Chapter 2
Literature Review

2.1 Financial Reform

There is no single definition to explain the term of financial reform. Byrns & Stone (1992) highlights that financial reform is caused by mounting pressure for economic efficiency, political freedom, and the globalisation of international markets.

Related work (Long, 1994) suggests that there are six main dimensions of financial reform; (1) to achieve a sound macroeconomic situation involving a reasonably modest rate of inflation, (2) to achieve a resolution of the financial problems of state-owned enterprises, (3) to have realistic and moderately stable structures of relative prices, (4) to have realistic levels of interest rates to stimulate adequate savings while at the same time avoiding excessive disincentive to investment, (5) to have a strong financial infrastructure, including a sound system of regulation of financial institutitons and timely and efficient enforcement of the rules, and (6) to incorporate the deepening of the institutional structures of banks and non-banks as well as a diversified structure of financial investments, maturities, and so forth.

Alternative view (Tseng and Corker, 1991) suggests that financial reform in the banking sector is aimed at reducing obstacles to competition, and market segmentation by allowing greater freedom of entry, expanding the scope of permissible business activities for different types of financial institutions, and relaxing restrictions on the activities of foreign banks.

Consequently, financial reform leads to a better management which means that banks need to be given greater autonomy and more responsibilities for their operational performances. Improved management necessitates new lending policies, better loan recovery procedures, more sophisticated information system and better trained staffs.

2.2 Financial Reform and Banking crisis

Banking crisis refers to a situation in which actual or potential bank runs or failures induce banks to suspend the internal convertibility of their liabilities or which compels the government to intervene to prevent this by extending assistance on a large scale. This crisis has been identified as being preceded by low growth, high real interest rates, high inflation, deteriorating terms of trade, explicit deposit insurance[1] and by lax law enforcement (Demirgüç-Kunt & Detragiache, 1997).

When the crisis arises in the banking sector, the policy makers will have no other choices, but to reform their financial systems[2]. Many studies find that banking crisis has no single cause. After the experience of the Great Depression and during the several decades since World War II, banks around the world were considered as very solid and sound institutions. This was possibly due to two factors: first, banking laws protected them from competition while restricting the number of activities banks were allowed to undertake, and second, the macroecnomic environment was fairly stable (Corbo & Hernandez 1994).
However, the situation changed significantly in the 1980s when more than twenty-five governments rescued their distressed financial institutions (The World Bank Annual Report, 1990). The occurrence of banking crisis in the 1980s

[1] They believe that deposit insurance can be explicit, that is, banks may purchase full or partial insurance on behalf of depositors from a government agency or from a private insurer. While deposit insurance may reduce the incidence of self-fulfilling bank panics, it introduces a significant degree of moral hazard, which often has not been successfully curbed through appropriate design of the insurance scheme or through effective prudential supervision and regulation.
[2] Financial system can be broadly categorised into three groups: the banking system, the non-bank financial intermediaries, and the capital market .

and 1990s has been expressively higher than in the 1970s, and much higher than in the more stable period of the 1950s and 1960s.

Related study (Honohan, 1996) finds that the frequency and size of financial crises during the last quarter-century is much worse than was experienced prior to 1950s. Many countries have experienced at least one serious problem in the banking sector which relates to financial liberalisation (Lingren et al. 1996).[1]

Banking crisis requires serious attention from the policymakers because of its consequences to the economies. The crisis can be very costly in terms of fiscal and quasi-fiscal costs of restructuring the financial sector and its effect on economic activity (Goldstein and Turner, 1996; Corsetti *et al.* 1997). In addition, since international financial markets have become more integrated, the crisis in one country can happen to other countries (Masson, 1998).

Bank difficulties are assumed to generate more serious negative externalities for the rest of the economy than those at either other kinds of financial or non-financial firms. For example, banking crisis has led to balance-of-payments crisis in emerging markets during the last 15 years (Kaminsky and Reinhart, 1995). Serious banking problems also lead to difficulties for monetary policy. Such difficulties may not only distort the normal relationships between monetary instruments, the intermediate and final targets of monetary policy, but also compromise the overall stance of monetary policy.

[1] He finds that, over the 1980-1996 period, at least two-third of International Monetary Fund (IMF) member countries experienced significant banking sector problems which possibly related to the financial sector liberalisation.

2.3 Banking Development in Malaysia

Banking in Malaysian can be traced back to year 1859 (Lin, 1994) when the first commercial bank, a branch of a foreign bank, was established in Malaysia (Penang). In the early years right up to the 1960s, foreign banks dominated the banking establishment (eighteen foreign and eight domestic banks in 1959) and were engaged primarily in financing plantations, agriculture, tin mining and international trade.

The Central Bank of Malaya (renamed Bank Negara Malaysia in 1963) officially opened its doors on 24 January 1959 under the Central Bank of Malaya Ordinance 1958. This law provided the central bank full powers to promote monetary stability and a sound financial structure as well as to influence the credit situation to advantage the country (Pang, 1995). The central bank recognised very early that a sound and strong domestic banking industry is a necessary precondition for balanced economic and social development. Therefore, financial reforms are not a new issue to the Malaysian financial system.

Since the 1950s, and especially from 1960s onwards, the evolution of the banking system had been intensive and typical. Bank Negara Malaysia had promoted establishment of new branches of domestic banks throughout the country, especially in small towns and rural areas where banking facilities were generally lacking or inadequate. The result was that domestic commercial banks had been progressing very rapidly, particularly in the 1960s and early 1970s.

To counteract the competitive disadvantage of domestic banks, foreign banks operating in Malaysia had not been allowed since 1966 to set up new branches in the country (Lin, 1994). Hence, there are now more domestic than foreign banks in Malaysia. Bank Negara Malaysia took a further important step to encourage the dispersion of bank ownership by limiting corporate ownership to no more than 20% of any bank and individual ownership to no more than 10%.

The search for growth and profit by commercial banks had some unfavourable consequences, for example, the decline of the capital/asset ratio of domestic banks, deterioration in the quality of bank loans, and a lack of professionalism in banking service (Bank Negara Malaysia, 1975). The recession in 1974-75 gave the banking institutions a warning that they should consolidate their position and improve their administration. The financial crisis in the mid-1980s also reflected that the deposit-taking cooperatives undermined depositor confidence in the banking sector.

During 1980s, the economic and financial environment in Malaysia, as well as in other Asian countries, had changed significantly and many reforms in the banking sector were implemented to liberalise interest rates, reduce controls on credit, enhance competition and efficiency in the financial system, strengthen the supervisory framework, and promote the growth and deepening of financial markets (Tseng & Corker, 1991).

The implementation of financial liberalisation varied across the countries in terms of speed and scope of reforms. In Malaysia, financial liberalisation began in the early 1970s and accelerated in 1978 with the freeing of interest rates abandoned and reversed in 1983 (Zainal et al. 1994). Liberalisation efforts were resumed in earnest in 1987 as the economy improved, with full deregulation of lending rates only in early 1991.

To streamline the effective control and regulation of the various financial institutions, the Banking and Financial Institutions Act 1989 (BAFIA) was declared to repeal the earlier Acts: Banking Act 1973 and the Financial Companies Act 1969. The new act provided Bank Negara Malaysia greater powers to regulate its financial system and to ensure the orderly conduct and expansion of the banking sectors. Furthermore, introduction of the Offshore Banking Act, 1990 and Offshore Insurance Act 1990 is to provide a relatively relaxed regulating environment vis-a-vis the domestic banking system and promotion of the offshore insurance activities respectively.

In December 1994, the central Bank implemented the two-tier regulatory system as part of Bank Negara Malaysia's broader plan to liberalise the financial sector in line with the global trend (Bank Negara Malaysia, 1995). To permit only well-capitalised and well-managed banks to operate in a more liberal environment could accelerate the process of liberalisation. In addition, this two-tier system was to assist stimulating the transformation of the banking sector, leading to the emergence of strong and competitive domestic banks to compete effectively in the domestic market, as well as venture abroad.

It is almost three decades that Bank Negara Malaysia has developed and liberalised its financial system. Overall, financial liberalisation in Malaysia has been a gradual, phased and continuing process, rather than being concentrated in discrete episodes of comprehensive liberalisation. Zahler (1994) highlights that financial liberalisation generates an increase in savings which is determined by the level of investment and improves the efficiency of the capital accumulation process. It is possibly true as the Asian countries experienced rapid economic growth, especially during 1990s.

Although financial liberalisation certainly offers opportunities, one must be careful in its implementation. With no adequate and appropriate regulations including prudential supervision, the financial liberalisation may, instead, result in disadvantages to the host country.

The recent East Asian crisis has reflected the adverse impacts of financial liberalisation. Malaysia, as one of the affected countries, has considerably reformed its financial system, part of this reform is to restructure the banking sector which is the main subject of this research.