for each one of the NPLs, are aspects of the agency that I cherish most, a trait that helped Danaharta achieve its objective.

A key risk of Danaharta was of "reputation". Being subject to both local and international scrutiny, the agency was aware of the need to maintain its credibility and transparency. Danaharta thus made it a point to disclose its results on a timely and interactive basis to the press. Key credit must go to Datuk Azman Yahya, the pioneer Managing Director of Danaharta for having understood the importance of Danaharta's role and its impact if managed properly. Datuk Azman would later be named "The Restructuring Agency Chief of the Year" by Asiamoney in 2000.

Methods adopted for recovery

If the borrower is viable, they were given a chance to restructure/ rehabilitate their loans according to Danaharta's loan restructuring policy and guidelines. This arrangement was preferred as a voluntary loan restructuring generally yields higher recovery rates vis-à-vis other methods. The loan management methods employed were Plain Loan Restructuring, Settlements & Schemes of Arrangement.

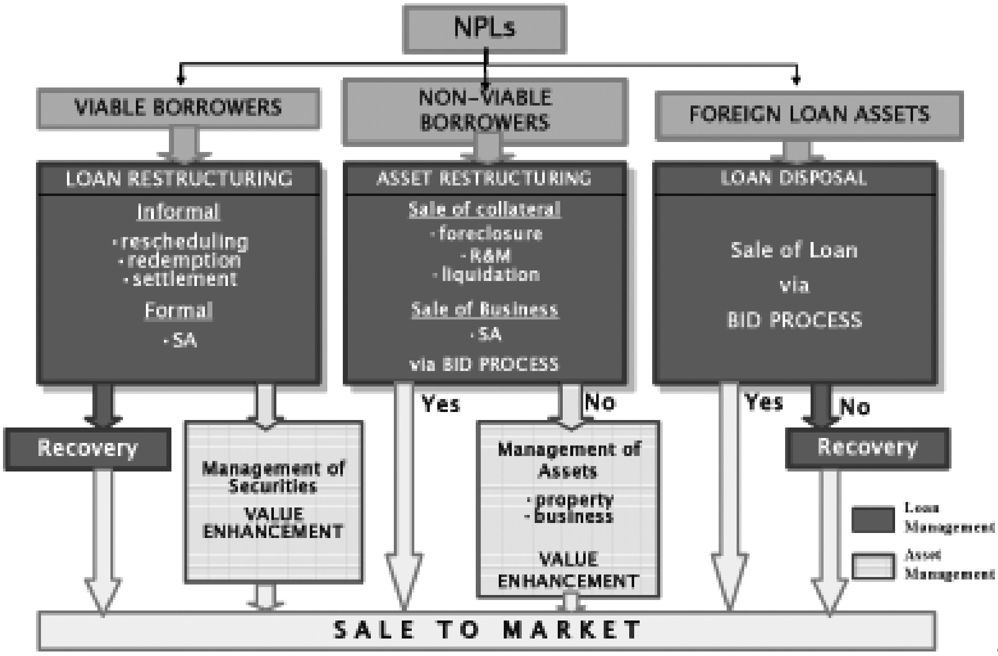
For non viable borrowers/guarantors and in cases where borrowers failed to comply with the loan restructuring guidelines to restructure its loans, the recovery approach normally involved the sale of a borrower's business or the underlying collateral. The methods adopted were Foreclosure (sale of collateral) and Appointment of Special Administrators (SAs), who undertook disposal of assets and business. These actions were accompanied by legal action to exhaust all possible recovery.

Recoveries were not always in cash. In some Schemes of Arrangement and workouts of Special Administrator, debt to equity investments including redeemable loan stocks with convertible features were accepted. Danaharta would accept these as we anticipated an upside in gain once the share market improved.

Foreclosure of properties was carried out through tender processes. Properties were bundled together for sale under a tender and in total Danaharta carried out 10 tenders during its tenure. For many of the tenders, properties that did not attract bids above the minimum price set by Danaharta in each property tender were transferred to Danaharta Hartanah Sdn Bhd (Danaharta Hartanah), a wholly-owned subsidiary of Danaharta, via an automatic bid mechanism.

The objective was to facilitate the transfer of ownership of the unsold properties from the borrowers to Danaharta and help resolve the loan position. The properties transferred to Danaharta were at a discount to the market value. These properties were subsequently tendered again with any upside or downside accruing to Danaharta.

Efforts subsequently focused on converting the non-cash recovery assets, ie the properties, shares, loan stocks into cash, part of which was distributed to the financial institutions that had sold the NPLs to Danaharta (as required under the surplus sharing arrangements). The balance of the cash was used to redeem the bonds issued to the respective financial institutions in consideration for the NPLs.



Where foreign NPLs were involved, Danaharta disposed these through a tender process as the powers that came with the Danaharta's Act did not extend beyond Malaysian jurisdiction, meaning that there is little or no competitive advantage vis-à-vis a third party buyer in dealing with the foreign loan assets. Irrespective, through negotiations and properly managed tender processes, Danaharta achieved a remarkable recovery rate of 66% on the tenders conducted.

Closure

Danaharta ceased its operations on 31 December, 2005 after 7 years of operations. Both agencies, Danaharta and Danamodal by carving out the bad debts and recapitalizing the weak banks were instrumental in avoiding contraction in bank lending when it was needed most. Many have commended the agencies as reportedly being the most effective and far reaching financial system clean-up among the crisis countries. During it's time, the agency recovered approximately 60% of NPLs that it managed, well above the 20% to 50% that other similar agencies achieved. Danaharta's success nevertheless could not have been achieved if not for the strong creditors' rights and insolvency laws it possessed both prerequisites for successful and effective NPL resolutions.