



NORTHERN MALAYSIAN ECONOMIC BULLETIN

SCHOOL OF ECONOMICS

UNIVERSITI UTARA MALAYSIA

RESTRUCTURING THE BANKING SECTOR : ROLE OF DANAHARTA AND DANAMODAL

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Introduction

Although strong economic performance in recent years had placed Malaysia in a stronger position to withstand the regional financial turmoil, the intensity of the contagion effect nevertheless had deteriorated its economic situation. The currency crisis had caused strains in the financial system as well as undermined investors' confidence. Inefficiency and vulnerability had emerged in the financial sector due to several reasons. There has been a rapid expansion of credit' to the private sector, particularly in the broad property and stock markets, indicating inappropriate direction of lending. The economy is highly leveraged with heavy reliance on short-term domestic debts that increased the overall solvency risk of both the corporate and financial sectors. Also, banks are burdened with increasing level of non-performing loans (NPLs) that lead

to erosion of their capital adequacy. These factors partly contributed to the instability of the financial sector, which in turn, affect the real sector. Consequently the economic growth has been slowed down.

Efforts are directed towards minimising the adverse impact of the crisis on the economy. Series of policy packages had been implemented to restore confidence in our macroeconomic stability, with priorities given to maintaining financial market stability so that it becomes resilient to external shocks. An overly fragmented and high level of fragility in the banking sector reflects the need for restructuring. Restructuring the banking sector is crucial and need to be tackled quickly if the economy is to regain its footing. Accordingly, measures had been taken to tackle the most challenging tasks in the restructuring process, that is, resolving the NPLs

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¹ The ratio of bank lending to nominal GDP rose from 98.6% in 1990 to around 145.1% in 1997

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problem and recapitalising the financial institutions. Hence, government had established Pengurusan Danaharta Nasional Berhad (Danaharta) to deal with the situation of rising non-performing loans and Danamodal Nasional Berhad (Danamodal) dealing with recapitalisation of the banking sector as well as to act as a catalyst to rationalise the sector.² These two agencies complement each other towards the strengthening and safeguarding the stability of the financial market (figure 1). A safe, sound and efficient domestic banking sector helps to create a positive environment to expedite the economic recovery process. This short article highlights the role played by Danaharta and Danamodal in assisting the economy towards recovery through the restructuring of the banking sector.

Danaharta

Danaharta, a government-owned agency³, was set up with the main objective of removing the distraction of non-performing loans (NPLs) from the banking system and to maximise the recovery value of the acquired assets. Since the currency crisis began, the ratio of NPLs had grown substantially as a result of business failures. The situation is worsened as the crisis became more severe and prolonged, and continued contraction of the economy. The NPLs ratio

rose from 3.5 % in March 1997 to 13.2% as at November 1998.⁴ Danaharta's role is to purchase NPLs of the banking institutions⁵ so as to ensure the ratio remains at manageable level. The financial institutions will be relieved from the burden of managing the NPLs and defending their capital base. In fact, it helps to improve the overall asset quality and risk weighted capital ratio (RWCR) of the financial institutions. They can then focus on their core activity of providing loans to potential borrowers.

To accomplish its mission effectively, Danaharta has been accorded a special power⁶ that facilitates the takeover⁷ of NPLs from the selling banks. It allows the use of shortcut procedure for the transfer and ownership of the assets. The acquired NPLs will be managed and where appropriate, Danaharta will take necessary actions to maximise its recovery value. For viable loans, Danaharta may rehabilitate, implement restructuring programmes and injecting additional funding to ensure the loans operate efficiently. If the assets are unviable, it will be transferred to the Asset Management Unit (AMU)⁸ for disposition or rehabilitation using various methods. In the case where the borrowers are unable to meet their obligations, Danaharta has the power to takeover the management of the companies, and appoint a Special Administrator to manage the dis-

tressed companies.

Danaharta is not aiming to remove all NPLs in the system; it only buys NPLs worth more than RM5 million based on their fair market value.⁹ In exchange for the purchase, Danaharta will issue government guaranteed five-year zero coupon redeemable bonds and cash to financial institutions involved. It is estimated that the amount of funding required to acquire the NPLs is RM15 billion,¹⁰ of which RM1.5 billion is provided by the government while the balance funding will come from the issuance of bonds and borrowings in the domestic markets. Danaharta will issue up to RM10 billion worth of nominal value government guaranteed zero coupon redeemable bonds, where so far about RM3.7068 billion has been issued to various financial institutions. The acquisition process has begun in September 1998 and is expected to complete by the end of 1999. The NPLs acquisition is carried out in three stages and four phases based on the classification of the NPLs and financial institutions.¹¹ Currently, Danaharta is acquiring NPLs in the first stage¹² group which involve the purchase of secured loans and those in strategic sectors (property and stock market) from the weaker banks and are in needs of recapitalisation from Danamodal (phase 1). However, Danaharta has also acquired some non-phase one financial institutions'

2 Another committee, Credit Debt Restructuring Committee (CDRC) was also established to complement the roles of Danaharta and Danamodal with the objective of restructuring corporate debts.

3 Incorporated under the Companies Act 1965 on 20 June 1998. Its operation is supervised and controlled by a Board of Directors appointed by Bank Negara Malaysia (BNM) and an Oversight Committee. This oversight committee consists of a representative from the Finance Ministry, BNM and the Securities Commission.

4 Based on three months classification.

5 Financial institutions with NPLs above 10% are required to reduce the ratio to less than 10% by selling to Danaharta.

6 Under the Danaharta Act.

7 The negotiation for the takeover of NPLs are on commercial and on willing buyer, willing seller basis.

8 Danaharta has created 6 subsidiaries under AMU that will manage assets according to sectors; property, hotel/leisure, construction, infrastructure, industrial, and general investment. Each subsidiary will aim to maximise the recovery value of NPLs.

9 Danaharta buy the NPLs at a weighted average discount of 61%. If excluding one large loan, the weighted average discount is 37%. Any gains from NPLs sales are to be shared 20:80 between Danaharta and the selling banks.

10 Initial estimates were RM25 billion, but was reduced due to reclassification of NPLs, lower interest rates and improved liquidity.

11 The financial institutions are categorised into 4 categories: the weaker FIs that need recapitalisation, FIs with high NPL ratio and low RWCR, strong local FIs and foreign FIs.

12 There are 18 financial institutions in phase one category, and the acquisition process in this stage is expected to complete in March 1999.

NPLs. Stage two involves the acquisition of unsecured loans, commenced in January 1999 while foreign currency loans, financial guarantee and private debt securities will be acquired in stage three. Soon after acquisition process is completed, the asset management phase will begin, where it will maximise the value of the assets acquired through various techniques before the NPLs is disposed.

Acquisition agreements have been signed with 14 financial institutions. About RM11.2 billion worth of gross NPLs will be acquired from 11 financial institutions¹³ (representing 22% of the total NPLs in the system).¹⁴ These NPLs are mainly in the strategic sector such as the broad property sector (32.5%), financing, insurance and business services (30.0%) and manufacturing (11.5%). The remaining is expected to be acquired before end of March 1999.

Danamodal

To complement Danaharta in strengthening the banking industry, a special purpose agency, Danamodal Nasional Berhad¹⁵ was established with two objectives. First, to recapitalise the domestic banking institutions by providing interim financing to banks that having difficulties meeting their capital adequacy requirements. Second, to help facilitate the consolidation and rationalisation of financial institutions through mergers. Danamodal's role is to facilitate and guiding the recapitalisation and consolidation process and act as a catalyst to guide mergers. In other

words, it is not a vehicle for bailing out failure and weak banks. Therefore, Danamodal's operation is based on commercial and market-oriented principles so as to minimise moral hazard risks. This will ensure the aim of promoting a healthy and competitive banking system can be achieved. A sound and efficient banking system will restore public confidence and thereby help to stimulate the real economy.

Although banks are relieved from the problem of managing their NPLs, the sales of NPLs at a discount have weakened the capitalisation of the banking institutions. For that reason, recapitalisation¹⁶ from Danamodal will help to strengthen the capital base of the banking institutions and increase their risk-weighted capital ratio (RWCR) to at least 9%.¹⁷ This would enable the FIs to fully focus on providing intermediation facilities. While weaker financial institutions will be restructured and strengthened, and if necessary they are encouraged to merge so as to form a core group of strong domestic banking institutions. Core banks could acquire other smaller banking institutions that are not viable.

In identifying weaker institutions whether they need recapitalisation; merging or restructuring, the financial institutions are required to submit a rehabilitation plan.¹⁸ Danamodal together with Bank Negara Malaysia will conduct due diligence exercise to evaluate the performance of the banking institutions, such as their financial health, future strength and competitive position. Any capital injection,

restructuring, or mergers decision made are subject to assessment result of the proposals. In certain case, banks may be required to merge as a condition for recapitalisation.¹⁹ Thus far, about 14 financial institutions have been shortlisted for recapitalisation, of which, 11 FIs have signed conditional agreements with Danamodal. With the capital injection, Danamodal will then have board representation in the recapitalised banks, and is in the position to assist and guide the restructuring, merger and consolidation process.²⁰ Once the task is completed and these institutions gain a stronger footing, Danamodal will select an appropriate exit strategy.

Total funding required to recapitalise the banking system is estimated to be RM16 billion, based on a minimum RWCR of 8%. Bank Negara Malaysia provides an initial capital of RM1.5 billion, while the balance will be raised domestically through the issuance of bonds. About RM7.7 billion has been raised from the issuance of zero coupon bonds which was subscribed by 57 banking institutions.

Progress

In view of the achievements made by Danaharta and Danamodal, it can be said that the restructuring programme is progressing at a faster rate. In resolving the NPLs problem, Danaharta has made a notable progress. The acquisition process is expected to complete by the end of June, 1999, six months ahead of the schedule date of end-December, 1999. Danaharta has

¹³ Danamodal has also identified these financial institutions for recapitalisation.

¹⁴ As at end of September 1998.

¹⁵ Set up on August 10, 1998. Owned by Bank Negara Malaysia, commenced its operation in September 1998. It operates within the regulation and supervision framework provided by Bank Negara Malaysia, and a Board of Director who provides oversight and ensuring its activities are in line with government policy.

¹⁶ Most recapitalisations will take the form of preference shares (Tier 1) or subordinated debt (Tier 2).

¹⁷ The minimum level of RWCR set up by Bank of International Settlement (BIS) is 8%.

¹⁸ Financial institutions with RWCR falls below 8% under stress tests conducted are earmarked as potential candidates for recapitalisation.

¹⁹ Previously 23 FIs have been identified for recapitalisation that include 24 banks, 7 finance companies and 4 merchant banks.

²⁰ Besides providing recapitalisation, Danamodal will also regularly monitor progress on risk management, corporate governance, and management quality of the institutions to ensure standards is maintained at acceptable levels.

completed the acquisition of NPLs worth RM10.073 billion, and is managing about 11.622 billion, while some RM2.76 billion were pending completion. In total, as at 15 March 1999, Danaharta has acquired and managed RM21.695 billion of NPLs (about 20% of the NPLs in the banking sector based on a six month classification). This action has led to a decline in the net NPLs ratio of the banking system to 8.0% (based on six-month classification). With to regard Danamodal, it has injected RM6.15 billion of new capital into 10 banking institutions of which 5 are commercial banks, 3 finance companies and 2 merchant banks (table 1). The remaining four financial institutions have opted for their own solutions over the capitalisation. This exercise has resulted in an increase in the RWCR of the banking system to 12%.²¹ Based on this progress, it is likely that Danaharta and Danamodal will complete their respective task earlier than schedule. As the burden of NPLs and recapitalisation has been lifted up, the financial institutions are now able to provide more loans to productive economic sectors.²²

In relation to rationalisation and consolidation of the financial institutions, Bank Negara will continue to promote mergers of finance companies and commercial banks. Bank Negara is working hard towards accelerating the consolidation pace because the merger programme would turn finance companies into bigger entities, which would contribute more effectively to the development and efficiency of the banking sector. A fair progress was achieved in this effort. The plan is to have 16 finance companies be absorbed

by their parent banks, and merge the remaining into 8 anchor groups. To date, 9 finance companies have been absorbed by their parent commercial banks. For the case of commercial banks, two out of fifteen banks have been absorbed by healthier institutions with government's help. Bank Bumiputra Malaysia Berhad and Bank of Commerce (M) Bhd have merged recently. Another merger is between Sime Bank and RHB Bank.

Conclusion

A pragmatic strategy adopted by the government in dealing with the banking sector problems has brought some stability in the banking system. Rapid pre-emptive actions taken by both Danamodal and Danaharta had generated positive results. Removal

of NPLs and recapitalisation efforts helped the banking institutions to focus on lending activities and reduce the risk of deposit runs, thereby eliminate the possibility of banking crisis. The formation of these agencies also helps to enhance the existing regulatory framework. Nevertheless, there are still much more to be done for the domestic banking system to strive for resilience. Micro-level banking reforms like risk management capabilities of the domestic banking institutions and bank supervision need to be upgraded in order to reduce the sector's vulnerability to external shocks. By that, it is hoped to further strengthen and enhance the efficiency in the country's financial system, and restore public confidence that will spur foreign investors' interest.

²¹As at end of September, 1998, the banking system RWCR is 11.4%.

²²The Star, 26 February 1999.

Figure 1
Relationship between Danaharta, Danamodal and CDRC

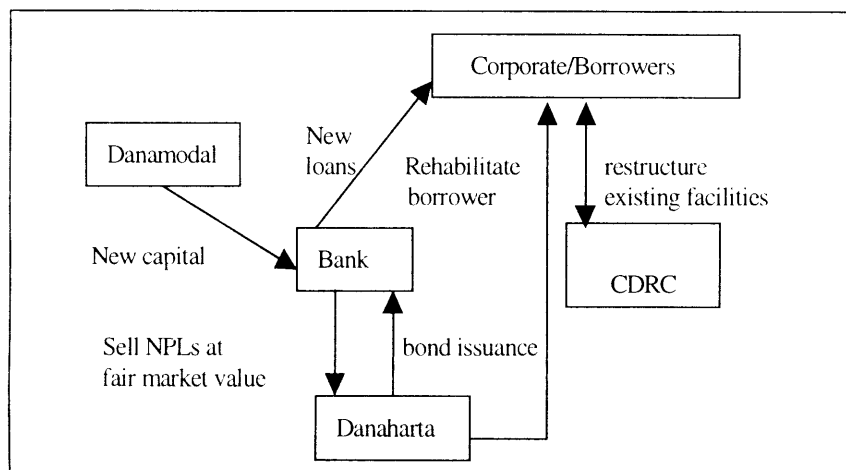


Table 1

Danamodal: Capital Injection as at 15 February 1999

Financial Institutions	Capital Injection (RM bil.)	Status
RHB Bank / Sime Bank	1.5	Purchase agreement signed on 30 Nov 98
Arab-Malaysian Bank Berhad	0.8	Purchase agreement signed on 5 February 99
Arab-Malaysian Finance Berhad	0.5	Purchase agreement signed on 5 February 99
Arab-Malaysian Merchant Bank Berhad	0.4	Purchase agreement signed on 5 February 99
BSN Commercial Bank (M) Berhad	0.21	Purchase agreement signed on 5 February 99
Oriental Bank Berhad	0.15	Already signed conditional agreement, discussion still on going.
Sabah Bank Berhad	0.14	Purchase agreement signed on 12 February 99
United Merchant Finance Berhad	0.8	Signed conditional agreement, discussion still on going
Perdana Merchant Bankers Berhad	0.05	Capital injection on 13 Nov 98
Utama Merchant Bank Berhad		Choose market solution
MBf Finance Berhad	1.6	Purchase agreement signed on 12 March 99
Perwira Affin Bank Berhad		Choose market solution
Bank of Commerce Berhad		After merging with BBMB, the new entity does not require capital funding from Danamodal
Bank Bumiputra Malaysia Berhad		After merging with BOC, the new entity does not require capital funding from Danamodal

Source: Berita Harian, 3 March 1999.

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