Donald Joshua Jaganathan: Non-Performing Loan Resolution

Opening remarks by Mr Donald Joshua Jaganathan, Assistant Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the World Bank Regional Conference on NPL Resolution, Kuala Lumpur, 29 April 2019.

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It gives me great pleasure to be here this morning, to welcome you to this Regional Conference on Non-Performing Loan Resolution. I would like to congratulate the organisers for successfully gathering a selection of distinguished speakers to share their thoughts and invaluable experiences. I would also like to take this opportunity to record Bank Negara Malaysia's appreciation to Mr. Alfonso Garcia Mora and the World Bank for giving Bank Negara Malaysia the opportunity to co-host this event in Kuala Lumpur.

The journey to a high-income economy is not always a smooth one. Often, there will be hiccups, setbacks, and false starts. Those entrusted with the responsibility to steer the economy and the financial system will often have to make policy adjustments and overcome one obstacle after another. And at times, the economy or the financial system can overextend itself, similar to how a ship can, midway in its journey steer in the wrong direction. The pullback in the form of economic or financial crisis and the subsequent regeneration of economic activities is both trying and difficult.

As most of you would know, economic and financial crises often result in high volumes of impaired credit or bad debt that can linger and become a drag to economic growth and recovery. During such periods many households and businesses default on their loan obligations resulting in the erosion of banks' profit and capital. This adverse financial implication coupled with an environment of uncertainty inevitably make banks more risk-averse to new lending and shift their focus to NPL recovery as they seek to minimise losses.

Consequently, creditworthy households and businesses face greater difficulty in sourcing new funds, thus further reducing their consumption and investment, resulting in lower economic activity. Ultimately, this negative feedback loop dampens economic growth and destroys value as viable businesses are unable to operate due to lack of financing.

Therefore, it is imperative for regulators and supervisors to ensure that these NPLs are managed and resolved in a timely fashion. Decisive leadership on the part of authorities in addressing rising NPL level in the financial system can slow-down the adverse economic impact, dampen banks' knee-jerk reaction and jumpstart the economic machinery.

Like most countries, Malaysia has seen her fair share of financial and economic crises in the past. Although twenty years have passed since the Asian Financial Crisis, it has left a legacy of important lessons for those who are affected by it. Allow me to share with you some of the lessons, which may be relevant to this conference.

Early preparation by regulators

There is a simple saying in the Malay language that goes like this – 'Sediakan payung sebelum hujan' which translates into English as having an umbrella ready well before it rains. I am sure that this is not unique to Malaysia and many of you here have similar phrases in your own native language. As regulators, we always strive for the best but at the same time, must always prepare for the worst. And the best time to prepare is during good times, when the sun is still out so that our preparations can guide us to be clear-headed and decisive in the midst of turbulence or stormy weather. In the context of today's conference, early preparation means that the national authorities create a conducive environment so that NPLs can be resolved in a timely and orderly manner during good times as well as during crisis episodes.

NPLs can be resolved either via market-led or government-led initiatives or through a combination of both, depending on the nature of the situation and the resources available. Regardless of the preferred approach, there are many areas within the NPL management and resolution process that will greatly benefit from early preparation. For one, having clear legal frameworks and regulatory requirements would significantly enhance the viability of market-led NPL resolution. A clear legal and regulatory framework will shorten the sale and purchase process, reduce the discount factor and improve the overall outcome of the NPL sale.

As regulators, early preparation in developing an active and liquid capital market and broadening of investor base would increase the likelihood of a market-led approach to resolution. We can also use this lead time to address common hurdles experienced during the NPL resolution process such as valuation subjectivity, misaligned incentives of different stakeholders and tax treatment of NPL write-offs.

However, despite authorities' best intentions, the market for NPL resolution is unlikely to be sufficient to absorb the build-up of NPL during a crisis. Behaviourally, there will be players that are unwilling to dispose of their assets due to the endowment effect, whereby they often misguidedly believe the value of their NPLs to be much higher than the price offered by potential buyers. Some market participants will take a wait-and-see approach and look towards the authorities for either leadership or some form of guidance. In view of this, we, the national authorities should always be prepared to play a more active role in NPL resolution.

In Malaysia's experience during the Asian Financial Crisis, the nascent capital market and small investor base at the time of the crisis made a market-based resolution approach implausible. It was quite clear then that the financial crisis would evolve into a full-fledged banking crisis if no intervention measures were taken. Bank Negara Malaysia's intimate understanding of market forces at play and the nature of crisis enabled it to swiftly coordinate with key stakeholders such as the government, legislative bodies and the banks, which led to multi-pronged measures to safeguard the financial system. In a few short months in 1998, we quickly established Danaharta, our public asset management company (AMC); Danamodal, our special purpose vehicle to address the erosion of bank capital; and the Corporate Debt Restructuring Committee (CDRC) a mechanism to resolve debt of large corporations. Looking back, our decision to intervene early and decisively gave us precious lead time to mitigate the crisis before the build-up of NPLs could take a greater toll on the banking system.

Role of financial institutions in developing their internal capabilities

As we, national authorities and regulators strengthen our bases, it is equally vital that financial institutions play their part and develop the agility and competency to manage their NPL resolution process. Without robust internal capabilities such as a good IT infrastructure and sound risk governance, financial institutions will be at a great disadvantage if they are unable to adequately resolve their NPL book, especially during a crisis.

In this increasingly digitised age, financial institutions with good IT and risk management infrastructures are able to swiftly assess their portfolio asset quality and risk. Adopting technology does not only provide a competitive advantage during good times but also during stress periods, whereby timely, accurate and actionable data are urgently required. A robust information management system would allow banks to identify weak borrowers across the various business lines and determine the estimated recovery value from each borrower in the event of default. Combined with strong risk management, banks would be able to forecast the build-up of NPLs in a timely manner, identify potentially impaired assets eligible for sale and determine the appropriate value and the estimated loss that they would have to bear.

In this regard, recent global reforms in financial regulation have had a largely positive effect of nudging financial institutions in the right direction by providing incentives to enhance their risk management framework and IT architecture. With reforms such as Basel III, recovery planning and IFRS 9, financial institutions have had to re-think their entire approach to risk management and crisis preparedness. These reforms position financial institutions to better navigate during stress episodes and reduce their likelihood of failure. As part of implementing these reforms, financial institutions will have to continuously assess their existing systems and people readiness and make the necessary investments to strengthen their defences. Such efforts will yield significant benefits in the long-run as financial institutions become more agile and resilient.

Value Preservation

As regulators and banks strengthen their internal preparedness and coordination to enable timely resolution of NPL, it is worth taking a step back to re-examine the purpose of NPL resolution. The purpose, as we see it in Bank Negara Malaysia, is to ensure that financial institutions continue to play an effective role in financial intermediation, thereby supporting the needs of the real economy.

This brings me to my final point on value preservation. In approaching NPL resolution, national authorities and banks ought to balance the need for a swift execution process against the need to preserve value in good businesses that might be temporarily facing setbacks. In a crisis, borrowers – whether individuals, small and medium enterprises (SMEs) and large corporates – may experience temporary difficulty in meeting their loan obligation. In such an instance, banks would be inclined to write-off these loans and to initiate foreclosure of collateral properties.

While a one-size-fits-all approach will yield short-term gains, in that banks will have a cleaner balance sheet and are able to focus on lending, it carries negative unintended consequences to the economy in the long-run, whereby good functioning businesses facing temporary setbacks will be put out of business. Once dismantled, these businesses and their productive capacity may never be fully restored especially in industries with high barriers to entry. And when the tide turns, the crisis abates and the economy turns to recovery, authorities will be left with a slower economic recovery as there are fewer firms to generate economic activity.

During the Asian Financial Crisis, Danaharta, our public asset management company was cognisant of this and took a balanced approach in managing the NPLs. A soft-approach on viable businesses to restructure their financing arrangement was coupled with a hard-approach that began foreclosure proceedings on non-viable businesses. The Bank then later extended the Corporate Debt Restructuring Committee (CDRC) and set up the Small Debt Resolution Scheme (SDRS) which provides even small businesses an avenue to work out feasible debt resolution without having to resort to legal and foreclosure proceedings. Meanwhile, for individuals, the Bank set up the Credit Counselling and Debt Management Agency (AKPK) with the aim of assisting individuals to take control of their financial situation via a debt management programme. A balanced response of this nature is in my view critical, especially for emerging market economies, as the dismantling of productive capacity will have adverse long-term consequences on the economy.

Final Note

In conclusion, the experience from both the AFC and GFC has taught us, regulators and national authorities a great deal about NPL resolution. Since then, there have been many new and recent developments in the NPL management and resolution space. I look forward to hearing from many of you of your respective country's experiences and unique viewpoints on this subject. With that, I wish all of you a productive conference ahead and thank you for your attention.