

Chapter 3

HISTORY OF FINANCIAL SECTOR

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The commercial planting of rubber and discovery of tin in Malaysia began at the end of nineteenth century. The industrial revolution created an international demand for rubber and tin due to mass production of motor car. As a result of rapid development of tin and rubber, increasing foreign trade and expansion of additional services and industries, branches of foreign banks were opened in major cities such as Penang, Kuala Lumpur, Taiping, Seremban, Malacca and Ipoh. The Chartered Merchant Bank of India, London and China was the first commercial bank to be established in Penang in 1859. The first domestic bank was the Kwong Yik (Selangor) Banking Corporation established in July 1913. In 1926 there were about 18 banking offices in Malaya. In the early days, banks acted as moneylenders in mobilising savings and lending to meet domestic businessman. In addition, the nature of banking business was financing foreign trade or concentrating on overdrafts, foreign exchange transaction and commercial trade bills (Johnson, 1994).

Since independence in 1957, with new political and economic development, Malaysian financial system remained to be a highly trade-oriented structure. The rapid expansion and diversification of local economy made the banking system play a crucial role. To ensure the growth and control the financial system, the Central Bank of Malaya (now known as Bank Negara Malaysia) was established on January 26, 1959, which enable it to initiate, encourage and speed the process of developing diversified banking system that would serve the essential needs of the country. The activities of commercial

banks were supervised by the Central Bank under the Banking Ordinance 1958 and later the Banking Act 1973. As the banking sector developed, the Banking and Financial Institutions Act 1989 (BAFIA) was announced to replace the former to control the commercial banks, finance companies, merchant banks, discount houses and money brokers.

The expansion of banking in Malaysia can be divided into the following stages(Bank Negara, 1994):

- a) **Colonial period (Before 1957).** During this period very few institutions or only commercial banks were in operation. With the development brought by the industrial revolution, branches of foreign banks, mainly British, were opened in major cities. Chinese businessman and Indian traders also incorporated a few local banks. Money in circulation was backed by foreign exchange reserve and was guaranteed by the colonial masters.
- b) **Early years (1957-1967).** In the first decade of independence, the financial sector comprised primarily the commercial banks. Non-financial institutions were not established yet. At the end of 1959, there were a total of 26 banks with 111 banking offices which doubled to 215 offices by 1962.
- c) **Growing financial sector (1968-1973).** By the end of 1968, the process of currency changeover from old Malayan dollar to new Malaysian ringgit was completed. During this period, the transformation of banking structure was remarkable. The structure and character of banking had also changed. At the end of 1970, there were 38 commercial

banks with 177 banking offices. At the same time, finance companies grew and at the end of 1969 about 25 finance companies with 130 branches existed. The first merchant bank was established in 1970 and by the end of 1973, 5 merchant banks had commenced business in Kuala Lumpur.

d) Consolidation (1974-1978). By the end of 1978, the number of commercial banks was 37, with 509 banking offices. Out of 37, about 20 were domestic compared to 8 in 1959. For the finance companies, the number of companies had increased to 33 with a total of 197 branches. At the same time, merchant banks had increased to 12. The period of 1974-1978 saw the consolidation of financial systems to regroup, reorganise and modernise the system in order to face the 1980s challenges.

e) Maturity period (1979-1988). This period saw a further broadening and deepening of Malaysian financial infrastructure. By the end of 1988, the number of commercial banks increased by one to 38 with 895 banking offices. The number of finance companies increased to 47 with 471 branch offices while 12 merchant banks remain.

f) Developed financial sector (1988 till now). The commercial banks are the largest group of financial institutions in the country, accounting for RM358.1 billion of total assets of financial system as at 31 December 1996. At the end of 1996, there were 37 banks operating in Malaysia of which 23 were domestic incorporated banks. Finance companies, the second largest group after commercial banks, with RM119.6 billion assets as at end of December 1996, compete with commercial banks for savings and fixed deposits while in credit operations they concentrate on hire purchasing and house loan finance. There are 40 finance companies with 1096 branch offices at that period. On the

other hand, there are 12 merchant banks with 24 branches actively involved in wholesale banking with total assets RM34.0 billion as at end of December 1996.

The outgrowth of commercial banks was extreme especially in 1970s and 1980s. The number of commercial banks grew steadily from 1959 till now. The list of commercial banks as at 31 December 1996 is shown in table 3-1. Finance company on the other hand, expanded in mid 1960s with participation of commercial banks into the business. The rapid growth of these companies gave impact on the domestic financial situation. Of the 40 finance companies, 16 are subsidiaries of the commercial banks and of these 12 are owned by domestic banks. Table 3-2 shows the list of the finance companies as at end of December 1996. The first merchant bank was approved in July 1970 to function primarily in wholesale banking. The list of merchant banks in Malaysia is as in table 3-3.

In October 1994, the two-tiered regulatory system was introduced in Malaysia. An institution must comply with the CAMEL framework i.e. Capital adequacy, Asset quality, Management efficiency, Earnings performance and Liquidity, to qualify as Tier-1 bank. At that period there were only seven banks under this category namely, Malayan Banking Berhad, Bank Bumiputra Malaysia Berhad, Bank of Commerce (M) Bhd, Public Bank Berhad, Hongkong Bank (M) Bhd, OCBC Bank (Malaysia) Bhd and DCB Bank Berhad. Three more banks joined the group last year and the list of Tier-1 banks is shown in Table 3-1.

Table 3-1: Commercial Banks in Malaysia as at 1.7.97

No	Commercial Banks	Assets as at 31.12.96 (RM million)
TIER-1		
1	Bank Bumiputra Malaysia Berhad	36153.6
2	Bank of Commerce (M) Berhad	15615.1
3	DCB Bank Berhad	23180.0
4	Kwong Yik Bank Berhad **	8906.9
5	Malayan Banking Berhad	59553.8
6	Public Bank Berhad	25098.4
7	The Pacific Bank Berhad	9382.7
8	Citibank Berhad	9037.0
9	Hongkong Bank Malaysia Berhad	17222.2
10	OCBC Bank (Malaysia) Berhad	13365.4
11	Standard Chartered Bank Malaysia Berhad	11778.3
TIER-2		
12	Allied Bank (Malaysia) Berhad	7161.3
13	Arab-Malaysian Bank Berhad	8124.7
14	Ban Hin Lee Bank Berhad	5456.0
15	BSN Commercial Bank (Malaysia) Berhad	5086.7
16	Bank Utama (Malaysia) Berhad	5508.3
17	Eon Bank Berhad	4282.4
18	Hock Hua Bank Berhad	4462.9
19	Hock Hua (Sabah) Bank Berhad	883.5
20	Hong Leong Bank Berhad	9464.6
21	Multi-Purpose Bank Berhad	6712.9
22	Oriental bank Berhad	7517.2
23	Perwira Affin Bank Berhad	12459.2
24	Sabah Bank Berhad	2114.3
25	Southern Bank Berhad	6272.1
26	Sime Bank Berhad	14312.2
27	Wah Tat bank Berhad	692.7
28	ABN Amro Bank Berhad	1728.2
29	Bangkok Bank Berhad	757.8
30	Bank Of America Malaysia Berhad	2644.1
31	Bank of Tokyo-Mitsubishi (Malaysia) Berhad	2562.1
32	Chung Kiew Bank (Malaysia) Berhad	6550.8
33	Deutsche Bank (Malaysia) Berhad	2390.4
34	Overseas Union Bank (Malaysia) Berhad	4620.1
35	The Bank of Nova Scotia Berhad	1256.4
36	The Chase Manhattan Bank (M) Berhad	969.7
37	United Overseas Bank (Malaysia) Berhad	4823.9

** Merged to become RHB Bank

Table 3-2: Finance Companies in Malaysia as at 1.7.1997

No	Finance Companies	Asset as at 31.12.1996 (RM million)
TIER-1		
1	Mayban Finance Berhad	18765.4
2	Public Finance Berhad	794.3
3	Hong Leong Finance Berhad	7541.1
TIER-2		
4	AFFIN Finance Berhad	1076.0
5	Abrar Finance Berhad	285.8
6	Arab-Malaysian Finance Berhad	15613.3
7	Asia Commercial Finance (M) Berhad	3380.7
8	Advance Finance Berhad	258.7
9	Allied Finance (Malaysia) Bhd	59.2
10	BBMB Kewangan Berhad	4794.9
11	Bolton Finance Berhad	1142.9
12	Boon Siew Finance Berhad	247.3
13	Cempaka Finance Berhad	852.9
14	Chew Geok Lin Finance Berhad	273.4
15	City Finance Berhad	500.7
16	Credit Corporation (Malaysia) Berhad	5858.8
17	DCB Finance Berhad	1704.1
18	Delta Finance Berhad	927.1
19	EON Finance Berhad	2872.4
20	Hock Thai Finance Corporation Berhad	936.6
21	HSBC Finance (Malaysia) Berhad	1289.8
22	Interfinance Berhad	578.1
23	Kewangan KGN Berhad	39.3
24	Kewangan Industri Berhad	994.0
25	Kewangan Utama Berhad	462.1
26	Kewangan Bersatu Berhad	3307.3
27	Kwong Yik Finance Berhad **	1017.5
28	Perkasa Finance Berhad	84.5
29	Malaysia Credit Finance Berhad	1623.8
30	MBF finance Berhad	19743.1
31	Multi-Purpose Finance Berhad	2164.7
32	Oriental Finance Berhad	1114.0
33	OCBC Finance Berhad	1398.3
34	OUB Finance (Malaysia) Berhad	609.6
35	Perdana Finance Berhad	386.7
36	Sabah Finance Berhad	397.0
37	Southern Finance Company Berhad	1373.3
38	Sime Finance Berhad	1628.8
39	United Overseas Finance (M) Bhd	201.8
40	United Merchant Finance Berhad	6131.5

** Merged to become RHB Finance

Table 3-3: Merchants Banks in Malaysia as at 1.7.1997

No	Merchant Banks	Assets as at 31.12.1996 (RM million)
TIER-1		
1	Arab-Malaysian Merchant Bank Berhad	12237.3
2	Aseambankers Malaysia Berhad	3746.8
3	Commerce International Merchant Bankers Berhad	1752.8
4	DCB Sakura Merchant Bankers Berhad	4473.5
TIER-2		
5	Amanah Merchant Bank Berhad	1456.4
6	Sime Merchant Bankers Berhad	809.5
7	Bumiputra Merchant Bankers Berhad	1851.8
8	Malaysian International Merchant Bankers Berhad	1966.5
9	Perdana Merchant Bankers Berhad	1157.8
10	Perwira Affin Merchant Bank Berhad	2730.7
11	BSN Merchant Bank Berhad	549.0
12	Utama Wardley Berhad	1273.4

Upon attaining the status, the Tier-1 banks are required to raise their shareholders fund up to RM1 billion within three years. Furthermore Tier-1 banks are allowed to undertake additional services more liberally, for example it can offer foreign currency accounts and customers can open multi-currency accounts in these banks. Even though, these additional activities are subject to Bank Negara's conditions after certain limit, bankers feel that it is a good move from traditional modes of financing and collateral to financial deepening. In 1996, Bank Negara Malaysia has also extended the Two-Tier Regulatory System to merchant banks and finance companies. The Tier-1 Merchant Banks are required to have initial minimum capital of RM250 million, to be raised to RM500 million by end of 1998. The necessary capital requirement for the Tier-1 finance companies was set at RM300 million, to be uplifted to RM600 million by end of 1998.

Lately, efforts to merge the banking industry to make it more efficient and become tougher competitors are remarkable. Deregulation and liberalisation of financial institution locally and abroad leads to the effort to consolidate. Bank Negara considered Commercial Banks, Finance Companies and Merchant Banks as being too many for Malaysian population (Malaysian Business, September 16, 1997). At the end of July 1997, the number of commercial banks operating in the country was 35, of which 22 were domestic and 13 were foreign controlled banks. The number of finance companies as at July 1997 were 39. Out of 39, 11 were wholly owned subsidiaries of domestic commercial banks and 4 were subsidiaries of locally incorporated foreign commercial banks. Merchant bank remained at 12 with 24 branches.

Table 3-4 shows the growth of financial assets of the financial system during the period 1960-1996. In comparing the assets, commercial banks are the largest group that grew at an average annual rate of 17%. Finance companies, the second largest group compete with commercial banks, with a faster growth of 25% per annum. Even though merchant banks are relatively new, in terms of asset growth they have grown at an average annual rate of 45%.

Table 3-4: Malaysia: Assets of financial system 1960-1996 (RM million)

	1960	1970	1980	1987	1996
Central Bank	184	2227	12994	24190	96738
Commercial bank	1232	4460	32186	85813	358107
Finance company	10	531	5635	21267	119610
Merchant bank	-	-	2229	6340	34005

Source : Various Bank Negara Report

Some key data of financial system comprising the commercial bank, finance companies and the merchant bank are shown in table 3-5.

Table 3-5: Banking Institutions details

	1995	1996
Number of		
Commercial banks	37	37
Finance companies	40	40
Merchant banks	12	12
Risk-weighted capital ratio (%)		
Commercial banks	10.6	10.4
Finance companies	9.7	9.8
Merchant banks	11.9	11.7
Branch network		
Commercial banks	1433	1569
Finance companies	988	1096
Merchant banks	17	24
ATM Network		
Commercial banks	2230	2412
Finance companies	402	513
Persons saved per office		
Commercial banks	14024	13675
Finance companies	20341	19350
Number of employees		
Commercial banks	64461	69154
Finance companies	24593	26728
Merchant banks	2334	2592

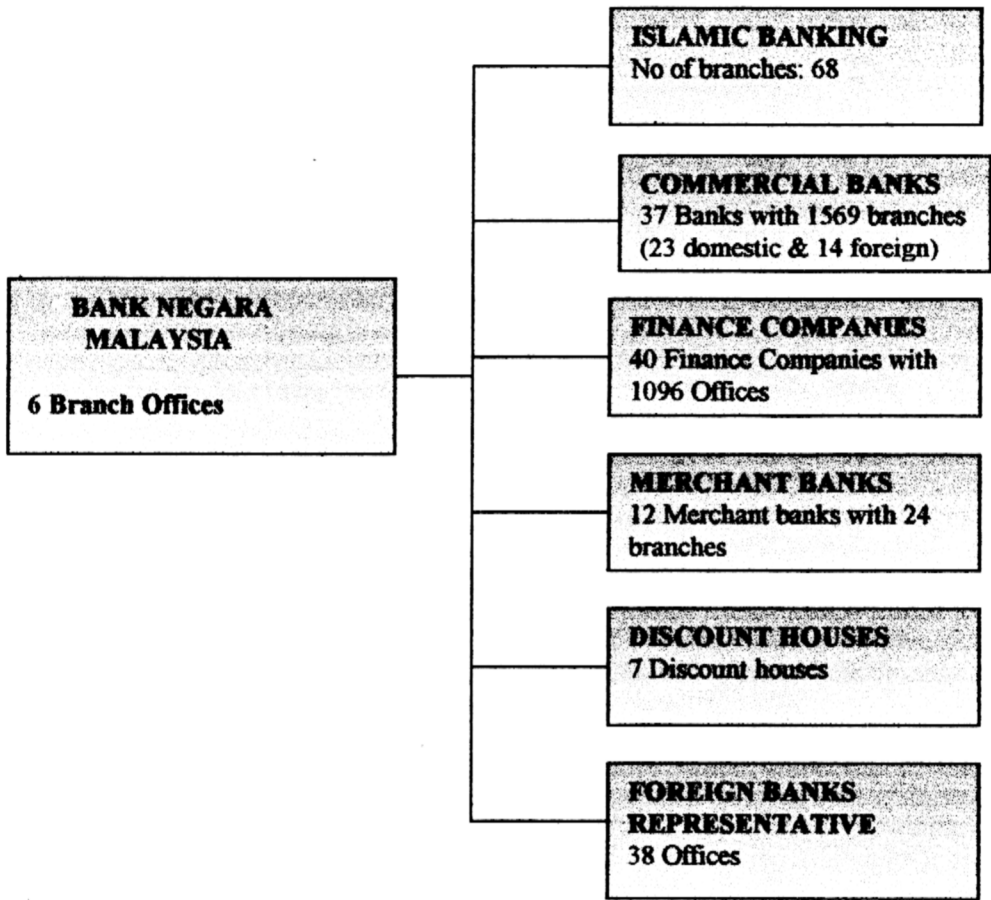
Source : Bank Negara Malaysia

3.1 THE STRUCTURE OF FINANCIAL SYSTEM

Financial systems in Malaysia can be divided into two; namely the banking system and non-banking financial intermediaries. The banking system includes Bank Negara Malaysia as the top, commercial banks, merchant banks, finance companies and discount houses. Figure 3-1 and 3-2 give an inner insight of the structure of banking system and non-financial intermediaries in Malaysia respectively. On the other hand, non-bank financial intermediaries comprises of savings institutions, the development finance

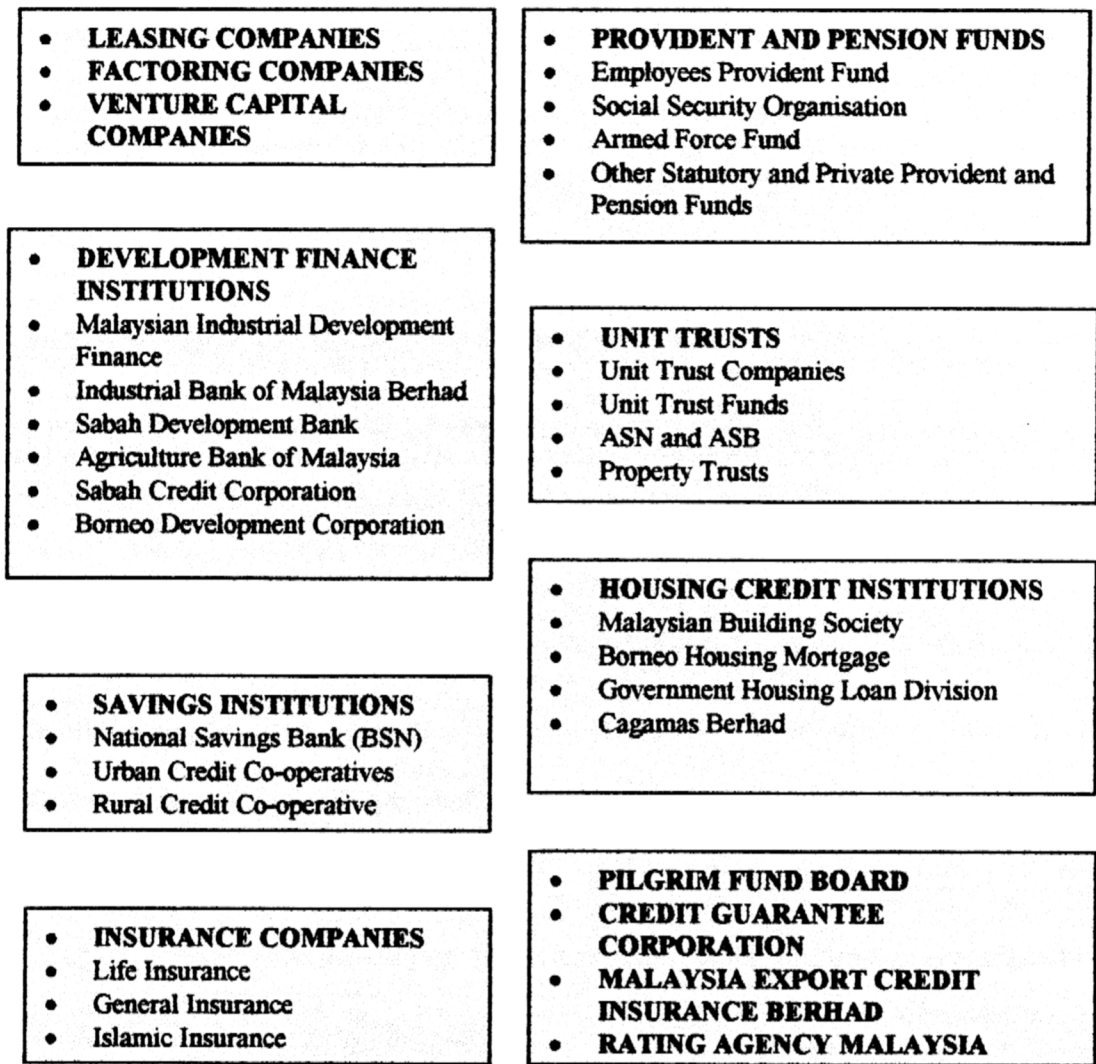
institutions, the provident and pension funds, the insurance companies, and a group of other financial intermediaries.

Figure 3-1: The structure of banking system



Source : Bank Negara Malaysia

Figure 3-2: The structure of non-bank financial intermediaries



Source: Bank Negara Malaysia

3.2 THE ROLE OF CENTRAL BANK

The Central Bank of Malaya (now known as Bank Negara Malaysia) was established on January 26, 1959. The main role of Bank Negara is to supervise and regulate business of financial institutions. Basically Bank Negara's fundamental objectives includes:

- Issuing currency.
- Banker to the Government and financial institutions.
- Promote monetary stability and a sound financial structure.
- Holding official external reserves and secures the value of the currency.

In view of the significance of the financial system in laying the foundation for the economic growth, Bank Negara Malaysia regulates and supervises these institutions precisely. Bank Negara has comprehensive legal power on financial institutions under the following legislations:

- Central Bank of Malaysia Act 1958 (Revised 1994) provides powers, objectives and duties of Bank Negara Malaysia.
- Banking and Financial Institutions Act 1989 (BAFIA) provides law and regulations for commercial banks, merchant banks, finance companies, discount houses and money-brokers.
- Islamic Banking Act 1983 provides rules and regulations on Islamic banking businesses.
- Exchange Control Act 1953 empowers the control of foreign exchange, imports and exports.

- Emergency (Essential Powers) Act 1979 and Essential (Protection of Depositors) Regulations 1986 give power to Bank Negara to investigate the affair of deposit-taker.

3.3 IT IN BANKING

Even though banking institutions play an important role in stimulating, enhancing and developing the economy, their existence with old banking method does not guarantee their role in the competitive world. The financial system as the responsive stimuli of development must update itself in order to survive in the coming era. At this point, although the current banking system is an integral part in stimulating the present stage of economy, its role will be diminishing unless there is a structural change in IT.

In recent years, banking has become technology-driven and globalised. Both trends are inter-related. As banking technology advanced with computerisation and telecommunications, financial markets become more integrated. The traditional lines of business between different types of institutions become more blurred. Financial markets are not only becoming inter-dependent within a country but also becoming more global in nature. The lines between finance companies and banks for example are no longer so particular, even finance companies offer ATM facilities. The range of services offered by banks and finance companies become much more sophisticated. Not only are the banks

facing greater competition from other financial institutions, non-financial institutions are beginning to venture into finance business.

Computer technology is being used to process information, improve risk monitoring and provide a wide range of better and faster services. ATMs, telebanking and Electronic Fund Transfer at Point of Sale (EFTPOS) have come to stay. The study will look at the usage of IT in banking services in retail as well as corporate banking. EFTPOS eliminates the necessity of using cash at the point of sale. Either debit or credit cards can be used when purchasing things.

ATMs operate 24 hours daily, and are placed outside the banks or shopping complex. Through ATM, cash withdrawal, balance inquiries, statement request, deposits and bill payment can be made. This device delivers a wide range of functions and services that provide customers greater assistance. Today integration of the three ATM networks makes customers able to withdraw and inquire balance at any ATM nationwide for a minimum fee.

To exploit large-scale economies, banks and finance companies are coming together to share computer resources to established shared ATM networks. In 1996, the three ATM networks namely, The Malaysian Electronic Payment System (MEPS), the Automated Banking Consortium (ABC) and the Group Electronic Automated Transfer (GREAT) networks were integrated. With this integration, customers are able to

withdraw and inquire balance in 2769 ATMs nationwide. Thus, electronic commerce is becoming a reality.

Now, there is a tendency of elimination of the bank teller. In this case, fewer employees mean savings in terms of salary. The first stage will be the placement of multimedia kiosks or information kiosks, where a video teller will carry out the functions of a bank. This means customer can do transactions via multimedia kiosks where previously they would normally visit a bank. The smart card will be established, to simplify shopping and banking operations. Smart cards will solve today's home banking problem i.e. deposit and cash withdrawal. Home banking will substitute ATM to become the next competitive base (Bermant, 1995).

In this phase of rapid changes, banking environment in the next decade will be quite different from that in 1980s and 1990s. The banks and finance companies will have to gear themselves to meet these challenges, particularly in upgrading the skills which can cope with the increasing demand for better and more sophisticated services. Financial deregulation, emergence of complex business and advanced customer requirements force banking industry to invest in IT to cater for the rapid business advances. Thus, IT is considered the cost-effective strategy to service consumer demands. New technologies are expected to enable customers with additional facilities such as home banking, remote banking, integrated account statements and self-serving terminals.

Self-service banking includes telephone banking, home banking using PCs or information kiosks terminals that are available in public places and corporate terminals. In many developed countries, most homes have a PC terminal and home banking as a popular mode of transaction. The services provided include banking services, margin trading, rates inquiry and change pin number. Banking services comprise balance inquiry, transfer fund, statement inquiry, status inquiry, fixed deposit, bill payments and stop cheque, through the information kiosks.

On November 24 1997, Bank Negara introduced a new cheque clearing system. With the new system, the dayhold of outstation cheques is expected to be a maximum of 5 days and local cheques are processed on the same day. The system will use automated clearing system with imaging techniques to examine and verify the signature (Refer appendix D).

For the corporate customers, IT helps them to reduce costs and increase efficiency. Corporate banking eases customers to control or monitor their accounts and transactions. With the system, customers are able to observe their balance daily, do reconciliation, transfer funds, make payments, make investments and capture latest market information without visiting the bank.

Due to the need, IT has received serious attention in the banking industry. In the early 1990s, banking institutions started to invest rapidly in IT. A survey conducted by the

Institute of Bankers Malaysia in 1993 showed that large and medium-sized banks accounted for 40 percent of the overall spending on IT by the banks (Malaysia, 1996). The investment was mainly on upgrading and modernisation of existing infrastructure. On the other hand, the small banks expenditure was mainly on new IT infrastructure building. Table 3-6 shows the distribution of banks' IT expenditure by item in 1993.

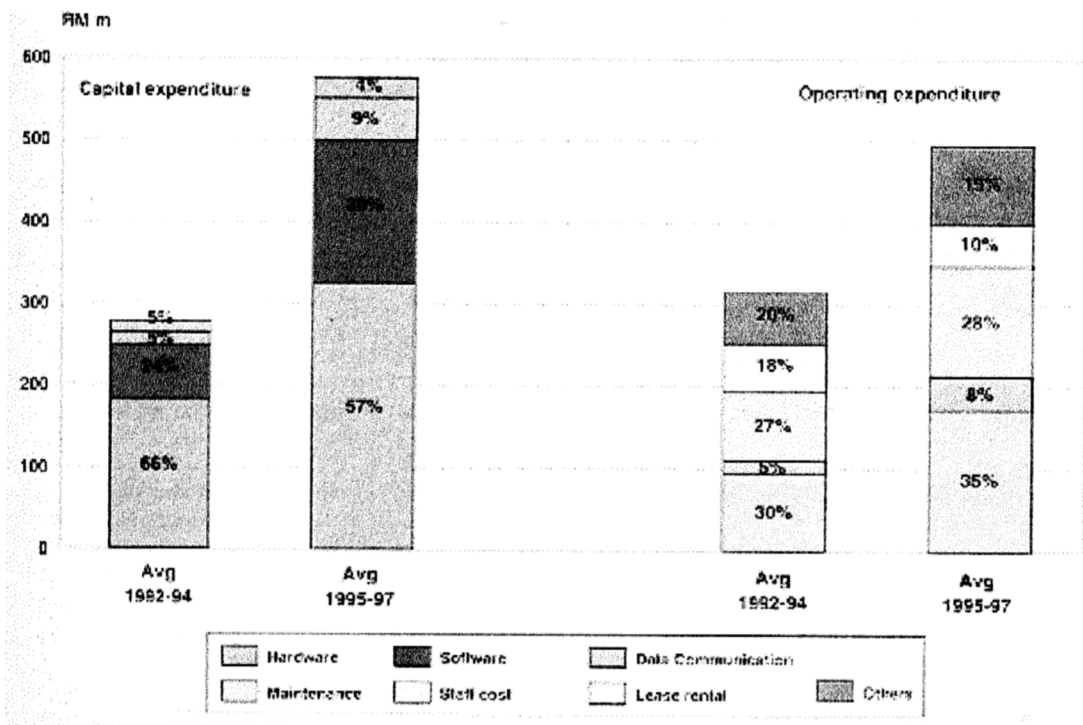
Table 3-6: Banks' IT expenditure, 1993

ITEM	%
Equipment & Hardware	44
Salaries	17
Software	15
Data Communication	7
Services	6
Others	11

Source : Institute of Bankers Malaysia in Malaysia (1996)

During 1992-1994 average IT expenditure by banking institutions recorded RM594.6 million, 12% of the average total expenditure of the industry. IT expenditure showed a significant increase of 69% in 1995 i.e. from RM618.3 million in 1994 to RM1044.5 million, which is about 20% of the nation's IT expenditure (Bank Negara, 1996). In 1997, IT expenditure is expected to increase more than 100%. Figure 3-3 shows the proportion of IT capital and operating expenditure of the banking industry.

Figure 3-3: Capital and Operating Expenditure of the Banking Industry



Source : Bank Negara Malaysia

During the period of 1994-97 commercial banks recorded a significant increase as a major spender in IT. Some examples are given below. In 1994, EON bank embarked on a comprehensive computerisation project known as the EON Bank Group IT Project, which also covers its subsidiary, for the period of 1994 to 1999. The five-year project with a budget of about RM28 million is aimed at upgrading its entire banking system. The project covers Customer Information File (CIF), savings, current accounts, fixed deposits, ATM, loans, remittance and general ledger. CIF would be the core of EON Bank's entire computerised systems, providing the basic information about customers for the bank to

customise its services and products. The main aim is to use the latest technology to automate its backoffice functions efficiently (New Straits Times, November 10, 1994).

In 1995, Multi Purpose Bank Berhad invested RM 2 million to develop its largest desktop banking product called *Multilink Corporate*. It is designed specifically for the bank's corporate and commercial customers where the system will bring the bank to the customer's office via electronic means. Customers are able to access their accounts information, transfer funds electronically over the network, perform payments and remittances for liquidity control and management, trade finance and payroll services for the payment of salary. This leads to a further increase in paperless transactions (Star, October 11, 1995).

Mid 1995 also saw Hong Leong Bank and Hong Leong Finance announce a budget of RM 20 million to be invested in Information Technology for the period of 1995-1997. It includes customising front-end system, standardising Microsoft Backoffice suite and purchasing more ATMs. The Backoffice is used to develop and automate critical applications and the new front-end system (Star, April 11, 1995).

In July 1995, BSN Commercial Bank invested in Total Banking Solution (TBS) System called *Bancs*. This will facilitate customers to make inquiries, transfer funds, conduct telebanking and printout statements using the self-service terminals. Internally, *Bancs* are used for retail, wholesale and electronic banking, branch, customer information,

MIS and decision-making. The five-year project, which costs RM45 million, will be linked to the banks' branches with computerised retail banking facilities, LANs, PCs and EIS (Star, July 18, 1995).

In August 1995, Bank of Commerce improved their Customer Management System (CMS). The system highlights enhancement and is aimed to increase productivity and effectiveness of users. CMS are able to create, inquire, update customers basic information and financial statements. Furthermore, all the administrative functions including loading customer data from branches to head office can be done easily.

In April 1997, Ban Hin Lee Bank, Kewangan Utama and Multi Purpose Finance switched to its new online version Integrated Computerised Bank Account (ICBA) software. The typical configuration of online version ICBA cost about RM2 million to RM 10 million. It supports the integration of various applications such as telebanking, ATM, over-the-counter transactions, Internet banking, credit, debit and smartcards (Star, April 8, 1997).

In September 1997, RHB Bank launched its new online banking service. With the new service, customers are able to carry out banking services from their PCs with the exception of cash withdrawal. RHB account holders i.e. savings accounts, current accounts, loan accounts and Visa Credit card holder, can utilise the service by paying

RM100 signup fee. In addition, customers will also be able to carry out stockbroking service through it (Star, September 2, 1997).

On November 20 1997, Maybank announced its new ATM card. With Maybank's new *Kawanku* ATM card, customers can access and make withdrawal at any ATM worldwide using worldwide Visa Plus and Visa Interlink facilities. *Kawanku*, issued to savings or current account holder enables customer to withdraw local currency of the country where the transaction is made. The exchange rate is computed accordingly at the point of withdrawal. In addition, the card can also be used at any shopping complex offering EFTPOS (Malay Mail, November 20, 1997).