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Financial institutions have to fight on all fronts under the IMF programme, but the government's capital-support scheme will partly reduce their burden, the SCB Research Institute comments.

With the Siam Commercial Bank (SCB) in the limelight after a successful recapitalisation which has marked the largest recap in the non-Japan market, it is worth looking at the details of the Aug 14 measures.

To help increase the viability of Thai financial institutions, the government announced the restructuring package on Aug 14, 1998, to extend tier-1 and tier-2 capital support on the realisation that to revive the economy the banking system must be strengthened and be able to lend to the real sector.

So far rising non-performing loans (NPLs) and heavy loan provisions have been obstacles to commercial banks' credit expansion as provisions have led to operating losses and a decline in capital. Moreover, under the current economic recession, it is a tough condition for the commercial banks to raise capital through new investors.

Any institution applying for tier-1 capital support must adopt up front the end-2000 provisioning rules and seek private capital equivalent to or higher than the government's assistance. The injection will be in the form of tradeable government bonds carrying market-related interest rates. The institution will issue preferred shares which do not have a redemption period and dividend-accumulation feature to the government, and the latter reserves the right to convert the stocks into common shares at any times.

During the fourth to sixth years of the scheme, the government will set the appropriate selling prices of the shares in hand related to the market prices of the institution's common shares. The government will give priority to participating private investors to buy these shares.

In the case of tier-2 recapitalisation, the government will support banks in raising the capital in the form of a matching fund by buying banks' subordinated debentures, and it may convert subordinated debentures into shares for tier-1 capital if the institution's tier-1 capital is below the 4.25-per-cent requirement. The supporting amount will depend on capital write-down resulting from corporate debt restructuring exceeding previous provisioning and net increase in lending to both restructured and new corporations.

The injection will decline over time to encourage early debt restructuring and accelerate new net lending to the private sector. In all, each institution will receive less than 2 per cent of risk assets. The government will issue 10-year non-tradable bonds to pay for the subordinated debentures, which carry one percentage point higher than on government bonds.

The Aug 14 measures benefit only banks which are unable to raise capital by themselves.

The measures will help attract investors to banks which have severe problems in raising capital. The eligible banks must have below-par net share value after full provisioning up front. This will allow the government to buy the shares not higher than the adjusted book value per share.

It will also help banks which have no problem in raising capital. The entire capital of the bank may come from private investors or one-half from the government. The government does not have to be the sole contributor of capital.

Banks without problems will benefit by raising only half the capital needed with the other half obtained from the government. For example, if the total capital needed is Bt30 billion, the bank has to raise only Bt15 billion from private investors, and the other Bt15 billion will be contributed by the government. Private investors may benefit more by buying the shares back from the government. Based on the Bt10 book value, they will benefit from higher

share prices if the bank's financial condition improves. They can buy the shares within the first three years at the book value plus 5 per cent annual interest.

It is clear that the government provides the capital support schemes without seeking profit. This implies that the government is confident that the banks under the schemes will survive. As a result, the schemes will boost investors' confidence instead of waiting longer for the economy to recover or for banks to realise profit. If all banks succeed in the recapitalisation, they will definitely resume lending to stimulate the real sector of the economy. If the recapitalisation process is delayed, stimulation of the real sector will be postponed too. That is because other efforts initiated through the government's special financial institutions, i.e. the Government Savings Bank, have not shown any significant progress yet. Under the alternative of letting the banks be taken over by foreigners, foreign owners might not cooperate in boosting the country's real sector. Thus the government has paved the way for bank recapitalisation in exchange for a say in management conditions as deemed necessary.

To ensure that the capital injection will be productive, the government reserves the right to manage banks with poor management. Besides, banks under the capital-support schemes will enjoy a lower cost of capital than by recapitalisation by themselves. Those joining the tier-1 capital-support scheme will issue preferred stock with no obligation to pay dividends in the event of operating losses. This differs from capital raised by issuing Stapled Limited Interest Preferred Structures (Slips) and Capital Augmented Preferred Structures (Caps), which provide high-interest returns (at least equivalent to the rate of interest on subordinated shares).

However, the government is exposed to the risk inherent in holding preferred shares if financial institutions operating with losses are unable to pay dividends in the future. The risk will depend on the length of time required for the economy to recover. Assuming no adverse developments take place, it is possible that the economy will recover within the period of such schemes.

"Recapitalisation to stimulate the economy" is the major essence of the Aug 14 measures. It reflects the government's intention to support bank capitalisation to expedite the restructuring process in the financial sector and the recovery of the economy. The concept is profound, based on sound principles and politically sensible. No one stands to gain at anyone else's expense. Moreover it has principles and political reasons. Furthermore, similar measures have also been implemented in Japan, where financial difficulties were been in the making even before Thailand's crisis took The tier-2 capital can be regarded as a reward for every bank trying to extend loans and/or to restructure debts with the business sector. (The government will contribute funds accounting for 20 per cent of new loans, or 100 per cent of the total loss from debt restructuring exceeding provisioning.)

If all the commercial banks cooperate in raising capital adequately and resume lending to the business sector, the banking system will serve as a vital mechanism to drive the economy towards a recovery. If the commercial banks do not expedite their raising of capital as soon as possible, the whole banking system will shrink, impede rapid economic recovery and at the same time incur great time loss and opportunity costs to society at large.

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