

Non Performing Loans (NPLs): The Borrower's Viewpoint

Suthep Kittikulsingh*

A bright hotel banquet room crowded with bankers, clients and their friends in business suits bumping into each other to the sounds of clinking glasses of scotch and soda—this was the scene at the launch of yet another property development. A miniature representation of the project, enclosed in a glass case and lit up by spotlights, lay in the center of the room for all to view. It was a sprawling complex—clean geometric lines, a large area of well manicured grass—and it overlooked a blue river.

A project like this in the early 1990s in Bangkok was a sure winner. Fifty percent of the available units had been sold, and the buyers were already reselling some of the purchased units at a profit. The developer was withholding further sales until he received the right price. The bankers felt fortunate to be in on this deal. It had been a hard, long negotiation and the interest rate spread was rather slim (especially considering that half the loan was to be in US dollars). However, the instructions from the top had been, somehow, to clinch the deal. Getting a share of this project was important because it would be the bankers' passport to the monumental one the same developer was to unveil in five months time.

But too many successful deals by too many developers and bankers were tilting the resources the wrong way and creating an ugly, oversized bubble. There was a huge mountain of real estate development based on a molehill of market research. Unknown to everybody present in the banquet room, they had just sown the seeds of what was to become the monster of Bangkok—an NPL.

NON-PERFORMING LOANS: CAUSES

The Bubble Economy

Did the bubble have to burst? If the answer is a definitive yes, then the assumption is that bubbles are recognizable and predictable. Charles Kindleberger, the economist, thought otherwise, and said that a bubble was defined by its bursting. Now that it has burst, it is easy to reminisce on how real estate prices were climbing every week and how there was always that gut feeling that the climb was not going to last forever. To some extent, the bubble was acknowledged, but its existence was only confirmed once it burst. The same gut feeling now makes us queasy about the Dow Jones Industrial Average. Let us hope that bubble (?) never gets defined.

When prices of a commodity move up fast (like 10% per month), a disaster is waiting to happen. It is a pity that there is no system to check the prices of specific goods that are spiraling out of control, because if checked at this early stage, it is easier to contain the problem before it starts to infect the price of other goods. A micro solution (taxation to reduce demand of the product in question or reduction of import duties on competing products to spur competition etc.) can be used to contain these micro problems. But if they remain unchecked, the virus spreads and it could well become a macro problem of the overall price level or inflation. Then the sharpshooter's rifle will not do. Nothing less than a machine gun (the interest rate) will do the job. Unfortunately, the machine gun will kill many innocent victims along with the criminals. Industries already suffering from anemic demand will fall victim to the anti-inflation gun, and their plight will worsen.

In any case, regulators face a hard choice, in fact, a no-win situation. When bubbles burst naturally, then the regulators have been asleep at the wheel. When the regulators cause them to burst, then they become responsible for having labeled healthy growth a bubble and then killing it, or at least for not having engineered a soft landing.

All that is history now—the Thai bubble finally burst. In a speech a few days back, US Federal Reserve Board Chairman Alan Greenspan said that financial crises are unpredictable, their consequences are unknowable in advance

and that the current generation of risk models is not equipped to handle these events. “In a real crisis, investors can recklessly sell everything, even assets they know to be perfectly fine,” he said. Just as there was not much the Thai regulators did to control the bubble in the initial formative stages, there was not much they did to mitigate its effects after it burst (though, admittedly, after the crisis, their hands were tied).

When the Bubble Burst

By the end of 1994 through 1996 price pressures were being felt across the country across many industries. Exports were not getting much stronger, but pre-committed export-directed investment continued. The 1996 merchandise export figures showed a disturbing 0 percent growth. To some extent, the slowdown was an Asia-wide affair. Thailand was ahead of the pack in the growth race but it was over financed—like an athlete on steroids with not much of his own internal strength. Once the effects wore off, it was the first to stumble. Weaknesses in the real estate sector were being felt though buildings were still being built because land had been procured and financing had been arranged. Doubts started to surface in the minds of the entrepreneurs that these were the twilight days of easy money. Interest costs and other costs were high. Competent personnel could not be hired because they were too expensive and too busy hopping from one job to another. Engineers were in very short supply. The euphoria among the business community was waning and passion was fading. Selling prices of manufactured products faced intense competitive pressures. Listed companies started losing money. The Stock Exchange of Thailand (SET) index had been in decline since 1995. In May 1996, the Bangkok Bank of Commerce scandal was exposed in parliament when the Democrats in opposition tried to score points against the government in a no-confidence debate. That marked the turning point in confidence in Thai financial institutions in general and in the regulatory process in particular. It turned out to be a missile aimed directly at the Bank of Thailand (BOT). By November 1996 the first attack on the baht was reported.

The pressure on businesses to pay back their loans had started. The bigger the financial institution, the less they valued long-term relationships with individual clients. The smaller institutions were desperate because their loans (borrowed from abroad or from the bigger institutions locally) were being recalled. Financial institutions that were previously taken for granted were suddenly undependable and relationships with them were now on an on-call basis. Initially, businesses responded by juggling the loans around, borrowing from one institution to pay off another. As more and more institutions made the same demands, the game drew to a close. When the repayments slowly ground to a halt (there was really nowhere else to borrow from), and requests by the borrowers for a little more time fell on deaf ears, high short term interest rates were imposed—by then, short-term rates based on the interbank rate had made an acquaintance with the stratosphere. Between November 1996 and July 1997 quite a number of attacks on the baht had taken place and interest rates rose in response. The rates were crazy and businesses either paid back some of their loans, paid the crazy interest rates or lost their credit rating. Many did all the three in sequence.

The damage to business was more than just higher interest costs affecting the bottom line. The sudden withdrawal of funds demonstrated the marked difference between the money market and the goods markets in a crisis. Less supply of any product should normally increase the relative demand, which would automatically increase the price and bring in more supply, which would restore the balance (as in the classic demand-supply graph). But the equations for money in a crisis are not so straightforward. Less supply increased relative demand and consequently higher interest rates, but the higher the rate paid by the borrower, the worse his credit rating became and the higher the rate that he would have to keep on paying—the equilibrium price (interest rate) on the supply-demand graph for him just kept shifting upwards. He was being sucked into a black hole through which he was going to be blasted into oblivion if he did not act to save himself.

Though prices of products, especially commodities, move up and down continuously and are a major cause of business tension, and even of business success or failure, the goods market is not as perfect or efficient as the money market or the stock market. Stocks are expected to oscillate within a certain range every day and dealers take the profits and losses from their stock trades in their stride. But when price swings are much greater than expected (and this is especially so with products whose prices do not swing that rapidly), the number of defaults are higher because of the surprise or shock factor. For example, some customers who had a perfectly good record of honoring their contracts for years, backed out when Value Added Tax (VAT) was suddenly increased from 7 percent to 10 percent because of the 3 percent additional tax they would have to pay, claiming that this was *force majeure*—a situation that could finally be resolved only by price re-negotiation. Shocks and defaults became commonplace until there was no more shock in a default.

The withdrawal of funds from the money market had a devastating effect on sales. Businesses were busy trying to bridge gaps in their cash flows—more time was spent on reducing inventories at a discount and collecting payments than on promoting new business—in their own way they were doing exactly what the banks were doing. Lower sales

led to lower prices. Lower prices led to panic sales in anticipation of even lower prices, and so the downward spiral continued.

Meanwhile, more and more fronts were opening up in the battle for the baht. Importers and exporters were hedging their payments and proceeds, while banks, hedge funds and other funds were short selling the baht outright. The BOT was resisting the attack by funneling dollars to the spot and to the forward markets. By the end of June 1997 the game was up and the BOT had surrendered. The baht was finally floated, jeopardizing Thailand's ability to repay about 90 billion dollars of private and public sector foreign debt.

The business community was shaken up. Many of the big borrowers knew all would be lost if the devaluation was not contained. Initially, there was a slight feeling of relief that the war was over—you were only safe from a devaluation after it had occurred. The general view was that the baht would not weaken more than 10 to 20 percent—but that turned out to be just the calm before the storm.

The BOT, after having unsuccessfully tapped the international market for some bridging finance, appealed to the International Monetary Fund (IMF). It is the IMF's job to see that countries do not default on their international debts. The standard IMF recipe for solving these supposedly short term problems is to extend a credit line (to revive confidence rather than to refill the coffers) and to ensure that a punishingly high domestic interest rate is enforced to curb borrowing for speculative purposes, with a side effect of killing inflation. But the IMF, with all the wisdom gleaned from its South American and Mexican experience, looked at Thailand with disdain and decided that the country needed more than just short term medication. It needed major surgery to ensure that it could make do with a minimum amount of financial assistance, and so that it would not keep coming back to the IMF for more assistance.

The solution for Thailand was simple. Support only what was commercially viable and shut everything else down. Start with the finance companies and banks that were feeding off the BOT's Financial Institutions Development Fund (FIDF). Then restructure the viable companies and close the rest. Let the country concentrate on where it had a comparative advantage—like agriculture. Privatize state enterprises so that the same tough rules could be applied to them, and to reduce public sector debt and to increase forex reserves. Down-size the unwieldy government bureaucracy. Ensure that government spending was reduced by setting a target budget surplus of 1 percent of GDP. Increase VAT from 7 percent to 10 percent to increase mandatory savings and reduce aggregate demand. Ensure that the currency was spared from speculative attacks by increasing interest rates. This would, supposedly, have the beneficial side effects of curbing economic activity, down-sizing the private sector that had been hyperactive over the last decade, and in reducing the current account deficit. Open up the market to foreign investors in all sectors, especially in the real estate sector. Targets for foreign exchange reserves and a ceiling for the current account deficit were set. Loan disbursements by the IMF would be contingent upon Thailand meeting those targets. It was not the Thai economy that the IMF was worried about. It was Thailand's ability to service its international debts.

Picture, hypothetically, the Thai economy successfully disassembled and remodeled by the IMF. There would be fewer banks and finance companies (at least fewer belonging to Thais). Many of the financial institutions would have been auctioned off to foreign investors who would bring in much needed banking professionalism and foreign exchange. There would be a much leaner and efficient government with the biggest state enterprises efficiency-enhanced by the entrance of foreign private companies and bolstered by more foreign capital. Many private companies would have been restructured financially and operationally with the help of new foreign financial or strategic partners, bringing in even more foreign exchange. The non-viable companies would have folded and stopped being a drag on the economy. Exports would have boomed with the new supercharged baht trading at about 33 to the dollar. The current account deficit would be within manageable limits and would keep reducing from year to year as more export-oriented ventures took off. Foreign direct investment would be boosted with the opening up to foreigners of all the previously closed sectors and because of the economy's new-found vibrancy. With so much foreign exchange flooding in, reserves would be replenished and the economy would stabilize. Thailand's external debt problem would be solved. QED.

Now picture the real Thailand ravaged by IMF policies. It was far easier to disassemble the economy than envisaged, since it was barely hanging in the balance. Putting Humpty-Dumpty back again, though, was something else. It was no great feat pushing the economy downhill—the problem was going to be hauling it back uphill. Once at the bottom of the hill, there was no question about restraining the current account deficit. Shrinking imports created a massive current account surplus such as the country had never seen before. Thai manufacturers, finding their domestic markets shrivel, desperately tried to export their way out of trouble, but now that Indonesia, Malaysia, Korea and other countries were in much the same predicament, it was like a dozen drowning men grabbing the same little plank to save themselves. Unemployment—oops! the IMF forgot about that—zoomed. Privatization hit a stumbling block—the

labor unions, and of course politicians, suddenly finding an opportunity for some free publicity.

As for the baht, it was knocked senseless. When it finally managed to crawl back on its feet, the IMF and the government took the credit for stabilizing the currency. Yes, foreign direct investment shot up, but only because multinationals, under pressure from banks, had to bail out their Thai subsidiaries. Thailand became a smaller economy, battered and bruised. The current account deficit in the years before the crisis was the crime. The current account surplus after the crisis was the punishment. The savings investment gap had reversed. While the government claimed success in bringing down interest rates, they received considerable help from the banks and their clients. The loans to deposits ratio had receded to 1993 levels. The banks did not want to lend money; the clients did not know what to do with the money.

NON-PERFORMING LOANS: FANNING THE FLAMES

The weak baht and the high interest rates made the IMF more successful than even they had dared to hope. Inflation was unexpectedly mild despite the fact that the baht had disappeared off the screen. The current account deficit dropped to zero and then moved into surplus territory, but every successful move by the IMF was at the expense of the corporates who were collectively sliding toward their doom.

The government had ordered the closure of 56 finance companies (out of a total of 91) over a period of about eight months. These finance companies were financing clients less than refinancing themselves to handle runs by jittery depositors, so removing them from the economy was not such a bad idea. However, by closing these companies, the government slammed the door on their clients, of which there were two groups, the tired and the wishful. The tired ones were exhausted from running from pillar to post trying to arrange loan repayments to the finance companies, but mainly in trying to plead with them for more time and for lower interest rates. The wishful ones still had projects in the pipeline partially complete, only partially financed and awaiting further loan draw-downs from the closed companies. The former had lost hope of recovering their credit lines anyway, and the latter (the wishful group) had a rude awakening and were instantly flung smack into reality.

After the closure, the finance companies suddenly became incommunicado. Nobody seems authorized to deal with clients on any terms except for collecting repayments with punitive interest rates, failing which, then for sending out legal notices—no surprise that the only defense left for the corporates was to stop paying and to wait for someone with authority to come forward for meaningful negotiations. Unfortunately, during the interminable wait for some sensible compromise with the closed finance companies, the other IMF measures started to bite and intentions to pay were eclipsed by the need for self-preservation. Soon after, the Financial Restructuring Authority (FRA), mandated to sell off the finance companies' assets, openly published in the newspapers (on quite a few occasions) the list of borrowers, putting the spotlight on the NPLs Anonymous. The NPLs, now an officially recognized body, attracted more and more members to their ranks. They found themselves in the very good company of the ex-high and the ex-mighty. Could a company that used to make tens of millions of baht in each quarter (with results audited by an international auditor) also be an NPL? By the time the finance companies' assets (loans) were auctioned off, all their clients were non-performing, some possibly feigning, but the majority just incapable of paying. By then, most NPLs understood that it could not just be their own bad management that eroded their capacity to service debts—could every company be poorly managed?

When a client is in financial trouble, most suppliers will panic and offer discounts or more lenient payment terms in order to recover their money. Only the Revenue Department and the banking industry expect additional payments as punishment for a client's incapacity to pay, because they have always been in a position of power and face little or no competition. They are also out of touch with the real world and always equate incapacity with unwillingness—hence tax fines and punitive interest rates. It is not surprising that when the baht was floated and dropped to levels that caught everybody unawares, bankers forced the clients that could not pay back their dollar loans to convert them into baht loans at the new low exchange rates. To add insult to injury, they demanded high short term baht interest rates on the newly converted loans. So a US\$5 million loan on which the client was paying 8 percent annual interest, or about 10,000,000 baht per annum before the baht was floated, was suddenly converted at 40 baht per US dollar into a baht loan with a 20 percent interest rate, resulting in an annual interest amount of 40,000,000 baht per annum—an increase of 300 percent. Is it that difficult to understand NPLs?

With NPLs increasing by the day, the banks had to stop functioning. When new Thai Farmer's Bank (TFB) shares were first sold after the crisis had struck, the proceeds were promptly deposited with the FIDF, which was paying high short term interest rates. No business could afford to pay that kind of interest rate because, unlike the FIDF, they were not backed by the note printing authority. This happened before the IMF saw the error in its ways, and reversed course

to allow the country to run a budget deficit and to reduce VAT back to 7 percent from 10 percent.

When interest rates are this high, no business wants to pay interest if it can help it. They would rather dump their inventory, induce their customers to pay a little earlier by offering generous cash discounts, keep delaying payments to their suppliers and attempt to reduce their expenses. While it is a good tactic for one business, it backfires when every business and every household starts to reduce expenses. The result is a drop in income for all and no increased savings. Thailand's real GDP dropped by about 1 percent in 1997 and a further 10 percent in 1998. The IMF inflation targets were bettered (or worsened, depending on your point of view). By the first quarter of 1999, there was disinflation and worries about a Japanese-type of deflation. Businesses slashed prices to levels at which sales brought relief but no profit (in many cases no gross profit, let alone net profit). If the real GDP figure for 1998 had been -15 percent instead of -10 percent, there would be no performing loans and no banking system left. At -10 percent, half the loans are non-performing and more than the total equity in the banking system has been wiped out. The Bank for International Settlement's (BIS) ratios have been maintained by the BOT's staggered provisioning requirements, hybrid equity issues by the major banks and debt equity swaps by the FIDF for the smaller ones.

The losses are more than the GDP figures depict. With so many of the marginal producers closed down and so many buildings not complete, there is a big possibility that even when the economy gets back on track, many of these ventures will not be revived. Many factories will be auctioned off piece meal and many buildings torn down. The difference between GDP and Net Domestic Product—NDP (gross domestic product less depreciation) would be considerably wider than is usually the case. NDP is not usually a consideration except when there is a massive destruction of national assets. Of course, some of this asset depletion will be compensated by "haircuts on loans" made by offshore lenders directly to the private sector.

A good way out of this economic trap should have been exports. But exports were constrained by quite a few problems, some external and some self created. Credit lines were fixed in baht (based on 25 baht to the dollar), while export business was in dollars. The squeeze on working capital resulted in lower selling prices in a catch-up game to meet payments. Export volumes shot up as businesses tried to get rid of their production and inventory, but this was achieved at the expense of price, so export values were stickier. It was taking time to find new markets and new customers for the increased volume of exports and any door that Thai manufacturers knocked on, they found Indonesian, Korean, Malaysian and Chinese exporters behind them. Credit the IMF for an Asian-wide economic failure because they found it too expensive to ease Thailand down for a soft landing. Besides this, the Revenue Department had an agenda of its own, which it thought was paramount to the government's efforts of turning the economy around.

Many small and even some of the bigger exporters had to pack up because they could not claim their VAT refunds. The Revenue Department was alleging that the overload of work in checking the records was preventing it from making prompt refunds. But exporters knew that it was merely an excuse for a lack of intention. VAT had increased to 10 percent, which was more than exporters made in profits. Many exporters have not been paid for nine months. The BOT has announced that three months default of interest or principal was to be considered a default. That made the Revenue Department the biggest NPL (see [Box 1](#)). Considering that the Revenue Department was paying no interest on the extra taxes it had collected and was supposed to refund, it was, in effect, responsible for a good chunk of the punitive interest charges that banks were billing the exporters.

The Revenue Department had set a VAT collection target for each area based on past records. The fact that domestic sales were dwindling and exports were replacing them was totally lost on the department. Exports meant 0 percent VAT and more exports meant less VAT. Instead of cheering for an export-led recovery, the department was more concerned about its targets and more interested in hassling the VAT-exempt exporters. Every few months, academics, the Board of Trade, the Federation of Thai Industries and others would meet to discuss the slow progress in the Thai economic recovery. The finger would always be pointed at the Revenue Department, which, for many years, had wax in its ears. (Maybe, with a bit of technical assistance from the Labor Congress of Thailand, exporters should have set up tents, put their lament to music and serenaded outside the department to grab more attention). Anyway, within a few weeks of those meetings, the department would start clearing up its arrears after clever negotiations in which it would force the exporters to leave behind 20 percent of the refundable amount as additional tax for underreporting sales. This was a clever tactic as far as the department was concerned, but it was quite dumb when looked at in terms of the damage done to the economy as a whole. After the arrears were cleared, the department would go back to its old ways. Only crooks do not pay taxes, it thought, and exports were just a convenient tax loophole.

Textile producers had to contend with Indonesia, a country of 200 million people in dire straits for whom suddenly textiles were a dispensable luxury product. The textile industry in Indonesia was modern, large and desperate. The

Indonesian rupiah was wild, unruly and unpredictable. Indonesian manufacturers had every incentive to sell at any price as long as they landed the right exchange rate at shipment time. Thai manufacturers found it difficult to complete. The baht was steadier and strengthening, so leveraging on the currency was not an option. As far as customers were concerned, desperation was equal to competitiveness. If there was anything more painful than the losses due to the baht's loss in value, it was the new round of losses due to the strengthening baht. The non-performing prices had to lead to NPLs.

NPLS: DESPERATION, DEFENSE OR STRATEGY?

First there was pain, then a build up of resistance and finally a scheme to counter the threat of extinction. Desperation, defense or strategy? The answer could be: all of the above in sequence if not a little bit of each in concert.

After the desperation exacerbated by the attitude of the finance companies and the banks, the defense fell in place automatically. Most sensible manufacturers logically identified and prioritized their obligations thus:

- Priority 1 Obligations to their workers for wages and salaries
- Priority 2 Obligations to export customers (who had established letter of credits (L/Cs) for their purchases) to ensure that goods were shipped to them as contracted
- Priority 3 Obligations to domestic customers and to raw material suppliers (to ensure that their factories kept running)
- Priority 4 Obligations to financial institutions that were prepared to keep working with them (in order to keep credit lines open without causing a financial drain)
- Priority 5 Obligations to financial institutions that were not prepared to keep working with them but only wished to have their money back
- Priority 6 Dividends to shareholders.

The first three obligations were necessary for maintaining a going concern. The fourth would have been a nice touch if the financial institutions had had the foresight to understand that, by cooperating with their customers, they could keep alive both their clients and their chances of recovering the amounts due from them. Unfortunately, most banks were unable to see far enough in the future. They had become over-regulated and their appetite for risk was a fraction of what it used to be. At any sign of a default (e.g., an exporter's customer not establishing an L/C on time, making the packing credit overdue), they would react by debiting the customer's account by the overdue amount immediately. In a market hit by nearly worldwide recession, customers backing out of, or delaying fulfillment of contracts, was commonplace—but the banks were not having any of this. Any and every excuse was proffered by the banks to limit the customer's credit line, to the extent that paying off a previous credit became a strict precondition for availing of some new credit.

Each bank had its own terms and ruled its own territory without competition—after all, where could these partially-performing customers in a non-performing economy go? They imposed exorbitant interest rates and exploited the clients with impunity. The BOT put the fear of God in the financial institutions. Suddenly, the BOT was beyond any political interference and it had the right to close any of the weaker ones as it saw fit, especially the ones that kept on knocking on the FIDF's doors. For the banks and finance companies, reeling in all the credits had a twofold benefit—it improved their cash flows and it reduced the need for bigger capital and reserves on which the operations were based—freeing up some of that capital for NPL provisions and saving them that much recapitalizing effort. Performance in the financial sector was reduced to an ability to down-size fast and the finance industry kept on tightening the noose around their customers' necks.

For the clients, it became too expensive a luxury to maintain these banking connections—something that had distinguished the ordinary businessman from the business tycoon in the bubble era. It was common practice for businesses in Thailand to have two sets of account books, one for the shareholders and one for the Revenue Department. The banks were now so nervous that any rumors or any bad news about any clients was enough for them to freeze credit to those customers. They were now practically warning customers that they would not tolerate any surprises in the year-end accounts, so customers obliged by giving them a third set of account books that lived up to their expectations. The banks would then be content to continue business as usual (part of which was to keep complaining that they had no way of knowing whether the accounts were correct).

If the banks were not extending additional credit, if they were only returning to the customer as a new loan (and that too, at steep interest rates) only the funds that he was paying back, if for every late payment they were charging a

penalty and if, for any excuse, they were attempting to reduce his credit line, then it made perfect sense for the customer to freeze the repayments and the banking relationship. It was a tough environment to do business in and it was a battle on every front. It was difficult enough fighting to retain customers complaining about high prices, suppliers complaining about late payments, employees complaining about bonus cuts and the Revenue Department claiming more taxes and refusing to refund what was due to the businesses. In the scheme of things, the banks were comparatively dispensable—and once dispensed with, then one battle less to fight. The banks had become inflexible and refused to acknowledge the changed business circumstances, so good clients rebelled and their accounts suddenly became defensive NPLs.

As for the banks fitting Priority 5, they made no bones about only wanting their money back. The clients, in turn, wanting to escape an early death, were not chickening out from refusing them.

THE BANKS FIGHT BACK

The legal departments of the banks and finance companies had their hands full. Legal notices started to fly all over town. Some minor interest rate compromises were made, some interest and loan repayments made, but mainly, borrowers pleaded for more time. Every day's delay was costing the banks in lost interest but, more importantly, in NPL provisioning. The simple escape for the banks would have been to reduce interest rates to the level that the customer could, or claimed that he could, afford, but this was not acceptable to the BOT. Any interest rate reduction below market rates was a *de facto* payment by the banks of the reduced interest amount in lieu of the customer—something that was construed as an illegal escape from NPL provisioning. The only reason for an interest rate reduction acceptable to the BOT was a debt workout plan (a business plan with a debt repayment schedule) that established the inability of the borrower to pay the market rate of interest. The plan was meant to be drawn up by an independent financial advisor and approved by a majority of the creditors. This was called the Debt Restructuring Plan (preferably following a Corporate Restructuring Plan). Debt Restructuring was on every banker's lips—an imported idea that stalled any compromise between lender and borrower, a one-lane road that created the biggest NPL traffic jam in history.

The concept of the Debt Restructuring Plan was the logical means of resolving the deadlock between lenders and borrowers. But it was an ambitious, far-fetched idea devised without considering the realities on the ground in Thailand. The Thai economy was afflicted way beyond the available medical capacity to treat it. There were not enough practitioners available to make Corporate Restructuring and Debt Restructuring Plans. That was not the only problem. Since banks had stopped lending money for quite some time, the cleansing of the corporate scene of nonviable companies with negative cash flows had already taken its toll. Many of these companies had disappeared and would never be restructured. The rest of the companies considered the whole concept of official debt restructuring with a public display of corporate X-rays as a conspiracy by the finance industry against them and resisted with creative delaying tactics.

Meanwhile, the Thai economy seemed to be wasting away. Foreign financial analysts kept claiming that Thailand was being kept in the slow lane by the leisurely pace of corporate debt restructuring. The Finance Ministry and the BOT were under more and more foreign pressure to do something about bank recapitalization and corporate debt restructuring. The answer to the former was to pressure the banks to recapitalize at the peril of nationalization, and the answer to the latter was to pressure the corporates to agree to restructuring at the peril of being declared bankrupt by the court. There were legal problems in achieving both these aims and the government machinery moved to address these problems. In August 1998 new regulations for recapitalizing banks were issued by the BOT. They basically allowed more flexibility to the banks in attracting capital, but they put strict guidelines and a definite time frame for the assessment and completion of the recapitalization. For the banks that could not muster the capital (or expensive convertible loans disguised as capital) within the stipulated time frame, the BOT would step in. Should the BOT be forced to step in, it would be a day of reckoning for the bank, and there would be a massive house cleaning resulting in a smaller, stronger balance sheet and, in all probability, a dismissal of errant bank executives. Bankruptcy laws, foreclosure laws, an express Bankruptcy Court along with other laws allowing for more foreign ownership of assets (what was the point of foreclosing if you could not have ownership?) were pushed through the legislative process with heated debates colored by US-model winner-take-all capitalism on one side and a mix of socialism, nationalism and every other economic and political "ism" on the other.

In September 1998 the BOT set up a committee called the Corporate Debt Restructuring Advisory Committee (CDRAC). The first job of this body was to pressure the finance industry, which was, in turn, to pressure clients to undertake debt restructuring under its auspices. Companies that failed to respond were to be sued for bankruptcy. The CDRAC process was an attempt to get banks and their clients, under BOT pressure, to sign up to a rigid six-month

timetable for a debt restructuring process outside the judicial system. The process involved an official meeting of the debtor and creditors, the appointment of a financial advisor, preferably a creditor's steering committee, a debt restructuring plan, and finally a vote of approval for the plan by the creditors. Failing this, a second plan could be presented for another vote—all this within a fixed number of days from the date of the debtor-creditor agreement. If the second plan was shot down, there was a provision for arbitration, and if that failed too, then there would no longer be any excuse not to run the company through the judicial system. The court would decide whether the company was to be rehabilitated or declared bankrupt and auctioned off piece by piece. The CDRAC process was resisted by both creditors and debtors, not so much for the fixed timetable for each part of the process itself, but for the inevitable court procedure in case that the final plan failed to win creditor approval. A bankrupt company would have been a disaster for both the creditors and the debtor, a lose-lose situation for both.

The BOT was too powerful not to win. With banks unsure about their future or how much they would need the BOT to assure that future, and with the newly conceived Bankruptcy Court sniffing for victims, no banks or borrowers were about to risk the BOT's ire. All the banks based in the country, both local and foreign, and about 360 major debtors signed up in the CDRAC's first sweep. This was followed by a second sweep of about 500 companies a few months later. Meanwhile, the economy seemed stuck to the floor, as Thailand, all battered and bruised, was slowly lifting itself up after regaining consciousness. Foreign analysts, looking disappointedly for a Korean type of economic rebound, kept on blaming the authorities about the way bank recapitalization and corporate debt restructuring was being handled. By then, the BOT had lost its nerve and just wanted to get this job over with, but nobody else seemed to be in a hurry. Plans were made, rejected and were being made all over again. Debt restructuring, even in fast-track mode, was not so simple after all.

Debt restructuring hinged on the issues and problems listed below:

1. Projected revenue growth and projected EBITDA (see [Box 2](#)) growth based on historical company data, on general economic growth forecasts and on specific industry growth forecasts. Historical company data in Thailand was not such a sure thing, and growth forecasts of particular industries, or of the overall economy for the next 10 years (in many restructurings, the forecasts had to extend to 20 years to cover debt repayments) were even less certain. The pessimists thought that real GDP growth rate for the country would not exceed 4 percent to 5 percent per year for the next 10 years, while the optimist thought that it would surely bounce back to 8 percent within 1 or 2 years. As for specific industry estimates, there seemed to be less available information, so it was anybody's guess.
2. Determining the level of sustainable debt. This was based on an interest rate level and the number of years allowed for debt repayment. Both were contentious issues. Nobody knew what interest rate to use or how many years of debt repayment was realistic. Interbank rates were at historically low levels, deposit rates were political rates (set grudgingly higher to avoid a public backlash against high bank interest rate spreads) and the Minimum Lending Rate (MLR) and the Minimum Overdraft Rate (MOR) had no basis in reality. There was no equilibrium interest rate in Thailand as a good portion of the funds were out of play and banks were not lending. Borrowers had no choice of banks to approach to refinance their loans, and were captive customers of their regular banks which charged them whatever rates they wanted. For the customers who had decided to throw in the towel, the banks had become their captive lenders and were paid whatever the borrowers wished—usually no interest. These money market conditions were not conducive to defining the equilibrium interest rate. The only real market interest rate in which borrowing and lending was done at freely negotiated rates was the interbank rate. In debt workout negotiations, borrowers liked referring to the interbank rate and the deposit rates, while lenders preferred to refer to the MLR. Since the two rates were miles apart, the drive toward a mid point was a long and tiresome affair. The borrowers had a stronger argument though. If a borrower who was classified as an NPL because he could only pay half the official MLR rate, suddenly managed to dispose off some assets and repaid his loan, the bank would be at a loss in placing these new funds profitably with any other borrower. Most credit worthy customers did not want to borrow money. The bank would have no choice but to lend into the interbank market, depressing the interbank rate even further. So an NPL borrower paying 4 percent per annum interest instead of the 9 percent per annum demanded by the bank, could, in effect, increase operational losses for the bank if he paid back his loan. (Of course, the bank could show profits by reversing the provisions for the NPL because of this borrower's sudden resurrection.) Anyway, this is only a theoretical assumption and was very unlikely to happen. For the NPL to pay back, he would have to first settle the accrued (punitive) interest overdue which would probably be much more than any assets that he owned.
3. Viability. The viability of a company was usually considered as the profitability of the company. The many ways of determining this profitability are listed below:

- A. Under normal conditions, the profits had to cover expenses, depreciation, debt servicing and taxes with something remaining for the shareholders.
 - B. The terms for post-crisis viability were understandably relaxed. Companies that were not NPLs became super-prime viable companies because they could pay all their expenses and even interest on their loans. Not being able to provide for depreciation and for loan principal repayments no longer made the companies unviable, as principal repayments could always be rescheduled.
 - C. Companies that could not cover even their operational costs were certainly not viable. They either had to reduce costs or go out of business. However, just reducing some costs to remain in business was not the same thing as being viable if they could not afford to pay any interest at all. But many companies thought that they could suddenly become viable again by becoming NPLs and by stopping interest payments completely—except that the banks did not agree on this definition of viability.
 - D. A compromise definition of viability became available—a debt restructuring to restore viability. Of course, the condition was that the company had to have a positive future cash stream that it was prepared to divert to its lenders. The cash flow, when discounted to its net present value, had to exceed what the creditors would recover in a liquidation of the company. That would make the option of liquidation less attractive than waiting it out for the company to deliver its projected cash flows. It also demanded a new appraisal of the company to determine its liquidation value (after allowing for employee retrenchment costs), and more importantly, it required that the loan be brought down to a level that reflected this revised viability.
4. Liquidation analysis. When creditors kept threatening to bankrupt the company, it was finally the liquidation analysis that knocked some sense into them. This analysis usually showed a value much lower than what the creditors, and certainly less than what the owners thought they were worth as a gone concern (as opposed to a going concern). Appraisal companies tended to be a little more careful when they worked out the liquidation analysis of a company because for once, their valuation skills could be put to a quick test if the debt workout failed. Asset appraisals for loans, on the other hand, were seldom tested immediately—normally it would take a few years for a loan to go bad, and by then the asset valuation would be out of date.
 5. Discount Rate. If banks could not decide the current interest rate that was staring them in the face, what chance was there of their making a forecast of what interest rates would be in the next 10 years or 20 years. But when loans were to be paid back over a 10 year or 20 year period, then it would have been useful to have been able to predict interest rates in the future as a basis (though it needs not have been the only basis) for determining the discount rate. This was the rate at which all the future cash flows were to be discounted to determine the Net Present Value of those flows for comparison with the Liquidation Value. No two banks worked on the same discount rate and this complicated debt restructuring.
 6. Hair cut. The main reason that analysts kept harping that bank recapitalization was the necessary condition for corporate debt restructuring was that bald men do not take kindly to haircuts. Recapitalizing on the grand scale that was required by the banking industry was a cat and mouse game. As banks recapitalized, good loans kept pace by becoming sour, necessitating further recapitalization. The chase has not ended by far. A recent Standard and Poor's (S&P) report showed a worst case requirement for an additional US\$30 billion besides the fancy hybrid equity issues which they thought tilted more toward debt than equity. In the aftermath of the crisis, foreign banks lost confidence fast and wanted a quick exit. They were prepared to offer substantial discounts (up to 75% of principal for unsecured loans) if they could be paid within a short period. Thai banks and finance companies were not so well endowed or so hopelessly dispirited as to offer such major write-offs. Of course, they too acknowledged the depth of the recession and were prepared to accept sub-market rates of interest for a few years, as long as they could collect the principal over the long run (sometimes stretching to 20 years, which was how long, in many cases, it would have taken to make full repayments of loans plus subsidized interest based on very optimistic EBITDA forecasts).
 7. Creditor's Steering Committee Meetings, General Creditors' Meetings and a Creditors' vote for a restructuring plan. All these were necessary parts of the restructuring process and the number of these were in direct proportion to the time taken for any decision. As the number of restructuring cases has now exceeded the collective executive decision taking capacity of the whole banking industry, it seems that an amnesty for delinquent borrowers and another one for poor banking decisions may have to be considered if we want to move at foreign analyst-approved speed.

THE THAI ECONOMY: NPLS TO THE RESCUE

So the economy, for all intents and purposes is doomed. The banking sector is crippled, dysfunctional and largely irrelevant to the economy. Half the loans are in arrears. Surely the other half must mainly consist of loans other than corporate term loans (short term working capital loans, interbank and inter-finance loans, housing loans, auto-loans for cars that escaped repossession etc.). Interest rates are more strategic, defensive and political than market driven and, as a result, are as widely divergent as each bank's need or strategy. Productive capacity is running at about 60 percent, which is 25 percent less than normal utilization. Analysts say the economy cannot improve unless the banking sector is sorted out. Only then, they contend, can the corporate sector revive. Private investment, that used to be the engine of this economy, is still dropping but at a slower pace—again supposedly awaiting the recovery of the corporate sector.

But yet, surprisingly, this economy is moving, and slowly picking up speed. The facts do not seem to add up. The facts show that we should be trapped in the swamp for years. It was not the Miyazawa Fund¹ or the reduction of VAT that roused the economy from its stupor, even though they did help to stop the continuous decline. Nevertheless, something is moving this economy. Amazingly, it is a combination of corporate sector recovery (despite the financial sector) and the carnage in the domestic market (still depressed by the real estate sector) pushing the country inevitably toward an export-led recovery. The newspaper *Business Day* (5 November, 1999) carried a caption: "World Bank: Recovery at Risk on Account of Bad Loans." It seems the World Bank hit the nail on the thumb. Ouch! The real risk is poor restructuring of the bad loans while the banking sector is not functioning and acting merely as a vacuum cleaner for funds required to keep the economy ticking.

The corporate sector now consists of two parts, the performers and the NPLs. The latter have won a reprieve from heavy interest payments and are, presently, (for the most part) cash positive. They are, today, as capable as the former in performing a function for the economy. Suddenly, we seem to have a stronger corporate sector (somewhat at the expense of the banks and finance companies) that is capable of turning this economy around without any additional financial help. Economically, for the NPLs, it may be a short term pilferage of viability—but then, if the NPLs were non functional, this turnaround could never have happened. If the NPLs had not applied the corporate equivalent of Mahathir-style currency controls when the withdrawals of funds threatened their survival, today there would only be half a corporate sector left. Could half a corporate sector have brought life back to the economy, even if the banking sector was still healthy—and besides, why even contemplate the existence of a banking sector if half the corporate sector has disappeared? Could the country have survived the massive blockage that banks created in its financial artery if the NPLs had not bypassed it to keep the blood flowing through the economy?

The NPLs may be overdue on interest but they still pay wages, buy raw materials and export products. As far as the economy is concerned, the NPLs are now performing companies that have not yet resumed interest payments. And they play nearly as important a part in the economy as do the companies that have managed to maintain interest payments. In fact, the interest not paid to the banks can be considered as the required impetus for the economy and its multiplier effect is even greater than that of the Miyazawa Fund. Any money moving from the real economy into the financial sector is now totally sucked out of the available money supply by a factor of the multiplier because banks are not re-lending. On the other hand, money retained by the corporate sector, NPLs or not, are moving the economy, albeit with a slower velocity than before the crisis. Even a low 2 percent interest rate on 2.7 trillion baht of NPLs (if we assume that 2% is all that they can afford to pay) will yield an amount equivalent to the Miyazawa Fund within one year—and it is certainly money more usefully spent in keeping private companies alive. If these companies failed, the economy would demand many more handouts to keep it twitching—fiscal plans that would be unsustainable if the performing companies could not fill the vacuum left by the failed NPLs. You cannot create a replacement entrepreneurial class overnight.

So what will happen if the NPLs are restructured. Bank recapitalization makes sense, not because by doing so they will be able to afford generous hair cuts and lower interest rates on restructured loans, but in order to equip them with the incentive to re-lend the money that they will have collected as interest. If the re-lending does not occur, recapitalizing of banks and restructuring of corporate loans will not help. Rather, it will hinder the turn around of the economy and disturb the already fragile *status quo*. If the interest payments are not reinvested, then the NPLs, un-restructured as they are today, remain in a better position to move the economy than the banks are. After restructuring, the NPLs will have their wings clipped, and it will then be the banks' responsibility to push economic growth.

Successful restructuring should result in strong balance sheets. This can only happen if banks stop the denial and accept losses. Owners must, in return, be prepared to disclose all relevant information for the banks to allow them to take correct decisions with regards to their companies. Audit committees would not be out of place as a confidence measure for the creditors and as compensation for the reduction in loan principal and interest. Debt-equity swaps are a

possibility for listed companies, and better than a complete write-off. For non-listed companies, prompt loan and interest repayments over the rescheduled and restructured payment lifetime should be a condition for waiving the unsustainable part of the debt. Interest rates must be a realistic compromise between the lenders and the borrowers while there is no real market rate on which to base it.

With strong balance sheets, companies can grow again, and along with them, the economy should be able to grow too. However, there is still a lot of opportunity for the authorities to derail the nascent recovery. Besides badly restructured loans, ill conceived plans to expel cheap (competitive) foreign labor rather than to regulate it, allowing the baht to strengthen relative to the Indonesian rupiah, the Philippine peso or the Singapore dollar (never mind the US. dollar), there are plenty of other possibilities for the authorities to throw a spanner in the works.

Analysts are waiting for a dramatic rebound and if we touch 8 percent GDP growth again next year, imports could shoot up even more and the current account surplus could disappear. Inflation could rear its head again, the real estate sector could splutter into life, labor shortages could become evident again, while more tax collection should contain the fiscal deficit—all familiar pre-crisis symptoms and everything required by the rating agencies to upgrade Thailand's sovereign ratings. Rating agencies follow bubbles closely. The ratings go up when the bubble increases and promptly readjust downward after it bursts. After that, the agencies want an assurance that the bubble is well in place again before they make a new upward reassessment. There is little danger of another bubble occurring so soon after the last one because the climate of doubt still hangs over borrower and lender, both of whom have lost their nerve and appetite for debt. For the long term, hopefully, some lessons will have been learnt from the last crisis, but you can never say. We learn from history that we do not learn from history.

EPILOGUE:

A DEVIL'S DICTIONARY OF FINANCIAL TERMS

arbitrage: Smart dealers of stocks or foreign currencies can find price discrepancies and make money by making nearly simultaneous purchases and sales to take advantage of these tiny price gaps before they get bridged by other dealers. The interest difference on baht loans and dollar loans was not a tiny gap—it was a gaping hole and banks, finance companies and corporates could not resist trying to make money on the difference. Of course, it was not strictly arbitrage because the profit could only be made if they left themselves exposed. But then again, it could have been considered as arbitrage if the baht was meant to be practically pegged to the dollar and the BOT (with the help of the prime minister at the time) was guaranteeing that peg with frequent pronouncements. Even banks that had actually engaged in riskless arbitrage found out after the peg broke that it took two to tango, and the arbitrage was only as good as the counterparty. The lesson: stick to horse racing. It is more fun and your chances of making money are as slim.

asset growth: Since the flow of money from abroad was multiplying every month during the bubble, there was a great opportunity for banks and finance companies to grow. The banks and finance companies coped with the increase in the supply of funds by setting high lending targets (asset growth) of about 20 percent per year. The marketing departments of the financial institutions were the heroes who had to achieve this growth and the credit departments (whose job was to ensure quality growth) eclipsed into the background as sore losers in the race to the top of the corporate ladder. You could not grow at 20 percent per year if you were going to listen to a wise credit guy who knew all the facts—he would stop every move you made.

collateral: Experienced bankers knew that to trust a client's cash flow projections was immature. The smaller companies did not have a clue about projections and the big companies were far too smart not to get the projections perfect. So bankers preferred collateral lending i.e., using the borrower's property as security for loans. Collateral in the order of the bankers' preference was usually (a) land (b) buildings and (c) plant and machinery. Cash flow projections may have been unreliable but nobody predicted a total collapse of the real estate market, which made collateral lending almost like a commitment by the banks to buy every empty building in Bangkok.

debt-equity ratio: When a banker wanted to calculate how much money you, as the borrower, were prepared to lose on your risky project, before they would have to start losing on it, they would work out the debt:equity ratio of the project. There was no hard or fast rule as to what the ratio should be. The ratio rule could be relaxed for very credit worthy borrowers, especially if they were prepared to tender personal guarantees or cross company guarantees. Banks have always given debt-equity ratios more importance than they deserved. If they were so crucial to financial health, then adherence to BIS ratios should have shielded the financial sector from the currency crisis. This just goes to prove that it is not what equity you have that counts. It is what you do with the equity that you have. The baht crisis has shown that for a business, there is really only one safe debt:equity ratio—and that is 0:1

good corporate governance and international best practices: Other terms that have surfaced, quite often in discussions about the reasons for our famous meltdown. These, or actually, the lack of these, are supposed to be the primary reason for the crisis. The terms apply to both the lenders and the borrowers. Preaching about good corporate governance and about international best practices is normally done by auditing companies, consultants and foreign banks who have not lost money in Asia. Foreign banks that have lost money here will not admit to being guilty, and will usually shift the blame to the corporates and complain about their “lack of transparency.” It is surprising that foreign banks which had been doing a thriving business and making money in Asia for umpteen years suddenly realized that companies were less than transparent. If they had had their glasses on, they could not possibly have failed to notice the very transparent fact there was lack of transparency everywhere.

hedging: Gambling in reverse. To reduce their forex exposure, prudent borrowers supposedly were meant to buy currency insurance. This was done by buying foreign currency for delivery some time in the future. The trouble with this kind of insurance is that the premium is only low when you do not think you need it, but when you suddenly feel an urgent need for it, you realize that the whole country has the same compelling need, by which time it is too expensive to insure. Many borrowers remembered that in the last devaluation, the baht plummeted from 23 to the dollar to 27 to the dollar before slowly climbing back to 25, and they thought they knew everything there was to know about devaluations. Exporters thought they had a natural hedge because of their dollar income stream. The hedge turned out to be as effective as a garden hedge that is supposed to stop floodwaters from destroying the garden. The lesson from the currency crisis is that a natural hedge means not borrowing in foreign currencies.

moral hazard: A term which has become very popular ever since the Asian financial meltdown. It refers to the circumstances which have propelled what is now seen as reckless lending. Central bank support for commercial banks was supposed to give them enough comfort and back-up to embark on risky lending ventures with juicy interest rate spreads. Central banks, supposedly, in turn, were obliviously content to let the commercial banks continue their joy ride with the comfort of knowing that Daddy IMF was always there to bail them out when the going got too rough. But that is a rather simplistic view of the situation. Bankers may have been reckless, but they were not so hell-bent on self-destruction as it appeared at the time of the events. With the wisdom of hindsight, it is easier to pass authoritative judgments about what lending was unwise. The real problem was that the foreign money deluge had blown aggregate lending beyond the country's capacity to offer viable projects to absorb those funds. So the funds homed in on marginal projects. The moral hazard was that losses in any one project were financed by funds drawn down for the next project or for some other purpose—and the funds kept on coming. The finance industry was so busy stuffing money down clients' throats that they failed to notice that many of them had long stopped breathing.

short term loan: Any loans that were repaid were a nuisance for the banks. It made it more difficult for them to meet the lending target. So a manufacturer who made a timely repayment of his machinery loan on the date due would be asked by the bank if he needed more working capital. The bank, if pressured enough, was suddenly able to advance the working capital without the machinery as collateral. A string of short term loans, one following another, becomes a long term loan. Overdrafts, which are supposed to be temporary facilities, and availed of only in case of unexpected cash flow hitches, became permanent loans requiring no repayment at all. If not for the annual agreement-signing ritual, the borrower might well have forgotten that the money belonged to the bank. In the boom years there were only two kinds of loans:

1. Long term loans
2. Long term loans that were called Short term loans or Overdrafts