CHAPTER ONE

INTRODUCTION

This chapter discusses the evolution of the banking system in Malaysia since 1957. It highlights the development of the three main groups of banking institutions, namely commercial banks, finance companies and merchant banks. The chapter also introduces the CAMEL rating framework which is used to evaluate the relative performance of commercial banks, finance companies and merchant banks in Malaysia from 1990-1998. The purpose and organisation of the study is then presented and this is followed by a discussion of the limitations of the study.

1.1 An Overview of the Banking System in Malaysia

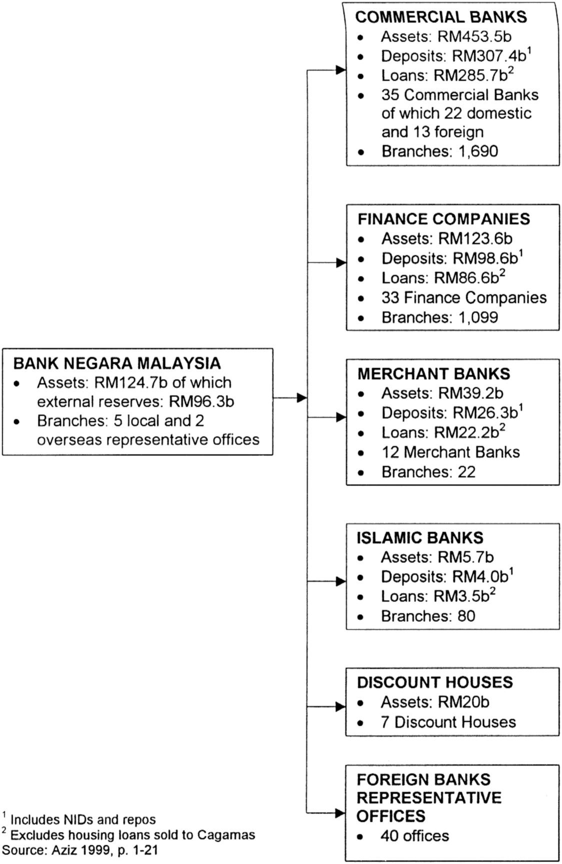
The evolution of the banking industry in Malaysia since the early 1960s reflects the rapid growth and structural change in the domestic economy. The BNM plays a central role in promoting a banking system that is essential for the expanding economy to achieve the social economic growth. More emphasis will be placed on the BNM especially on the bank's capital strength, internal control systems, management and supervisory processes.

The introduction of the Banking and Financial Institutions Act 1989 (BAFIA) to replace the Banking Act 1973 and Finance Companies Act 1969 is mainly intended to provide an integrated supervision of the Malaysian financial system and to modernise and streamline the laws relating to the banking institutions. Generally, the BAFIA empowers the BNM with the authority to regulate deposit-taking institutions, stipulate entry criteria for licensed institutions and prescribe comprehensive protective regulations to protect the interest of depositors and to maintain the confidence and integrity of the banking sector. With regard to the protection of depositors' interest, the BAFIA stipulates that in liquidation, depositor claims are ranked in priority over all other liability claims against the banking institution.

The banking system lies at the heart of the financial system, accounting for more than 70 per cent of total assets of the financial system in 1997 (Aziz 1999, p.1-29). The banking institutions in Malaysia comprise Commercial Banks, Finance Companies, Merchant Banks, Islamic Banks, Discount Houses and Foreign Banks Representative Offices as depicted in Figure 1.1. They are registered, supervised and regulated by the BNM.

The banking institutions act as an intermediary between borrowers and lenders. Equipped with an extensive branch network throughout the country, the banking institutions mobilise savings from the surplus units of the economy and channel these funds to the deficit units, in a cost-effective manner. The banking institutions basically serve to assist in the allocation of scarce resources from the surplus to the deficit. The scarce resources would then be used to their optimum for the development of the nation. In short, as financial intermediaries, banks play a crucial role in the operation of most economies especially in a developing country, like Malaysia. The rapid economic growth and the changing demands of the market transformed the role of the banking system in Malaysia from financing trade, to mobilising savings and effectively channelling these resources to productive sectors. Indeed, the banking system has undergone a profound evolution since Malaysia's independence. Levine's (1996) study has shown that the efficacy of banking intermediation can affect the economic growth.

Figure 1.1: Structure of the Malaysian Banking System
(As at 31st December 1998)



[1] Includes NIDs and repos
[2] Excludes housing loans sold to Cagamas
Source: Aziz 1999, p. 1-21

This study focuses on the three main groups of the banking institutions in Malaysia - commercial banks, finance companies and merchant banks. A brief introduction on the functions of these banking institutions[1] are described as follows:

1.1.1 Commercial Banks

Commercial banks are the largest groups among the banking institutions in Malaysia. Savings account, current account, fixed deposit and negotiable instruments of deposits (NIDs) are the typical transaction accounts provided by commercial banks. They also offer payments or monetary transfers in domestic and foreign currencies, locally as well as internationally. Besides this, commercial banks also provide loans in the form of overdrafts, revolving line of credit, term loans, bridging finance, trade bills, bankers acceptances for working capital, trade finance and capital expenditure.

Prior to the establishment of the BNM in 1959, the operations of the commercial banks in Malaysia were under the ambit of the Companies Ordinance 1948. With the establishment of the BNM in 1959, the activities of the commercial banks were brought under its supervision through the Banking Ordinance 1958, which was amended subsequently on a number of occasions to become the Banking Act 1973. The Banking Act 1973 was further amended with effect from February 23, 1982 to strengthen the basic structure and to tighten supervision of the banking system. This act was subsequently replaced by the Banking and Financial Institutions Act in 1989.

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[1] This section draws substantially from two sources: (1) Money and Banking in Malaysia, 4th edition, 1994 and (2) Bank Negara Malaysia, Annual Report, various issues.

The total number of commercial banks operating in Malaysia as at 31st December 1998 is 35, of which 22 are domestic banks and 13 are foreign banks. Due to the restrictive policy of BNM towards foreign banks operating new branches in Malaysia, the domestic banks have been expanding their branch networks into rural areas.

Table 1.1 compares the commercial banks and branch offices, local as well as foreign incorporated, operating in Malaysia since the early 1960s. This shows that the domestic commercial banks play a dominant role.

Table 1.1: The Breakdown of Commercial Banks Operating in Malaysia

End of Year	Banks			Branch Offices		
	Domestic	Foreign	Total	Domestic	Foreign	Total
1960	10	18	28	29	102	131
1970	16	22	38	177	159	336
1990	22	16	38	852	106	958
1998	22	13	35	1546	144	1690

Source: Computed from Bank Negara Malaysia, Annual Report, various issues

1.1.2 Finance Companies

Finance companies licensed under the Finance Companies Act 1969, come under the supervision of the BNM. The Finance Companies Act 1969 was repealed by the Banking and Financial Institutions Act 1989 (BAFIA). The finance companies are the second largest mobiliser of funds in the country as well as the second important source of raising funds after the commercial banks. Alike commercial banks, finance companies provide financial services to both the business and commercial sectors as well as the household sector. The predominant activities for finance companies are hire-purchase financing for vehicles, consumer durables, office equipment and machinery, leasing, housing and education loans as well as lending for the purchase of securities. In view of this, finance companies like commercial banks are deemed as "retailers" in the banking industry. However, finance companies are authorised to operate savings and fixed deposits accounts, but not checking account deposits nor engaging in foreign exchange activities.

Table 1.2 shows the growth of finance companies over the years. The growing number of finance companies again shows the importance of this sector in the Malaysian banking industry.

Table 1.2: The Breakdown of Finance Companies Operating in Malaysia

End of Period	Financial Companies	Branch Offices
1969	28	169
1982	41	248
1990	45	542
1998	33	1099

Source: Computed from Bank Negara Malaysia, Annual Report, various issues

1.1.3 Merchant Banks

Currently, merchant banks are the third largest group of banking institutions in Malaysia. Merchant banks entered the banking industry in early 1970s. They have been permitted to operate in Malaysia to complement and supplement the activities and services already offered by the existing banking institutions. The primary function of merchant banks is predominantly focused on wholesale banking, mainly in the area of financial advisory and consultancy services such as underwriting for initial public offerings (IPOs). They therefore operate both fund-based and fee-based activities. They are also actively involved in the primary and secondary money market and trade in money market instruments.

Merchant banks have traditionally been required to observe a minimum fee-based income of 30 per cent to ensure that the merchant banks remain focused on fee-based activities. In line with the effort to gradually liberalise the structural barriers between the different types of banking institutions, the BNM removed the minimum fee income requirement in December 1996. Nevertheless, active participation in fee-based activities remain a requirement in the maintenance and awarding of Tier- I status for merchant banks.

A total of 12 merchant banks were set up in the early 1970s. At the end of 1998, the number of merchant banks still remained at 12, with 22 branches around the country.

1.2 Two-Tier Regulatory System

In December 1994, the BNM implemented the Two-Tier Regulatory System ("TTRS") for commercial banks. Subsequently, the TTRS was extended to finance companies and merchant banks in April and January 1996, respectively. The purpose of the TTRS serves as a stepping stone in meeting the broader objective of creating a core of strong and competitive domestic banking institutions. This is also in line with the Government's policy to promote Malaysian banks to venture abroad and to expand overseas companies that need large capital. Indeed, if Malaysia intends to be a global player, it will have to play the global rules and the rules of the game are clear, namely open market access, free competition which is intensely sophisticated and sound management.

Under this system, strong and well-capitalised banking institutions would be permitted to undertake a broader range of business activities and operate under a more liberal environment. In short, the TTRS is allowed to have greater flexibility in offering new products and business expansion. Under the TTRS, commercial banking institutions will be categorised as either Tier-I or -II, based on their achievements. The requirements for commercial banks to qualify for Tier-I status are as follows:

(a) Minimum requirements of shareholders' funds (excluding investments in subsidiaries) of RM500 million by end-1995, RM1 billion by end-1998 and paid-up capital of RM1 billion by end-2000;

(b) A composite rating of at least strong (2) for CAMEL rating based on the five acronym components, notably **C**apital Adequacy, **A**sset Quality, **M**anagement Competency, **E**arnings Performance and **L**iquidity Position.

Similar to commercial banks, financial companies and merchant banks that satisfy a progressive minimum capital requirement and a strong composite CAMEL rating will be accorded Tier-I status. They are permitting to undertake a broader range of activities and provided greater operational freedom. It is envisaged that the process of differentiating the larger and stronger Tier-I institutions from Tier-II institutions and allowing the Tier-I institutions to lead developments in the industry would encourage consolidation in the industry. This would encourage Tier-II institutions to either merge to become stronger or build up their strength at a much faster pace to face the challenges ahead. The Tier-I domestic banking institutions would be better positioned to face further challenges brought about by the liberalisation and globalisation of the financial sector in the near future.

1.3 Purpose of the Study

With the Malaysian economy moving forward at a rapid pace, especially in the early 1990s, growth and expansion has taken place in banking institutions. It is therefore timely to evaluate the relative performance of commercial banks, finance companies and merchant banks which have been said to be the most prudent regulated banking institutions in Malaysia. The specific objective of this study is to evaluate the relative performance of commercial banks, finance companies and merchant banks using the CAMEL analysis. The CAMEL is the acronym for **C**apital Adequacy, **A**sset Quality, **M**anagement Competency, **E**arnings Performance and **L**iquidity Position.

1.4 Organisation of the Study

This study consists of five chapters and is organised in the following manner:

Chapter One	Introduces the Malaysian banking industry since 1957, functions of commercial banks, finance companies and merchant banks, the Two-Tier Regulatory System implemented by the BNM, purpose and limitations of this study.
Chapter Two	Presents the theoretical and conceptual frameworks used in analysing the performance of banking institutions.
Chapter Three	Sets out the methodology used in the evaluation of data obtained.
Chapter Four	Presents results obtained from the findings

Chapter Five	Summarizes and discusses important findings and recommendations, along with suggestions for future research.

1.5 Limitations of the Study

The financial data used in this study is in the form of minimum disclosures in the BNM reports. However, the performance analysis for individual commercial bank, finance company and merchant bank was unable to be carried out due to the lack of financial data such as the risk-weighted capital ratio (RWCR), which requires information on core capital or risk-adjusted assets and NPLs. This data is not available for the public.