EliScholar – A Digital Platform for Scholarly Publishing at Yale

YPFS Resource Library

2000

Towards a Sustainable Banking Sector-Malaysia

Soo-Nam Oh

https://elischolar.library.yale.edu/ypfs-documents/14388

This resource is brought to you for free and open access by the Yale Program on Financial Stability and EliScholar, a digital platform for scholarly publishing provided by Yale University Library.
For more information, please contact ypfs@yale.edu.

Towards a Sustainable Banking Sector—Malaysia

Soo-Nam Oh

Soo-Nam Oh is Economist at the Asian Development Bank. The author gratefully acknowledges the help of Ramesh Subramaniam and Peggy Speck who contributed inputs to this report.

Executive Summary

The Malaysian banking sector has played a leading role in indirect financing, while experiencing problems similar to those of other Asian countries suffering from the financial crisis. The direct reasons for the problems include a downturn of the economy and collapse of the property and stock markets. However, more fundamental reasons are state-directed loan policies, lack of competition, and lack of prudential regulations.

Recently, Bank Negara Malaysia (BNM) moved to improve the soundness of banking institutions (BIs). Each measure falls roughly into one of three categories:

- improvement in credit allocation,
- strengthening of prudential regulations, and
- resolution of nonperforming loans (NPLs) and recapitalization and consolidation of the banking sector.

As the crisis escalated and began to infect the economy, BNM relaxed monetary policy on 27 August 1998. On 1 September 1998, the authorities announced capital control measures with two primary objectives:

- elimination of speculative flows, and
- allowance of a progressive reduction in interest rates.

BNM took additional banking measures to promote economic recovery on 23 September 1998.

The Malaysian banking sector was fairly healthy at the onset of the regional financial turmoil. However, finance companies have been particularly overexposed to broad property and consumption credit. Banks have also overextended themselves to politically well-connected corporate entities backed by volatile assets in the form of shares and real estate. The share of substandard loans in NPLs for these financial institutions has risen, with the increase for finance companies and merchant banks substantial compared to that for commercial banks.

One of the crucial indicators of asset quality is collateral exposure, and it is likely that the collateral position has also significantly deteriorated. On the other hand, a tight monetary policy has had an adverse effect on credit generation. There are two steps in resolving the NPL problems faced by the banking system:

- recovery of assets behind the NPLs, and
- recapitalization if some or all of the capital and reserves are wiped out due to deteriorating asset quality.

The Government has taken the right steps by establishing asset management company Pendurusan Danaharta Nasional Berhad (Danaharta) and special purpose vehicle Danamodal Nasional Berhad (Danamodal) to deal with NPLs and recapitalization. However, the financing arrangements for these agencies are still being finalized. In this regard, recourse to BNM financing or lending to insolvent banks should be avoided. The Government should draft a comprehensive recapitalization plan, which should include provisions for direct Government equity participation in the short run, if necessary. Any such intervention should be financed through the issuance of Government bonds. At a more fundamental level, free entry and firm exit policies are essential in solving these problems. Danaharta has to function independently without any Government interference. And it should not take an unduly long time to maximize the value of the assets purchased while in the process holding on to those assets until the domestic economy revives, given the slow process of liberalization to allow entry of foreign investors. Also, the pricing of NPLs should be based on a transparent rule.

In response to the financial crisis, many policy measures were taken to limit the amount of credit to the more volatile sectors of the economy, to moderate continued high credit growth, to put in place more stringent prudential requirements, and to enhance financial disclosure by financial institutions. In particular, stringent prudential measures were imposed to foster quicker recognition of asset quality problems, and to allow for appropriate and timely actions to be taken by bank managements.

Regarding the five core principles for credit risk management, BNM has a well-developed program

for compliance with all but country/transfer risk management. Potential areas of concern that banks could address with regard to country/transfer risk include: to assess the nature of the risks for individual countries, to have systems in place to measure the various types of exposures, and to have a mechanism for establishing and reviewing country limits with the flexibility to incorporate rapidly changing conditions.

BNM remains informed about key developments in the financial sector. Its supervisory functions are well established. However, given the adverse economic circumstances, BNM should continue to accelerate the on-site examination schedule to verify the quality of assets and overall soundness of Malaysian BIs.

Other major policy recommendations are as follows:

- policy loans and commitments need to be transferred to the Government budget, to resolve any political problems. This will also help BIs to recover their screening and monitoring functions;
- there must be greater disclosure of the shortfalls between the collateral values and the loans for share purchases;
- the legal framework must be strengthened in line with international best practices;
- a prudential limit such as the single party ceiling has to be rationalized with the prevention of circumvention in mind;
- a good fraction of the nonresident component of the Labuan loans seemed to go to Malaysian companies investing abroad, but such loans do not come under the purview of BNM. The scale of dollar denominated lending undertaken by Malaysian banks based in Labuan needs to be disclosed;
- given the rapid changes in asset quality, details of NPLs and collateral exposure must be made publicly available;
- the Government should set up a concrete plan of when and how to open the financial markets;
- in order to ensure transparent policy decisions, the Central Bank of Malaysia Act needs to be revised to clarify the composition of the Board of Directors. And BNM needs to disclose the minutes of the decision of the highest policy making body;
- BNM supervises insurance companies according to the Central Bank of Malaysia Act. An independent supervisory agency for insurance companies should be established;
- regarding a credit crunch, more fundamental and contingency plans have to be considered together;
- the amount of the principal and accrued interests completely insured by the Government needs to be reduced;
- more efforts should be directed to financial innovations. Country specifics including the tradition of Islamic banking and the Bumiputra policy could be utilized for inventing new financial products; and
- apart from deposits, BIs' bond issuance should be examined to encourage savings mobilization by satisfying the customer's preference and to diversify the sources of funds. BIs can invent good saving instruments, providing greater variety and profits to depositors, by linking commercial banking business with securities business.

Overview of the Banking Sector[1]

The financial crisis in Asia has shown that a robust financial system is one of the key components of economic progress. Without it, misallocation of investments could seriously disrupt development. This study provides a closer look at the Malaysian banking system with a view to analyzing and deepening understanding of the causes of the currency and financial crisis and recommending suitable preventive measures.

The Malaysian banking system comprises monetary and nonmonetary institutions. The monetary institutions are the central bank, Bank Negara Malaysia (BNM), and the commercial banks (including Bank Islam). The nonmonetary institutions fall into

two groups. The first group is supervised by BNM: finance companies, merchant banks, discount houses, foreign banks representative offices, and offshore banks in the International Offshore Financial Centre in Labuan. The second group under supervision of various government departments and agencies includes development finance institutions, savings institutions, provident and pension funds, insurance companies, and other financial intermediaries. The insurance industry was brought under the supervision of BNM from 1 May 1988.

As of the end of 1997, the licensed banking system consists of 35 commercial banks, of which 22 are domestic banks and 13 are foreign-controlled (or 44 percent of total financial system assets), 39 finance companies (14 percent), 12 merchant banks (4 percent), 7 discount houses (2 percent), and money and exchange brokers (Appendix 1 and Table A2.1). Among these banking institutions (BIs), only commercial banks can accept demand deposits from the public or engage in foreign exchange operations. Hire-purchase lending is the exclusive business of the finance companies and constitutes their main line of business; while merchant banks concentrate on investment banking.

BIs are closely connected through subsidiaries or parent company relationships. Several banks are subsidiaries of corporate conglomerates, while numerous finance companies and merchant banks are subsidiaries of commercial banks. In addition, some financial groups have securities trading subsidiaries and branches in offshore Labuan. Government and other public sector involvement in the banking sector is high—the Government owns Bank Bumiputra, the second largest commercial bank, and through an investment trust holds a controlling stake in Maybank, the largest commercial bank, among others.

Banks play a leading role in indirect financing. Their share measured by M2/M3 is about 75 percent, which is high compared with other countries (e.g., 30 percent in Korea). This simple ratio has two implications. First, BNM could control monetary targets relatively easily and implement effective monetary policy. Second, the development of the banking sector has been heavily dependent on BNM's policies. In terms of growth, total assets of BIs have grown 3.8 times on average in the period 1990–1997, equivalent to 2.4 times the nominal gross domestic product (GDP).

Among the 35 commercial banks operating in the country as of the end of July 1997, the total number of branch offices of domestic banks was 1,480 and that of foreign-controlled banks was 144. As of the end of 1997, 10 commercial banks have been accorded tier-1 status and allowed to undertake a number of activities subject to prudential limits and conditions determined by BNM. These activities include issuing negotiable instruments of deposit (NIDs) up to five times their capital funds, participating in equity derivatives, undertaking securities borrowing and lending activities subject to Securities Commission approvals, and expanding their operations through setting up of branch offices, representative offices, subsidiaries, or on a joint venture basis (Appendix 3).

BIs have shown remarkable growth (Table 1), but in common with banks of other Asian countries suffering in the financial crisis, there has been a surge in nonperforming loans (NPLs) (Table 2). As of the end of May 1998, the ratio of NPLs to total loans was 8.5 percent. Direct reasons for the NPLs include downturn of the economy and collapse of property and stock markets. But more fundamental reasons for the large NPLs are state-directed loan policies, lack of competition, and lack of prudential regulations.

However, the authorities have not been completely complacent. For example, in the Seventh Plan for 1996–2000 prepared in 1996, it was emphasized that the financial sector had to be further strengthened and modernized to provide new instruments of funding and promote savings.[2] Confronting increasing globalization, the future operating environment for the banking industry was expected to be more dynamic and competitive. So BIs were encouraged to increase their competitiveness by enhancing operational effi-

Table 1: Total Assets, Deposits, and Loans of the Banking System

Financial Institution	Total Assets 1985	Total Assets 1990	Total Assets 1997	Total Deposits + NIDs (A) 1985	Total Deposits + NIDs (A) 1990	Total Deposits + NIDs (A) 1997	Loans and Advances (B) 1985	Loans and Advances (B) 1990	Loans and Advances (B) 1997	Loans-Deposits Ratio (B/A) 1985	Loans-Deposits Ratio (B/A) 1990	Loans-Deposits Ratio (B/A) 1997
	Amount (RM million)											
Commercial Banks	74,233	129,285	481,114	47,994	74,272	283,472	48,982	80,758	276,111	1.02	1.09	0.97
Financial Companies	17,833	39,448	152,404	14,541	28,437	79,661	12,327	27,023	102,546	0.85	0.95	1.29
Merchant Banks	6,296	11,063	44,329	4,569	5,709	22,346	4,489	6,252	23,052	0.98	1.10	1.03
Total	**98,362**	**179,796**	**677,847**	**67,104**	**108,418**	**385,479**	**65,798**	**114,033**	**401,709**	**0.98**	**1.05**	**1.04**
	Percent share											
Commercial Banks	75.5	71.9	71.0	71.5	68.5	73.5	74.4	70.8	68.7			
Financial Companies	18.1	21.9	22.5	21.7	26.2	20.7	18.7	23.7	25.5			
Merchant Banks	6.4	6.2	6.5	6.8	5.3	5.8	6.8	5.5	5.7			
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**			

NID = negotiable instrument of deposit.
Source: Bank Negara Malaysia, *Monthly Bulletin,* various issues.

Table 2: Performance of the Banking System, 1990–1997

Item	1990	1991	1992	1993	1994	1995	1996	1997
	Amount (RM million)							
Net Interest Income	4,115	4,832	5,658	6,973	8,868	10,392	13,389	16,637
Pretax Profit	1,985	2,271	2,657	3,788	5,205	6,869	8,721	7,949
	Percent							
Return on Assets	1.4	1.3	1.3	1.5	1.7	1.9	2.0	1.3
Return on Equity	21.5	17.6	16.8	20.2	24.2	26.2	27.5	19.0
Specific Provision/Total Loans	5.3	3.6	3.4	3.2	2.2	1.6	1.0	1.0
General Provision/Total Loans	0.7	0.9	1.1	1.3	1.6	1.6	1.9	2.0
Nonperforming Loans/Total Loans	20.3	15.6	14.9	12.6	8.1	5.5	3.9	5.7

Source: Bank Negara Malaysia.

ciency and being more innovative in developing competitively priced financial products. The need to serve the increasingly diverse and sophisticated needs of consumers and businesses was also realized.

In an effort to contain the impact of the Asian financial crisis, the main focus of recent financial policy has been on improving the soundness of the financial system through strengthening preemptive and prudential regulations. The Government has not sought rescue funds from international financial institutions, and therefore has not come under direct pressure to implement specific economic reforms. But since early 1997, BNM has taken a series of measures to help strengthen prudential regulation and transparency. Basically in line with International Monetary Fund (IMF) packages forced on Indonesia, Korea, and Thailand, the measures concern NPL classification and provisioning standards, capital adequacy ratio (CAR), lending to the property sector and for the purchase of stocks and shares, single customer limits, disclosure and monitoring, and establishment of asset management company (Appendix 5). These measures, on the one hand, have greatly contributed to stabilizing financial markets. On the other hand, they brought about an extremely passive attitude to the management of banking.

Such a financial policy may cut the long-term profits of the BIs. The authorities need to insert dynamics into the financial market by promoting local as well as global competition. In parallel with strengthening of the prudential regulations, it is necessary to pursue deregulation and liberalization.

Recent Developments in the Banking Sector

Initial Impact of the Asian Financial Crisis on the Banking Sector

Until the onset of the Asian crisis, Malaysia's banks were regarded as having a well-developed supervisory and regulatory framework. As a result, NPLs remained at only 4 percent of the total loans at the end of 1996. However, rapid credit expansion (particularly by smaller tier-2 financial institutions) to the property sector and to the stock market, as well as consumer lending at fixed interest rates by finance companies, has placed Malaysia's financial system at considerable risk from deflation in property and other asset markets. As the crisis has evolved, more problems of the weak banking system have been exposed. The economy had more domestic debts than other economies in Southeast Asia, reaching about 170 percent as a proportion of GDP. It was expected that the soundness of the financial institutions could deteriorate quickly in the event of a slow recovery in the real estate sector.

As the property bubble burst, shares fell, and loans to borrowers in Thailand and Indonesia turned bad, market concerns about vulnerability in the financial system grew during the second half of 1997. Towards the end of the year, there were signs of a shift in deposits from domestic financial institutions to foreign banks, and from smaller to larger financial institutions. Against this background, BNM extended significant liquidity support to affected institutions—primarily tier-2 commercial banks and finance companies—and announced in January 1998 that all depositors would be guaranteed. The authorities also tightened provisioning and disclosure standards and put forward a merger plan for finance companies by end-March 1998.

Reflecting a worsening situation in banks, in February 1998 the authorities announced that five institutions (two banks and three finance companies) were in need of recapitalization, based on their position at end-1997. On 3 March 1998, BNM revealed that Sime Bank, the country's sixth largest, had lost RM1.6 billion ($420 million) in the second half of the previous year and would need $320 million in new capital. It also disclosed that Bank Bumiputra, the second largest, could need $200 million in new capital, and that two small finance companies were in difficulties.

Financial Policy Responses to the Crisis

The ultimate goal of measures taken by BNM has been to improve the competitiveness of banks, thus setting up a market-driven order rather than the old regulation-driven order. This has been pursued in three categories:

- improvement in credit allocation,
- strengthening of prudential regulations, and
- resolution of NPLs and recapitalization and consolidation of the banking sector.

IMPROVEMENT IN CREDIT ALLOCATION

Strong monetary expansion was a concern during 1997 because of the need to contain inflationary pressures. Increased access to bank financing could contribute to further price rises, fueling concerns about asset inflation and its potential destabilizing effects on the economy.

Hence, in April 1997, BNM limited the banking system's exposure to the broad property sector[3] at 20 percent of outstanding loans and to institutional and individual purchases of stocks and shares at 15 percent (30 percent in the case of merchant banks). Also, financing of second houses was reduced to 60 percent of the property value and a levy of RM100,000 was imposed on real estate purchases by foreigners.

In aggregate terms, an indicative target was set for growth in M2 at 25 percent by end-1997, 20 percent by end-March 1998, and 15 percent by end-1998, as given in the Credit Plan of October 1997.

However, commercial banks continued to provide credit to the priority sectors of the economy, namely, the Bumiputra Business Community, housing, and to small-scale enterprises under the New Principal Guarantee Scheme (NPGS) of the Credit Guarantee Corporation (CGC).

STRENGTHENING OF PRUDENTIAL REGULATION AND SUPERVISION

Among the controls on BIs that BNM strengthened, most notable are greater transparency in monetary operations, the increased requirements for CARs, and stringent new mandatory provisions for "substandard" loans. BNM promised much more transparency in monetary policy, with daily statements and better accounting between support operations for distressed banks and day-to-day monetary management. It also reduced the time lag in the release of data and analysis of monetary trends from six to four weeks, and launched a home page on the Internet containing up-to-date information on economic and financial developments. On the other hand, BNM requested all financial institutions to disclose quarterly data on NPLs and capital adequacy ratios.

With effect from financial year beginning January 1998, the classification of NPLs and suspension of interest in NPLs were tightened. Through this, the arrears period for classifying a loan as nonperforming was reduced from six months to three months. At the same time, the minimum requirement for general provision for bad and doubtful debts has been raised from 1 to 1.5 percent.

To regain market confidence, on 24 March 1998 the authorities announced that the Employees Provident Fund (EPF), the Permodalan Nasional Berhad (PNB) (a large unit trust fund), and other quasipublic financial institutions could take an interest in BIs, but only if they would maximize value for their shareholders. They added that the Government would be responsible only for injections of capital in Government-owned BIs. Earlier, in January 1998, BNM reaffirmed that the Government would protect the principal and accrued interest of deposits.

RESOLUTION OF NONPERFORMING LOANS, AND RECAPITALIZATION AND CONSOLIDATION OF THE BANKING SECTOR

The Government on 16 July 1998 passed the Pengurusan Danaharta Berhad Bill to pave the way for the establishment of a national asset management company, Danaharta, to acquire NPLs and maximize their recovery value. Four days later, Danaharta was incorporated with a paid-up capital of RM250 million. It will help BIs focus on giving out loans to viable businesses by taking care of NPLs. It is likely to raise about RM25 billion through Government-guaranteed bonds on the domestic and international markets, especially in the United States (US).[4] This would enable the agency to purchase the assets behind almost all the NPLs in the system (about RM42 billion), assuming a discount factor of about 40 percent.

Danaharta plans to complete its work within 5 to 10 years. In the first stage, its acquisition process addressed the secure NPLs and those in sectors considered strategic to the nation, such as manufacturing and infrastructure. This stage was scheduled to be completed by the end of March 1999. The second stage involved acquisition of unsecured loans, while the third covered more complicated facilities such as foreign currency loans and guaranteed facilities. To give transparency to the takeover process, an oversight committee was to be set up, consisting of a representative each from the Ministry of Finance (MOF), BNM, and Security Commission.

Complementing Danaharta to strengthen the banking system, Danamodal, a special purpose vehicle to recapitalize and consolidate the banking sector, began operations in September 1998. The main objectives of Danamodal are to recapitalize and strengthen the banking industry and help in the consolidation and rationalization of the banking system to support economic development. Danamodal's proposed investment budget is RM16 billion in the form of equity,

hybrid instruments, or debt. With this, BNM expects BIs to refocus on prudent lending, in the process accelerating the pace of economic recovery. Danamodal will be the interim funding vehicle for the injection of funds into troubled institutions. BNM will provide seed capital of RM1.5 billion to start operations, which will be according to market-based principles and methodologies.

Introduction of Capital Controls and Easy Monetary Policy

Malaysia has worried constantly about speculation and pursued a credit-financed growth policy. As the crisis escalated and began to infect the real economy, the necessity for supervision of potentially destabilizing capital flows became ever more strident. Matters came to a head when official data released on 27 August 1998 revealed that the economy had slipped into deep recession. BNM figures showed that GDP contracted by 6.8 percent year-on-year in April-June, and the bank revised the first quarter's contraction from 1.8 to 2.8 percent. The deterioration of the economy also put the effectiveness of IMF-inspired austere monetary and fiscal policies in doubt. Under these circumstances, BNM relaxed monetary policy that day.[5]

Then the authorities announced capital control measures on 1 September 1998.[6] The measures had two primary objectives: first, they would eliminate speculative flows that had battered the ringgit and the stock market for more than a year; and second, by securing monetary independence, they could allow a progressive reduction in interest rates (without the risk of a deterioration in the exchange rate and capital flight) to encourage increased investment and consumption, and thus a reactivation of the economy.

As a consequence of the measures, on 3 September 1998, BNM slashed its three-month intervention rate—the benchmark for commercial bank lending—from 9.5 to 8 percent and then to 7.5 percent, expecting this to moderate the maximum basic lending rate. The statutory reserve requirement (SRR) was also lowered from 6 to 4 percent[8] to boost liquidity by reducing the cost of funds and by enhancing lending capacity of BIs. At the same time, the liquid asset ratio requirement of commercial banks was reduced from 17 to 15 percent of total eligible liabilities. Also, lending for the construction or purchase of residential properties costing RM250,000 and below was exempted from the 20 percent limit imposed on the broad property sector, to encourage BIs to prioritize lending for the construction or purchase of residential properties.

On 23 September 1998, BNM took additional banking measures to promote economic recovery as follows:

- the default period for classifying a loan as nonperforming by BIs was increased from three months to six months;
- BIs would no longer be automatically required to provide a 20 percent specific provision on substandard loans. The quantum of provisioning for the substandard loans would be assessed for each BI by BNM during the approval of half-year and annual accounts. The amount of provisioning required would be dependent on the adequacy of the respective BI's loan-loss coverage;
- for NPLs that have been restructured or rescheduled, such loans might be reclassified as performing when the repayments under the rescheduled terms were complied with for a continuous period of six months, instead of the current practice, which requires 12 months of continuous payment;
- the limit on loans for the purchase of shares and units of unit trust funds would be increased from 15 to 20 percent of total outstanding loans for the commercial banks and finance companies. The limit for merchant banks remained at 30 percent; and
- to ensure continued financing for viable businesses and projects, BIs should not withdraw facilities from their customers, based solely on problems that the customers have with other BIs.

Improvement of Asset Quality: Policy Issues and Recommendations

Recent Trends in Banking Sector Indicators

While no new financial institutions have entered the Malaysian banking sector since the early 1970s due to restrictions on domestic and foreign entities, the incumbents have grown at a rapid rate, particularly over the last four to five years. Loans and advances in the banking system at the end of 1997 stood at 152 percent of Malaysia's GDP, with commercial banks accounting for two thirds of the total credit outstanding of RM421 billion. Appendix Tables A2.4 and A2.5 present some historical patterns in total lending by commercial banks and finance companies, disaggregated by major economic sectors. Total lending by commercial banks grew at a compound rate of 17 percent per annum from 1980 to 1997, with a growth rate of 25 percent for the period 1993–1997, whereas lending by finance companies grew at 21 percent from 1982 to 1997 and 24 percent from 1993 to 1997. The tables also present the annual growth rates by sector: commercial bank credit to almost all the major sectors (such as broad property, manufacturing, financial services, and share purchases) has grown significantly in the last four years. Credit for consumption, manufacturing, and financial services has fueled the growth of finance companies during this period.

BNM introduced in December 1994 a two-tier structure for commercial banks, which was extended to finance companies and merchant banks in 1996. Tier-1 BIs are allowed a wider range of businesses and easier branch opening (Appendix 3).

The introduction of the two-tier system is one of the main reasons for the rapid growth in banking loans and advances.[9] BNM's primary objective in this process was to consolidate the banking industry in order to prepare the sector for external competition. It attempted to do this by imposing high capital requirements and creating the two tiers of institutions in which banks in tier 1 would be stronger and more efficient than those in tier 2. Banks in tier 1 were accorded a number of incentives, the most important of which was the operation of foreign exchange accounts of exporters. However, the two-tier system has not produced the desired result in that only one bank merger has been carried out since the system was introduced, and an agreement has been reached for another.[10]

The smaller banks in tier 2, encouraged by the strong profits due to solid economic growth, have not been willing to merge with the larger banks in tier 1. The shareholders of these banks instead have been augmenting their capital to graduate to tier-1 status; and, in order to secure a sufficient return on capital, several tier-2 banks have been aggressively lending in the last three to four years.

Following the deepening of the financial crisis, the Government has taken stronger measures to promote (forced) merging of finance companies. BNM in January 1998 announced a merger plan, instead of closing affected institutions as Korea and Thailand had done, in which 39 finance companies were to be consolidated into eight.[11] However, it remains to be seen if the move will be successful. The market's perception is that the stronger finance companies will suffer as they merge with the weaker ones. Similar views are expressed with regard to suggestions that banks be merged as a route towards recapitalization.

Malaysia has been relatively less affected by the recent financial turmoil compared with Indonesia, Korea, and Thailand. It has avoided the currency-mismatch problems that the corporate sectors of other economies have faced, through development of the primary bond market and prudent controls on foreign exchange.

The banking sector was fairly healthy at the onset of the regional financial turmoil. The relatively stronger capital adequacy and profitability[12] indicators in

the Malaysian banking sector have ensured that it took somewhat longer for the fragility of the banking system to surface. Table 3 presents data on risk-weighted and core capital ratios for Malaysian banks: there is considerable variation in many of the performance indicators within the banking sector between small and large banks, with the risk-weighted capital ratio (RWCR), for example, in the range of 8 to 14 percent. Malaysia ranks behind Hong Kong, China; Philippines; and Singapore, which have RWCRs in the range of 16 to 20 percent, but above Indonesia, Korea, and Thailand.

But increasingly, the banking sector has faced problems similar to those of other affected economies, including poor risk management in the face of rapid economic growth, maturity mismatch, and politically directed lending. Further, a lax monetary policy regime in the 1990s and the two-tier system of classification of banks contributed to a significant growth in credit, much of which was directed to sectors prone to volatile asset-price cycles, such as broad property and speculative activities. The economic crisis has acted as a trigger point in bringing these banking problems to the surface in the form of rapidly rising NPLs.

Table 4 presents the latest available data as of May 1998 on loans made by commercial banks, finance companies, and merchant banks to various major economic sectors. Total loans stood at RM419 billion (representing a decline from the end of 1997). Broad property accounts for the largest share for commercial banks and merchant banks, while consumption credit—primarily lending for hire-purchase activities—represents the largest component in the loan portfolios of finance companies. Commercial banks have lent a sizable share of their credit to manufacturing activities followed by financial services, whereas merchant banks have lent close to 18 percent of their credit to the financial services sector. In summary, finance companies have been particularly overexposed to two of the weakest sectors, namely, broad property and consumption credit, in the Malaysian economy.

Table 3: Capital Ratios of the Banking Sector, December 1996 and March 1998

	Banking System		Commercial Banks		Finance Companies		Merchant Banks	
Item	Dec 1996	Mar 1998	Dec 1996	Mar 1998	Dec 1996	Mar 1998	Dec 1996	Mar 1998
Risk-Weighted Capital Ratio (%)	10.6	10.6	10.8	11.0	9.8	10.7	11.7	14.1
Tier-1 Core Capital Ratio (%)	9.3	9.0	9.3	9.2	8.1	8.5	10.3	12.1

Source: Bank Negara Malaysia.

Table 4: Loans By Major Economic Sectors, May 1998

Sector	Banking System	Commercial Banks	Finance Companies	Merchant Banks
		Amount (RM million)		
Broad Property	144,380	105,302	31,701	7,377
Consumption	53,417	17,331	35,955	135
Manufacturing	64,636	56,745	5,200	2,692
Financial Services	35,922	28,098	3,781	4,043
Share Purchases	37,546	24,428	9,142	3,977
		Percentage share in total loans by institution		
Broad Property	34.5	35.9	30.8	32.6
Consumption	12.8	5.9	35.0	0.6
Manufacturing	15.4	19.3	5.1	11.9
Financial Services	8.6	9.6	3 7	17.9
Share Purchases	9.0	8.3	8.9	17.6

Note: The figures do not add up to 100 percent since only the five major sectors are reported here.
Source: Bank Negara Malaysia.

Prudential Regulations

Malaysia went through a banking crisis in the second half of the 1980s, when NPLs rose above 30 percent of the total loans. The sector subsequently has experienced a recovery and rebound, which lasted until the corporate sector difficulties became severe in 1998.

On 1 January 1998, BNM introduced major changes in the loan classification and provisioning requirements for commercial banks, finance companies, and merchant banks. The measures were recorded as revisions to BNM/GP3 "Guidelines on the Suspension of Interest on Nonperforming Loans and Provision for Bad and Doubtful Debts." Key points were as follows:

- the period of arrears for classification of a loan as nonperforming was reduced from six months to three months. BIs were to "claw back" interest to day one for new NPLs effective from 1 January 1998. "Claw back" means to reverse accrued but not collected interest out of income and balance sheet accounts;
- for loans of RM1 million and below to be classified as substandard, the period in arrears was reduced from six months to three months; doubtful, from 12 months to six months; and bad, from 24 months to 12 months. These classifications would be in effect unless evidence to support more severe classification will be identified;
- accounts or portions classified bad or deemed uncollectible were to be written off;
- minimum general provision for bad and doubtful debts was raised to 1.5 percent of total loans (net of specific provisions and interest-in-suspense), from 1 percent in effect from 1 January 1986.
- specific provision on uncollateralized portion of substandard loans was set at 20 percent; and
- provisions were required for off-balance sheet items where the BI faces credit risk from failure of counterparts to meet contractual obligations.

The reduction of the period of arrears to three months for the classification of a loan as nonperforming showed BNM's intent to identify problem assets early. When initially placed in effect on 1 January 1986, the guidelines specified a period of 12 months in arrears for a loan to be classified as nonperforming. The period of arrears was later reduced to six months for financial accounts beginning 1 January 1990. This guideline is consistent with US accounting standards, which specify that loans and lease receivables are to be placed on nonaccrual if principal or interest has been in default for 90 days or more, unless the loan is both well secured and in the process of collection. Hong Kong, China and Japan have also moved toward a three-month standard in reporting NPLs.

The requirement to "claw back" interest to day one for loans newly categorized as nonperforming as of 1 January 1998 represents a return to the more conservative approach that was in place from 1 January 1986 through calendar year 1989. BNM did not require BIs to reverse out accrued but uncollected income for loans newly categorized as nonperforming during the period 1 January 1990 through calendar year 1997. In comparison, it is generally the accounting practice in the US to reverse out previously accrued but not collected interest income when a loan is placed nonaccrual.

The requirement to classify loans RM1 million and below as substandard when in arrears for three months, doubtful when in arrears for six months, and bad when in arrears for 12 months was instituted to expedite the evaluation of loans and subsequent provisioning. The time frames for these classifications in effect since 1 January 1990 were reduced from six months for substandard, 12 months for doubtful, and 24 months and above for bad loans. The guidelines instruct BIs that the appropriate classification for an individual account will be determined on a case-by-case basis, and that the above standards apply unless there is evidence to support a worse-off classification. As with other BNM guidelines, these are considered to be minimum standards and BIs are encouraged to adopt more stringent standards.

BNM supervision staff have clarified that for larger loans, case-by-case evaluation and classification is

expected, with a view to providing more rapid and conservative classification rather than relying on the mechanics of past due status as noted for loans RM1 million and below. If the classification standards are applied conservatively as defined, they should give a good indication of the extent of the problem assets in a BI's portfolio.

The revision to GP3 issued on 17 October 1997 reiterated that accounts or portions thereof that are classified as bad or deemed uncollectible should be written off. In previous guidelines BNM emphasized that BIs have the option of either writing off bad assets or covering them with a specific provision amounting to 100 percent of the amount outstanding. In cases where recovery was still possible, BNM encouraged institutions to retain the asset on the books but set aside the 100 percent specific provision. BNM's stated objective was to ensure that a liberal write-off policy was not used to suppress the true level of NPLs; the stated accounting practice provides for continued disclosure of the bad assets in the portfolio.

Moving to the provisioning requirements of 20 percent against assets classified as substandard, 50 percent against doubtful assets and 100 percent against bad (or loss) assets brings Malaysian standards in line with international standards for classified assets. In previous guidelines, no provision was required for assets classified as substandard. BNM supervision staff indicated that they were pleased with the progress financial institutions had made in implementing these new standards, in advance of the effective dateof 1 January 1998. The increase in the general provision for bad and doubtful debts to 1.5 percent of total loans is another sound step towards ensuring that BIs are providing for potential losses in difficult economic times.

Instructing BIs to set aside provisions for off-balance sheet items where credit risk of the counterparts is evident is another prudent step, particularly under current economic conditions where counterparty defaults may rise. Implementation of off-balance-sheet provisioning to appropriate levels is complicated by continued deterioration in the economic environment. This makes the determination of the risk of default more difficult, as well as more critical. And there is a need to determine appropriate levels of provisions for the credit risk inherent in the variety of off-balance sheet instruments. Under BNM guidance, financial institutions have begun the review of the various instruments in their off-balance sheet portfolios to assess for potential defaults.

Two additional areas of importance in ensuring that BIs have assessed their asset portfolios in a prudent and conservative manner are the valuation of collateral and the treatment of restructured loans. Both of these items are addressed in the revision to GP3 that took into effect on 1 January 1990.

The "Guidelines on the Valuation of Security" issued as an annex to GP3 on 26 December 1989 indicate values for security in the context of asset classifications and provisioning. With regard to assessing the value of property, the guidelines specify when to use forced sale value, fair market value, or the reserve price fixed when an auction is pending. The guidelines also specify that in the absence of current valuation reports, defined as not more than two years old, the full Property Market Report quoted prices should be taken. This report is issued annually by MOF with data that represent a timelag of several quarters. Given recent economic conditions in Malaysia in which the value of various sectors of the property market has deteriorated significantly, the values quoted in the Property Market Report or in valuation reports of up to two years in age would be unlikely to reflect appropriate collateral values for the purposes of asset classification and provisioning.

The need for current and conservative valuation of collateral is well recognized by BNM supervision staff. Examiners are instructed to seek current valuations during the on-site examination process for property securing extensions of credit of RM500,000 and above. However, as noted by several commercial bankers, it is difficult to assess the fair market

value of property at this time in Malaysia, since few property sales have taken place to set these values under current conditions. It is recommended that BNM provide additional guidance to BIs and bank examiners with regard to the mechanisms and prudential standards for the valuation of collateral, particularly of property. This could be accomplished through a comprehensive update of the 1989 Guidelines.

BNM's regulatory guidance on the treatment of restructured loans is conservative. Restructured loans classified as nonperforming before the restructuring, remain as nonperforming until 12 months of payments have been received. During this time the credit facilities continue to be classified at least as substandard until returned to performing status. Loans that are restructured but have not been indicated to be nonperforming remain in the performing category, unless there is an aggregate of three months in arrears noted before or after restructure, at which time the loan will be accounted for as nonperforming. (The three-month period came into effect on 1 January 1998; before this an aggregate of six months of arrearages triggered nonperforming status.) Within the BNM regulatory reporting requirements there is no separate line item to track restructured loans. The current treatment does ensure that restructured credit facilities receive close monitoring to enable the ultimate success of restructuring. However, to facilitate tracking of restructured troubled debt facilities, BNM may wish to consider enhancing regulatory reporting to accomplish this task.

In conclusion, BNM has established in place an integrated and increasingly conservative set of prudential guidelines over the course of the 1997/1998 period. The continued reduction in the period of arrears for classifying credits as nonperforming, accompanied by increases in specific and general provisions and instructions to BIs to make provision against potential credit losses in the off-balance sheet portfolios, serve to foster increasingly prompt recognition of asset quality problems. To further support this objective, it is recommended that BNM provide additional guidance to BIs and bank examiners with regard to the mechanisms and prudential standards for the valuation of collateral, particularly property, in the current economic environment. However, on 23 September 1998, the Government increased the default period for classifying a loan as nonperforming from three to six months, and waived an automatic specific provision of 20 percent on substandard loans. These measures were taken to promote economic recovery, but obviously were against the current of the strengthening of prudential regulations.

Trends in Nonperforming Loans

For commercial banks, finance companies, and merchant banks, the share of substandard loans in NPLs has risen since the start of 1997, as shown in Table 5. The increase has been particularly substantial for finance companies and merchant banks compared with that for commercial banks.

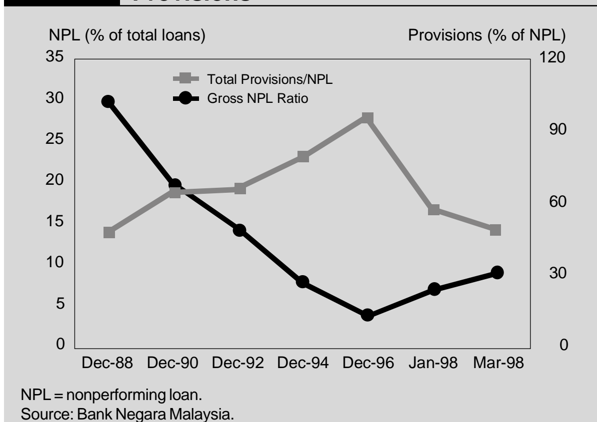
Table 5: Nonperforming Loans by Type of Classification, December 1996–March 1998

NPL by Type	Dec 1996	Jun 1997	Dec 1997	Mar 1998
	Amount (RM million)			
Commercial Banks				
Bad NPL	3,388.9	2,935.0	3,884.1	6,559.1
Doubtful NPL	1,064.9	1,217.5	1,848.1	3,882.3
Substandard NPL	3,708.8	5,080.7	7,221.6	11,836.2
Total NPL	8,162.6	9,233.2	12,953.8	22,277.6
Finance Companies				
Bad NPL	2,710.5	2,419.6	3,539.2	4,162.2
Doubtful NPL	400.8	441.5	1,090.1	2,879.2
Substandard NPL	890.5	1,378.1	3,867.5	7,184.4
Total NPL	4,001.8	4,239.2	8,496.8	14,225.8
Merchant Banks				
Bad NPL	226.4	186.8	285.7	364.1
Doubtful NPL	15.3	22.0	121.8	395.6
Substandard NPL	73.0	224.1	631.1	1,034.6
Total NPL	314.7	432.9	1,038.6	1,794.3
	Percent share in total NPLs			
Commercial Banks				
Bad NPL	41.5	31.8	30.0	29.4
Doubtful NPL	13.0	13.2	14.3	17.4
Substandard NPL	45.4	55.0	55.7	53.1
Finance Companies				
Bad NPL	67.7	57.1	41.7	29.3
Doubtful NPL	10.0	10.4	12.8	20.2
Substandard NPL	22.3	32.5	45.5	50.5
Merchant Banks				
Bad NPL	71.9	43.2	27.5	20.3
Doubtful NPL	4.9	5.1	11.7	22.0
Substandard NPL	23.2	51.8	60.8	57.7

NPL = nonperforming loan.
Source: Bank Negara Malaysia.

The reduction of the classification period has partly contributed to the recent rise in NPLs, as shown in Figure 1, although the primary reason for the deteriorating asset quality lies in real estate sector difficulties. The chart also presents the worsening trend in the ratio of total provisions (comprising specific and general provisions) to NPLs. The NPL ratio has declined from 30.1 percent in 1988 to about 12.3 percent in 1993, reaching a low of 3.7 percent by the third quarter of 1996. The sharp increase in the NPL ratio from the third to the fourth quarter in 1997, to 6 percent, is partly explained by the fact that many banks had begun to report NPLs under the three-month classification before its effectivity. The system-wide NPL ratio stood at 9.1 percent at the end of the first quarter in 1998; and the ratio of total provisions (sum of interest in suspense, specific and general provisions) to the NPL has declined from 100.6 percent in March 1997 to 49.3 percent in March 1998, reflecting the burden placed on banks by the rising NPLs.

Figure 1: Nonperforming Loan and Loan-Loss Provisions



NPL = nonperforming loan.
Source: Bank Negara Malaysia.

Table 6 presents data on NPLs by major economic sectors from the end of December 1996 to March 1998: absolute NPLs have more than doubled in commercial banks, tripled in finance companies, and increased fivefold for merchant banks. Provisions relative to NPLs have declined significantly for the finance companies and merchant banks. The sectoral distribution of NPLs across the major economic activities appears to be similar to the pattern for total loans (Table 4). The NPL share of the broad property sector has remained almost the same for commercial banks until the first quarter of 1998, while significantly increasing for merchant banks and declining in the case of finance companies. The latter, on the other hand, report a significant increase in the NPL shares of consumption credit and share purchase activities.

How have the loans and advances been secured in the banking system? One of the crucial indicators of asset quality is collateral exposure. With rapidly deteriorating asset prices, it is important to know the collateral cover of the financial institutions. BNM publishes an aggregate table on the ratio of provisions and collaterals to NPL: as of December 1997, this ratio was 194 percent for commercial banks, 135 percent for finance companies, 211 percent for merchant banks, and 174 percent for the banking system as a whole. However, as discussed above (in Figure 1), there was a rapid decline in the ratio of total provisions to NPL in 1998, and it is likely that the collateral position has also significantly deteriorated. Table 7 presents some data on banking system loans secured by different types of collateral. Commercial banks and merchant banks have a fairly large share of their loans not secured by any collateral, and it is not clear from aggregate data what type of loan facilities are extended without any collateral and if they are risky. The fraction of loans backed by shares is also fairly high for all institutions, and particularly so for merchant banks. It should also be pointed out that a significant share of the lending secured by “other” collateral is likely to be backed by volatile assets such as property.

The relative strength of the Malaysian economy (until the third quarter of 1997, at least) only delayed, but did not fully prevent, the impact of the regional crisis. As a result of the contagion, the ringgit depreciated after July 1997 by more than 34 percent. The central bank has opted to follow a tight monetary policy to stabilize the currency and avoid inflation. The base lending rate (BLR) of commercial banks has increased by about 2 percentage points from December 1997; the overnight interbank money

Table 6: Nonperforming Loans by Major Economic Sectors, December 1996–March 1998

Item	Banking System		Commercial Banks		Finance Companies		Merchant Banks	
	Dec 1996	Mar 1998	Dec 1996	Mar 1998	Dec 1996	Mar 1998	Dec 1996	Mar 1998
	Amount (RM million)							
Broad Property	5,288	14,010	3,066	8,223	2,172	4,966	50	821
Consumption	1,891	6,931	872	1,860	1,010	5,004	9	67
Manufacturing	2,093	4,929	1,737	3,801	241	878	115	250
Financial Services	412	1,730	315	1,129	90	500	7	101
Share Purchases	288	4,743	155	3,012	73	1,446	60	285
NPL	12,480	38,298	8,163	22,278	4,002	14,226	315	1,794
	Percent share in total NPLs							
Broad Property	42.4	36.6	37.6	36.9	54.3	34.9	15.8	45.8
Consumption	15.2	18.1	10.7	8.3	25.2	35.2	3.0	3.8
Manufacturing	16.8	12.9	21.3	17.1	6.0	6.2	36.5	13.9
Financial Services	3.3	4.5	3.9	5.1	2.2	3.5	2.1	5.6
Share Purchases	2.3	12.4	1.9	13.5	1.8	10.2	18.9	15.9
	Percent							
NPL/Total Loans	3.7	9.1	3.6	7.6	4.7	13.5	1.7	7.9
Provisions/NPL	100.6	49.3	98.3	55.8	87.9	37.7	155.6	60.4

NPL = nonperforming loan.
The figures do not add up to 100 percent since only the five major sectors are reported here.
Source: Bank Negara Malaysia.

Table 7: Loans by Type of Collateral, December 1996 and April 1998

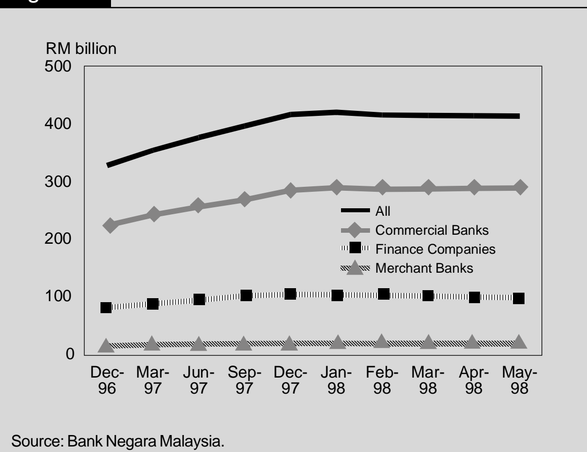
Type of Collateral	Percent of Loans Secured	
	Dec 1996	Apr 1998
Commercial Banks		
Entirely by Shares	6.8	7.1
Partly by Shares	1.7	1.9
Other Collateral	70.7	70.5
Unsecured Loans	20.7	20.5
Finance Companies		
Entirely by Shares	10.6	8.6
Partly by Shares	1.2	1.7
Other Collateral	84.9	88.3
Unsecured Loans	3.3	1.4
Merchant Banks		
Entirely by Shares	14.9	11.7
Partly by Shares	1.8	3.5
Other Collateral	42.8	53.7
Unsecured Loans	40.5	31.2

Source: Bank Negara Malaysia.

market rate has sharply increased by about 5 percentage points to about 10.5 percent (April 1998) since the onset of the crisis, and the three-month interbank rate rose to 11 percent, up from about 8 percent in September 1997. While on the one hand the sharp increase in interest rates has had an adverse effect on credit generation, the worsening NPL position of a number of banks led to a flight in deposits from the smaller to the larger banks, and a small fraction also fled the banking system.

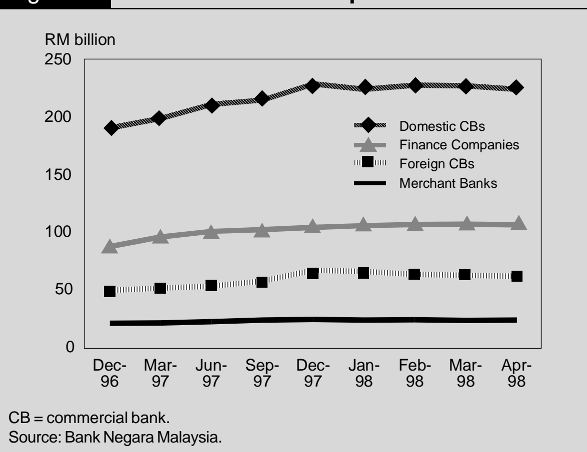
Figure 2 presents the recent trends in loans and advances in the banking system; and Figure 3 presents the same for deposits held by domestic and foreign commercial banks, finance companies, and merchant banks. Year-on-year credit growth has been decelerating in the system, from 16.9 percent in March 1998 to a little more than 12 percent in May 1998, as against BNM's credit growth target of 15 percent by the end of 1998. Total deposits declined by about RM9 billion since December 1997, of which the domestic banks, foreign banks, and merchant banks lost RM4.7 billion, RM0.1 billion, and RM1.2 billion, respectively, while the finance companies posted a growth of about RM2 billion. While data are not available on individual institutions, this trend is perhaps due to the higher deposit rates being offered by the smaller finance companies. Another important trend is the increase in loans-to-deposit ratio in the banking system, which went up from 93.2 percent in December 1996 to 98.8 percent in April 1998.

Figure 2: **Recent Trends in Loans**



Source: Bank Negara Malaysia.

Figure 3: **Recent Trends in Deposits**



CB = commercial bank.
Source: Bank Negara Malaysia.

Resource Implications of the Rising Nonperforming Loans

Of fundamental concern now is how much worse the NPL situation will become in the next three to four quarters, and what can be done about the deteriorating capital positions of financial institutions. There are some good reasons as to why the peak NPLs will not exceed the level of 1988, when the banking crisis was aggravated by significantly higher property sector exposure, and more important, by a weak supervisory regime. The consensus forecast for NPLs was in the range of between a 15 and 18 percent peak level by the end of 1998, and 20 to 25 percent in 1999, as against the peak of 33 percent in 1988. Much of it would depend on interest rates, property developments, and corporate developments. With regard to interest rates there seems to be a difference of opinion among policymakers, though there has been a clear signal since the last week of June 1998 with the lowering of the SRR, which will inject much needed liquidity into the system.

Real estate companies are struggling to cope with a sizable excess supply as a result of overexpansion. Several new properties are under construction despite less than full occupancy rates. Property prices have gone down by between about 10 and 15 percent, and a further equal decline is expected. Furthermore, while many positive developments have taken place, such as the establishment of Danaharta and Danamodal to deal with recapitalization, mergers of finance companies, and strengthening of prudential standards, market participants are still concerned about political interference and decision making governed by insiders. Lack of transparency has partly fueled such concerns.[13]

There are two steps needed to resolve the NPL problems in the banking system: recovery of assets behind the NPLs, followed by recapitalization if some or all of the capital and reserves are wiped out due to deteriorating asset quality, a scenario that seems almost inevitable. The first step is crucial and will determine the impact on the banks' capital positions. This is where Danaharta has a leading role to play, either by direct participation or by indirectly providing good benchmark levels for discounting. As of end-1997, BNM reported that the collateral exposure (value of collateral to NPLs) of the banking system stood at 105 percent. However, this ratio is likely to be much smaller now, with the downturn in the property and stock markets. In this regard, BNM has initiated a process of stress testing (ST) to estimate a recapitalization threshold for each financial institution. On the basis of the tests, the central bank reported that Bank Bumiputra will need a recapitalization of RM750 million and that Sime Bank will need RM1.2 billion in fresh capital injection. The Government-owned Bank Bumiputra is likely to receive support from public funds, and the required capital for Sime Bank will be provided

through its merger with the Rashid Hussain Banking (RHB) Group.

BNM's ST methodology or the results from the application of ST on individual banks have not been made available yet. However, there are some conservatively estimated private sector figures available for the banking system as a whole. The Nikko Advisory Services Group (June 1998) estimated that the entire banking system can sustain an NPL level of up to 34 percent of total loans before it financially collapses, on the assumption that 50 percent of the assets backing the NPLs is recoverable. The recapitalization threshold for NPLs, or the level of NPLs up to which the banking system can sustain an RWCR of 8 percent without resorting to recapitalization, is estimated at 11.6 percent. Table 8 shows these threshold limits.

Table 8: Banking System Financial Collapse and Recapitalization Thresholds for Nonperforming Loans (%)[a]

Financial Institution	Financial Collapse Threshold	Recapitalization Threshold (with RWCR at 8 percent)	Current NPL (Mar 1998)
Banking System	34.0	11.6	9.1
Commercial Banks	35.7	11.1	7.6
Finance Companies	27.2	9.0	13.5
Merchant Banks	43.2	18.7	7.9

NPL = nonperforming loan, RWCR = risk-weighted capital ratio.
[a] Assumption: Asset recovery at 50 percent of NPLs.
Source: Banking Sector Report: *How Much Stress can the Banking System Take?* Nikko Advisory Series (1 June 1998).

These numbers indicate that, while the financial collapse threshold provides some cushion (based on the premise that the crisis is not as severe as that of the 1980s), there is a need to prepare a recapitalization plan for the banking sector. In this regard, how much worse are the NPL figures likely to get, and what will be the recapitalization needs? Table 9 presents five sets of private sector estimates, which provide a conservative view based on reasonable assumptions with regard to asset recovery (50 percent), and loan and asset growth, taking into account the current decline, sectoral NPL scenarios based on current trends and evolution of asset prices, and classification of NPLs and provisioning. In this context, the Government has estimated that RM16 billion would have to be spent over the next two years for recapitalizing the banking system.

Table 9: Peak Nonperforming Loans and Estimates of Recapitalization Needs (private sector estimates)

Group	Peak NPL Estimates (%) 1998	1999	Recapitalization Estimates (RM billion)
SocGen Crosby (May 1998)	19	22.3	18.8[a]
Nikko Advisory Services (June 1998)	15–18	20–25	19–29[b]
Fitch-IBCA (May 1998)	15	20–25	11[c]
Goldman Sachs (March 1998)	18.5	22.5	na
RHB Research Institute (April 1998)	15	20	18

na = not available, NPL = nonperforming loan, RHB = Rashid Hussain Bank.
[a] Estimated from the figures presented in the report, to derive the recapitalization requirements to attain 9 percent RWCR; and
[b] To attain 8 percent RWCR.
[c] Only for commercial banks.

While all the above estimates are based on conservative assumptions, their validity and certainty depend on the actual outcomes with regard to property and other asset values of the NPLs as they unfold, and much more so on the asset recovery possibilities. Based on a 20 percent estimate for NPLs, there is consensus that the amount required for recapitalization is between about RM17 billion and RM19 billion. Taking into account the outlook for property and stock markets in particular, interest rates, and corporate sector difficulties, these estimates would seem to be about right. NPLs could rise to the 18 to 20 percent range by the end of 1998, and to 22 to 25 percent by the end of 1999.

Market sentiment seems to be that the banks themselves should take steps to boost their capital, with the Government playing a facilitating role in creating an enabling policy environment. In addition, Malaysian banks have fairly sizable off-balance sheet assets that could be reduced. Banks also need to change the risk profile of both off- and on-balance

sheet assets. There seems to be political support as well for banks calling in for new rights issues, though given the current market conditions it may be a costly option.[14]

The Government (BNM) should prepare a systematic plan with regard to recapitalization: if the CAR of a particular financial institution falls below a stipulated minimum, then BNM should require that institution to prepare a recapitalization plan within three to four weeks, and subject to BNM's approval, the plan should be implemented within four to six months. If any financial institution is unable to prepare and implement a satisfactory plan, then the Government should intervene by participating as a shareholder in that institution and its equity could be sold off subsequently. The Govern-ment's participation in the recapitalization process will be facilitated by the issuance of bonds for this purpose. If the Government's equity in an institution goes above a certain limit, to be determined relative to that of the largest shareholder, the institution is nationalized and will be privatized at a later date. It would not be a sound practice for BNM to engage in any cash injection into institutions facing difficulties, as it has done in the past.

What are the resource implications of the estimated recapitalization costs? Various private sector assessments indicate that the resources of the magnitude suggested in Table 9 could be met through the earnings and cash flows of a combination of domestic entities. EPF and the various pension funds, and Petronas have been suggested as potential sources of assistance to the banking system. It is estimated that EPF and Petronas, between them, can utilize their annual inflows of about RM16.4 billion in any recapitalization operations. Petronas has been called in to help Bank Bumiputra Malaysia twice in the past (in 1982 with a RM2.5 billion capital injection, and again in 1989 with RM1 billion inflow). However, there have been some indications from the Government, but no clear signals yet, that these agencies will not be called in to participate this time. It is essential that the Government draft an appropriate recapitalization plan, which will be financed by the issuance of bonds rather than through the use of EPF or Petronas. In this regard, it has been indicated that the Khazanah (Treasury) has an estimated potential of raising RM3 billion over two years through issuance of bonds. BNM does not have any resources at this point, barring the use of its international reserves, which is likely to be kept as the last option.

Several options have been suggested by market participants for recapitalizing the banking system:

- financial sector liberalization to increase foreign participation;
- rights issues by Banks, as market conditions improve;
- asset securitization, which may prove beneficial, again depending on market conditions, in reducing the banking system assets. In this regard, however, there is a need to modify the current full-recourse arrangement existing for loans sold to Cagamas, the national mortgage corporation; and
- mergers and consolidation.

The most preferred approach would be to encourage free entry of domestic as well as foreign participants. One of the key weaknesses of the Malaysian banking sector is restrictions on entry, with the result that there have been no new entrants since the 1970s. In addition, there are still many restrictions on foreign banks, particularly in terms of branch expansion, despite the fact that all the incumbent foreign institutions have been in the country for more than two decades. Greater participation through new entry or mergers of strong foreign banks with domestic banks will promote institutionalization of the shareholding structure in the financial institutions, besides freeing domestic resources for other needs. Efficiency of the domestic entities will also be enhanced.

With regard to mergers and consolidations, it is essential to understand that recapitalization is a systemic issue that cannot be solved through mergers. Furthermore, it is not clear if there is a sufficient number of healthy banks with shareholders who are willing to invest in weaker institutions, given the asset quality situation. While the initial phase of the merger and acquisition process in the finance company sector has taken place as planned, the impact of the mergers on the asset quality of the new groups formed, and particularly on the anchor finance companies, remains to be seen. The Government has guaranteed the value of the assets acquired by the anchor companies for one year. The six anchor finance companies have their own NPLs to manage, in addition to those of the merger partners. Of these, the market seems to be watching Hong Leong Finance, EON-CCM, and United Merchant Finance with particular concern. Financial institutions that have not received the Government guarantee are particularly vulnerable to further deterioration in their asset quality. The Government must draft a clear strategy before taking any decisions on bank mergers.

To sum up, the route taken for recapitalization should not introduce new problems or aggravate existing ones. The Government has taken the right steps by establishing Danaharta and Danamodal to deal with NPLs and recapitalization. However, the financing arrangements for these agencies are still being finalized. In this regard, recourse to BNM financing or lending to insolvent banks should be avoided. The Government should draft a comprehensive recapitalization plan, which should include provisions for direct Government equity participation in the short run, if necessary, and any such intervention should be financed through the issuance of bonds. It should be stressed that the market does not view favorably any potential role for EPF or Petronas in the recapitalization process. At a more fundamental level, free entry and firm exit policies are essential in solving the current problems.

Management of Nonperforming Loans and Recapitalization

Financial markets have been concerned for some time that BNM never fully recognized or acknowledged the scale of problems in the banking sector due to the rising level of NPLs. Danaharta was established to manage and liquidate the NPLs under a value-maximization approach, in order to derive the highest returns possible from the assets. While Danaharta will inject much needed liquidity into the banking system, it will also fill the gap in the skills needed in the financial sector to manage the problem assets besides allowing financial institutions to focus on the task of providing credit to the economy.

The preemptive nature of setting up the agency, the selection of private sector consultants for asset valuation, and the principles on which it will function are viewed in a positive light by market participants. But there are still some concerns as to the ability of Danaharta to function independently, without Government interference. Despite the Government's announcement to the contrary, the market worries that Danaharta will end up bailing out politically connected corporate sector entities. Private sector analysts feel that the Government will sacrifice currency, inflation, and financial sector stability in order to assist corporate enterprises and promoters of major infrastructure projects that are in trouble. In this regard, Danaharta's first few asset purchases will send an important signal to the market. The market is also concerned that Danaharta may take an unduly long time to maximize the value of the assets purchased and in the process hold on to those assets until the domestic economy revives. Given the slow process of liberalization to allow entry of foreign investors, it would be a big setback if Danaharta started running businesses rather than quickly turning the assets around.

Pricing of loans is another area of concern: given the thin markets and uncertain times, private analysts are concerned about Danaharta's ability to determine a fair market value. While bank participation

is voluntary, the market appears to feel that banks may be forced to sell their best possible NPLs at discounted values, thus precluding any opportunity to recover them when the economy revives. On the other hand, banks may be left with many bad NPLs that they will not be able to recover at any time.

Supervision: Policy Issues and Recommendations

Basle Core Principles

The Basle Committee on Banking Supervision released the Basle Core Principles for Effective Banking Supervision in September 1997. The Basle Core Principles address preconditions for effective banking supervision, licensing and structure, prudential regulations and requirements, methods of ongoing banking supervision, information requirements, formal powers of supervisors, and cross-border banking.[15] For the purposes of this review, reference is to the five core principles for credit risk management under the prudential regulations and requirements. They are as follows, and BNM has a well-developed program for compliance with all but Principle 11.

Principle 7: An essential part of any supervisory system is the evaluation of a bank's policies, practices, and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

Principle 8: Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices, and procedures for evaluating the quality of assets and the adequacy of loan-loss provisions and loan-loss reserves.

Principle 9: Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

Principle 10: In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

Principle 11: Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring, and controlling country and transfer risks in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

Through its program of on- and off-site supervision, BNM evaluates the policies, practices, and procedures of the BIs in the granting of loans, the making of investments, and the ongoing management of those portfolios (Principle 7). BNM is able to satisfy itself of the appropriate evaluation of the quality of assets and the adequacy of provisions as set by the BIS (Principle 8).[16] BNM has acted to set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers (Principle 9).[17] In addition, through the on-site examination process, examiners are expected to verify the identification and tracking of concentrations in banking portfolios. With the reduction of the single customer limit to 25 percent of a bank's capital funds, effective March 1998, the Malaysian guidance in this area has moved to the standard noted in the Basle Core Principle. Through the examination process, extensions of credit are monitored to prevent abuses arising from connected lending (Principle 10).[18]

Principle 11 has not yet been specifically addressed in supervisory guidance from BNM. Guidance for this area was to be considered as part of the review of regulations scheduled for completion by year-end 1998. For on-site examination activities, country/transfer risk[19] is considered within the general pool of credit risks reviewed in the asset portfolios. However, specific instructions for this type of risk are not outlined in the examination manual. According to statistics cited in the BNM Annual Report 1997, the country/transfer risk exposure of Malaysian banks

has been modest to date. The exposure of the Malaysian banks to the East Asian region at year-end 1997 consisted of $2.4 billion or 2.9 percent of the total assets of seven Malaysian banks. Reportedly, 20.5 percent of the exposure was classified as nonperforming as at year-end 1997. Potential areas of concern for the banking community to address with regard to country/transfer risk are (i) to assess the nature of the risks for individual countries; (ii) to have systems in place to measure the various types of exposures; and (iii) to have a mechanism for establishing and reviewing country limits with the flexibility to incorporate rapidly changing conditions.[20]

Review of Mechanisms for Assessing and Monitoring Compliance with Asset Quality Related Prudential Standards

Through off-site monitoring and on-site examination presence, BNM keeps informed about the key developments in the financial sector. Regulatory reporting mechanisms are extensive and there are regular internal reporting mechanisms in place to ensure transmission of supervisory information to BNM senior management. BNM appears well-regarded as a supervisor and regulatory measures have been received generally favorably. One area noted for continued attention is BNM's effort to accelerate the on-site examination schedule to verify the quality of assets and overall soundness of the population of Malaysian BIs, given the changed economic circumstances.

OFF-SITE MONITORING

The foundation of the off-site monitoring process is the regulatory database that has been developed from the series of regular statistical reports submitted to BNM by commercial banks, merchant banks, finance companies, and discount houses licensed under the Banking and Financial Institutions Act 1989 (BAFIA). These institutions submit weekly, monthly, quarterly, and annual reports to the Statistical Services Department of BNM as follows:

- weekly—Report on Domestic Assets and Liabilities;
- monthly—Report on Global Assets and Capital, Report on Domestic Interest Rates;
- quarterly—Report on Unaudited Income and Expenses; and
- annual—Report on Consolidated Assets and Capital, Report on Audited Income and Expenses.

A circular issued on 10 November 1997 increased the frequency of reporting monthly for asset quality information on NPLs, provisions, market value of collateral, and loans in arrears. An additional regulatory reporting mechanism, the Classified Loans and Advances System (CLASS) requires periodic submissions of data by commercial banks, merchant banks, Islamic banks, and finance companies. CLASS reporting provides BNM with detailed information on NPLs in the domestic banking system. BNM's "Guidelines on the Suspension of Interest on Nonperforming Loans and Provisions for Bad and Doubtful Debts (BNM/GP3)" provide the minimum basis for the classification of loans reported in CLASS. CLASS reporting has generally been for the third and fourth quarters of the year; however, under current market conditions, BNM is considering increasing the reporting frequency to monthly. The information from CLASS is utilized in a variety of formats, including review of NPLs by the amounts of shortfall in specific provisions, security, classification types, and aging of facilities.

The statistical database is also manipulated within the banking supervision function to provide additional monitoring reports for the off-site surveillance of banks. A series of reports is generated monthly. These reports provide comparative information to survey trends on an institution-by-institution basis and on an industry basis. Commercial banks, finance companies, and merchant banks, tracking both percentage composition and changes in absolute amounts can generate the information. Key asset quality indicators tracked in these reports include classification of loans by type, customer, and sector; and NPLs by sector, security, and classification.

Further enhancements to the off-site monitoring mechanisms are being developed. In particular, a supervisory early warning system is in the process of development with the assistance of the World Bank, targeted for year-end 1998 completion. The intention of the system is to utilize the existing statistical database to produce management reports similar to those currently produced by the reporting mechanism, but on a more automated basis.

BNM supervision staff indicated that during the financial crisis, additional ad-hoc reports have been generated to provide more current and focused information on banking sector exposures to BNM senior management. These reports have included reports on large borrowers, exposures to the stock market, and regional exposures. In addition, a monthly Watch List is being generated that provides the most current information on problem BIs such as those rated CAMEL (capital adequacy, asset quality, management, earnings, and liquidity) 4 or 5, or with special circumstances requiring close monitoring. The Watch List reports are routed through the assistant governor, deputy governor, and governor level at BNM and can result in more frequent meetings with the management of a particular BI.

The information generated by off-site monitoring is utilized as one of the planning tools before an on-site examination. Once an examination is completed, relevant information from the examination is incorporated in the off-site monitoring process.

ON-SITE EXAMINATIONS

There are three broad categories of on-site examinations:

- normal/routine examinations,
- nonroutine examinations usually conducted to investigate certain matters or follow-up on past examination findings, and
- the review of draft final accounts to assess the adequacy of provisions for loan losses.

On-site examinations are intended to assess an institution's financial soundness as well as compliance with laws and regulations.

Within the last couple of years, BNM's supervision function has moved towards a risk-based supervision approach in which greater emphasis is placed on the review of the BIs' internal mechanisms for risk management. Risk-based supervision techniques also allow for a more dynamic monitoring of the circumstances of an institution and increasingly effective planning of examinations. This shift in approach was outlined in a concept paper, which has been followed by a series of modules on examination techniques for specific areas of an institution's activities. These modules are in the process of being incorporated in the examination manual.

Various new elements of examination planning are to be introduced as part of the risk-based supervision process. These include a supervisory plan for individual BIs/groups, an examination-planning memorandum, and various risk assessment documents. The supervisory plan is to be maintained by the off-site officers in the Banking Supervision Departments, to be utilized as a planning tool for the on-site examination work. The activities for the on-site work would be recorded in an examination-planning memorandum. Risk assessment is a systematic process for assessing and integrating professional judgments about risks in institutions' activities. The financial crisis has placed a greater burden on BNM's supervisory functions and required increased on-site examinations. Thus, implementation of various aspects of the risk-based supervision process has been delayed.

As the risk-based supervision approach places an increased emphasis on developing a profile of the institution to be examined, there is a greater need for a more open exchange of information with the management of the institution. As a result, BNM has been moving towards more scheduled rather than surprise examinations, to allow for the information exchange in advance of the on-site presence. Also as part of this open exchange of information, BNM staff members have been scheduling annual meetings with the management of financial institutions and

talk more frequently with the internal and external auditors of the institutions.

The on-site examination process conducted by BNM consists of a full scope review within a one-to-three-year cycle, under normal circumstances, supplemented by more frequent on-site presence as needed to investigate specific areas of concern. The most problematic institutions (CAMEL rating 4 or 5) are subject to an annual on-site examination, whereas those of least supervisory concern (CAMEL rating 1 or 2) may not be examined on-site for up to a three-year period. An institution with a CAMEL rating of 3 would generally be examined every 18 months.

As anticipated, given present financial sector concerns, the emphasis in current examinations has been on asset quality reviews, adequacy of provisions, and structure of liabilities. Also, BNM supervision staff indicated that the frequency of on-site examinations has increased, particularly for large institutions. Continued efforts to accelerate the on-site examination schedule to verify the quality of assets and overall soundness of the Malaysian BIs are particularly important, given present conditions.

At the conclusion of an on-site examination, a meeting is held at BNM with BI management to review examination concerns and finalize the CAMEL rating. Examination conclusions are then presented to the institution's board of directors, and a formal response to findings is provided to BNM. If there are significant areas of concern, the board of directors may be called in to BNM for a meeting.

The scope for coverage of asset portfolios, including loan portfolios, has generally been in the range of between 50 and 80 percent of the total asset category. Problem loans are classified as substandard, doubtful or bad. Nonperforming assets (NPAs) are classified in one of these adverse categories.

With regard to valuation of collateral for land and properties, the examination manual indicates that the values offered as security are assessed either by the BIs or by professional property valuers. These reports usually indicate two values: a fair market value and a forced sale value. The former is normally accepted for credit appraisal, whereas the forced sale value is normally adopted for classification of credits and determination of specific provision for loan losses. If valuation reports are out-of-date, examiners are referred to the Property Market Report published annually by MOF. However, this report may not be the best reference because its data have a time lag of several quarters. Examiner judgment is to be used and, according to discussions with BNM supervision staff, a more current valuation is obtained during the course of the examination for property securing extensions of credit of RM500,000 and above.

In the case of valuation of quoted shares, the BIs are expected to use the closing price of a specific day of the week to determine the values of the shares deposited as security. Examiners are expected to use the lowest of the share values from either the commencement or the conclusion of the on-site examination.

Assessment of Supervision

BNM has a well-developed program for compliance with the Basle Committee Core Principles for Effective Banking Supervision in the area of credit risk management of the domestic asset portfolios (Principles 7 through 10). With regard to Principle 11, which addresses country and transfer risks, BNM Bank Regulation Department staff have identified the need for additional supervisory guidance in this area and were incorporating it as an item for the review of regulations scheduled for year-end 1998 completion.

The supervisory functions at BNM are well established, with comprehensive regulatory reporting requirements, a variety of off-site monitoring tools, and detailed guidance in the area of on-site examination practices. Given the adverse economic circumstances affecting banking, BNM should continue its efforts to accelerate the on-site examination schedule to verify the quality of assets and overall soundness of Malaysian BIs.

Further Issues and Policy Recommendations

Specific Issues with Regard to Asset Quality

POLICY LOANS

The banking sector should not be utilized as a tool for the Government's industrial policy. Since the moral hazard problem is crucial in financial intermediation, every loan should be made under each BI's responsibility. There is evidence that policy loans could produce higher NPLs than regular loans. The main reason is that policy loans discourage screening and monitoring, which are fundamental functions of financial institutions. In this sense, policy loans and commitments such as loans to the Bumiputra community need to be transferred to the Government budget (Appendix Table A2.3). If so, any problem raised by political consideration could be resolved politically. It will also help BIs to recover their screening and monitoring functions.

LENDING FOR SHARE PURCHASES

This category, at 8.9 percent for the banking sector at the end of May 1998, is still within BNM's limit of 15 percent on loans collateralized by stocks. However, the true exposure is not known, as many financial institutions with stockbroking subsidiaries are likely to be affected. Any further decline in stock prices will also affect banks through corporate sector difficulties and direct margin financing. The number of corporate sector borrowers using ordinary business loans to assist their stockbroking companies is not known. With regard to loans in this category, there is anecdotal evidence that banks are not making margin calls when the value of the collateral depreciates. Private sector analysts feel that banks are not calling in large, politically connected entities to top up their share collateral that has gone down in value. There must be greater disclosure of the shortfalls between the collateral values and the loans extended.

FORECLOSURES/RECEIVERSHIPS

It appears that while political factors partly explain why banks do not resort to foreclosing on companies or place them under receivership, there are also legal loopholes (particularly in Section 176) in the Company Law that hinder financial institutions from taking this route. It is essential that the legal framework in this regard is strengthened in line with international best practices. The recent foreclosure of Wembley Holdings by Phileo Allied Bank to recover debts reported at RM100 million is seen by the market as a hopeful sign. MBf Holdings Berhad, the parent company of MBf Finance Berhad, has sought court protection from financial institutions covering its debts of about RM500 million. There have been reports that Time Telecoms Berhad, a subsidiary of the well known and politically connected Renong Berhad, may seek court protection from its creditors to cover its debts of about RM5 billion. If companies continue utilizing the legal provisions in this way, NPLs are likely to exceed even the worst case scenarios presented above.

SINGLE-PARTY LIMIT

BNM's supervisory procedures reveal that a prudential limit such as the single party ceiling is strictly enforced. However, there is anecdotal evidence that Malaysian companies circumvent this ceiling by setting up third-party entities operating through nominees,[21] who are difficult to trace for lending decisions or for prudential purposes.

FOREIGN CURRENCY TRANSACTIONS

The seven major Malaysian banks[22] that have facilities in Labuan had lent about $2.36 billion at the end of 1997 to the four affected and vulnerable East Asian economies (Indonesia, Korea, Philippines, and Thailand). This amounted to about 2.2 percent of all outstanding loans in the banking system. While the total loan size is relatively small, a significant share (20.5 percent) of this regional total is classified as nonperforming. The total

Labuan operations of the seven banks were to the tune of $5.1 billion in December 1997. About 66 percent of all loans and advances originating from Labuan, or $11.6 billion out of the total $17.5 billion, was lent to corporate entities resident in Malaysia at the end of 1997.

The limited exposure of Malaysian corporates to foreign currency debt, relative to their counterparts in the other affected economies, has been a saving grace in the Malaysian economy. However, while no official numbers are available, there is anecdotal evidence that a good fraction of the nonresident component of the Labuan loans went to Malaysian companies investing abroad. An example is the $718 million loan made in 1997 by MayBank, Bank Bumiputra, RHB, and Bank of Commerce to Hottick Investments, a company incorporated in Hong Kong, China with links to the Malaysian-based Renong Group. This loan facility was provided to Hottick to buy a controlling stake in the Philippine-based National Steel Corporation. The loan has been restructured and repayment will be delayed for a year. The concern is that such loans do not come under the purview of BNM. Another example is a $150 million loan made by Malaysian banks in Labuan to the Renong Group, which reportedly does not have any foreign exchange earnings. While a major portion of the $11.6 billion, cited above, has been lent for foreign investments or trade-related activities of Malaysian entities, such practices of lending for apparently unrelated activities clearly defeat the main purpose of Labuan. Another crucial problem in Labuan operations is disclosure of information: market watchers feel that the scale of dollar-denominated lending undertaken by Malaysian banks based in Labuan is rarely disclosed. An example is the lack of transparency in Sime Bank's Labuan operations, which reportedly lent more than $400 million to Indonesian and Thai companies. However, market analysts have favorably viewed the transparent manner in which BNM announced Sime Bank's financial problems.

RISK MANAGEMENT AND HUMAN RESOURCES

The rate at which some of the smaller, tier-2 banks have expanded their credit and the resulting increase in NPLs are indications that risk management is not carried out properly because of insufficient human resources in a number of financial institutions. While there is no hard evidence, market analysts in Malaysia and outside feel that risk assessment, and even routine and important processes such as cash-flow analysis, are not satisfactorily carried out in many institutions, particularly in the case of lending to Government-supported Bumiputra entities.

GOVERNMENT ASSISTANCE TO FAILING INSTITUTIONS

The signals coming from the Government with regard to financial institutions and corporate entities that are in trouble have been conflicting. In general, market participants strongly feel that since the country does not have a large foreign debt, it will nationalize the banking and corporate sector problems, though BNM and MOF officials have been presenting quite sober economic forecasts and promising comprehensive reforms in banking. Further, the lack of transparency over some of the recent corporate deals that took place with the Government's support has created a negative impression and led to lower confidence. Examples are the directed bank lending to United Engineers Malaysia (UEM) for purchasing a stake in the Renong Group, and the proposed restructuring of the Malaysian Airlines System and affiliated companies. To the extent that such transactions do not make any commercial sense, they have serious implications on the financial health of the concerned entities and banks.

BANK NEGARA MALAYSIA'S BANKING SECTOR DISCLOSURE OF INFORMATION

BNM has, over time, considerably strengthened the disclosure and reporting requirements for financial institutions. Since the first quarter of 1998, financial institutions are required to publish (unaudited)

data on income and operating expenses, total loans, NPLs, and provisions on a quarterly basis. However, BNM does not publish disaggregated NPL figures by substandard, doubtful, or loss categories. Given the rapid changes in asset quality in the financial sector, it is essential that such data are made publicly available. Another area is collateral exposure of financial institutions: BNM publications do not present any information in this regard. In the present context, this is particularly important for loans backed by shares.

Opening of the Banking Industry

In Malaysia, it is widely believed that authorities exhibited caution in opening the banking sector. The difficulty of putting in place a concrete strategy plan for liberalization is also recognized. Foreign equity investment in financial institutions is limited to 30 percent, and there are restrictions on the activities of the 13 locally incorporated foreign banks (these account for 22 percent of total assets of BIs) operating in Malaysia. Foreign banks can extend loans only in partnership with domestic banks. Since 1983, no new foreign (as well as domestic) bank licenses have been granted and foreign banks are restricted in their ability to open branches. The rationale of the measure was to protect domestic banks. This policy has been maintained for more than 10 years and has forced foreign banks to get used to the restrictive business environment.

Opening the banking sector has potential risks. They include an increase in capital volatility and encouragement of excessive borrowing, which could eventually destabilize the domestic financial markets. These factors have been blamed as the prime causes of the Asian financial crisis. On the other hand, if domestic banks compete with more advanced foreign banks, they would likely strive to work for more efficient management and financial innovation. At the same time they would introduce and develop a better supervision and regulation system. These factors will contribute to improving financial services, economic growth, and a sound banking system. Whether the positive or negative effects would prevail, particularly in the long run, remains an open question.

However, empirical studies support the view that liberalization of banking will have favorable results. Effective and rapid improvement requires a certain goal and counterparts to compete against. Self-strengthening of the BIs has a limit. Therefore, BIs in Malaysia are currently considered to be paying high implicit costs by delaying their internal reforms and neglecting financial innovations. BIs tend to regard competition as a factor that causes profits to decline. Instead, the value of competition has to be evaluated from the point of view of customers who cannot influence the market individually. However, since it is doubtful that BIs can achieve international competitiveness without a strong external stimulus, foreign banks can be utilized as a catalyst in developing the banking sector. The Government should set up a concrete plan of when and how to open the financial markets. For example, in the first stage, which could be initiated within one year, foreign banks could be encouraged to help domestic banks develop specific areas such as risk management, foreign exchange, and derivative trades. In the next stage, current locally incorporated foreign banks could be allowed to open more branches according to their contribution in the first stage.

Regulatory Fragmentation

MOF and BNM share the overall supervision of BIs. Licensing of BIs is handled by MOF while regulation and supervision belong to BNM.

The main concern of BIs regarding regulation and supervision is that the Government and BNM hold too much power. Primarily this perception arises from lack of transparency in decision-making processes. Even though there have been intensive efforts to enhance transparency of policy making and supervi-

sion during the crisis, there is room for improvement. One obvious example is the clause that BNM can approve from time to time exemptions in the credit limit to a single customer.

In order to ensure transparent policy decisions, the following measures could be introduced. First, the Central Bank of Malaysia Act needs to be revised to clarify the composition of the board of directors of the bank for internal balance. Currently the board of directors is composed of the Governor, not more than three Deputy Governors, and five to eight directors. But there is no clarification on what each director represents. Second, BNM needs to disclose the minutes of the decisions of the highest policy making body, in addition to the prudential regulation-related information. These measures will prevent forbearance of BNM that can easily be transformed into a bailout of the financial institutions.

Lack of consistency in financial policy is a problem as serious as lack of transparency. Even though the Government encourages mergers, it does not seem to have a clear exit policy. For example, one authority says the Government would support troubled banks, but another authority indicates that ailing banks would be allowed to fail. The current inconsistent statements of the Government could be attributed to lack of a long-term financial reform plan. Therefore a long-term blueprint is necessary to ensure a more consistent set of regulations.

In a related issue, BNM supervises insurance companies according to the Central Bank of Malaysia Act. However, the rationale behind this practice seems not aligned with the roles normally assumed by central banks. A central bank is defined as a bank of banks, and has to play the role of a lender of last resort to BIs when necessary. Insurance companies are not categorized as BIs and, therefore, exempted from reserve requirements, and not allowed access to the discount window. At the same time businesses of BIs and insurance companies are clearly distinguished. From BNM's point of view, apart from the cost it has to pay for insurance sector specialists, these factors can impair its credibility if insurance companies are confronted with problems. Therefore, it may be time to develop an independent supervisory agency for insurance companies.

Credit Crunch

The precise origin and nature of a credit crunch changes from one time to another. There could be multiple reasons for the current credit crunch. First, unstable foreign exchange markets require a policy of monetary restraint and high interest rates. These tend to reduce credits to the private sector by financial institutions. Second, strict enforcement of the BIs' capital adequacy ratio can reduce their credit capacity. Since bank managements were unable to raise additional capital in these exigent circumstances, they had no choice but to call in loans to improve their capital adequacy ratios. Such calls might well be made on the soundest clients, since they were in the best position to repay, whereas others might have been forced to default, occasioning still more write-downs. New lending, of course, was severely inhibited. Third, uncertainty in the economy as well as in the corporate sector causes financial institutions to hesitate to provide credits to the potential borrowers. Fourth, instability of the currencies of People's Republic of China; Hong Kong, China; and Japan potentially impairs foreign capital inflows into the country. In the case of Malaysia, the credit crunch is viewed to be not as serious as that of other affected countries, an indication that the factors causing it are less serious. However, there is a strong possibility that the current credit crunch could lead to a vicious circle if the present economic and banking situation deteriorates.

The Government has made several efforts to mitigate the worsening credit crunch. Measures include:

- reduction of the SRR and the liquid asset ratio requirement;
- lowering interest rates through the lowered BNM intervention rate and revision of the basic lending rate framework;

- encouragement of lending for the construction or purchase of residential properties, and shares and units of unit trust funds;
- freeing BIs to determine the margin of financing for credit facilities granted for the purchase of broad properties;
- relaxation of the definition of NPLs;
- removal of the specific provision requirement for substandard loans; and
- encouragement of credits by imposing a minimum annual loan growth target of 8 percent to be met by BIs by the end of 1998.

There is a limit for resorting to the supply of credit to revive the economy. Such measures could seriously weaken Malaysia's already overstretched domestic banks. The new credit could find its way into speculative investments and simply add to national leverage levels that are already unacceptably high. A change in the rules on NPLs and provisioning means the extent of the deterioration will be obscured. Moreover, pumping liquidity into the system could conflict with efforts to reform the banking and corporate sectors.

As long as the credit crunch is explained by a host of factors, fundamental and contingency plans have to be considered together. First, the concept of profit maximization of financial institutions needs to be reconsidered. The credit crunch seems to be a natural result of the profit-maximizing management of BIs. However, considering the generic nature of BIs that arises from long-term contracts with customers under informational asymmetry, insurance also has to be taken into account in financial policy. This implies that BIs have to maximize their profits, not in the short term but in the long term. In turn, this implies that it can be theoretically rationalized to encourage BIs to exert more effort to support their customers facing temporary difficulties. Second, the authorities can adjust the growth rate of monetary aggregates to a higher level. In order to measure the liquidity condition properly, lowered velocities have to be taken into account. Third, the burden to fulfill the BIs' capital adequacy ratio needs to be lightened by allowing them to have a lower capital adequacy ratio than the international standard of 8 percent, if they give up riskier businesses such as foreign exchange trades and derivatives. Fourth, in order to avoid the excessively passive attitude of BIs towards lending, BNM needs to prepare a guideline that credit examiners should be exempted from punishment when the loan turns nonperforming. Their performance needs to be evaluated based on achievement for a certain period, for example, three years. Finally, the Government needs to increase the funds of CGC to promote access to institutional credit for small-scale enterprises and for Bumiputra entrepreneurs.

Deposit Insurance

The flight of deposits to sound BIs as the financial crisis develops proves that depositors' confidence in individual financial institutions is shaky. Shifts of funds among financial institutions are costly from the depositor's point of view. But they are more hazardous to financial institutions. There is evidence that tier-2 banks in Malaysia have been paying higher deposit rates (of about 0.5 to 1 percent more on average). These can cause even solvent banks to go bankrupt and eventually cause systemic risk. Therefore, it is important to prevent excessive disintermediation or shifts of financial assets.

Currently, the Government protects principals and accrued interests on deposits in BIs. This blanket guarantee by the Government was confirmed on 20 January 1998 to prevent excessive shifts of deposits and possible bank runs. Considering the extreme lack of confidence of depositors, it was an indispensable measure from the Government's point of view. However, as the market stabilizes, protection has to be accorded by the market instead of the Government. This implies that the market mechanism should be allowed to work in the deposit market.

Allowing the market mechanism to function can be achieved step by step. In the first stage, the amount

of the principal and accrued interests insured by the Government needs to be reduced from the entire amount to a certain small amount.[23] In the second stage, a private deposit insurance company should replace deposit insurance by the Government at a certain date. For instance, considering the current composition of fixed deposits by maturity (average maturity of around two years), 2001 would be the appropriate time for depositors to start to play a role in monitoring BIs.

Another option is to extend Government protection to a far later date, say, until 2003, and to reconsider its extension in 2000, i.e., three years ahead of 2003 and so on. The reason for the long grace period and reconsideration is that the current difficulties in the financial sector do not leave much room for BIs to contribute insurance premiums. This option can also be rationalized by the following consideration: academics and practitioners have long discussed the pros and cons of deposit insurance. The key point in the discussion is how to strike a balance between the explicit financial costs and the implicit costs incurred due to moral hazard. The current trend to strengthen market discipline, in particular introduction of a prompt corrective action, could take over a role of the deposit insurance.

Financial Innovation

The liabilities of BIs are sources of banking business. The availability of attractive deposit instruments and services is as crucial as the soundness of BIs for operation. In the case of Malaysia, if the amount due to other financial institutions is excluded, deposits are virtually the only source of funds. (As of the end of 1997, deposits made up 74.8 percent of total resources for commercial banks, 84 percent for finance companies, and 78.6 percent for merchant banks.)

Lack of competition due to the closed system is reflected in the lack of dynamism in the financial market. One measure of dynamism is changes in the composition of monetary aggregates. In Malaysia, the relative shares of M1 and M2 in M3 are stable. This indirectly proves not only BNM's tight control on BIs, but lack of competition among financial assets.

When the time comes to open up the financial market to foreigners, either by external pressure or by an internal voluntary decision after the soundness of BIs is secured, primary competition among BIs will occur in deposit taking. In this context, financial innovation surrounding deposits has to be encouraged far in advance. Currently, many BIs do not realize the importance of financial innovation and some even worry about the adverse effects on their profits. However, competition needs to be encouraged for customers' sake.

In most cases, an inner stimulus is not sufficient for a fundamental structural change. Financial institutions cannot be competitive enough without allowing foreign competition, even though they agree on the importance of competitiveness. There is plenty of room for financial innovation in Malaysia. First, considering the influence of Islamic banking, deposits would be presumably less sensitive to interest rates, and financial innovation can be promoted at less cost. Second, since BIs' coverage of business is wide, inventing new products is relatively easy. The Bumiputra policy will also provide a basis for inventing new and country specific financial products. It is a good idea to provide patent to an institution that develops a new financial product/service.

Apart from deposits, BIs' bond issuance needs to be examined to encourage savings mobilization by satisfying the customer's preference and to diversify the sources of funds. Currently, the tedious processes and high cost of bond issuance are major obstacles to the issuance of private bonds by BIs. It is necessary that BNM's involvement in BIs' bond issuance be minimized. Greater bond issuance will also contribute to the deepening of the bond market as well as financial innovation.

Since 1986, financial institution units have been permitted to engage in banking as well as in securities business but under separate subsidiaries and

regulatory agencies. BIs can invent good saving instruments, providing greater variety and profits to depositors, by linking commercial banking business with securities business. Fortunately, the current universal banking system is better than a universal banking system that allows one entity to engage in various businesses in terms of securing the stability of the banking system and reducing the cost of supervision.

Appendix 1

The Banking Institutions, as of end-December 1997

Bank Negara Malaysia

Assets (of which external resource = RM59.2 billion) RM109.0 billion

Number of branch offices 6

Islamic Bank[a]

Assets	RM4.0 billion
Deposits	RM3.3 billion
Loans	RM2.4 billion
Number of branches	68

Commercial Banks[a]

Assets	RM481.1 billion
Deposits	RM300.4 billion
Loans	RM276.1 billion
Number of banks:	
Domestic	22
Foreign	13
Total	35
Number of branches	1,624

Finance Companies[a]

Assets	RM152.4 billion
Deposits	RM106.5 billion
Loans	RM102.5 billion
Number of companies	39
Number of offices	1,096

Merchant Banks[a]

Assets	RM44.3 billion
Deposits	RM26.4 billion
Loans	RM23.1 billion
Number of banks	12
Number of branches	24

Discount Houses

Assets	RM20.9 billion
Number	7

Foreign Banks Representative Offices[a]

Number of offices	38

[a] Supervised by Bank Negara Malaysia.
Source: Bank Negara Malaysia.

Appendix 2: Statistical Tables

Table A2.1: Assets of the Financial System

Financial Institution	Annual Change (RM billion)		As of End-1997	
	1996	1997	Value (RM billion)	Percentage Share
Banking System	116.1	181.4	813.2	72.8
Bank Negara Malaysia	8.3	12.2	109.0	9.8
Commercial Banks[a]	68.6	122.5	486.6	43.6
Finance Companies	27.9	32.6	152.4	13.6
Merchant Banks	7.0	10.3	44.3	4.0
Discount Houses	4.3	3.8	20.9	1.9
Nonbank Financial Intermediaries	55.4	16.7	304.0	27.2
Provident Pension and Insurance Funds	27.5	24.0	191.0	17.1
Employees Provident Fund	18.5	15.0	132.4	11.9
Other Provident and Pension Funds	3.3	3.5	21.9	2.0
Life Insurance Funds	3.4	3.6	24.5	2.2
General Insurance Funds	2.3	1.9	12.2	1.1
Development Finance Institutions[b]	1.4	2.0	15.3	1.4
Savings Institutions[c]	3.0	1.2	19.4	1.7
Other Financial Intermediaries[d]	23.5	(10.5)	78.3	7.0
Total	**171.5**	**198.1**	**1,117.2**	**100.0**

( ) = negative values are enclosed in parentheses.
The numbers above are based on old bank formats and may differ from those in Appendix 1.
[a] Includes Bank Islam Malaysia Berhad.
[b] Includes Malaysian Industrial Development Finance Berhad (MIDF), Bank Pertanian Malaysia, Borneo Development Corporation, Sabah Development Bank Berhad, Sabah Credit Corporation, Export-Import Bank Malaysia Berhad, Bank Pembangunan Malaysia Berhad, and Bank Industri Malaysia Berhad.
[c] Includes National Savings Bank, Bank Kerjasama Rakyat, and cooperative societies.
[d] Includes unit trusts (ASN, ASB, ASW 2020, and ASM Mara), building societies, Pilgrims Fund Board, Credit Guarantee Corporation, Cagamas Berhad, leasing companies, factoring companies, and venture capital companies.
Source: Bank Negara Malaysia.

Appendix 2

Table A2.2: Lending Guidelines

Item	1994 (Compliance date: 31 March 1997) Target	Achieved	1996 (Compliance date: end 1997) Target (31 March 1999)	Achieved
Loans to Bumiputra Community				
Total Outstanding Loans (RM billion)				
Commercial Banks	21.3	52.8	53.0	76.9
Finance Companies	7.8	22.3	19.4	37.0
Total Outstanding Loans (percent)				
Commercial Banks	20.0	49.5	30[a]	43.5
Finance Companies	20.0	57.2	30[a]	57.2
Noncompliance (no. of institutions)				
Commercial Banks	na	1	na	9
Finance Companies	na	na	na	6
Housing Loan Commitments				
Total Houses (units)				
Commercial Banks	75,000	84,197	100,000	94,568
Finance Companies	25,000	42,771	40,000	41,002
Noncompliance (no. of institutions)				
Commercial Banks	na	10	na	12
Finance Companies	na	5	na	13
New Principal Guarantee Scheme				
Total Guarantee Cover (RM million)				
Commercial Banks	350.0	859.7	1,000.0	2,286.0
Finance Companies	60.0	161.8	240.0	1,210.0
Noncompliance (no. of institutions)				
Commercial Banks	na	5	na	7
Finance Companies	na	15	na	6
New Principal Guarantee Scheme (for Bumiputra Community)				
Total Guarantee Cover (RM million)				
Commercial Banks	175.0	217.5	500.0	570.0
Finance Companies	30.0	70.8	120.0	274.9
Noncompliance (no. of institutions)				
Commercial Banks	na	5	na	16
Finance Companies	na	18	na	9

na = not available.

[a] Under Lending Guidelines 1996, the target for loans to Bumiputra community has been increased from 20 to 30 percent, while the targets for housing loan commitments of commercial banks and finance companies have been increased from 75,000 units and 25,000 units, to 100,000 units and 40,000 units, respectively.

Source: Bank Negara Malaysia, *Annual Report 1998.*

Appendix 2

Table A2.3: Sources and Uses of Funds of the Financial System (outstanding in RM million)

Item	1993	1994	1995	1996	1997
Sources of Funds					
Capital, Reserves, and Profit	41,936.2	55,886.5	78,696.4	109,462.5	103,072.3
Currency	14,649.0	17,170.3	18,913.2	21,065.6	24,532.3
Demand Deposits	33,449.7	40,051.8	46,155.8	56,231.9	59,078.3
Other Deposits	254,653.1	269,219.8	318,307.7	399,163.2	490,954.5
Of which:					
Public Sector	28,351.3	27,544.1	41,420.7	35,937.0	38,590.6
Other Financial Institutions	95,506.1	90,081.0	99,506.0	124,716.7	160,807.6
Private Sector	127,237.3	147,233.9	171,804.3	233,142.4	283,901.6
Foreign	3,558.4	4,360.8	5,576.7	5,367.1	7,654.7
Borrowings	5,767.8	6,811.0	6,322.4	8,376.6	31,108.1
Funds from other Financial Institutions	43,713.7	39,901.3	50,039.1	55,994.6	98,713.6
Domestic	14,324.7	24,245.5	33,611.8	34,043.4	57,702.2
Foreign	29,389.0	15,655.8	16,427.3	21,951.2	41,011.4
Insurance, Provident, and Pension Funds	93,625.1	108,961.4	127,055.4	146,888.5	169,214.8
Other Liabilities	84,361.9	87,417.6	102,074.0	121,917.8	140,550.9
Total Liabilities	**572,156.5**	**625,419.7**	**747,564.0**	**919,100.7**	**1,117,224.8**
Uses of Funds					
Currency	1,597.2	1,383.4	1,929.3	2,812.3	4,112.3
Deposits with other Financial Institutions	117,597.2	121,286.4	139,216.6	146,615.6	215,803.3
Domestic	110,537.3	113,453.2	130,830.7	139,231.8	197,682.5
Foreign	7,059.9	7,833.2	8,385.9	7,383.8	18,120.8
Bills	7,824.8	12,081.1	16,391.6	16,312.6	21,327.6
Treasury	2,737.0	4,061.2	3,887.4	1,916.8	3,912.2
Commercial	5,087.8	8,019.9	12,504.2	14,395.8	17,415.4
Loans and Advances	209,801.6	242,498.2	305,751.1	384,269.2	486,698.8
Public Sector	2,757.9	4,446.4	4,582.0	3,966.3	7,024.1
Other Financial Institutions	21,535.3	19,467.7	26,069.8	13,615.5	20,615.3
Private Sector	184,198.4	217,677.4	274,075.1	364,705.3	455,986.5
Foreign	1,310.0	906.7	1,024.2	1,982.1	3,072.9
Securities	105,245.3	124,731.8	160,280.7	202,523.0	213,036.9
Malaysian Government	61,046.5	61,056.1	61,532.8	67,626.9	66,818.9
Foreign	68.8	91.6	92.8	385.9	790.6
Corporate	41,703.1	56,061.0	53,575.6	124,565.9	138,543.2
Others	2,426.9	7,523.1	45,079.5	9,944.3	6,884.2
Gold and Foreign Exchange Reserves	75,309.4	66,830.8	61,681.9	67,864.6	57,068.2
Other Assets	54,781.0	56,608.0	62,312.8	98,703.4	119,177.7
Total Assets	**572,156.5**	**625,419.7**	**747,564.0**	**919,100.7**	**1,117,224.8**

Source: Bank Negara Malaysia.

Appendix 2

Table A2.4: Commercial Banks: Loans and Advances to Major Sectors, 1980–1997 (RM million)

Sector	1980	1985	1990	1995	1996	1997	Annual Growth (percent) 1980–1997	1993–1997
Broad Property	5,349.2	16,995.5	24,205.7	46,363.3	58,919.7	76,372.9	17	21
Consumption Credit	147.1	590.6	1,906.3	6,390.3	8,097.2	7,016.4	25	16
Manufacturing	4,693.8	8,583.9	18,743.7	42,410.1	47,950.1	58,348.0	16	21
Financial Services	1,297.3	5,809.2	9,115.3	23,766.2	33,892.4	45,375.0	23	28
Share Purchases	201.7	1,073.7	2,280.6	7,998.6	9,409.8	10,788.5	26	37
Wholesale/Retail Trade	4,644.2	8,752.0	11,642.6	19,075.4	22,190.7	29,349.1	11	21
Total Lending[a]	21,031.1	48,981.7	80,758.0	175,007.4	217,820.5	289.583.4	17	25

[a] Inclusive of other sectors.
Source: Bank Negara Malaysia.

Appendix 2

Table A2.5: Finance Companies: Loans and Advances to Major Sectors, 1982–1997 (RM million)

Sector	1982	1985	1990	1995	1996	1997	Annual Growth (percent) 1982–1997	1993–1997
Broad Property	2,449.7	5,061.3	8,430.1	15,070.3	18,336.0	21,437.2	16	14
Consumption Credit	1,414.5	2,964.9	11,588.4	32,605.2	43,179.9	48,429.0	27	23
Manufacturing	294.6	617.8	1,336.0	4,004.7	4,999.1	6,699.4	23	28
Financial Services	187.7	603.9	641.3	1,647.1	2,103.7	2,030.2	17	21
Total Lending[a]	5,712.0	12,325.8	27,023.0	62,752.0	82,496.7	102,545.8	21	24

[a] Inclusive of other sectors.
Source: Bank Negara Malaysia.

Appendix 2

Table A2.6: Banking System: Key Data, as of Year-end, 1993–1997

Item	1993	1994	1995	1996	1997
Number of Institutions					
Commercial Banks	37	37	37	37	35
Finance Companies	40	40	40	40	39
Merchant Banks	12	12	12	12	12
RWCR (percent)					
Commercial Banks	12.4	11.3	11.1	10.8	10.3
Finance Companies	8.8	10.1	9.7	9.8	10.6
Merchant Banks	10.0	8.2	11.9	11.7	13.3
Number of Branch Network					
Commercial Banks	1,220	1,283	1,433	1,569	1,671
Finance Companies	789	860	988	1,096	1,144
Merchant Banks	17	17	18	24	24
Number of ATM Network					
Commercial Banks	1,558	1,975	2,230	2,326	2,573
Finance Companies	299	345	402	525	627
Persons Served per Office					
Commercial Banks	15,614	15,191	14,024	13,492	12,986
Finance Companies	24,100	22,849	20,341	19,314	18,969
Number of Employees					
Commercial Banks	54,569	59,674	64,461	68,068	73,530
Finance Companies	20,500	22,488	24,593	26,322	27,937
Merchant Banks	1,900	2,179	2,334	2,592	2,802

ATM = automated teller machine, RWCR = risk-weighted capital ratio.
Source: Bank Negara Malaysia.

Appendix 3

Capital Components and Incentives Accorded to Tier-1 Banking Institutions

CAPITAL COMPONENTS

The key component of total bank capital is equity or tier capital, which has three subcomponents, as follows:

- paid-up share capital;
- share premium (the difference between the price at which the common stock is sold and its par value, times the number of shares sold); and
- retained earnings through undivided profits.

INCENTIVES ACCORDED TO TIER-1 BANKING INSTITUTIONS

Commercial Banks

- issuance of negotiable instruments of deposit up to five times of their capital funds; participation in equity derivatives subject to compliance with the Guideline on "Minimum Standards on Risk Management Practices for Derivatives";
- participation in the share borrowing and lending activities subject to the approval of the Securities Commission; and
- for tier-1 domestic commercial banks, regional expansion of operations through the establishment of branch offices, representative offices, subsidiary companies, or on joint-venture basis.

Finance Companies

- provision of factoring services;
- provision of remittance service with Malaysia, including bankers' checks, demand drafts, payment order, and telegraphic transfer. However, a finance company should use only the checks of the commercial bank belonging to the same group, or otherwise, the checks of tier-1 commercial banks;
- participation in special funds established by BNM (such as Fund for Food, Special Fund for Tourism, New Entrepreneurs Fund, and Bumiputra Industrial Fund);
- granting of unsecured business loans, up to a maximum of RM500,000;
- participation in venture capital financing; and
- issuance of negotiable instruments of deposit up to five times the capital funds.

Merchant Banks

- participation in the following foreign exchange business with the prior approval from the Controller of Foreign Exchange:
  - trading on its own account in the foreign exchange market,
  - undertaking foreign exchange transactions with any customer,
  - lending in foreign currency to resident and nonresident customers other than for the purpose of trade financing subject to the approval of other relevant authorities,
  - borrowing any amount in foreign currency from any licensed bank, licensed merchant bank, or nonresident, and
  - underwriting foreign securities and holding the securities in the event of under subscription;
- participation in domestic and global derivatives markets, subject to compliance with the guideline on "Minimum Standards on Risk Management Practices for Derivatives";
- participation in share borrowing and lending activities subject to the approval of the Securities Commission;
- investment in shares listed in the stock exchanges of Association of Southeast Asian Nations (ASEAN) countries subject to prudential limits;
- issuance of negotiable instruments of deposit up to five times the capital funds;
- acceptance of deposit from individuals subject to minimum amount of RM1 million; and
- expansion of operations regionally through the establishment of branch offices, subsidiary companies, or on joint venture basis.

Source: Bank Negara Malaysia.

Appendix 4

The Evolution of Banking Regulations

Banking reforms were instituted in Malaysia since the 1980s. However, the banking crisis of the mid-1980s and the recent financial crisis have highlighted the weaknesses in the banking sector that were mainly caused by lack of appropriate prudential regulations and adoption of best practices. Strengthening the banking sector will depend much on the effort of the authorities to implement essential structural and policy reforms and embracing global standards of banking practices.

Entry Requirement and Minimum Capital

Commercial banks have to be licensed and no new license has been issued since the 1970s. The minimum shareholders funds of a commercial bank was raised from RM2 million to RM10 million in February 1982 and was further raised to RM20 million in November 1989. BNM has announced that the minimum capital funds for finance companies will be raised from RM5 million to RM600 million by year end-2000 with an interim target of RM300 million to be achieved by mid-1999, and that the required minimum capital for a commercial bank and a merchant bank is under review.

Capital Adequacy

A minimum capital adequacy ratio was first introduced in September 1981 in which local banks were required to maintain a ratio of "free" capital (shareholders funds less investments in long-term assets to total assets) of 4 percent and for foreign banks, 6 percent. In line with the Basle Capital Accord of July 1988, the new guidelines required local and foreign banks to maintain a risk-weighted capital ratio (RWCR) of 8 and 10 percent, respectively, by end-1992 and attain an immediate target of 7.25 and 9.25 percent by end-1990. To reflect the higher risk profile of finance company business, Bank Negara Malaysia (BNM) announced on 25 March 1998 that the minimum RWCR requirement for finance companies would be raised from 8 to 10 percent by end-1999 with an interim target of 9 percent to be achieved by end-1998. An announcement was also made to expand the capital adequacy framework to incorporate market risks for all financial institutions (FIs).

Restriction in Ownership

Legal provisions to regulate the size of share-holdings in an FI came into force in January 1986. The maximum holding of an individual including family holding companies in the equity of an FI is 10 percent while any company or cooperative may not hold more than 20 percent. But there are provisions in the legislation to empower the authorities to exempt any person from these shareholding limits. This was aimed at meeting the Government's goal on equity ownership with respect to indigenous communities. However, in the mid-1990s, nonindigenous groups were also allowed to acquire a majority interest in an FI. Although there were no provisions in the legislation specifying who should or should not be shareholders, there was an unwritten consensus restricting cross-ownership between banks and the corporate sector. This consensus had been broken in the mid-1990s with conglomerates allowed to take majority stakes in FIs. But this should not create a moral hazard type of behavior because of prohibitions on the granting of director or shareholder related loans (except in cases where the shareholding interest is nonmaterial).

Single Borrower Limit

Lending to a single customer (or to a group of related companies) was set at 30 percent of a bank's shareholders funds and to large borrowers (each with loans of 15 percent or more of a bank's capital funds) at 50 percent of its total credit facilities in September 1984. The single customer limit was reduced to 25 percent with effect from 25 March 1998 with the proviso that in cases where the consolidated limit exceeded the 25 percent limit, banking institutions (BIs) would be allowed to run these facilities to maturity.

Interest Suspension and Specific Provisions with Respect to Nonperforming Loans

Although the guidelines became effective in January 1986, compliance became mandatory only in January 1990. Almost all financial institutions were complying even before it became mandatory. Until 1989, the guidelines required that interest be suspended only after the loan has been nonperforming for 12 months. However, on all such nonperforming loans (NPLs), the guidelines required a claw back to day one of interest income that had been recognized but had not been collected. With effect from January 1990, the claw back requirement was suspended but interest had to be suspended on all loans that had been nonperforming for at least six months. In general, the guidelines on interest accrual, loan classification, and loan-loss provisioning did not meet the standards of international best practice.

These guidelines were improved effective 1 January 1998 but they still fall short of current international standards. The default period for classifying a loan as a NPL and for suspending interest by a licensed FI has been lowered from six to three months. FIs are allowed to claw back interest to day one only for new NPLs. With respect to loan-loss provisioning, starting July 1998, the requirement has been raised to 20 percent for a substandard loan, remains unchanged at 50 percent for a doubtful account, and 100 percent for a bad account. The period of default beyond which a worse-off classification is required was reduced to six from 12 months in case of a substandard loan and to 12 from 24 months for a doubtful account.

In 1990, foreign banks were required to maintain a general provision account amounting to at least 1 percent of their total loans, net of specific provisions for bad and doubtful debts. This has been increased to a minimum of 1.5 percent beginning January 1998.

Financial Reporting and Disclosure Requirements

Financial reporting improved from 1990 onwards with the guidelines issued on interest accrual, loan classification and loan-loss provisioning. Some disclosure measures were also implemented to determine whether these guidelines were being adhered to.

Further disclosure requirements on loan quality were introduced in January 1998, to include the size of FIs' NPLs (net of interest-in-suspense and specific provision). With respect to the reporting standards of FIs' portfolio of investment securities (as opposed to trading securities), the guidelines need to be tightened as they are based on the higher of cost or market value and there exists no clear distinction between type of securities. The difference is amortized over the remaining life of the securities and charged to the profit and loss account. Likewise, the reporting system for off-balance sheet items is reportedly not meeting best international practice.

FIs' financial statements had been released on a semiannual basis but only year-end results were audited. Effective July 1998, the FIs have been required to release quarterly reports on their capital position and the size of their NPLs.

Reserve and Liquidity Requirements

Statutory reserve requirement (SRR) as a percentage of the eligible liabilities base was 5 percent from 1980 to 1984 when Malaysia was pursuing a tight monetary policy. This ratio declined to 3.5 percent in 1986 and remained at that level until 1988. Thereafter, the ratio was raised steadily but was set at 13.5 percent in June 1996. The ratio was again reduced gradually to 4 percent in 1998 to minimize the problem of disintermediation.

From 1980 to 1985, a commercial bank was required to hold a minimum overall liquid asset ratio of 20 percent against its eligible liabilities base, of which half had to be in the form of primary liquid assets. The minimum overall liquid asset ratio requirement was reduced to 17 percent in 1986. The primary liquid asset requirement was reduced from 10 percent in 1986 to 8 percent in 1987 and 5 percent in 1988.

No restriction has been placed on the composition of overall liquid assets from 1990.

The eligible liabilities are now defined more broadly to capture all types of funding. These include repos and the net inflow of funds from abroad, which together constituted 10 percent of the eligible liabilities base in 1995. This means that a SRR of 13.5 percent is equivalent, on a conservative basis, to a requirement of 15 percent on the more narrowly defined eligible liabilities base, which was in use until 1989.

Restrictions on Banks Investing in Potentially Volatile Securities

From 1985, banks were permitted to invest in trustee shares of up to 10 percent of the paid-up capital of a publicly quoted company, or 10 percent of the shareholders' funds of the concerned bank provided that the aggregate of investments in trustee shares did not exceed 25 percent of their shareholders' funds. A bank could acquire any shares in satisfaction of debts and for a specified period only with the approval of the central bank. In 1989, a bank's investment in shares, units in property trusts, and fixed assets could not exceed 50 percent of its capital base (net of investment in subsidiaries and in other FIs). Effective 30 April 1991, shares or properties acquired involuntarily as a result of underwriting commitments in satisfaction of debts or due to foreclosure were not required to be included in the 50 percent limit provided the period for which they have been held did not exceed the allowable time period. In February 1991, a limit was imposed on loans of merchant banks secured by shares to 25 percent or less of their total credit facilities. The corresponding limit that applied to a commercial bank was 10 percent. Effective October 1994, the limits on lending secured by shares and assets of unit trust funds were raised to 15 percent for commercial banks and 30 percent for merchant banks. The limit for commercial banks was raised to 20 percent in September 1998.

Mechanisms to Control Currency and Maturity Risks, Including Off-Balance Sheet Risks

BNM sets limits on banks' foreign exchange (FX) exposures, generally equivalent to RM400,000. The advantage of such limits was for banks to have little or no currency risk. However, such limits were seen to have curtailed the FX treasury operations of the banking system and hampered the development of its expertise in managing currency risks.

BNM does not set any specific limits on a bank's maturity risks. The maturity mismatch when a bank funds its long-term assets with short-term funds gives rise to a liquidity risk, rather than to an interest rate risk. Most loans including the long-term ones are priced on a variable basis, which minimizes any interest rate risks.

In the management of the liquid asset portfolio, an FI is exposed to the highest degree of interest rate and liquidity risks. Under Malaysian regulations, 17 percent of an FI's eligible liabilities has to be held in the form of certain designated liquid assets. Most FIs have been relying on fixed rate Malaysian Government securities of up to 10-year maturities to comply with their liquid asset requirements. The lack of well-developed and liquid cash futures markets in bonds have made it impossible for an FI to hedge the interest rate risk on its Malaysian Government securities portfolio. This is also the case for FIs' leasing portfolio and finance companies' hire-purchase portfolios as these loans are priced on a fixed rate basis and are usually of three to five years maturity. Cagamas Berhad has reduced the liquidity risk of the banking system from the big mismatch it faced in funding its sizable portfolio of long-term housing loans with short-term funds. Cagamas Berhad is a national mortgage corporation established in 1987 that specializes in buying and refinancing housing loans on a securitized basis through the issue of Cagamas bonds. In fact, the development of the mortgage bond market has also enabled the banking system to raise long-term fixed rate funds from the sale of such housing loans to Cagamas Berhad.

Until the mid-1990s, BNM did not impose any restrictions on or have any reporting requirements to monitor and control the off-balance sheet risks of a bank, especially with respect to derivatives. Onshore banks had been engaged in derivative trading with Malaysian corporates on a back-to-back basis with offshore banks. Any Malaysian corporate could only buy an option but not write one, even if its underlying position could enable it to do so with little or no risk. After the much-publicized derivatives debacles of 1994, BNM prohibited banks from engaging in derivative trade without its explicit approval. This blanket ban was lifted in 1996. A bank is permitted to engage in derivative trading as long as its board has satisfied itself that it has the in-house resources systems and dynamic hedging capability to manage risk exposures arising from such trades. The bank is also required to submit regular reports on its net open positions in derivative products. However, because of the underdeveloped domestic markets, even rudimentary value-at-risk analysis and dynamic hedging will be constrained by the illiquid markets and the paucity of hedging tools.

Neutrality of the Regulatory Framework Across Institutions and Activities

In the mid-1980s, the regulatory framework was not neutral across institutions and activities. The reserve requirement was 5 percent for commercial banks, 2.5 percent for finance companies, and 1.5 percent for merchant banks; and the reserves earned no interest. The differential was reduced in 1985 and eliminated in 1989.

Liquidity requirements were 20 percent for commercial banks, and 10 percent for finance companies and merchant banks. There was no distinction in the liquid assets held by merchant banks but commercial banks and finance companies had to hold half of their liquid assets in the form of primary liquid assets and the balance in secondary liquid assets. The average yield was higher on secondary liquid assets than on primary liquid assets. However, these yields were often below their funding costs. From 1986, the liquidity requirement of commercial banks was reduced to 17 percent. The primary liquid asset requirement was cut from 8 percent in 1987 and 5 percent in 1988. No restrictions were imposed on the composition of liquid assets from 1989.

Finance companies were no longer required to hold primary liquid assets from 1989. Although the liquidity requirement of finance companies and merchant banks has been set at 10 percent, finance companies and merchant banks with the authority to issue negotiable certificates of deposits since 1990 and 1987, respectively, have been required to maintain the ratio at 12.5 percent. Thus there has been still a significant differential in liquidity requirements for commercial banks, finance companies, and merchant banks from 1989.

The priority sector lending requirements were imposed only on commercial banks and finance companies but not on merchant banks. In 1985, about 25 percent of the loan portfolios of commercial banks were subject to an interest rate ceiling. This was reduced to below 20 percent in 1989 and to below 5 percent in 1995. But the interest rate ceilings were less pernicious in the lower interest rate environment during the late 1980s and the 1990s. Likewise, the lending quotas were also set often below the market clearings.

With respect to gearing, until the mid-1980s, a commercial bank was allowed to gear itself up to 25 times its shareholders funds whereas a merchant bank or a finance company was allowed a gearing of only 15 to 20 times, respectively. From September 1989, FIs were required to adhere to the same capital adequacy framework based on the Basle Capital Accord. Under this risk-weighted assets approach, a capital adequacy ratio (CAR) of 7.25 percent was required to be attained by end-1990 and the minimum standard of 8 percent by end-1992.

An FI often incurs a funding loss on its holdings of statutory reserves and liquid assets. These assets do not contribute anything towards the recovery of an

FI's overhead or contribute any returns to its equity capital. Although there are little or no losses incurred on the funding of priority sector loans, they make little or no contributions towards overhead or equity.

In the mid-1980s, the impact of existing regulations and guidelines was such that the worst hit were the finance companies followed closely by the commercial banks while the least hit were the merchant banks. With the easing of the interest rates from the late 1980s, the cost of the regulatory burden has come down and with the harmonization of regulations across institutions the differential cost burden has been reduced considerably.

Audit and Replacement Capacity of the Regulatory Institutions

The supervisory process is conducted via on-site examination as well as off-site supervision. On-site examinations cover credit risks, foreign exchange, interest rate, and liquidity risks from mismatches in assets and liabilities, as well as internal controls.

On-site examinations are confined not just to prudential concerns for the safety and soundness of a bank. A great deal of time is also devoted to examining if a bank is complying with BNM's regulations and directives. This is a factor undermining the effectiveness of on-site examination strictly from a prudential standpoint.

The prudential reports of most off-site surveillance activities focus on the liquidity and statutory reserve ratios and not enough on an ongoing assessment of a bank's asset quality or of its off-balance sheet exposures. But the blanket banning of derivative activities from early 1995 and the extremely conservative limits set on overnight foreign exchange exposures limit the off-balance sheet risks of Malaysian banks.

Generally, it can be said that the off-site supervisory process relies not only on a static review but also on a comparative analysis of data. Although BNM has the power to suspend licenses, it has never exercised this power although it has been prepared to change the board and management, or the shareholding of a bank when necessary. The fines and sanctions imposed are commensurate with the violations and if warranted by the severity of the violations, the sanctions are made public. Cease and desist orders have also been issued and the censures have been published.

The shortage of skilled personnel in the country, a remuneration package that is not market-determined, and overpreoccupation with distribution considerations in its employment policy have undermined the quantity as well as the quality of BNM's examination and enforcement activities in recent years.

Source: Thillainathan, *The Current Malaysian Banking and Debt Crisis and the Way Forward*, 1998.

Appendix 5

Recent Banking Sector Stabilization Measures

Measures	Status/Implementation Date
Loan Classification and Provisioning Standards	
• Minimum level of general provisions for bad and doubtful debts raised to 1.5 percent of total loans.	January 1998
• Classification standards (including three months for nonperforming loans [NPLs]) brought to best practice.	January 1998
• A 20 percent provisioning required against the uncollateralized portion of substandard loans.	January 1998
• Off-balance-sheet items incorporated in the loan classification and provisioning system.	March 1998
• Classification period for NPLs relaxed from three to six months.	September 1998
• Automatic 20 percent specific provision removed for substandard loans.	September 1998
Capital Adequacy Framework	
• All banking institutions (BIs) required to value their credit exposure for interest rate and foreign exchange related contracts by using "current exposure method" instead of the "original exposure method."	June 1997
• RWCR to be complied with on consolidated basis every financial quarter.	April 1998
• Capital adequacy framework expanded to incorporate market risk.	July 1998
• Minimum risk-weighted capital ratio (RWCR) of finance companies increased from 8 to 10 percent with interim compliance of 9 percent.	9 percent—end-1998 10 percent—end-1999
• Minimum capital funds of finance companies increased from RM5 million to RM300 million and subsequently to RM600 million.	RM300 million by mid-1999 and RM600 by end-2000
Intensified Monitoring Institutions	
• Bond Information and Dissemination System launched to provide comprehensive market information on domestic debt securities to market participants.	October 1997
• More intensive and rigorous supervision including conducting monthly stress tests on individual BIs.	Ongoing
• Surveillance system to be continually enhanced and refined to ensure early detection of potential risks.	Ongoing
• Cooperation and coordination to be enhanced with other supervisory authorities.	Ongoing
Liquidity Support and Management	
• Preemptive prudential measures to limit lending to the property sector and for the purchase of stocks and shares.	April 1997
• Limits on noncommercial related ringgit offer-side swap transactions with foreign customers.	August 1997
• Prudential standards to be strengthened by: – classifying NPLs in arrears from six to three months, – greater financial disclosure by BIs, and – increasing general provision to 1.5 percent.	October 1997
• Credit plan introduced to limit loan growth to 15 percent by end-1998.	October 1997
• Rules tightened in hire-purchase financing.	October 1997
• Good corporate governance to be promoted through enhanced disclosure of information and closer scrutiny for corporate restructuring.	December 1997
• Funds raised in the corporate market must be allocated to the productive sectors.	December 1997
• Statutory reserve requirement (SRR) reduced by 3.5 percent of eligible liabilities to 10 percent to enhance efficiency and effectiveness of the intermediation process. SRR amount offset by reducing Bank Negara Malaysia's (BNM) lending to BIs by at least the same amount.	February 1998
• Single customer limit reduced from 30 to 25 percent of capital funds.	March 1998

Continued next page

Appendix 5

Recent Banking Sector Stabilization Measures (Cont'd)

Measures	Status/Implementation Date
• Market participants to be provided with daily information on BNM's operations and its impact on liquidity.	April 1998
• BNM's three-month intervention rate raised from 10 to 11 percent.	April 1998
• Daily band for averaging of balances to meet the SRR to be widened.	June 1998
• Liquidity framework reviewed to provide BIs with more efficient mechanism to manage their own liquidity and provide BNM with more effective means to assess liquidity position of BIs.	July 1998
• Liquidity support to BIs to be separated from the normal liquidity operations of BNM in the conduct of monetary policy. Lending to BIs to be at penalty rates and fully collateralized. Support would be short-term with clear time frame for repayment.	July 1998
• Role of SRR and liquid asset ratio requirement and measures to improve efficiency in the interbank and loan markets under review.	July 1998
• Base lending rate framework under revision.	September 1998
• A minimum loan growth rate of 8 percent to be achieved by the end of 1998.	September 1998
• BIs urged to accord priority in lending for the construction or purchase of residential properties.	September 1998
• Limit on loans for the purchase of shares and units of unit trust funds increased from 15 to 20 percent for commercial banks and finance companies.	September 1998
• Indirect monetary instruments (open market operations and repurchase operations) to be developed to replace uncollateralized deposit placements.	1999
Disclosure	
• Statistics aggregated on NPLs, provisions, and capital position of commercial banks, finance companies, and merchant banks.	October 1997
• Financial institutions (FIs) required to report and publish key indicators of financial soundness such as NPL, capital adequacy, etc., both at bank level and on consolidated basis.	October 1997 (every financial quarter)
• Reserve money and its components from BNM.	February 1998 (implemented)
Legal Framework	
• Relevant legislation to be reviewed to effect changes in monetary management and measures to strengthen the banking system.	December 1998
• Regulations governing investment in authorized securities by FIs under review.	December 1998
• Further liberalization of rules to be undertaken at an appropriate time to enhance the ability of businesses to manage their foreign exchange exposure.	Ongoing
Other Issues	
• Implementation of Real Time Gross Settlement System.	January 1998
• Establishment of a national asset management company.	June 1998
• Technical study to be conducted on international practices regarding depositor protection and deposit insurance schemes, and examine possible implications for Malaysia.	November 1998

Notes

[1]The final revision of this report was made in October 1998.

[2]The Seventh Plan's major strategies with respect to the banking sector include:

- maintaining financial stability and enhancing competitiveness of the banking system through increases in the capital base and upgrading of management capabilities;
- increasing efficiency of the banking system through the use of information technology and development of a reliable payments system;
- ensuring prudent management of derivatives activities by banking institutions to avoid financial instability;
- instilling market discipline in the banking system through market forces; and
- developing Islamic banking into an effective avenue for the mobilization and allocation of funds.

[3]Broad property sector excludes the construction of residential properties costing RM150,000 and below; infrastructure projects, public utilities, and amenities; and industrial buildings and factories.

[4]The initial paid-up capital of the agency is estimated at about RM250 million. The seed financing will be from the Government, which will provide a start-up grant of RM50 million to help in the establishment of the agency. Danaharta plans to raise about RM10 billion for its initial phase of operations through an international and domestic bond issue. Of this, $1 billion to $2 billion will be raised in the international bond markets with a Government guarantee and the remaining funds will be raised internally within the country. Private equity participation will be considered in the succeeding phases.

[5]These measures included:

- reduction of BNM intervention rate from 10 to 9.5 percent;
- reduction of statutory reserve requirement (SRR) from 8 to 6 percent; and
- revision of the basic lending rate framework to allow a faster transmission of changes in monetary policy on interest rate levels, and reduction of the administrative margins of financial institutions from 2.5 to 2.25 percent.

[6]These measures included:

- the repatriation by 1 October 1998 of all ringgit held abroad,
- an end to offshore trading in ringgit instruments and to domestic credit facilities for overseas banks and stockbrokers,
- the retention of the proceeds of the sale of Malaysian securities in the country for a year,
- payment in foreign currency for imports and exports,
- central bank approval for the conversion of ringgit into foreign currency, and
- the fixing of the exchange rate at 3.8 ringgit to the dollar (announced on 2 September 1998).

[7]The SRR declined from 13.5 percent in mid-February 1998.

[8]Unless otherwise stated, all the data used in this publication are from Bank Negara Malaysia monthly and quarterly statistical bulletins and annual reports.

[9]A bank had to show shareholders' funds of RM500 million to qualify as a tier-1 bank when the scheme was introduced. In addition, the banks also have to fulfill certain criteria based on the capital, adequacy, management, earnings, and liquidity (CAMEL) rating accorded to them. Currently, shareholders' funds should be RM1 billion by end-1998, and, further, the institution should have RM1 billion in paid-up capital by end-2000.

[10]Rashid Hussain Bank (RHB) was formed out of a merger between DCB Bank and Kwong Yik Bank, both tier-1 institutions, and emerged as the second largest bank. RHB has agreed to buy Sime Bank, which suffered a loss of RM1.8 billion for the half-year ended December 1997 and was in need of RM1.2 billion in additional capital.

[11]There will be six anchor companies: Maybank Finance, Public Finance, Hong Leong Finance, Arab Malayan Finance. EON Finance, Credit Corporation, and United Merchant Finance.

[12]Malaysian banks posted an increase of 25 percent in 1997 in their pretax income over 1996; and pretax return on equity increased from about 21 percent in 1993 to about 26 percent in 1997.

[13]The views expressed here with regard to the market's perception of the problems are based on the discussions with a number of bankers and private sector analysts in Malaysia and Singapore.

[14]In an interview with *Euromoney* Magazine (10 April 1998), the former Minister of Finance and now Minister of Coordination stated that rights issues would allow banks to recapitalize on their own, which is a desirable option.

[15]Supervisory authorities have been invited to endorse the Core Principles, not later than October 1998. Endorsement includes undertaking a review of current supervisory arrangements against the Core Principles.

[16]Refer to BNM/GP3, “Guidelines on the Suspension of Interest on Nonperforming Loans and Provision for Bad and Doubtful Debts” and the on-site examination process.

[17]Refer to BNM/GP5, “Guidelines on the Credit Limit to a Single Customer” and sectoral limits such as for the broad property sector and lending for the purchase of shares.

[18]Refer to BNM/GP6, “Guidelines on Prohibition of Loans to Directors, Staff and their Interested Parties.”

[19]Country risk refers to risks associated with the economic, social, and political environments of the borrower’s home country. Transfer risk arises when a borrower’s obligation is not denominated in the local currency; the currency of the obligation may become unavailable to the borrower regardless of the borrowers’ particular financial condition.

[20]BNM’s Bank Regulation Department will be considering additional guidance on country/transfer risk via an amendment to BNM/GP3 “Guidelines on the Suspension of Interest on Nonperforming Loans and Provision for Bad and Doubtful Debts” to establish specific provisions for country/transfer risk. This would likely also result in a revision to examination procedures.

[21]As a private sector analyst commented, “Malaysian conglomerates have become masters at weaving complex forms of corporate restructuring, opening the possibility of transferring the root of the problems from one company to another.”

[22]Maybank International, Sime International Bank, BBMB International Bank, RHB Bank, Public Bank, Bank of Commerce, and AMMB International are the Malaysian financial institutions that have their subsidiaries operating in Labuan.

[23]Say, RM30,000, which is equivalent to four times of per capita gross domestic product.