

Chapter 4

Asset Management Companies as a Solution to the Non-Performing Loans Problem

4.1 The Function of Asset Management Companies (AMCs)

Asset management process is the process whereby non-performing assets are first identified and organized into one of four categories of action which is selling, recovering, restructuring and writing off such assets. Conflicts may arise among the competing objectives of asset management, for example a high rate of recovery and a swift resolution are sometimes incompatible (Woo, 2000). Asset management companies (AMCs), whose main function is to takeover the non-performing assets of distressed financial institutions, are generally founded on the supposition that they can help facilitate financial restructuring, maximize the recovery of non-performing assets at the same time (Woo,2000) and avoid distracting the budgetary, monetary and supervisory authorities from their regular tasks (Clarke & Johnston, 1995).

4.2 Centralized and Decentralized Asset Management Companies

Researches have basically identified two types of AMCs which is the centralized and decentralized AMCs. In decentralized AMCs, the workout units are within or

outside individual banks and can have the advantage of allowing banks to build their capacity to assess problem loans, however when there is bankruptcy there is generally no administrative structure for loan workout and this can lead to duplication of administrative costs excessive depression of market values of assets (Clarke & Johnston, 1995). The centralized AMC can be more cost effective, although it is likely to result in more financial sector burden, depending on how it is financed (Dziobek & Pazarbasioglu, 1997).

4.3 Effectiveness of Asset Management Companies

The desirability of transferring debt to an AMC has been subject to considerable policy discussion. Many researchers like Clarke & Johnston (1995) and Hawkins & Turner (1999) have explained that the reason for leaving the loans with the originating bank is that the bank knows the borrower. In addition to creating asset value losses through large transfer of loans without bank involvement, past experience suggest that many times an AMC “sits” on its loans, often in fear of antagonizing the “powers that be” that contributed to the bad loans in the past (World Bank, 1998). The arguments for transferring the NPLs to the AMC is that the originating bank lack skills of handling non-performing assets (Berggren, 1996; as cited by Woo, 2000), may be less objective and may even continue lending to delinquent debtors (Clarke & Johnston, 1995), and therefore “AMCs can shift the balance of power to creditors in the case of large corporations”

(World Bank, 1998). Removing non-performing loans and transferring them to a separate loan recovery agency could be an effective way of addressing the stock problem and indirectly, the flow problem because separating the non-performing loans immediately improves banks' balance sheets and helps bank focus their attention on their core business (Kochhar et. al.,1998), although "there is also a case for not moving all NPLs away from the bank, as it is unfair to the better managed banks if the distressed banks end up with no NPLs" (Hawkins & Turner, 1999). Loan workout procedures and asset sales are important to recover some of the costs of restructuring (Kochhar et. al., 1998). Restructuring or closing insolvent firms must be part of the restructuring process; otherwise the recapitalized intermediaries that continue to lend to them will once again become insolvent (Long, 1990). Policy makers are reluctant to resort in large scale liquidation of non-performing assets because they are ineffective in minimizing losses and could result in asset price deflation with consequent macroeconomic effects (Clarke & Johnston,1995), high social and political repercussions and therefore rehabilitation of non-performing assets is more beneficial (Woo,2000).

The success of an AMC in improving the balance sheets of banks' need to be qualified against the residual risks that the AMC, the banks themselves and the central bank are facing (Hawkins, 1999). While an AMC may be one solution to resolve excessive NPLs in banks, it cannot ensure that new NPLs will not be

created (Fung, George, Hohl & Ma, 2004). In some cases, the restructured loan can over time become an NPL again which in the end may cost the AMC more than originally thought (Hawkins, 1999). According to Klingebiel (2000), the most successful AMCs have been those with more narrowly defined mandates. In connection to this, according to (IMFa, 1999) as cited by (Woo, 2000), using AMCs to recapitalize financial institutions by purchasing NPLs from these institutions at above market value is inferior to direct recapitalization. However, according to Hawkins & Turner (1999), the risk of AMCs purchasing assets at discounted present value or market value is that the assets may be repurchased at a deep discount by the previous owner who remained in default on their original debt loan. The approach of transferring loans to AMCs may be suitable in countries where the problems are predominantly with a few number of large enterprises, which are difficult to restructure and require government involvement, however for most East Asian countries none of these conditions apply and thus may lead to the government owning much of the corporate sector through AMCs (World Bank, 1998).

4.4 Conclusion

The subsequent chapter reviews the application of Danaharta, an AMC in Malaysia in response to the 1997-1998 East Asian crisis.