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Stabilisation Package for the Financial Sector

Bank Negara Malaysia/Central Bank of Malaysia

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Stabilisation Package for the Financial Sector

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Further to the announcement by the Deputy Prime Minister at the Dewan Rakyat on 24 March 1998, on the package of macroeconomic measures aimed at fully restoring investor confidence and creating an environment that would support the return of the economy to a stronger growth path, Bank Negara Malaysia (BNM) provides below details of the package pertaining to the financial sector.

Monetary Policy

The maintenance of a tight monetary policy is an integral part of the economic stabilisation policy package that was implemented in 1997. This stance will continue in 1998 to contain inflationary expectations that may be generated by higher import prices as a result of the ringgit depreciation. At the same time, monetary policy has to be flexible, given the uncertainties on the external front, notably the magnitude and duration of the regional financial crisis, the prospective stance of United States monetary policy and concerns over the sustainability of its equity markets, and developments in Japan.

The elements of monetary management are as follows:

(a) M3 growth is estimated at 12% to be consistent with GDP growth of 2-3% and an inflation rate of 7-8%.

(b) Credit growth will moderate to about 12-15% in line with the October 1997 credit plans of banking institutions. Within the credit ceilings announced in March 1997 and the guidelines for drawing up their respective credit plans, low priority should be given to the financing for property (other than residential property costing less than RM150,000 per unit) and for stocks and shares.

(c) While it is critical that credit growth slows down to a rate that is consistent with the macroeconomic outlook, it is also essential, within the environment of slowing growth, to ensure that productive activities receive adequate financing. In this regard, flexibility has been accorded to all banking institutions that have the capacity, to continue to extend financing support and working capital for productive activities, including export-oriented industries. This flexibility is not expected to result in a breach of the objective to contain credit growth for the banking system to not more than 15% by the end of 1998.

(d) It is the Bank’s policy that the productive sectors should have access to funds at competitive and reasonable cost. In moving towards establishing a flexible interest rate regime, BNM will review its present practice of limiting the maximum margin which may be added to the market-determined BLR. This review will take into account the transparency of banking institutions in determining their lending rates.

(e) Interest rates will remain an important policy instrument. The underlying interest rate will be adjusted to contain inflationary expectations due to demand pressures. The objective of policy is to ensure a positive real rate of return to savers. In the day-to-day operations of liquidity, the Bank will continue to have the option of using interest rates for a short period of time to support intervention operations to stabilise the ringgit exchange rate.

(f) The Bank will continue to enhance information on liquidity operations so as to provide clear policy signals on the stance of monetary policy. Monetary management of the Bank will also be directed towards a sharper focus on interest rates as the intermediate target. In this connection, the normal liquidity management in the conduct of monetary policy will be separated from liquidity support operations. To promote greater understanding of the Bank’s market operations, information will be provided on a daily basis to market participants on the Bank’s operations and its impact on domestic liquidity.

(g) The Bank will undertake measures to remove distortions and enhance efficiency in the interbank and loan markets, as well as facilitate the flow of liquidity. The role of the statutory reserve requirement (SRR) and the liquid asset requirement (LAR) will be reviewed. In the immediate term, and under current circumstances, the SRR will be maintained at the current level of 10%. However, to allow banking institutions greater flexibility in managing their assets and liabilities, the Bank intends to widen the daily band for averaging of balances to meet the SRR.

(h) Transparency in monetary operations is being effected through disclosure and publication of a broad range of indicators of monetary conditions.

Monetary policy will continue to be implemented in co-ordination with other macroeconomic and prudential measures to achieve macroeconomic and financial stability. This co-ordination is essential in the light of the following:
Banking Sector

The focus of the measures announced by the Minister of Finance yesterday was directed at strengthening the supervisory and regulatory framework to safeguard the soundness of the banking system and enhance its ability to adjust to the more challenging business environment. The following paragraphs elaborate on the measures announced yesterday.

Strengthening the Regulatory and Supervisory Framework

Despite the persistent volatility in the foreign exchange and stock markets in the region, the banking system in Malaysia is still fundamentally strong. Nonetheless, as mentioned in early December last year, while the banking system remains intact and strong, there may be some banking institutions that may face difficulties should the adverse developments in the financial markets continue. This was reflected in the stress test conducted by BNM which highlighted that besides Sime Bank Berhad, three other banking institutions would require further recapitalisation should the extreme conditions materialise in order to comply with the minimum 8% risk-weighted capital ratio. The assessment was made against international best practices and stringent standards on loan classification and provisioning requirement, and assumptions on worst case scenarios on NPL and provisions.

Notwithstanding the stress test which revealed that the banking system remains resilient during this difficult period, BNM would further intensify the supervision of banking institutions, focussing on early identification of problems and taking of pre-emptive actions to require banking institutions to raise capital. Maintaining a sound and strong banking system remains a core objective of BNM. Therefore, BNM will forge ahead with efforts to further strengthen the banking system in terms of sound banking practices, stronger prudential regulations and supervision and greater transparency. Against this background, BNM will pursue the following policies and introduce the following measures:

(a) While reducing price and demand pressures and re-establishing macroeconomic stability are necessary to restore confidence, they are insufficient on their own. Stability in financial markets, including the ringgit exchange rate, is equally important. In this regard, ensuring that productive sectors of the economy have access to financing is the basis for sustained recovery, and is also an important element in restoring investor confidence.

(b) To achieve macroeconomic stability, both monetary policy and fiscal policy need to share in the burden of adjustment. The maintenance of tight fiscal policy ensures that the public sector does not aggravate demand pressures and promotes greater financial discipline in government expenditure. The shared burden will also ensure that there is no over-reliance on interest rates that will result in interest rates that are higher than necessary. In this way, the more serious adverse implications of such high interest rates on the domestic economy could be minimised. Monetary policy will, however, ensure that the real interest rate will remain positive to encourage domestic savings.
Liquidity support will be separate and distinct from the normal liquidity management in the conduct of monetary policy. The objective of this move is to enable greater transparency in the Bank’s liquidity operations. Lending to banking institutions under the new facility would be at penalty rates and fully collateralised. Banking institutions that borrow from this facility would be required to present concrete plans on how to normalise their liquidity position as well as plans for repayment of the support facility within a specified period.

The implementation of some of the measures described above may also require a review of certain provisions of the Banking and Financial Institutions Act 1989 and other related legislations.

Merger Programme for Finance Companies

The main objective of the merger programme is to consolidate the finance company industry. The programme is also part of an overall pre-emptive strategy of BNM to further increase the resilience of the finance companies to withstand any risk from the slowdown in the economy.

BNM wishes to emphasise that the current merger exercise is market driven with BNM facilitating the process. Mergers would only be allowed if the merged entity would be fully capitalised at all times. Final approval would be contingent upon the completion of upfront due diligence review by reputable international accounting firms. The due diligence would also assess the possible further deterioration in asset quality during the course of the year. By strict upfront due diligence in arriving at the purchase consideration, BNM is ensuring that the merger programme would be market-based and transparent and that the purchase consideration would be fair to all parties.

In cases where the assets and liabilities of the finance company are absorbed by their parent commercial bank, the commercial bank would be allowed to convert some of the finance company branches to commercial bank branches. Foreign-owned banks that absorb the business of their finance company subsidiaries would be allowed to relocate the same number of their existing bank branches. To ensure that the financial position of the acquiring institution is not weakened, and to ensure that the Government contributes its part in this effort to consolidate the industry through the merger process, the Government will extend a one year guarantee to the acquiring institution in the event of any further reduction in value of the acquired assets. It is emphasized that the guarantee will apply only to the valuations established after due diligence, hence minimising any risks to the potential use of government resources. In view of the strict due diligence process, any potential use of government resources is expected to be small. The use of government resources would be
undertaken in a consistent, explicit and transparent manner, through direct government allocation built into the budgetary framework, or through explicitly quantified tax credits. The Government’s interests will be protected throughout the merger process (from the commencement of due diligence through final closure of the merger process) to ensure that any claims on the Government are fully substantiated.

To protect the interests of the Government, and minimise costs, efforts in loan recovery will continue and specific incentives are being incorporated into the programme so that there is sharing of any upside benefits between the Government and the acquiring finance companies. Under this arrangement, 80% of all recoveries or liquidation of assets of the institution being acquired will accrue to the Government, while the remaining 20% will go to the acquiring institution.

The acquiring institutions are given the flexibility to implement cost rationalisation measures that may be necessary for future viability and in order for them to realise maximum benefits from the mergers.

The mergers of finance companies are progressing well with eight announcements made so far. It is expected that another 20 of such announcements will be made before the 31 March deadline. With these mergers, the number of finance companies would be reduced from 39 to about 10 institutions. To ensure that the finance company industry continues to remain sound, the minimum risk-weighted capital ratio requirement for finance companies will be raised gradually from 8% to 10% with effect from 1 January 2000, with an interim ratio of 9% to be complied by end of 1998. In addition, BNM will be reviewing the regulatory framework governing the operations of finance companies as well the scope of finance company activities after the consolidation of the finance company industry has been completed.

Any individual institution that elect to stay out of the merger programme will be required to demonstrate its ability and commitment to comply with the new capital requirement. If the finance company is unable to comply with this, appropriate actions as provided by the Banking and Financial Institutions Act 1989, including closing down these finance companies, would apply.

Development of the Financial System

The further development of the financial system to broaden and deepen financial markets is another important area of policy to ensure the maintenance of monetary and financial stability, while creating a more competitive financial sector. The development of the financial system in a coordinated and concerted manner would contribute to the strengthening of the financial system, enhance the risk-bearing capacity of the economy, improve the effectiveness of monetary policy, and raise the efficiency of the intermediation process. Specific measures will be adopted over the medium to longer term, and will be implemented in a coordinated manner to ensure that all factors for market success and prudential considerations are given appropriate attention.

In the immediate term, work has already commenced in several areas and announcements of their implementation will be made during the course of 1998 and 1999.

(a) **In the area of market development, efforts to develop the bond market will be expedited.** The development of this market, including measures to facilitate greater securitisation, will not only make available financing of the appropriate maturity structures but will also reduce reliance on the banking system. In 1997, several measures have been implemented to develop the bond market: the automation of the tendering process for commercial papers; the maiden issue of Khazanah bonds which will be the basis for developing the benchmark yield curve for the ringgit bond market; and the launching of BIDS (the Bond Information and Dissemination System), a computerised information system for market participants. In the foreign exchange area, further liberalisation of rules will be undertaken at an appropriate time to enhance the ability of businesses to manage their foreign exchange exposure.

(b) **BNM will also be developing more indirect instruments of monetary policy to replace uncollateralised deposits to provide greater scope and flexibility in the management of liquidity.**

(c) **The BLR (base lending rate) framework will be reviewed, including the maximum spread of four percentage points above the BLR.**

(d) **A new liquidity framework to provide BNM with a more effective means to assess the liquidity position of banking institutions, and to allow banking institutions to manage their own liquidity more efficiently.**

(e) **The regulations governing investment in authorised securities by financial institutions will be reviewed.**

(f) **The Real Time Gross Settlements System will be implemented on 1 January 1999.**

The time table for implementation of the measures is in the Appendix.

Bank Negara Malaysia
25 March 1998

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**Appendix**

**Malaysia : Details of Policy Package for Strengthening the Prudential Framework, Disclosure, and Monetary Management**
<table>
<thead>
<tr>
<th>Measures</th>
<th>Status/Implementation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Loan classification and provisioning standards</strong></td>
<td></td>
</tr>
<tr>
<td>• Bring classification standards (including 3 months for non-performing loans) to best practice.</td>
<td>January 1998 ( Implemented)</td>
</tr>
<tr>
<td>• Require 20 percent provisioning against the uncollateralised portion of substandard loans.</td>
<td>January 1998 ( Implemented)</td>
</tr>
<tr>
<td>• Incorporate off-balance sheet items in the loan classification and provisioning system.</td>
<td>Implemented</td>
</tr>
<tr>
<td><strong>Capital adequacy framework</strong></td>
<td></td>
</tr>
<tr>
<td>• Increase minimum RWCR of finance companies from 8% to 10% with interim compliance of 9%.</td>
<td>9% - end 1998 10% - end 1999</td>
</tr>
<tr>
<td>• Increase minimum capital funds of finance companies from RM5 million to RM300 million and subsequently to RM600 million.</td>
<td>RM300 million by mid-1999 and RM600 million by end-2000</td>
</tr>
<tr>
<td>• Comply with RWCR on consolidated basis every financial quarter.</td>
<td>April 1998</td>
</tr>
<tr>
<td>• Expand capital adequacy framework to incorporate market risk</td>
<td>July 1998</td>
</tr>
<tr>
<td><strong>Other prudential guidelines</strong></td>
<td></td>
</tr>
<tr>
<td>• Reduce single customer limit from 30% to 25% of capital funds.</td>
<td>Immediate</td>
</tr>
<tr>
<td>• Review liquidity framework to provide banking institution with more efficient mechanism to manage their own liquidity and provide BNM with more effective means to assess liquidity position of banking institutions</td>
<td>July 1998</td>
</tr>
<tr>
<td><strong>Intensified monitoring of institutions</strong></td>
<td></td>
</tr>
<tr>
<td>• More intensive and rigorous supervision including conducting monthly stress tests on individual banking institutions</td>
<td>On-going</td>
</tr>
<tr>
<td>• To continually enhance and refine surveillance system to ensure early detection of potential risks.</td>
<td>On-going</td>
</tr>
<tr>
<td>• Enhance cooperation and coordination with other supervisory Authorities.</td>
<td>On-going</td>
</tr>
<tr>
<td><strong>Liquidity support and management</strong></td>
<td></td>
</tr>
<tr>
<td>• Provide market participants with daily information on BNM’s operations and its impact on liquidity.</td>
<td>April 1998</td>
</tr>
<tr>
<td>• Liquidity support to banking institutions will be separated from the normal liquidity operations of BNM in the conduct of monetary policy. Lending to banking institutions will be at penalty rates and fully collateralised. Support would be short-term with clear time frame for repayment.</td>
<td>July 1998</td>
</tr>
<tr>
<td><strong>Disclosure</strong></td>
<td></td>
</tr>
<tr>
<td>• Aggregate statistics on NPL, provisions and capital position of commercial banks, finance companies and merchant banks.</td>
<td>Implemented</td>
</tr>
</tbody>
</table>
- Require financial institutions to report and publish key indicators of financial soundness, such as NPL, capital adequacy etc., both at bank level and on consolidated basis.
  Immediate (every financial quarter)

- Reserve money and its components.
  February 1998 (implemented)

### Legal framework

- Review the relevant legislation to effect changes in monetary management and measures to strengthen the banking system.
  December 1998

- Review regulations governing investment in authorised securities by financial institutions.
  December 1998

- Further liberalisation of rules will be undertaken at an appropriate time to enhance the ability of businesses to manage their foreign exchange exposure.
  On-going

### Monetary management

- Review BLR framework and maximum spread above BLR.
  May 1998

- Widen the daily band for averaging of balances to meet the statutory reserve requirement.
  June 1998

- Review role of SRR and LAR and measures to improve efficiency in the interbank and loan markets.
  July 1998

- Develop indirect monetary instruments (open-market operations and repurchase operations) to replace uncollateralised deposit placements.
  1999

### Other issues

- Conduct technical study on international practices regarding depositor protection and deposit insurance schemes, and examine possible implications for Malaysia.
  November 1998

- Implement the Real Time Gross Settlement System.
  January 1999