Chapter 9

Implications of the Restructuring of the Malaysian Banks

Even though the restructuring process is still ongoing, I would like to highlight some important implications arising from this restructuring.

9.1 Cost of Banking Restructuring

Cost of banking restructuring, in the case of Malaysia, depends on two aspects: the size of NPLs and capital adequacy requirement. Initially, estimate of RM 25billion is required by Danaharta to purchase NPLs, while Danamodal would need a total of RM 16 billion to bring the RWCR of all domestic banks to at least 9% (Bank Negara Malaysia, 1998i).

This cost (Shahrome, 1998) is based on wide estimate ranging of NPLs from 15% to 30% of loans against gross loans outstanding (including interest expense) of about RM 297 million at the end of June 1998. This equals to between RM 45 billion and RM 90 billion worth of NPLs which are expected to sell at a discount. Assuming Danaharta pays an average of 60% of the estimated NPLs, this would equal to potential purchases of between RM 16 and 32 billion of NPLs. Therefore, the amount of RM 25 billion estimated by Danaharta is possibly adequate to complete its operation (Danaharta, 1998).

However, this estimate is based on gross loans outstanding of commercial banks only (the aggregate amount of gross loans outstanding of the banking sector equals to RM 420,419.9 million at the end of June 1998), and it does not include financial companies' and merchant banks' gross loans outstanding. Therefore, the cost of restructuring the banking sector, as a whole, is possibly higher than this estimate.

On the other hand, this cost may be less, depending on banks' profits (to make higher provision, reserves to make loan write-offs) and accessibility and effectiveness of both Danaharta and Danamodal to accomplish their missions. In contrast, failing to actively manage the NPLs will increase the total cost of restructuring. Generally, the effectiveness of these two special agencies largely depends on (1) being given enough resources, (2) speed of actions, and (3) independence. Other measures include, for example, lower interest rate, easing liquidity, and fixed exchange rate policy, these will positively reduce NPLs of the banking institutions and consequently lower cost of NPLs purchased.

Furthermore, the ability to collect loans is also important for Danaharta. This is because loan collection reduces cost of the restructuring and indicates to future borrowers that they should expect to pay their loans or to be liquidated in the case of default (Caprio *et. al*, 1994).

9.2 Strengthening the Balance Sheet

Danaharta's objective is to restore banks' balance sheets by acquiring the NPLs from those banks at the discount rate. If NPLs are not removed from the balance sheets, banks' future earnings, liquidity and capital will continue to be under pressure.

With the new guideline on NPLs reclassification, NPLs will be rescheduled and also become serviceable as the borrowers are able to service their debts when the interest rate is reduced. This would further reduce NPLs from the banking sector's balance sheet. The ability to clean and start the new balance sheet does not only allow the banking sector to refocus on its core businesses, but also will

reduce systemic[1] risk in the sector as well as restore financial viability and public confidence.

9.3 Strengthening Banking Institutions

Danamodal will ensure that the banking sector meets the capital adequacy requirement and restore public confidence in the safety and soundness of the banking sector. Weaker banking institutions will be encouraged to restructure or merge to form a core group of strong financial institutions in order to effectively compete in an increasingly competitive global banking industry.

At the time of writing this paper, Danamodal has announced a recapitalisation package involving RM 1.5billion for the merged RHB-Sime Bank, and estimated that a sum of RM 9.4billion (including the RHB-Sime Bank exercise), would be required in the immediate term to recapitalise the weaker banks (RHB, 1998; Danamodal, 1998c). Other recapitalisation transactions include conditional investment agreements worth RM 3.3billion with 10 of the prioritised banking institutions[2] which is a pre-emptive move to enhance their resilience and increase the average risk-weighted capital ratio of these institutions from 9.75% at the end of August 1998 to 14.06% upon the completion of the recapitalisation exercises (Danamodal, 1998b).

To date, it has issued RM11 billion nominal value zero-coupon Unsecured Redeemable Bonds[3] (1998/2003) to raise about RM7.7 billion to fund its banking

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[1] Dziobek and Pazarbasioglu (1997) define "Systemic" as a situation where problems affected banks which, in aggregate, held at least 20% of the total deposits of the banking sector.

[2] They are Arab-Malaysian Bank Bhd, Arab Malaysian Finance Bhd, Arab Malaysian Merchant Bank Bhd, MBF Finance Bhd, BSN Commercial Bank Bhd, Oriental Bank Bhd, United Merchant Finance Bhd, Perdana Merchant Bankers Bhd, Sabah Bank Bhd and Utama Merchant Bank Bhd.

[3] These Bonds were allotted to 57 banking institutions (comprising 35 commercial banks, 10 core finance companies and 12 merchant banks) from the liquidity released into the banking sector from the reduction in the SRR on 16 September 1998. Each allotment is in proportion to the funds released from the reduction in the SRR.

institution recapitalisation programme (Danamodal, 1998d). This means Danamodal would need another RM 6.6 billion to meet the target. Therefore, the ability to raise funds to recapitalise weak banks is a very important task for Danamodal. If it is unable to raise funds fast enough to facilitate recapitalisation process, the central bank may have to cut the SRR further to finance Danamodal.

Theoretically, banks have other two choices to acquire new capital, from existing shareholders and from new foreign shareholders. The first choice may not be suitable at this moment due to economic slowdown. Therefore, acquiring new capital from foreign shareholders through raising limit on foreign ownership (currently 30% limit on foreign equity in local banks) may be considered not a bad idea. This is because new capital provided by foreign ownership has other potential advantages, such as new technology, new markets, new customers, new funding sources and a global reach (Shahrome, 1998).

9.4 Improving Lending Activities

The reduction in SRR and LAR released a total of RM 43.6 billion into the banking sector(Table 9.4.1). Together with the new BLR formula and the reduction in the 3-month intervention rate, the ceiling BLRs of commercial banks and finance companies has been reduced (Table 9.4.2).

Table 9.4.1: Funds Released Through Reductions in SRR and LAR (RM billion)

	SRR ratio	Amount Released
16-Feb-98	-3.5% points to 10.0%	14.0
1-Jul-98	-2.0% points to 8.0%	8.0
1-Sep-98	-2.0% points to 6.0%	8.0
16-Sep-98	-2.0% points to 4.0%	8.0
Sub-total		38.0
16-Sep-98	-2.0% of liquid asset ratio of commercial banks	5.6
Total		43.6

Source: Rashid Hussain Research Institute (1998)

Table 9.4.2: Change in BLRs of Commercial Banks and Finance Companies

	Ceiling BLRs	
	Commercial Banks	Finance Companies
	% per annum	
Jun-98	12.3	14.8
Jul-98	12.0	14.4
Aug-98	11.0	13.1
Sep-98	8.9	10.58
Oct-98*	8.5	10.06
Jun-Oct	-3.8	-4.74

Source: Rashid Hussain Research Institute (1998)
* Bank Negara Malaysia (1998b)

The introduction of capital and exchange controls on 1 September 1998 enabled the central bank to lower the domestic interest rates and, at the same time, stabilise the ringgit. Consequently, banks are able to provide more loanable funds to their customers at lower costs and therefore increase lending growth and investment rates. Furthermore, a higher limit of share purchases and liberalising loan extended to the broad property sector would contribute to increased lending activities in the banking sector.

However, experiences reveal that loans of the banking sector were exposed to certain sectors which, in turn, led to high NPLs. Therefore, the efficient allocation of funds should be reconsidered as one of major long-term critical factors to promote viability of banks and to revive the Malaysian economy.

Funds should be allocated to productive projects which contribute to export and GDP growth of the country, including educational and technological programmes that can enhance knowledge, efficiency and productivity of the country's resources. This, together with the depreciated ringgit currency, would eventually improve Malaysian competitive advantages in the world of market globalisation and liberalisation. Efficient resource allocation also minimises the social costs and strengthens social safety nets whenever crises arise.

9.5 Boosting Economic Activities

Lower interest rates are beneficial to households as they will service less in mortgage payments. Together with other measures revealed in the 1999 budget announcement (for example, tax exemptions on personal income tax for 1999, and capital gain from unit trust funds and so on) it would possibly lead to an increasing spending power and further stimulate domestic demand. This would contribute to growing economic activities and money supply. Once the economy improves, the principal and the interest on loans could be repaid. In turn, the result is lower NPLs from banks' balance sheets and higher profitability recorded in the banking sector. This would translate into an increasing value of shares of the banking institutions.

Whether the government can turn around its economy, however, does not solely depend on the financial restructuring programme. To achieve economic sustained growth again will mainly depend on fiscal and monetary policies implemented by the government and the central bank to address the economic fundamentals.

Furthermore, the Malaysian economy recovery requires strong external stimulus which comes in two forms; recovery in exports and the flow of foreign direct investment (FDI) into the country. Since Malaysia exports similar products as other affected countries in the region, the ability to improve its efficiency and competitiveness is very important, especially in the wake of the global downturn. Besides, export growth is crucial in keeping Malaysia's balance of payments since FDI is likely to decrease.

The capital controls are possibly useful to monitor short-term capital flows, but they may adversely affect investors' confidence, especially in the area of FDI which contributes to the nation's long-term economic growth. Their confidence in

Malaysian and other Asian nations largely depends on their anticipation towards the country's policies.

Since the Malaysian government intends to maintain its control policy until the international architecture of monetary system has been reformed (however, such new direction is unlikely to materialise any time soon), therefore, controls may reduce long term investment when implemented for too long.

9.6 Enhancing Transparency and Corporate Governance

Impacts of the crisis reveal that inadequate information is one of many factors leading to financial panics. To counter this issue, Bank Negara Malaysia has introduced various prudential guidelines and higher standard disclosures of the banks' financial reports and other disclosures to the public to promote soundness and stability of the banking sector. To attain this objective, however, the central bank should ensure that information disclosed by banks consists of the following six broad categories:-

(a) financial performance;
(b) financial position, including capital, solvency and liquidity;
(c) risk management strategies and practices;
(d) risk exposures, including credit risks, market risk, liquidity risks and operational, legal and other risks;
(e) accounting policies; and
(f) basic business management, corporate governance information.

Market discipline can only work well if the investors have an access to timely and reliable information which therefore enables them to assess and monitor banks' activities and the risks inherent in those activities. More important, prudential supervision and market discipline are critical to promote transparency and

governance of both individual institutions and the banking sector, and will eventually restore public confidence.

In addition, the central bank should also tackle the moral hazard problems in the banking sector. Since the implicit guarantees encourage banks to expand their credit facility with no adequate risk assessment, the result is higher NPLs in their balance sheets. Thus, reducing moral hazard problems will, in turn, reduce risk exposures in the banking sector as well.