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Corporate Debt Restructuring in Malaysia*

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Abstract: Restructuring in Asia has often been branded as band-aid reconstruction simply because of the seemingly less painful adjustments experienced by the Malaysian corporate and banking sectors. Critics are skeptical whether there has been any real restructuring when there is no pain suffered by investors and shareholders. This paper addresses concerns about the depth of corporate restructuring. Specially, it examines the issues of market stability–efficiency tradeoff, moral hazard, transparency and the impact of restructuring on resource allocation and the debt burden distribution. The arguments demonstrate how these concerns are mitigated through the CDRC (Corporate Debt Restructuring Committee) process. The paper also highlights the key challenges that must be addressed as a necessary follow-up to crisis management. As the economy rebounds and problems subside, there is a danger that the urgency to implement the necessary reforms to address structural shortcomings will no longer be a priority. These challenges include improvement of the insolvency system and strengthening the existing institutional framework by establishing a set of broad reforms including effective regulatory oversight.

1. Introduction

The new millennium has started on a heartening note for Malaysia. From crisis management in 1997, we are now at the tail-end of the stabilisation phase and progressing on to sustaining growth and rebuilding the long-term resilience of the economy. Likewise, most of the other Asian countries are undergoing a similar process. The speed with which the economic rebound has taken place in Asia, given the extent of the malaise in 1997, is indeed commendable. More so in Malaysia achieving the same, though it chose a path divergent from the standard IMF prescription. Predictably, the speed of recovery *sans* major disruptions and highly publicised or sensational liquidations has raised the eyebrows of critics who expressed concerns about the extent and depth of restructuring. The popular adage of 'no pain, no gain' remains their mantra. In Malaysia, these issues have assumed greater prominence because of the seemingly less painful adjustments experienced by the Malaysian corporate and banking sectors.

The next section discusses the Malaysian path to corporate recovery and the consequences arising from these actions. Is there a case of 'building the house on a foundation of sand?' It has now been internationally acknowledged that there is no 'one size that fits all.' The question then is at what cost?' These critical issues are highlighted in the following section. The various challenges that must be addressed in ensuring that the next phase of economic growth will be sustainable for Malaysia conclude the paper.

2. Restructuring : the Malaysian Experience

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2.1 Pre-crisis Conditions

Some of the factors cited for producing the debt crisis were extreme balance sheet leveraging and a banking implosion. It is generally acknowledged that Malaysia's corporate and banking sectors were relatively strong going into the crisis compared to its other Asian counterparts. No doubt, a decade of uninterrupted growth had fuelled the expansion of corporates and banks with significant strengthening of their balance sheets. However, recent studies have shown that these were not achieved at the expense of excessive growth or credit trends. During the period preceding the crisis, private sector credit growth averaged about 45 per cent annually, not an unreasonable figure. Understanding the pre-crisis conditions that prevailed in Malaysia is important if one is to appreciate our direction for restructuring.

A cross-country comparison of pre-crisis corporate performance between 1988-1996 placed Malaysian corporate profitability at reasonable levels ahead of the NICs and developed countries but below that of the other ASEAN countries. Similarly, Malaysian companies were lower-leveraged at an average of 0.9 times in contrast to 2 times in Thailand and Indonesia, and 3.5 times in South Korea (Table 1).

Asset growth in the pre-crisis period in Malaysia was funded fairly evenly between internal and external sources. An analysis of the funding pattern of Malaysian corporations between

Table 1: Cross-country comparison of pre-crisis corporate performance (1988-96)

Country	ROA (%)	Gross margin (%)	Real sales growth (%)	Capital investment (%)	Debt-equity (times)
ASEAN-4					
Indonesia	7.1	32.9	10.6	12.7	2.0
Malaysia	6.3	18.1	11.9	10.7	
0.9 Philippines	7.9	27.7	8.2	10.8	1.1
Thailand	9.8	25.2	9.7	13.7	2.0
NICs					
Hong Kong	4.6	18.7	9.2	8.3	
1.9 Korea		3.7	19.6	8.2	13.6
3.5 Singapore	4.4	14.9	8.7	10.4	0.9
Taiwan	6.7	22.6	9.3	8.7	0.8
Developed					
Japan	4.1	22.1	7.7	8.0	2.3
US	5.3	14.4	3.7	3.4	1.0
Germany	4.7	14.6	2.6	2.5	1.5

Source: Claessens and Djankow (1999).

1992 and 1996 indicate that internal funds from equity financing and retained earnings supported 55 per cent of total funding of companies. Of the 45 per cent that came from external funding, the bulk was from domestic banks and capital markets. The low build-up of foreign debt was largely due to regulatory constraints imposed by Bank Negara Malaysia (the Central Bank). This contrasted sharply with the situation in Thailand and Korea, which had extensive offshore borrowings (Table 2).

Another often cited factor of the debt crisis was the weakness of the banking system. In

Malaysia, the banking system's legal and regulatory framework had already been strengthened considerably following the crisis of 1985/1986. By end-1997, the non-performing loans (NPL)

Table 2: Sources of corporate funding (% of total funds, 1992-96)

Sector	Retained earnings	New equity	External borrowings	% of External Short term	% of External Long term
Financial services	*9.9*	*23.9*	*66.2*	*86.1*	*13.9*
Commercial banks	6.6	36.8	56.6	98.8	1.2
Finance companies & merchant banks	6.8	30.8	62.4	94.6	5.4
Insurance companies	7.1	13.4	79.4	62.2	37.8
Stockbroking	19.2	14.7	66.2	95.9	4.1
Non-financial services	*28.1*	*27.3*	*44.6*	*59.7*	*40.3*
Construction	23.1	22.3	54.7	38.3	61.6
Consumer	48.6	10.2	41.3	66.3	33.7
Diversified	14.5	13.9	71.7	65.7	34.3
Industrial	30.7	21.8	47.5	73.1	26.9
Mining	21.2	58.3	20.6	20.0	80.0
Plantation	33.7	34.0	32.3	70.4	29.6
Property	18.4	36.6	45.0	57.1	42.9
Trading & services	34.8	21.6	43.7	68.9	31.1

Source: Rating Agency Malaysia (1997).

ratio had declined to 6.8 per cent while the capital adequacy ratio was 11 per cent. All other parameters reflected levels within prudent banking practice.

Malaysia's distress was probably caused more by the contagion effects of capital flight and deflationary pressures. This is not to say that structural weaknesses did not exist. There were also deficiencies in the institutional infrastructure which affected restructuring efforts. In the course of corporate restructuring, there is evidence of over-capacity and over-leveraging especially in diversified conglomerates, and even poor management in a few cases.

In many cases however, the causes were mainly external in nature. Demand contraction, falling asset prices, high interest rates, credit squeeze and duration mismatch were key causal factors of corporate distress. A case in point is the over-dependence of Malaysian companies on short-term funds, which averaged 60 per cent of borrowings. In part, this was due to the underdevelopment of the private debt securities (PDS) market. PDS made up 30 per cent of domestic funds raised between 1992-96 and long-term fixed rate bonds of typically 5–7 years accounted for a third of that amount. Given the limitations of the long end of the market, companies had to borrow from banks that could only supply short-term credit.

In the course of restructuring, we have found that most companies were viable businesses with a liquidity problem. A recent World Bank-sponsored study confirmed that 41 per cent of a sample of Malaysian companies were found to have encountered illiquidity problems and only 1.5 per cent were insolvent. By contrast, over 60 per cent were illiquid and 53 per cent insolvent in Indonesia, 42 per cent and 8 per cent in Thailand and 28 per cent and 14 per cent in Korea respectively (Table 3).

Consistent with these findings, there is thus no reason for us to emulate the free market advocacy of weeding out weak and inefficient companies through liquidation and fire sale of assets. Preservation of a troubled enterprise at all costs is not the answer. However, there

Table 3: Estimates of corporate distress in selected Asian countries (% of all firms in sample)

	Illiquid and insolvent	Illiquid and solvent	Liquid and solvent	Liquid and insolvent	Total illiquid	Total insolvent
Indonesia	51.2	12.4	34.6	1.8	63.6	53.0
Korea	10.5	17.1	68.4	3.9	27.6	14.4
Malaysia	1.5	39.3	59.2	0.0	40.8	1.5
Philippines	4.1	35.0	58.9	2.0	39.1	6.1
Thailand	6.4	35.1	57.2	1.2	41.5	7.6
Average	14.7	27.8	54.9	2.6	42.5	17.3

Source: Claessens and Djankow (1999).

are many other factors that can justify rehabilitation.

The focus of restructuring in Malaysia hinges on a much broader framework of restoring stability and liquidity to the company that will preserve its enterprise value and retain the social fabric of the organisation. This can be achieved by shifting the credit risk of the firm from its creditors to present and future investors who are capable of absorbing these risks. By doing so, a better capital structure for the firm is achieved while maximising value of the firm and preserving jobs or strategic assets.

The value of the firm need not be destroyed if ways can be found to unlock the hidden values of the assets. An example of this is the restructuring of Renong Berhad by using PLUS assets. If Renong with all its strategic assets had been liquidated, it would have caused huge dislocations in the banking system and the economy on the whole. Instead, the restructuring of Renong has preserved the value of strategic assets and implicitly defining parameters for the group in managing its present and future obligations. Renong's current plans to dispose some subsidiaries and list PLUS on the exchange are some of the initial steps by the group to make good on its commitment to follow through the debt restructuring.

The bailing out of irresponsible investors is of course a serious problem. But to demand for economic reform with little regard for other aspects such as employment and social stability is an equal hazard. To ignore or treat these aspects as mere appendages in reform runs contrary to the moral obligations of the nation.

2.2 Consequences of the Malaysian Measures

Despite taking a different approach, the results achieved by Malaysia has the same outcome as the IMF-sponsored programme of rehabilitation. Amidst much skepticism, we have managed to restore stability and liquidity without major disruptions to the economy. The economic growth achieved by the country in 1999 is on par with Thailand and Korea, both of which, however, underwent the painful adjustments required by the IMF. The corporate sector recorded a significant turnaround in 1999 with many companies recording two-fold increases in profit and others returning to the black.

The question that has remained on everyone's mind is at what cost has Malaysia overcome the crisis? The seemingly painless outcomes that arose from corporate restructuring in Malaysia have prompted a myriad of concerns related to the depth of restructuring. The issues of transparency, moral hazard of bailing out irresponsible investors and corporate governance have surfaced often enough to warrant lengthy discussions. Some of these issues are addressed in the following section.

3. Key Concerns of Restructuring

3.1 Market Stability vs. Efficiency

In an economic crisis, stabilisation of the market takes precedence over its equilibrium as dictated by market forces. Without a stable environment, even the most viable of companies would fail. But this is not to say that we will rescue companies whose existence does not have any economic relevance. The CDRC has rejected more than 13 applications for assistance by companies that failed to meet this criteria.

The CDRC process has many safeguards against supporting non-viable firms. These include: (a) a well-defined and structured workout process that ensures transparency of decision and full information flow between creditors and shareholders; (b) the appointment of independent consultants, and (c) the option of all stakeholders to reject the restructuring solution proposed. Any decision-making is by consensus through a creditors committee thus ensuring that no one person can unduly influence the process.

These safeguards and the CDRC process balance the need to achieve a real and workable solution against the pace of restructuring. Although speed is crucial when a company is teetering on the brink of bankruptcy, accuracy must not be compromised in the process. We are wary of 'band-aid restructuring' which does not address the real problems faced by the distressed company.

3.2 Massive Risk-Loving Behaviour?

The CDRC's focus is to enable viable companies to maximise their going concern value. In doing so, creditors retain all their rights and as far as possible, are paid in full through the restructuring. Under the CDRC, if pain is necessary, then the brunt will always be borne by shareholders as last-ranking equity investors. However, if win-win solutions can be found which require no one to be hurt, then it should not be necessary to inflict the same on equity investors. For creditors and shareholders alike, the CDRC workouts so far, have fortunately involved relatively small or no haircuts. Unfortunately, this is often (mis)interpreted as the moral hazard of bailing out wanton investors. Indeed, the ability to distinguish between bailing out the firm and bailing out its shareholders is not always easy and can easily be clouded by fault-finding of events past. Is there really a need to demand for that proverbial 'pound of flesh' from every distressed company undergoing restructuring?

Even if recalcitrant shareholders or investors are penalised heavily for their present predicament, there is no guarantee that they would not engage in excessive risk-taking again since it is not possible for us to predict or control their future behaviour. In our view, such risk behaviour is best mitigated by improving prudential regulations and standards of corporate governance and information disclosure.

3.3 Resource Allocation and Debt Burden Distribution

Related to the issue of market stability-efficiency tradeoff is whether restructuring distorts resource allocation and promotes an uneven distribution of the debt burden. There is no concession to the costs associated with restructuring. Funds injected into the system are paid for at the prevailing market rates to minimise resource misallocation – for example, Danamodal funds injected into the banks carry high cost to the latter while Danaharta's valuation for its NPL purchase reflect (often steep) discounted net realisable value of assets. The relatively small haircut in many CDRC workouts is a natural outcome of compromise and understates the real rate of recovery. Creditors of restructured debts not only earn a full market yield commensurate with the credit risk of the company but, in many instances, are compensated with equity kickers and other incentives. An important point that must be stressed is that under the CDRC debtor and creditor approach, the negotiation is on a mutually willing basis. The choice to stay with the negotiation or walk out remains vested with each party at all times. The debt burden is borne by the private sector i.e. the shareholders and creditors. No public funds are used to prop up private companies except in situations where public projects are involved.

4. Conclusion

Although it may be premature to judge the country's corporate debt restructuring an unqualified success, there is little doubt that the restructuring efforts have helped to reduce financial distress and prevent a spillover into the real economy. Each crisis imparts invaluable lessons from which we must learn if we are to build a resilient economy for the future. In the aftermath of this financial crisis, some of the key challenges and risks facing the corporate and banking sectors must be addressed.

4.1 Improving the Insolvency System

A well-developed insolvency system is a critical component of every well-functioning market economy. It should be flexible in providing for both liquidation and rehabilitation. Liquidation will provide for smooth reallocation of resources into more productive uses for firms that cannot be returned to profitability while rehabilitation provides valuable 'breathing space' for firms suffering temporary financial difficulties. In times of systemic crisis, the availability of restructuring procedures is essential because many corporate failures stem from adverse macro-economic conditions rather than from poor management.

An effective insolvency system should develop mechanisms for both formal and informal channels. A well-developed out-of-court arrangement is equally important simply because courts will never have adequate capacity nor know-how to deal with all insolvencies in the most cost-effective manner. Most restructuring should occur out of court, leaving courts to intervene only when there is a genuine dispute. Nevertheless, the development of a complementary informal mechanism should not undermine the formal regime.

4.2 Strengthening the Institutional Framework

The financial crisis revealed several shortcomings in the institutional infrastructure of the country. A broader set of reforms is required to strengthen the institutional framework before any insolvency system can be effectively implemented. An effective institutional framework should be able to provide policy makers with early detection of impending problems well ahead of time.

Firstly, accounting and audit standards must be further strengthened to provide investors and creditors accurate, reliable and comprehensive financial information for informed decision-making. Secondly, it is necessary to improve the corporate governance structure of corporations and financial institutions to minimise the concentration of power in a few interested parties and thirdly, an effective regulatory oversight must be concurrently in place to achieve the first two objectives.

In Malaysia, there is also a need to achieve a better balance in the sourcing of funds. A key lesson from the recent crisis is the need to reduce over-dependence on the banking system on the one hand, and for corporates to maintain prudent debt levels, appropriate capital structure and matched funding on the other. Capital financing via the long-term bond market needs to be further promoted to provide a more efficient means of financing capital intensive and long gestation projects. Securitisation of debt is one way of providing greater flexibility to corporations in managing their financial risks.

The bulk of bank and corporate restructuring will likely be completed by the middle of 2000. However, efforts to streamline operations and increase productivity will continue over the next few years. It is hoped that the lessons of the 1997 financial crisis will serve us well in facing the challenges that lie ahead.

Appendix : Status and Statistics of CDRC cases

References

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Table A1: Progress of CDRC cases: 2 March 2000

	Number		Amount	
	Units	%	RM billion	%
Applications Received	68	100	36.5	100
Less				
Withdrawn/rejected	13	19.1	2.8	7.6
Transferred to Danaharta	10	14.7	3.3	9.0
Completed/resolved with Danaharta's assistance	19	27.9	14.1	38.5
Cases outstanding	26	38.2	16.4	44.9

Table A2: Progress of outstanding cases : 2 March 2000

Status	Number	Amount (RM billion)
Awaiting restructuring proposal	6	1.6
Awaiting revised restructuring proposal	14	12.3
Awaiting lenders' decision	6	2.5
Total	26	16.4

Table A3: List of completed CDRC cases: 2 March 2000

Company	Debt restructured (RM million)
Advance Synergy Berhad	331.90
Asian Pac Holdings Berhad	359.63
Business Focus Sdn Bhd	334.20
Chongai Corporation Berhad	60.80
Faber Group Berhad	983.25
Lien Hoe Corporation Berhad	211.67
Nam Fatt Corporation Berhad	477.00
Orlando Holdings Berhad	57.47
Park May Berhad	135.62
Pembangunan Bandar Mutiara Sdn Bhd	115.00
PROLINK Development Sdn Berhad *	759.10
PSC Industries Berhad	499.10
Renong Berhad	5,535.00
Tanco Holdings Berhad	238.00
Tenco Berhad	49.70
Tongkah Holdings Berhad	493.00
United Engineers (M) Berhad	3,014.00
United Merchant Group Berhad	211.50
Vibrant Omega Sdn Berhad *	195.20
Total	14,061.14

* Resolved with Danaharta's assistance.

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