# CHAPTER FIVE

# CONCLUSIONS AND RECOMMENDATIONS

This chapter summarizes the findings, makes recommendations and suggestions for additional research.

## 5.1 Summary and Recommendations

The risk-weighted capital ratio (RWCR) for all three groups of banking institutions remains at above 8 per cent. The minimum of 8 per cent RWCR for commercial banks, finance companies and merchant banks was the requirement of the BNM to enhance the banking institutions' ability to accommodate risk. The commercial banks, finance companies and merchant banks are well-capitalised as shown by their RWCR. This permits efficient operation in the future and to provide a buffer against unexpected shocks. The well-capitalised banking institutions helped them through the unusual difficult patch, preserved their solvency and the safety of deposits. The maintenance of depositors' confidence is the cornerstone for a stable banking system which is the life-blood of the economy.

Finance companies had the highest non-performing loans in terms of percentage of total loans, followed by commercial banks and merchant banks over the 1990-1998 period. Due to the highly fragmented nature of the industry and the nature of finance companies which focus mainly on hire-purchase financing, consumption credit and lending for the purchase of securities, they are inevitably prone to market sentiments. More than 50 per cent of finance companies loan portfolio comprises of hire-purchase and leasing (BNM 1998 p.142). Such heavy reliance implies that the finance companies would react to the business cycle in a peculiar way, benefiting quickly from an economic upturn while being extremely sensitive to an economic downturn. In the past, the finance company industry has not been managed to diversify its loan portfolio from its traditional line of business. Part of the reason has been the competitive nature of some of these markets particularly those with commercial banks presence.

What the BNM can do is to ensure finance companies with excessive concentration on a particular type of loan have enough provision to account for the additional risks engendered by such portfolios. This has already been partly enforced through the implementation of risk-weighted capital ratio. The BNM announced on March 25,1998 that the minimum RWCR requirement for finance companies will be raised from 8 per cent to 10 per cent by end of 1999 with an interim target of 9 per cent to be achieved by end 1998. This is to reflect the relatively higher risk profile of finance companies business (Aziz 1999, p.3-21). There is a trade-off between loan and loan provisions that sets aside to reflect its potential loss. Keeping too large loan provisions would be costly to banks since banks act as deposit-takers and pay interests to depositors. Nonetheless, setting aside the optimum levels of loan provisions serve as a cushion to absorb economic shocks and also to write-off the NPLs while allowing a bank to continue honouring all claims. A conservative approach will dictate that it is better to err on the high side rather than on the low side. Thus, this would protect banks from collapsing.

Various plans and schemes such as the merger programme have been implemented by the BNM. Through the merger exercise, those banking institutions especially the finance companies which do not have the size advantage should consider mergers to reap the benefits of synergies and scale economies in order to attain and sustain market dominance. Additionally, mergers also allow for the pooling of reserves and cost efficiency improvement. It also represents part of the overall pre-emptive strategy to increase the resilience of the finance companies to withstand risks arising from the economic slowdown.

Good management of expenses is one of the major contributors towards high profitability. As shown in the operating efficiency analysis, the merchant banks had the lowest operating expenses among the three groups of banking institutions. In other words, the merchant banks are more sound in the management of expenses. It is important for banking institutions to pay more attention to expenses such as staff cost and overheads, especially during difficult times in order to improve profitability.

Based on the return-on-asset (ROA) analysis, the merchant banks had the highest ROA as compared to commercial banks and finance companies. Part of the reason is the merchant banks mainly focus on fee-based and fund-based activities, namely loan syndication and management of consortium loans, corporate advisory services, underwriting services and portfolio management which tend to generate steady lucrative fees in tandem with the corporate activities and booming economy. Also, a high ROA shows that the merchant banks have the ability to utilize resources well and control operating costs. Thus, we can say that there is a positive relationship between profitability and operating efficiency.

A glance at the liquidity ratios for commercial banks, finance companies and merchant banks suggest that they have been complied with the mandatory set by the BNM. The banking institution must always be liquid to meet depositors' and creditors' demand in order to maintain the public confidence. A bank with insufficient liquidity to meet customers' demands will face dire consequence; a run on the bank will become a real possibility. The adequate liquidity surplus would enable banking institutions to sustain unexpected heavy withdrawals, as witnessed during the height of the 1997-98 financial crisis. A number of finance companies, big and small, experienced liquidity shortages, resulting in the rapid rise in interest rates on deposits. This was due to the brunt of depositors' withdrawals to flight for safety.

## 5.2 Suggestions for Additional Research

The following are some suggestions for future research, with particular reference to the analysis on the bank's performance, such as:

(i) The application of asset-liability management (ALM) is to improve the bank's' profitability. Asset-liability management is one of the risk management strategies in the bank operations. The heart of the asset-liability management would allow banks to have alternative interest-rate, liquidity and prepayment scenarios.

(ii) Strains and disturbances anywhere in an economy are likely to have repercussion on the banking performance. It is so commonly argued that the changes in the banks' earnings are influenced by economic conditions such as inflation, recession or perhaps monetary policy. To what extent do these factors would affect the banks' performance is questionable.

(iii) The loan-to-deposit (L/D) ratio can be used by bankers as an important self-regulatory loan growth control measure and also a prompt corrective. An early recognition of the L/D ratio limit will give indication that the banker should put a brake on loan growth that is associated with rising bank's profitability. To what extent can this measure be used to control excessive credit expansion remains unsolved.