

# **Chapter 1**

## **Introduction**

### **1.1 Overview**

The Malaysian banks had experienced high levels of non-performing loans (NPLs) since the recession in the mid 80s. This was due to excessive lending in particular the property sector and the stock market. In the 90s, prior to the East Asian Crisis in 1997, just like its regional neighbours, Malaysian banks continued to lend a lot to these sectors.

When the crisis triggered in mid 1997, falling asset prices exposed the vulnerability of the banks in the region. This led to an increase in the level of NPLs in the banks. Despite that, the central bank of Malaysia was confident that Malaysia would be able weather the crisis without experiencing significant deterioration in its own situation because it had lower non-performing loans and higher capital (Kochhar, Roger & Tzanninis, 1999). According to Kochhar, Loungani & Stone (1998), while countries like South Korea and Indonesia accounted for 20 percent and 14 percent of NPLs respectively to total loans, Malaysia only accounted for 4.1 percent on a net basis at the end of 1997. They

claimed that poor loan classification standards and evergreening 'practices' could have led to misleading indicators of the level of NPLs in Malaysia.

But in 1998, subsequent to the onset of the crisis, the non-performing loans in the Malaysian banking institutions continued to increase sharply because the Malaysian government had to protect the ringgit by raising interest rates. Besides that, loan classification standards and prudential measures were imposed on the treatment of non-performing loans. The period in arrears was reduced from 6 months to 3 months beginning 1998.

Since the level of NPLs became increasingly impaired in the Malaysian banks, the interest rates were gradually reduced. In September 1998, the classification of a loan as non-performing was relaxed back to 6 months, while other prudential measures imposed were maintained. In addition, Danaharta, Malaysia's national asset management company was established to remove non-performing loans in the banks and subsequently recover the loans.

## **1.2 Purpose and Significance of the Study**

This study is based on the management of NPLs of the banking institutions from 1995 to 2004. The study aims to determine if the NPLs have gone down and the asset quality has improved since the 1997-1998 crisis. In addition, the study aims

to verify the effectiveness of Danaharta in addressing the NPL problem in the banking institutions. This is in view of issues raised on AMC's warehousing the loans and assets transferred to their portfolios and lacking the incentive to dispose them.

### **1.3 Objectives of the Study**

The following are the objectives of this study:-

1. To determine the trend and the rate of change, in the level of NPLs and the amount of loan loss provisions from December 1995 to March 2004.
2. To compare the level of NPLs (after loans sold to Danaharta) with the level of NPLs (if loans are not sold to Danaharta) of the banking institutions and among the 3 categories of banking institutions from November 1998 to March 2004.
3. To compare the level of NPLs (after loans sold to Danaharta) with the level of NPLs (if loans are not sold Danaharta) of the banking institutions between the 3 months and 6 months NPL classification, from November 1998 to March 2004.
4. To determine the amount of NPLs restructured in proportion to total NPLs

and to analyze the expected recovery rates from 1998 to 2003.

5. To determine the proportion of the amount of recoveries received and recoveries realized to the total amount of NPLs and expected recovery rate for the acquired and managed NPLs in Danaharta's portfolio as at December 2003.
6. To determine the surplus distributed for the acquired and managed NPLs.

#### **1.4 Method of the Study**

The research questions, data collection and analytical procedures are determined in the method of the study.

##### **1.4.1 Research Questions**

The following are the research questions of this study:-

1. Has the level of NPLs in the banking institutions declined and is the change in the NPL ratios more stable since the 1997-1998 crisis?
2. Has the level of loan loss provisions declined after the 1997-1998 crisis compared to before the 1997-1998 crisis?

3. Has the level of NPLs in the banking institutions gone down as a result of Danaharta?
4. Is Danaharta warehousing a lot of assets in its portfolio?

#### **1.4.2 Data Collection Procedure**

The secondary data collected for this study are:-

1. Outstanding gross NPLs in the banking institutions (for 3 months and 6 months basis)
2. Gross loans (after loans sold to Danaharta).
3. Loans sold to Danaharta (in book value).
4. NPLs of banking institutions held in sectors (selected years only).
5. Ageing of loan in arrears after loans sold to Danaharta(selected years only).
6. Loan loss provisions in the banking institutions (selected years)
7. NPLs in Danaharta's portfolio in LRA value, ageing, sector, number of borrowers, and type of collaterals.
8. Expected, received and realized recovery rates of loans in Danaharta's portfolio.

9. Surplus distributed by Danaharta to the banking institutions.

These secondary data would be obtained on a quarterly or yearly basis for the period of 1995 to 2004 from various issues of BNM Annual Reports, BNM Monthly Statistical Bulletins and Danaharta's Annual and Operations Report. These data are considered reliable because they are obtained from official sources and the figures in these sources have been audited.

This study pertains to all the commercial banks, finance companies and merchant banks, in investigating whether the NPLs in the banking institutions have gone down as a result of Danaharta. However, in investigating the NPL recovery performance of Danaharta, the study accommodates the non-banking institutions in Malaysia because the data on Danaharta's recovery performance is not categorized according to financial institutions. Further, the amount of NPLs from the non-banking institutions is negligible compared to the amount of NPLs from the banking institutions.

Since data on gross NPL amounts and gross loans outstanding (if loans are not sold to Danaharta) are not available, this data needs to be computed to determine whether the NPLs have gone down as a result of Danaharta.

NPL to total loans ratios need to be computed on a gross basis instead of net basis because data on loan loss provisions (if loans are not sold to Danaharta) is unavailable. The gross NPLs (if loans are not sold to Danaharta) are computed by adding back the gross NPLs sold to Danaharta with the gross NPLs (after loans sold to Danaharta). Gross NPL ratios would be computed by dividing gross NPL amounts with gross loans.

### **1.4.3 Data Analysis Techniques**

For the first and second research question, an analysis would be made to determine if the gross NPL ratio has declined in March 2004 from December 1995. Then, the rate of the change in the NPL ratios and the proportion of outstanding specific provisions and interest in suspense to NPLs would be analyzed from December 1995 to March 2004. A more gradual change in the NPL ratio and higher provision would indicate prudential measures are being followed. An analysis would also be made on the outstanding loan loss provisions to NPLs to determine whether the total outstanding loan loss provisions of loans have been declining from December 1995 to March 2004. If it declines, this indicates that the asset quality of the banks has also improved.

For the third research question, the trend of the NPL to total loans ratios( after loans sold to Danaharta) and the NPL to total loans ratios (if the loans are not

sold to Danaharta) in the banking institutions are first compared from November 1998 till March 2004 under the 6 month NPL classification. If the NPL ratios (after loans sold to Danaharta) have declined but the NPL ratios (if loans are not sold to Danaharta) have not declined in March 2004 as compared to the NPL ratio in November 1998, then the NPLs have gone down as a result Danaharta. The analysis can be supported by analyzing the ageing of loan in arrears (after loans are sold to Danaharta) for the banking institutions to see whether there is a decline in the loan in arrears. Then, NPLs (in sector and ageing) in Danaharta's portfolio would be analyzed to see whether Danaharta has taken out the very bad loans and NPLs from the sectors that contributed to the large amount of NPLs in the banking institutions.

The same procedure would be repeated for each category of banks when analyzing the effectiveness of Danaharta among the commercial banks, finance companies and merchant banks. To determine the effectiveness of Danaharta in bringing down the level of NPLs under a stricter loan classification method like the 3 months NPL classification, the change in NPL ratios from December 1995 to March 2004 (after loans are sold to Danaharta) and (if loans are not sold to Danaharta) for both 3 months and 6 months classification are computed. Then the difference between the change (after loans sold to Danaharta) and (if loans are not sold to Danaharta) would be determined for both classifications. The



classification method that has a higher difference of change would indicate that Danaharta is more effective in that classification method.

For the fourth research question, the percentage of NPLs restructured and disposed to total NPLs in the Danaharta's portfolio can be used to measure how fast Danaharta has dealt with the NPLs in its portfolio or what proportion of the NPLs had been dealt with rather than being parked in the AMC. Other indicators like the proportion of recovery in both unrealized and realized basis to the expected recovery rate, and to the total NPLs in the portfolio, can be used to measure Danaharta's efficiency in disposing the NPLs, or the amount of NPLs warehoused in its portfolio. The received and realized recovery rate in proportion to its expected recovery rate and the surplus distributed to the financial institutions would also be compared between the acquired NPLs and the managed NPLs. According to Klingebiel (2000), longer term restructuring agencies that are not rapid disposition or liquidation agencies would be considered successful if they have sold off 50 percent of the total NPLs in their portfolio within a 5 year time frame. In this study, this 50 percent standard may be used on the realized recovery indicators of Danaharta. Since Danaharta was established in 1998, five years from its year of establishment would be year 2003, which is about two years before they expect to wind up.

## **1.5 Scope of the Study**

The period covered in this study is from year 1995 to year 2004, which is before and after the 1997 East Asian crisis and the bank restructuring efforts in 1998. The analysis of this study is based mainly on the banking institutions of Malaysia which are the commercial banks, finance companies and merchant banks. The evaluation of bank restructuring efforts covers only Danaharta and not Danamodal and CDRC.

## **1.6 Limitations of the Study**

In analyzing Danaharta's effectiveness in disposing the NPLs, the study does not discuss whether Danaharta has enhanced the value of assets disposed; it is only concerned in determining the proportion of NPLs disposed.

## **1.7 Organization of the Study**

This paper consists of seven chapters. The first chapter which is this chapter has mainly described the purpose and the method of the study. The next chapter reviews the concept, classification and treatment of NPLs. The effect of the 1997-1998 crisis on the level of NPLs in the banking institutions of Malaysia is reviewed in the third chapter. Then, the use of AMCs as a solution to the NPL problem and its application in Malaysia through Danaharta is dealt in chapter four

and five respectively. Subsequently, chapter six discusses the analysis and findings of this study. The final chapter concludes this paper with the lessons learnt from the study and suggestions for further study.