ADB

Report and Recommendation of the President to the Board of Directors

Project Number: 41918
October 2007

Proposed Senior Secured Loan
Malaysia: Eucalypt Mortgages Sdn. Bhd.

In accordance with ADB's public communications policy (PCP, 2005), this abbreviated version of the RRP excludes confidential information and ADB's assessment of project or transaction risk as well as other information referred to in paragraph 126 of the PCP.

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 31 August 2007)

Currency Unit	–	ringgit (RM)
RM1.00	=	$0.28542
$1.00	=	RM3.50365

ABBREVIATIONS

ABS	–	asset-backed securities
ACAP	–	ACAP Advisory Public Co. Ltd or its Malaysian subsidiary (as applicable)
ADB	–	Asian Development Bank
ADM	–	Asia Debt Management Hong Kong Limited
BNM	–	Bank Negara Malaysia
DMC	–	developing member countries
DPO	–	discounted payoffs
DSCR	–	debt service coverage ratio
EMSB	–	Eucalypt Mortgages Sdn. Bhd.
HSBC	–	HSBC Bank Malaysia Berhad
IRR	–	internal rate of return
LIBOR	–	London interbank offered rate
NPL	–	nonperforming loan
OPB	–	outstanding principal balance
PSOD	–	Private Sector Operations Department
SPV	–	special purpose vehicle

NOTE

In this report, "$" refers to US dollars.

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Director	W. Willms, Capital Markets and Financial Sectors Division, PSOD
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CONTENTS

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed senior secured loan to Eucalypt Mortgages Sdn. Bhd. (EMSB) to finance its acquisition of a portfolio of nonperforming mortgage loans (Portfolio) from HSBC Bank Malaysia Berhad (HSBC or the Seller), in the amount of up to $10 million (the Project).

II. BACKGROUND AND RATIONALE

A. Overview of the Asian Nonperforming Loans Market

2. Activity in Asia's nonperforming loans (NPLs) market has gradually picked up since Asia's economic crisis crippled its financial sector in the late 1990s. The Asian region's governments and banks have succeeded in removing more than $1 trillion of NPLs from bank balance sheets. That has been accomplished through various resolution measures including loan collection, restructuring, and reclassification; sale of NPLs to international investors; permanent write-offs; good bank/bad bank disposition strategies; and use of local asset management companies. While Asia's banks have approximately $746 billion remaining on their balance sheets, the region has made significant progress in financial system reform and NPL disposition. Financial system reform is advancing to prevent recurring NPL problems, and regulators have been pushing banks to develop new plans, processes, and systems to implement internal rating-based models.

3. However, while banks in the region are advancing measures to prevent new flows of NPLs, the existing NPL stock still needs attention. A vibrant secondary NPL market is needed, as well as viable and market- tested resolution strategies, so that existing NPLs can be resolved. In the case of new NPLs, banks and other market participants would also benefit from a fully functioning NPL market. In addition, in the growing Asian economies, bank management's full attention on best practice in lending and its continuous improvement are needed. NPLs (including existing NPL stock) would detract from this crucial exercise. Appendixes 1 and 2 give a detailed discussion of the benefits of NPL resolution and financial and corporate restructuring.

B. Nonperforming Loans in Malaysia

1. The Danaharta Experience

4. In 1998, Danaharta was established by the Malaysian Government as the national asset management corporation (AMC) to avert a collapse of the banking system due to the Asian financial crisis. Its purpose was to remove the NPL distraction from financial institutions by buying and rehabilitating NPLs while extracting maximum recovery value from them.

5. Danaharta completed its NPL acquisitions in 2000, and between then and 2005, recovery action on most of the loans took place. By 30 September 2005, the final tally of Danaharta's NPL portfolio amounted to RM47.68 billion, of which RM19.71 million constituted acquired NPLs[1] and RM27.97 million, managed NPLs.[2] In total, there were 2,902 accounts belonging to 2,563 borrowers (some borrowers had more than one loan account). The RM19.71 billion of acquired NPLs were acquired at a purchase price of RM8.94 billion, implying an average discount rate of 54.6%.

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1 Acquired NPLs are those paid for in cash and through the issuance of Danaharta's zero-coupon bonds.

2 Managed NPLs cost Danaharta nothing to "acquire", since Danaharta merely managed these loans on behalf of the Government and Bank Negara Malaysia (Central Bank).

6. Gross NPL levels in the banking system in Malaysia have been falling post-Danaharta carve-outs, from a high of RM61.9 billion ($16.3 billion)[3] in 2001 to RM45.2 billion ($11.9 billion)[4] as of end-2005. Malaysia's net NPL ratio as of end-2005 stood at 6.0%, well below the 13.6% recorded in 1998 at the height of the Asian financial crisis. As of 31 January 2007, net NPLs stood at RM26.6 billion, or 4.6% of total net loans. However, there is room for improvement, especially with the emphasis on risk management in relation to Basel II capital adequacy standards, targeted for compliance in 2008.

2. Recent Developments

7. In December 2005, Bank Negara Malaysia (BNM) issued "Guidelines for the Sale of NPLs by Banking Institutions" (the BNM Guidelines for NPLs), to allow Malaysian banks to dispose of NPLs of up to RM46 billion to other banks or domestic and foreign investors via special-purpose vehicles (SPVs). The guidelines were issued just as Danaharta was closing its doors after 7.5 years of operation.[5] The guidelines do not provide any other form of incentives, which are common in many countries embarking on NPL sales, i.e., tax exemption for stamp duty and other transaction costs. Appendix 3 presents the salient points of the guidelines.

8. Since then, the country has witnessed only one major NPL transaction. In January 2007, Malayan Banking Berhad (Maybank), Malaysia's largest bank, announced the sale of a portfolio of corporate NPLs consisting of almost 100 borrowers with a face value of RM2.2 billion ($612 million) to Standard Chartered Bank and Standard Bank of South Africa Group for a total consideration of RM424.8 billion ($123.30 million). The sale was completed in June 2007. This was the first time a Malaysian bank undertook such a sale by competitive open bidding. When the transaction was announced, it was widely felt that activity levels in the NPL market would pick up substantially with other Malaysian banks joining in the foray, with a portfolio sale having been completed, and that major disposals would follow closely. However, no other transactions have followed as yet.

3. Opportunities

9. Malaysia enjoys a number of advantages for NPL investment. The legal system is seen as both developed and robust compared with that in other NPL markets in Asia, and the political climate has proven to be historically stable. The real estate sector has also shown considerable growth in recent years across most sectors. Add to that the greater number of recovery options for holders of debt (receivership being one), and the perception that the risk profile of the Malaysian market appears lower than that of many of its Asian neighbors.

10. Regulatory actions are seen as a prime catalyst to force a significant proportion of the existing NPL stock off the balance sheets of the Malaysian banks. Since 2 years ago, BNM had imposed tightened loan provisioning guidelines for NPLs aged more than 5 years. This has provided incentives to banks to either resolve or dispose of these loans to avoid having to create additional provisions, or clean up their books. This fits well with the impending compliance with Basel II in 2008 and the ongoing liberalization of Malaysia's financial sector.

[3] $1 = RM3.800 as of 31 December 2001.
[4] $1 = RM3.779 as of 31 December 2005.
[5] Danaharta ceased operations on 31 December 2005.

11. One feature of the Malaysian NPL market is the requirement for buyers to be at least 51% domestically owned, meaning that any SPV established for an NPL transaction is limited to 49% foreign ownership. Unlike in many other Asian markets, this has led to early involvement of domestic investor groups, rather than 1-2 years into the sales cycle, which seems to be the norm.

12. To date, a number of investor groups have indicated their desire to acquire portfolios and/or large single credits. However, on the sell-side, except for Maybank (para. 8), banking institutions are not rushing to sell. Clearly, the next 2 years will be critical in inducing buyers and sellers into the Malaysian NPL market and establishing Malaysia as a fully developed NPL market.

13. In December 2005, the Asian Development Bank (ADB) teamed up with Asia Debt Management Hong Kong Limited (ADM) right after the announcement of the new BNM Guidelines on NPLs in December. A joint mission was scheduled in early 2006 to explore opportunities, and the transaction proposed in this report and recommendation of the President (RRP) is a direct result of those efforts.

III. THE PROJECT

A. Background

14. ADM and HSBC have been in discussion as early as 2 years ago regarding the disposal of HSBC's Portfolio. The transaction is on track to be the first negotiated NPL deal with third-party debt financing in Malaysia to reach financial close, pursuant to BNM's issuance of Guidelines for NPLs, and is expected to help catalyze the fledgling NPL market in Malaysia.

B. The Project Sponsors

1. Asia Debt Management Hong Kong Limited

15. ADM, founded in 1996, is an investment advisor registered with the Hong Kong Securities and Futures Commission. ADM manages distressed assets and special situations in Asia, Europe, and other countries. It has developed a strong track record in identifying and successfully realizing value from distressed debt opportunities in Asia, and is one of Asia's leading specialist managers of Asian distressed assets. ADM has also developed a close network of well-connected local partners and joint ventures in India, Indonesia, Republic of Korea, Philippines, and Thailand to source deal opportunities and obtain an in-depth understanding of local market conditions.

16. Since its inception, ADM has turned over in excess of $3 billion in face value of distressed debt and has been directly involved in restructuring over $2 billion in distressed assets. ADM advises the open-ended Galleus Fund, which has received several awards as one of the best performing funds in its class and in Asia, and a series of closed-end Maculus funds (ADM Maculus Fund I, II, and III). In April 2007, the Asian Investor gave the Best Distressed Fund award to ADM Maculus Fund I, II, and III.

17. ADM Maculus III (ADM III) will be the economic buyer, respectively the "equity provider", of the Portfolio being sold.

2. HSBC Bank Malaysia Berhad

18. HSBC Bank Malaysia Berhad (HSBC) is a wholly owned subsidiary of the HSBC Group, one of the largest banking and financial service organizations in the world. Its international network comprises about 10,000 offices in 82 countries and territories, operating in the Asia Pacific region, Europe, the Americas, the Middle East, and Africa.

19. HSBC's presence in Malaysia dates back to more than 120 years when the Hongkong and Shanghai Banking Corporation Limited established its first office in Penang in 1884. This was followed by offices in Ipoh, Malacca, Johor Bahru, and Kuala Lumpur in 1910. Since then the bank has expanded its network to 40 branches nationwide and employs approximately 5,000 employees.

20. HSBC was incorporated in October 1984 and was the first foreign-owned financial institution to be localized when operations were transferred from the Hongkong and Shanghai Banking Corporation Limited in January 1994. HSBC's pioneering role reflects its long-term commitment to its customers and to Malaysia. It has won various local and international accolades from FinanceAsia including Best Foreign Commercial Bank in Malaysia in 2005 and Best Foreign Bank in Malaysia in 2006.

21. HSBC will be the seller of the Portfolio.

C. Servicer

22. Established in 1998, ACAP is a financial services company based in Thailand focusing primarily on loan asset management, corporate finance advisory and rehabilitation planning, and administration. ACAP presently employs about 160 staff located in its two offices in Bangkok.

23. ACAP's Asset Management Division was established in 2004 to provide full servicing of nonperforming loans and assets for client owners of loan portfolios. Services offered include contacting and negotiating with debtors, determining plans of action for each case, tracking loan payments, managing legal procedures, selling asset collateral, and maintaining a customer and loan database. Current and past portfolios managed by ACAP amount to Thai baht 54 billion ($16 billion) in principal value. ACAP currently manages more than 35,000 loan accounts.

IV. THE PROPOSED ADB INVESTMENT

A. ADB Investment

24. ADB is contemplating the provision of a senior secured loan (the Senior Loan) to EMSB (or a related entity) in an amount of up to $10 million. It is likely that the financing will be coursed through one of ADM's SPVs to ensure compliance with approvals that have been obtained by EMSB.

25. The ADB investment will be financed from ADB's ordinary capital resources and will not exceed $10 million or 50% of the total project cost, whichever is lower.

B. Main Terms and Conditions

26. The proposed Senior Loan will be structured as a senior secured debt with a priority position in collection proceeds received by EMSB under the Portfolio, whether from debt service payments on loan assets, rents or disposition proceeds on foreclosed assets, interest or investment income from other sources.

V. INVESTMENT BENEFITS, IMPACTS, AND ASSUMPTIONS

A. Justification of ADB's Investment

1. Investment Objective

27. ADB's objective is to assist EMSB in acquiring HSBC's NPL portfolio through the provision of debt financing to fund the purchase price of the Portfolio.

2. Development Outcome

28. The proposed ADB investment will promote development at the following key levels.

(i) **Catalyze the Malaysian NPL market.** At the beginning of a new NPL market, local lenders often are not available to provide third-party financing to investors. This is, however, essential in a functioning market for NPL resolution and a key feature in all mature markets. By providing third-party debt financing for the purchase of NPLs in Malaysia, lenders such as ADB are able to bridge the pricing gap that prevents the sale of NPLs. Because investors can obtain loans at rates that are significantly less than their equity capital costs, they can pay more for NPLs than if they invested on an all-equity basis. As a result, ADB can contribute by helping local financial institutions recover higher market values from their distressed assets and make constructive efforts to remove such assets from their books. Experience has shown that over time, traditional lenders enter the market and replace early NPL financiers eventually. Until such time, ADB seeks to play a catalytic role in energizing the distressed asset market in Malaysia. By its intervention, ADB will demonstrate the credibility of this asset class and mobilize capital to support similar efforts in Malaysia and throughout Asia.

(ii) **Provide an NPL resolution demonstration effect.** Through the execution of the first negotiated NPL purchase from a Malaysian private sector bank with debt financing from a third party, ADB's proposed investment will help jump-start the Malaysian NPL market by implementing bankable NPL sales actually reaching financial close. The Project will achieve a demonstration effect by introducing a replicable, market-tested mechanism for NPL resolution that can be reproduced and will induce the development of the NPL market in Malaysia (as it develops benchmarks, bankable structures, and trust in the enabling legal and regulatory environment). It also sends a strong signal to Malaysian banks to proactively address their NPL problems.

(iii) **Create a best-practice mortgage NPL servicing entity in Malaysia.** With the setting up of the ACAP subsidiary in Malaysia, the first best-practices servicing platform for nonperforming mortgage loans will be created in the country. The ACAP platform envisages employment, training, and utilization of a number of

local professionals, who will augment the pool of available talent in the Malaysian financial sector.

3. Value Added of ADB

29. ADB's participation in the Project will be highly catalytic and demonstrative, as other financial institutions begin to enter the NPL market in Malaysia. With ADB being a critical force in supporting distressed debt sales in the region, ADB's presence in the transaction will add an extra level of confidence in Malaysia's fledgling NPL market**.** ADB is building on its very positive experience in the Philippines, where similar interventions helped in jump-starting the Philippine NPL market, resulting in the reduction of NPL levels to the present 5.21%. The transaction will be one of the earliest transactions to come to market and thus, may serve as a benchmark for future transactions in Malaysia. The success of this transaction, in part through ADB's participation, (i) will clearly encourage other private sector players to engage in similar transactions, resulting in more resources and expertise to be channeled toward viable NPL resolution in Malaysia; and (ii) would position Malaysia as one of the major focus countries for NPL investors in Asia in the coming years.

4. Design and Monitoring Framework

30. ADB has prepared a design and monitoring framework and will measure the expected development impact of the investment, in accordance with ADB's management development results policy (Appendix 12).

5. Fit to Sector and Country Strategy

a. Sector Strategy

31. A sound and efficient financial sector is a prerequisite for broad-based, private sector-led economic development that will directly contribute to poverty reduction. ADB, recognizing that the recovery of lending activities in the financial sector is vital to this goal, has made assistance to address the overhang of NPLs in both public and private financial institutions as one of its key thrusts.

32. ADB's proposed participation in the transaction will build on its strategy of helping its developing member countries tackle the burden of distressed assets and NPLs, and build a sound and efficient financial sector. For example, in the People's Republic of China (PRC), ADB helped the Cinda Asset Management Corporation (Cinda) deal with NPLs. ADB technical assistance (TA)[6] was given immediately after Cinda was established in 2001 to (i) provide Cinda with the technology to complete its mandate to undertake financial and corporate restructuring of companies whose assets were foreclosed, (ii) equip Cinda with the latest techniques used for the purchase and disposition of NPLs to achieve sufficient returns from funds injected to acquire NPLs, and (iii) help Cinda implement appropriate management information systems. The TA has quickly established Cinda operationally and provided broad recommendations on various legal and regulatory issues to policy makers in the Government of the PRC. A second TA[7] was approved to assist in developing an effective and comprehensive legal, regulatory, and policy framework for asset-backed securities (ABS) transactions by

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[6] ADB. 2001. *Technical Assistance to the People's Republic of China for the Institutional Strengthening of the Cinda Asset Management Company*. Manila (TA 3303-PRC).

[7] ADB. 2005. *Technical Assistance to the People's Republic of China for Development of Asset-Backed Securities Market and Restructuring of Asset Management Companies*. Manila (TA 39008-PRC).

structuring the issuance of an international/domestic ABS for Cinda. In India, ADB provided a TA to enable and structure asset reconstruction companies.[8]

33. Through its private sector operations, ADB was highly instrumental in laying the groundwork for creating and developing an NPL market in the Philippines (paras. 74–79). ADB was also involved in the ADM Maculus I and Maculus II funds, the Yangtze Special Situations Fund (PRC) and the formation of Actis Asset Reconstruction Company (India).

34. **The Philippine NPL Market.** In 2005, ADB supported the auction of the National Home Mortgage Finance Corporation's (NHMFC) portfolio of delinquent nonperforming mortgage loans by providing debt financing of up to $33 million to Balikatan Housing, Inc. (Balikatan), the SPV jointly owned by a Deutsche Bank fund (DBGO) and NHMFC. Balikatan acquired the NPLs from NHMFC and is subsequently resolving them. ADB also invested in a 10% equity stake in Bahay Financial Services, Inc. (BFS), a loan servicing company that was set up by DBGO to restructure and service the NPLs on behalf of Balikatan.

35. ADB was involved in the transaction from the very beginning, working alongside NHMFC and its external advisors in putting together a bankable structure. Given the difficulty of obtaining local or international debt financing for a new and untested asset class at the time, ADB played a critical role by providing third-party financing support. That ADB made such financing available helped to encourage DBGO's participation and set a precedent for them. Furthermore, by introducing a debt layer into the capital structure of the project, ADB was able to increase the cash purchase price paid by DBGO to NHMFC, as this allowed DBGO to submit a bid on a leveraged basis (versus on a total equity basis), given that local lenders were not yet ready to enter this type of market. Without ADB's offer of support, the pricing gap between NHMFC's reserve price and DBGO's bid price might not have been bridged,and could have caused the auction to fail. ADB's support in the early stages of the transaction also lent credibility and provided considerable comfort to the potential investors that the sale of the Portfolio would be implemented with transparency and in accordance with international standards and best practices.

36. ADB's ongoing involvement as a shareholder in BFS also ensures best practices and credibility to the company's operations as it services and resolves the portfolio. BFS' performance in its first year of operations has been very positive; it collected $14.5 million versus a target of $6.3 million. Given that these cash flows are a result of BFS' "touching" only 23% of the portfolio, such performance is expected to continue or improve further once BFS is able to "touch" the remaining 77% of the portfolio. BFS has its head office in Makati, and plans to establish a branch in Alabang, Muntinlupa, are under way to better service accounts. BFS is also expected to employ a total of 300 staff by the end of its second year as it ramps up its operations.

37. ADB's participation in the NHMFC transaction was highly catalytic and demonstrative, as other financial institutions entered the NPL market in the Philippines shortly thereafter. The success of this landmark transaction, in part through ADB's participation, clearly encouraged other private sector players to engage in similar transactions, resulting in more resources and expertise channeled toward viable NPL resolution and housing finance sector reform in the Philippines. This outcome was recognized in the Office of Evaluation Department's study on ADB's operations in the Philippines.

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[8] ADB. 2004. *Technical Assistance to India for Developing the Enabling Environment for and Structuring Asset Reconstruction Companies in India*. Manila (TA 3943-IND).

38. In its second NPL transaction in the Philippines, ADB assisted Bayerische Hypo-und Vereinsbank AG (HVB) in 2005 in the purchase of Equitable PCI Bank's portfolio of nonperforming loans and assets through the provision of debt financing. ADB's loan was repaid within a year, ahead of projections. Since then, HVB has been an active participant in the Philippine NPL market and acquired a number of NPL portfolios from several local banks.

39. Both transactions in which ADB participated helped generate considerable momentum for the Philippine NPL market, which has become one of the most active in Asia in recent years. In addition, the banking sector's NPL ratio stood at 5.21% as of end-June 2007, an improvement from the 7.22% NPL ratio registered a year ago, and a significant decline from the double-digit NPL levels after the Asian crisis. ADB is determined to repeat this positive experience in other markets.

b. Country Strategy

40. Following the Asian financial crisis in the late 1990s, Malaysia largely eschewed borrowing from multilateral assistance sources. No new loans from ADB had been approved since 1998. ADB has not prepared an operational strategy for Malaysia since July 1997. However, the proposed transaction would be in line with the Government of Malaysia's efforts in encouraging its financial institutions to resolve significant portions of existing NPL stock in its books, and the Government's ongoing efforts to effectively deregulate and liberalize its capital market.

B. Social and Environmental Safeguard Policies

41. The proposed investment is classified as Category C for environmental and social safeguard classifications. A desk review of the environmental and social implications indicates that the Project will not have any direct or immediate impact on the environment and on social safeguard issues. No involuntary resettlement is expected.

C. Anticorruption Policy, and Combating Money Laundering and the Financing of Terrorism

42. ADM and ACAP were advised of ADB's *Anticorruption Policy* (1998, as amended to date) and policy relating to the *Combating of Money Laundering and the Financing of Terrorism* (2003). Consistent with its commitment to good governance, accountability, and transparency, ADB will require EMSB through covenants in the documentation to institute, maintain, and comply with internal procedures and controls following international best practice standards for the purpose of preventing corruption or money laundering activities or the financing of terrorism; and covenant with ADB to refrain from engaging in such activities. The investment documentation between ADB and ADM and ACAP will further allow ADB to investigate any violation or potential violation of these undertakings.

VI. ASSURANCES

43. The proposed investment would, once approved by the Board, represent 1.34% of ADB's total nonsovereign exposure[9] in Malaysia, and increase ADB's nonsovereign portfolio

[9] Exposure refers to drawn and undrawn portions of PSOD's Board-approved (signed, i.e., not necessarily committed) nonsovereign loan, equity investments, and guarantees, as of 31 December 2006.

investment in (i) Malaysia from 0.01% to 0.27%; and (ii) in capital markets from 1.52% to 1.32%. The proposed investment is within ADB's aggregate country, industry, group, and single project exposure limits for private sector projects.

44. ADB will enter into suitable transaction agreements and other legally required documents, following approval of the proposed financing by ADB's Board of Directors. The agreements will be on terms and conditions satisfactory to ADB. In addition, ADB will need to be satisfied with all terms and conditions of any other documents associated with the proposed financial assistance.

45. Consistent with the Agreement Establishing the Asian Development Bank, the Government will be asked to confirm that it has no objection to the proposed ADB investment. No funding will be disbursed until ADB receives such confirmation.

VII. RECOMMENDATION

46. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve a dollar-denominated senior secured loan of up to $10,000,000 to Eucalypt Mortgages Sdn. Bhd. (or a related entity) from ADB's ordinary capital resources, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; and such other terms and conditions as are substantially in accordance with those set forth in this report, and as may be reported to the Board.

Haruhiko Kuroda
President

10 October 2007

BENEFITS OF THE RESOLUTION OF NONPERFORMING LOANS

1. Accelerating the Asian restructuring process is vital in regenerating regional growth, preserving investments in companies or projects to make them financially viable, getting businesses going forward rather than avoiding creditors, reestablishing confidence so that new investors will step forward to finance the continuing massive infrastructure needs, and getting people back to work (or protecting otherwise viable employment). For Asia as a whole, the presence of large numbers of companies that have defaulted weighs heavily on the banking and financial system. Even in cases where bad debts have been sold or have been transferred to asset management companies, the presence of large numbers of distressed companies weigh heavily on the economy as they are relatively unproductive. In some cases, the optimum solution may be closure, but in most cases the underlying companies continue to be productive and recover strongly once the weight of bad debt is removed.

2. The Asian development experience has shown that growth is one of the most powerful weapons in the fight against poverty. Growth creates the need for labor, the main asset of the poor. As growth continues, private sector employment becomes the major source of economic support for the majority of workers and their families. Growth also broadens the tax base, enabling governments to finance social services such as health and education.[1]

3. To restore the health of the banking industry in the targeted countries, it is necessary to work on corporate restructuring as was the case with the success of the Republic of Korea after the financial crisis of 1997. Vulnerability in the banking system and the economy is a result of rapid growth that outpaced the establishment of sound regulation, the building of institutional capacities, and formulation of sound corporate governance principles. The development of a sound and efficient financial sector is a prerequisite for broad-based private sector-led economic development that will contribute to poverty reduction. Not addressing the problem of nonperforming loans (NPLs) would translate into a further drain on future resources and potential earnings and impair capital significantly. As credit costs increase to cover the cost of NPL losses, financial institutions resist making fresh loans. Tighter credit restricts economic growth as enterprises are unable to access capital. Selling NPLs will alleviate these problems and help stimulate economic growth in the respective countries.

4. The benefits of resolving an NPL crisis are well-proven, judging from the success of countries outside of Asia, for instance, the US or Sweden (both of which of course had other supporting factors). In those countries, once the level of NPLs dropped, the national economy began to recover and grow; companies and businesses started creating new jobs; and investors, now more confident of a country's long-term growth prospects, began to pump investment capital into the country's stock, bond, and property markets as well as individual companies and businesses.

[1] ADB. 2000. *Private Sector Operations Strategic Directions and Review*. 37. Manila (para. 37).

FINANCIAL AND CORPORATE RESTRUCTURING[1]

A. Introduction

1. A company can be defined as a collection of contracting relationships among individuals—a "nexus of contracts."[2] The contracts make it possible for the company to conduct business. The parties to these contracts include shareholders, creditors, managers, employees, suppliers, and customers—in other words, anyone who has a claim on the firm's profits and cash flows. Therefore, restructuring is the process by which firms change these contracts. What usually drives firms to restructure is some opportunity to increase their market value. Restructuring can be very costly, however, so the value gap must be large enough to make it worthwhile.

2. One of the most compelling reasons to restructure is to address poor performance, i.e., to address losses in market value caused by poor performance or financial distress. Such losses may or may not be the management's fault: the management may have overdiversified into too many businesses or borrowed too aggressively. On the other hand, the firm's problems could be caused by an economic recession or an adverse change in currency exchange rates (the two other main reasons for restructuring are to pursue strategic opportunities or to correct valuation errors).

B. Overview of Restructuring

3. There are a number of ways to resolve unsustainable corporate debt. The usual response would be for the company to raise new equity, if possible, and/or undertake "operational restructuring" (e.g., discontinue less profitable or loss-incurring businesses, lay off excess labor, and reduce other costs to increase the company's earnings and debt service capacity, plus sell noncore businesses and assets—such as real estate—to retire debt).

4. If it appears that operational restructuring cannot reduce corporate debt to a sustainable level, or that stopgap liquidity is needed prior to such action, "financial restructuring" becomes appropriate. For example, creditors, either new or existing, could convert debt into equity and/or into lower-yielding corporate bonds, which usually requires a loss or "haircut" with regard to the original terms of the to-be restructured debt (through a reduction of principal or by forgiving interest/penalties or extending the maturity of the facility).

5. The mix and sequencing of such operational and financial restructuring measures for a distressed company will depend on the severity of the company's problems and differences among the interested parties. In essence, if the company's underlying business is nonviable, liquidation is appropriate. However, if the company is viable, albeit overindebted, financial and/or corporate restructuring presents the best route forward.

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[1] This section is a summary of current research on the benefits of corporate and financial restructuring from the following sources: ADB. 2000. *Bank and Corporate Restructuring.* Manila; Claessens, Stijn, Simeon Djankov, and Ashoka Mody. *Resolution of Financial Distress: An Overview*. Washington, DC: World Bank; Cho, Won-Dong, and Michael Pomerleano. *Corporate Debt Restructuring: The Missing Link in Financial Stabilization*. Washington, DC: World Bank (June); World Bank. 2001. *The Morning After: Restructuring in the aftermath of an asset bubble*. Washington, DC: World Bank (October); and Mako, William P. 2003. *Uses and Limitations of Our-of-Court Workouts: Lessons from East Asia*. Washington, DC: World Bank (October).

[2] Jensen, Michael, and William Meckling. 1976. Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure. *Journal of Financial Economics* 3:305–360.

C. Macroeconomic Implications and Policy Considerations

1. Market-Led Approaches to Restructuring I: Decentralization of Decisions

6. Corporate restructuring is an ongoing process that separates those firms that can survive and prosper from those that are too overwhelmed by current challenges and flounder. Governments have only a limited role to play in such restructuring, except to ensure an economic environment in which resources can be redeployed to new uses at minimal cost. However, when distress is widespread, there is a danger that it may be self-reinforcing.

7. Several types of coordination issues arise. Firms may have low incentives to restructure because other distressed firms—and, by implication, consumers—have a low demand for their products. Also, distressed firms are unable to repay debts, maintaining the pressure on financial institutions, which, in turn, restrict new lending that may be required to revive sectors where effective demand exists. Financial institutions may become insolvent, reducing the incentive of borrowers to repay loans. The judicial system will be overwhelmed with cases and will have no mechanism to prioritize which case to treat first.

8. To break out of this vicious cycle, on a *macro-economic level* three approaches have been employed. The first strategy is to depend on economic recovery to release the constraint on demand, thus improving cash flows and the repayment ability of firms. Such recovery can be engineered by increased government spending but may be limited by fiscal constraints, particularly in times of systemic distress. Recovery may also occur if the demand for exports is buoyant, as was the case in Mexico after the 1994–1995 crisis and in the Republic of Korea and Malaysia following the recent Asian crisis, with both countries benefiting from rapid growth in the trade of electronics products. However, reliance on an economic upturn may be naïve, as evidenced by the continued stagnation of the corporate sector in Japan over the last decade.

9. Furthermore, economic recovery by itself has proven to be insufficient in countries like Indonesia and Thailand, where more than half of the corporate sector was at one point experiencing distress. Many firms were in distress, not just because of an economy-wide crisis but because imprudent investment decisions had been made. The evidence shows that the distress of such firms and financial institutions persists for long periods, rendering the economy vulnerable to renewed financial pressures.

10. For this reason, the next set of alternatives is a variety of market-based measures, which need not require any fiscal layouts. Under this approach, the government sets the rules under which creditors and debtors work out their claims in a decentralized manner. These rules include rules governing normal restructuring and bankruptcy; enhanced measures for resolving financial claims (through special rules or moral suasion that supplements existing bankruptcy procedures); reduction of barriers to transfer of ownership and redeployment of resources (including more liberal foreign direct investment, mergers and acquisitions, and greater mobility in labor markets); and "super-bankruptcy" processes that, once again, change the incentives for the restructuring of claims.

11. The common feature of these decentralized approaches, whether normal creditor-led workouts, enhanced "market-based," or super-bankruptcy approaches, is that they rely on incentives and penalties for restructuring rather than on either government fiscal stimuli—as in the case of an engineered recovery—or on the assumption by the government of financial liabilities of bankrupt firms and financial institutions. In some cases, however, where economic recovery and enhanced incentives for restructuring are insufficient, governments may face the

assumption of financial liabilities or provide other forms of government support to shore up the financial or corporate sectors. Related to that is the degree to which governments should exercise regulatory forbearance on financial institutions in distress. Where governments do expend fiscal resources and assume nonperforming loans, they also seek to recover some part of those resources through centralized asset management companies. In practice, the dependence on economic recovery, sharper incentives and tougher penalties, and the assumption of financial liabilities go together. This is demonstrated by a variety of country examples. It is thus difficult to isolate the effects and benefits of pursuing an economic-recovery-only approach.

12. Some lessons on systemic restructuring have also become clear. There is a need to limit the government's role in establishing the enabling environment (insolvency, tax, accounting, etc., eventually providing resources) for the private sector to do the necessary restructuring. It has also become clear that it is important to adjust the approach to the type of assets, which are causing the distress. To the extent that the government directly intervenes in systemic restructurings, it should be careful on how it deals with "losers" (particularly banks and other financial institutions).

2. Market-Led Approaches to Restructuring II: More Benefits, Less Cost

13. A market-led approach to restructuring has, in principle, three main attractions. First, by drawing on private rather than public resources to facilitate restructuring, it helps limit costs to the taxpayer. Equitable cost-sharing arrangements under a market-led approach should help mitigate problems of moral hazard and create incentives for more efficient monitoring. Second, a market-led approach generally works better in recovering the value of nonperforming and bad loans than a bureaucratically administered system. Competition in the acquisition and disposal of assets should eventually make for more efficient debt workouts. Finally, a market-led approach should enhance systemic efficiency and safety. These benefits follow if market players who are better capitalized and managed are able to increase their market share at the expense of those that are weak and are a potential threat to system stability.

14. Corporate difficulties may be resolved by the market or within special-purpose frameworks intended to ease coordination problems. Market solutions entail mergers, acquisitions, and bankruptcies within an established framework of company law. Special-purpose frameworks may be either voluntary or compulsory. Voluntary frameworks are usually preferred since they provide an opportunity for the rehabilitation of asset values and a recovery of debt. The role of such agencies is crucial when there are many interlocking debtors and creditors. Negotiations among these parties are usually guided by a set of well-defined rules. These would normally assert creditors' rights, while providing some breathing space during which businesses enjoy a stay on their debt. The rules are likely to require that debtors submit plans for financial and operational restructuring to creditors for their approval. To help resolve coordination problems, majority voting on these and other matters is the norm. To the extent that voluntary arrangements work, both debtors and creditors should benefit. If they fail, or if no agreement can be reached, resolution of debts would normally occur through bankruptcy proceedings. Therefore, for voluntary arrangements to work there should also be a credible threat of action under binding foreclosure and bankruptcy procedures. If these do not exist, voluntary frameworks are unlikely to achieve much. Normally, some combination of market and special-purpose frameworks for debt resolution will be applied.

3. Restructuring: Prevention and Resolution of Financial Crisis

15. Weaknesses in the financial and corporate sectors were at the heart of the Asian crisis. In a situation where rapid financial liberalization had outpaced institutional capacities, vulnerabilities accumulated and put at risk the solvency of large parts of the affected economies. Inadequate regulation, weak supervision of financial institutions, poor accounting standards and disclosure rules, outmoded laws, corporate recklessness, and inferior governance all played their part. Together, these factors seemed to legitimize investor panic that culminated in the disorderly collapse of asset prices and exchange rates. Prompted in part by the terms of international assistance packages, the affected economies have now embarked on the complex and time-consuming task of tackling these institutional deficits.

16. Stanley Fischer, formerly of the International Monetary Fund and now with Citigroup, described the importance of corporate restructuring, particularly in the aftermath of a crisis, as a vital accompaniment to banking restructuring: “At this stage, bank and corporate debt restructuring should be closely coordinated, but often are not because of lack of capacity, data, and sheer complexity of the banks. Bank restructuring cannot take place in isolation from corporate restructuring.”

17. Instruments designed to mitigate the severity of bubbles as well as support remedial measures to deal with their aftereffects include a secondary market for debt, corporate financial restructuring funds, corporate restructuring vehicles, real estate investment trusts, and securitization. Two of the products—corporate financial restructuring funds and corporate restructuring vehicles—were successfully used in Korea after 1997, which sought to develop market solutions to facilitate the restructuring process in the aftermath of the Asian financial crisis. The Korean initiative might serve as a model for other countries.

4. Restructuring: Acceleration of Local Financial Competency

18. Provided that a country has a rich set of financial sector skills, it can develop a wider range of investment and risk management mechanisms that can help transfer liquidity, market, and credit risks and thereby dampen the volatility of the financial system. The prerequisite is that, in order to develop sophisticated financial market instruments, countries first need to acquire a base of human capital.

19. Similar to service sector skills, market-based instruments play an important role in mitigating the magnitude of bubbles as well as in expediting the mop-up process. In the aftermath of the Asian crisis, there is increasing recognition of the importance of corporate and financial sector restructuring and the challenges that restructuring poses in the absence of skilled financial sector expertise. It is believed that the buildup, duration, and severity of bubbles in equity and real estate markets, as well as the restructuring that occurs in the aftermath of such bubbles, are related to the availability of skills in financial sector services. Countries that have capable professionals such as appraisers, analysts, and insolvency experts have recognized and responded more swiftly to asset bubbles than countries with a limited base of skills in the financial sector. In addition, countries benefit from the development of market instruments that spread risks, such as secondary markets in distressed debt.

5. Public Policy Considerations

20. According to academic and multilateral researchers, policy measures directed at developing market-based instruments in distressed debt and corporate restructuring funds are

needed to bring greater transparency, efficiency, and liquidity to emerging markets. Policy makers need to remove the legal impediments to the development of a market for securitization through legislation enabling a legal structure for trusts, tax neutrality, and amendments to the insolvency legislation. Similarly, development of standard documentation for trading distressed corporate loans will lead to greater consistency, transparency, and therefore liquidity in the distressed debt market. To avoid moral hazard, the new set of creditors should retain some equity instrument (e.g., convertible bonds, debt-equity swaps, options, or warrants) to participate in any recovery while placing pressure on existing equity holders to enforce improvement measures. Term extensions may be acceptable, so long as they do not have the practical effect of transforming debt into an equity-like instrument without also giving creditors the rights of equity holders. Reducing interest below the risk-adjusted rate may also be acceptable, so long as the principal is repaid.

D. Cost of Restructuring

1. Cost of Restructuring and Value Creation

21. From an economic perspective, debt restructuring is almost always preferred over bankruptcy, as it is the less costly alternative, particularly when the firm in question remains a viable going concern. Every restructuring impacts the firm's market value for the same reason. There are certain market frictions or institutional rigidities that make it difficult for the firm to re-contract. Such frictions—called "market imperfections"—include transaction costs, agency costs, information costs, and taxes.

22. Transaction costs include all costs (both out-of-pocket costs and forgone opportunities) that firms incur when they restructure (e.g., fees in a bankruptcy reorganization and severance payments to employees laid off in a downsizing program). Agency costs include the loss in market value when managers take actions that benefit themselves but harm shareholders. These costs also include the costs to shareholders of trying to prevent managers from behaving this way. Information costs include the costs to investors of acquiring and processing information about the firm's activities and opportunities. In practice, these costs can be lowered by the activities of financial analysts, who provide expert commentary and analysis about companies to investors.

23. Finally, taxes—both corporate and personal—are a critical concern in almost every restructuring. If a firm wishes to rid itself of a business division (e.g., for strategic reasons), a corporate spin-off can avoid the onerous tax liability created by an outright cash sale. A firm that reorganizes in Chapter 11 [3]may choose to keep its debt level relatively high, because issuing new stock may limit its ability to use its net operating loss carry forwards. Understanding how these factors can impact market value in a particular situation is critical for successfully managing the restructuring process, addressing the firm's problems, and creating value.

2. Bankruptcy Costs

24. Investing in distressed situations involves purchasing the financial claims of firms that have filed for legal bankruptcy protection or else are trying to avoid bankruptcy by negotiations and out-of-court restructuring with their creditors. The show case is the United States (US), where corporate bankruptcy reorganizations take place under Chapter 11 of the U.S. Bankruptcy Code.

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[3] *United States Code Title 11 (Bankruptcy Code)*. 1994. Reorganization.

25. An out-of-court restructuring can almost always be accomplished at much lower cost than a court-supervised reorganization. Part of this difference reflects savings in legal and other administrative costs. More importantly, Chapter 11 or similar bankruptcy regimes generally impose a much heavier burden on the business because of the greater demands placed on management's time and costly delays engendered by litigation. Consistent with this cost differential, academic research[4] has found that firms that successfully restructure their debt out of court experience significant increases in their common stock price (approximately 30%, on average, after adjusting for risk and market movements) from the time they first experience financial distress to when they complete their restructuring. Over a corresponding interval, firms that try to restructure out of court but fail experience significant average stock price declines (also in the order of 30%).

26. Several studies have measured the costs of the reorganization process. Warner (1977) and Weiss (1990) conclude that the direct out-of-pocket costs of Chapter 11 (including professionals' fees, court filing fees, etc.) are less than 5% of corporate assets, on average. However, these costs are proportionately much higher for smaller firms. Altman (1984), Opler and Titman (1994), and Kaplan and Andrade (1999) attempt to measure the business losses caused by bankruptcy (for example, potential customers or suppliers may be reluctant to do business with a bankrupt firm.) These costs are potentially much larger than out-of-pocket bankruptcy costs, but measuring them is difficult because business losses may be the cause, rather than the consequence, of bankruptcy. The studies conclude that these additional costs average roughly 10%–25% of firms' stock market values before bankruptcy and that highly leveraged firms suffer greater losses of business than less leveraged firms during industry downturns. Gilson, John, and Lang (1990) show that direct costs are significantly lower in out-of-court restructuring than in Chapter 11. This cost advantage gives most firms an incentive to restructure out of court if they can. An alternative restructuring option that has gained popularity recently is "prepackaged" Chapter 11, which allows firms to reorganize in Chapter 11 more quickly. Tashjian, Leas, and McConnell (1996) show that the costs of prepackaged Chapter 11 are midway between the costs of conventional Chapter 11 and out-of-court restructuring.

a. Stock Prices and Long-Run Performance

27. Ahorony, Jones, and Swary (1980) show that when firms file for bankruptcy, their common stock prices decline significantly, on average (controlling for differences in firms' risk and market movements). Moreover, for up to 5 years before they enter bankruptcy, firms' stock prices significantly underperform in the market. Gilson, John, and Lang (1990) document that when distressed firms successfully restructure their debt out of court, their risk-adjusted stock prices increase by over 40%, on average, from the time they first default on their debt. In contrast, firms that file for Chapter 11 suffer an average 40% stock price decline. This difference suggests that for most firms, it is significantly less costly to resolve financial distress out of court. Hotchkiss (1995) shows that after firms leave Chapter 11, they tend to be significantly less profitable than the average for their industries. Consistent with Hotchkiss, Gilson (1997) finds that roughly one in four companies that reorganize in Chapter 11 subsequently has to return to bankruptcy court (as so-called "Chapter 22s") because they either continue to perform poorly or leave Chapter 11 with too much debt.

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[4] See Gilson, Stuart, Kose John, and Larry Lang. 1990. Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default. *Journal of Financial Economics*. 27 (2): 315–353; and Gilson, Stuart. 1991. Managing Default: Some Evidence on How Firms Choose Between Workouts and Chapter 11. *Journal of Applied Corporate Finance*. 4(2): 62–70.

b. Bankruptcy Resolution

28. A number of studies have documented patterns in how financial distress is resolved. Several studies—for example, Franks and Torous (1989, 1994); Eberhart, Moore, and Roenfeldt (1990); Weiss (1990); LoPucki and Whitford (1993)—show that debt restructuring plans, both in and outside Chapter 11, exhibit strong deviations from the “rule of absolute priority”. This rule, which has to be followed in a liquidation, states that no creditor or shareholder can receive anything of value under a restructuring plan unless all more senior claimholders have been made whole. Absolute priority deviations typically mean that shareholders receive something of value in a restructuring, even though the firm is insolvent. This outcome is a by-product of the US system, which encourages consensual reorganization of distressed firms. In other countries, where liquidation is more common or shareholders do not get to vote on the restructuring, absolute priority is more likely to be observed. As for how firms resolve financial distress, Gilson, John, and Lang (1990) find that most distressed large public companies are successfully reorganized—approximately half the time in Chapter 11 and half the time out of court. Firms that are able to restructure out of court typically have less complex capital structures, higher growth opportunities, and more bank debt. Finally, Gilson, Hotchkiss, and Ruback (2000) show that claimholders’ relative recoveries in Chapter 11 strongly depend on how disputes over the firm’s value are resolved.

SALIENT POINTS ON BANK NEGARA MALAYSIA'S "GUIDELINES FOR THE SALE OF NPLs BY BANKING INSTITUTIONS"

1. Outright sale is allowed to either eligible third parties or to special-purpose vehicles (SPVs) within the seller bank group. Eligible third parties include domestic banking institutions, other domestic investors, and foreign investors. However, foreign investors and nonbanking domestic investors must form SPVs to buy nonperforming loans (NPLs).

2. The SPVs must be locally incorporated and tax resident.

3. Equity participation by foreign investors is permissible in both types of SPV, but maximum participation is 49%.

4. Sales to third parties must be on a without-recourse basis, while sales to same-group SPVs can be either with or without recourse.

5. NPLs that can be sold include corporate, small- and medium-sized enterprises (SME), and personal loans.

6. Losses arising from sales cannot be amortized.

7. Approvals are needed from Bank Negara Malaysia (BNM) and the Minister of Finance pursuant to specific sections of the Banking and Financial Institutions Act 1989 and other existing regulations.

8. Seller institutions can act as service agents after the sale, subject to an arrangement with buyers.

9. If the buyer is another Malaysian banking institution, purchased NPLs may be classified as performing for the first 6 months after purchase.

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanisms	Assumptions and Risks
Impact The NPL market in Malaysia develops into a fully functioning market.	• At least 4 NPL transactions reach financial close within the next 24 months.	• BNM report	**Assumptions** • There is no change in the regulatory or legal environment regarding NPL disposition for banking institutions. • Economic development in Malaysia is stable or has increased. • There are no adverse developments in real estate market in Malaysia.
Outcome • The sale of HSBC's portfolio to EMSB reaches financial close by 4Q 2007.	• EMSB acquires the NPL portfolio of HSBC.	• BNM report • HSBC financial statements • EMSB financial statements	**Assumptions** • HSBC and ADM reach agreement on all negotiating points. • Approval from MOF and all other government approvals is obtained.
Outputs • ADB provides a Senior Loan to EMSB. • ADM III provides a Subordinated Loan to EMSB.	• EMSB receives funding for its purchase of the HSBC NPL portfolio.	• EMSB financial statements	**Assumptions** • ADB and ADM reach agreement on all negotiating points. • Approval from MOF and all other government approvals is obtained. • All approvals are in place for ADB.
Activities with Milestones 1.1 ADB provides a Senior Loan to EMSB (4Q 2007). o ADB and EMSB enter into a loan agreement. 1.2 ADM III provides a Subordinated Loan to EMSB (4Q 2007). • ADM III and EMSB enter into a loan agreement.			**Inputs** • ADB - $10.0 million • ADM III - $15.2 million

ADB = Asian Development Bank; ADM = Asia Debt Management Hong Kong Limited; ADM III = ADM Maculus Fund III, L.P.; BNM = Bank Negara Malaysia; EMSB = Eucalypt Mortgages Sdn. Bhd; HSBC = HSBC Bank Malaysia Berhad; NPL = nonperforming loan; Q = quarter.
Source: ADB analysis.