CHAPTER TWO

FINANCE COMPANIES IN MALAYSIA

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2.1 Finance Companies in Malaysia.

The finance companies (formerly known as borrowing companies), licensed under the banking and financial institution Act, 1989, are the second largest group of deposit-taking financial institutions in Malaysia. The history of the finance companies can be traced in the 1960s when they were established as limited companies to provide loans for the purchase of consumer durable, particularly motor vehicles on hire purchase terms, as well as the provision of short to medium term business finance.

Finance companies served to complement the credit operation of commercial banks which had traditionally been providing loan to customers through current account and overdrafts facility. However, finance companies were permitted to accept deposits, saving and fixed deposit from the public for capital mobilisation. More than 80 percent of the deposits with finance companies have been in the form of fixed deposits of varying maturities. Total assets of the finance companies increased by RM 37.4 billion or almost 20% of the increase in total assets of the financial system from RM 54.9 billion at the end of 1992 to 92.3 billion at the end of July 1998[7]. The growth of finance companies' share of total asset of the financial system increased from 12.3% at the end of 1992 to 18.2% at the end of 1997. Besides, it is expected that the finance companies to play some intermediate significant roles in enhancing the pace of economic development. Thus the enormous growth over the past two decades has put the finance companies in a vulnerable position in the overall financial system of Malaysia.

[7] Money and Banking in Malaysia, BNM, 1994 , page 164

In the late 1970s , the rapid expansion of finance companies both in number as well as in their scope of operations, particularly with the diversification of commercial banks into 'finance companies' business. This development arose from the inability of the banks to compete for and attract deposit through interest rate competition, since the deposit rate of banks were subject to ceiling levels prescribed by Bank Negara Malaysia. Consequently, it become more attractive for the commercial banks to establish their wholly-owned finance companies subsidiaries which could then compete for the deposits mainly through variation in the rate of interest. As at June 30 1998, there were 40 licensed finance company operating in Malaysia of which 15 were subsidiaries of banks[8].

2.2 Finance Company Industry's Consolidation During Mid 1980s (1985-1986)

The finance company industry experienced a particularly eventful period in the past few years which witnessed a consolidation of the industry as well as changes in its operating landscape. Since 1989, the number of finance companies operating in the country had been gradually reduced from 47 to 40 at the end of 1998(appendix 3), as a result of consolidation in the industry precipitated by the restructure of some finance companies which had become insolvent. These were the finance companies which were badly hit by the 1985-1986 recession and the financial crisis in middle of year 1997 as they were saddled with a huge proportion of non-performing loans (NPLs), the aftermath of over-lending to property sector and imprudent exposure to share based lending during the earlier boom years. This resulted in substantial provision for bad debts and interest in suspense caused these affected finance companies to suffer tremendous losses which wiped out their capital funds. As the shareholders of these companies were unable to inject the necessary new capital to restore solvency for the companies, the central bank was forced to devise and implement restructuring schemes for them. The schemes devised essentially

[8]Economic report 1998/99,volume 27, page 164

involved absorbtion of the assets and liabilities of the insolvent finance companies, stronger finance companies, and the subsequent revocation of the licenses of the insolvent finance companies, following the takeover. The implementation of such schemes served to weed out the weaker finance companies, thus promoting consolidation of the industry in the process. In the last few years, six finance companies had their operation absorbed by other finance companies, of which five were rescue cases. The remaining finance company, which was earlier used as a vehicle to resolve the problem of 12 troubled deposit-taking co-operatives (DTCs) in 1998, had its operations absorbed by a major finance company to facilitate expedited refund of money to the former shareholders who were previously depositors of the troubled DTCs[9].

2.3 Shareholding Structure Of Finance Companies

As discussed above, the consolidation process within the finance company industry has to some extend strengthened the shareholding structure of the finance companies in general as the rescuer finance companies which absorbed the operation of their insolvent counterparts are mainly owned by banks. In addition, the finance companies' shareholding structure is further strengthened by the restructuring process of the finance company to become subsidiary of a wholly or majority owned by banks/banking groups. With the strengthening of the shareholding structure of finance companies, capitalisation increased in the industry, despite the reduction in the number of finance companies.

2.4 Legislation Of Finance Companies

The rapid growth of finance company in the 1970s established them as an emerging force in the mobilisation of funds in the financial system. As the impact of their activities on the local monetary system became more profound, the government decided to bring them under the control of a central supervisory

[9] Money and Banking in Malaysia ,1994, page 184

authority, namely Bank Negara Malaysia (BNM) through the Finance Companies Act (FCA). The legislative and regulatory framework of the finance companies has also been rationalised in recent years. Moreover, the Finance Companies Act 1969 was repealed by the Banking and Financial Institution Act 1989 (BAFIA) which came into force with effect from October 1, 1989. With the introduction of the BAFIA , the finance companies are now brought under the same legislative framework of the commercial banks and merchant banks. While the 1969 Act defined "finance business", the BAFIA makes reference to "Finance Company Business" which is defined to mean finance companies were authorised to accept deposits from the public and engage in the lending of money and investing of these funds, leasing business and the business of hire-purchase[10]. Therefore, the introduction of BAFIA was meant to provide for an integrated supervision of the Malaysian Financial System and to moderate and streamline the laws relating to banking and financial institution.

2.5 Capital Requirement Of Finance Companies

Initially, the minimum legal capital requirement of RM1 million under the repealed Finance Companies Act 1969, has been raised to RM 5 billion, that is, to be maintained by end September1994. For most finance companies, the higher capital requirement was not a problem as their capital funds already excess the minimum requirement of RM5 million in December 31,1996. More of concern to many finance companies would be the need to raise new capital to support their expansion of operation while at the same time complying with the new capital adequacy requirement. Now, all the finance companies are required with effect from September 1, 1989, to observe a new capital adequacy framework based on the Basle Capital Accord. Under this risk - weighted asset approach, a capital adequacy ratio was increased from 7.25% in 1990 to 8%. In the transition period, the previous capital framework which required the finance companies to

[10] Banking and financial institutions act and regulation. 1995, Page 10

observe a risk asset ratio of a maximum of 15 times shareholders fund[11]. The implementation of this risk-based capital standard would encourage the finance companies to structure their balance sheets more prudently as different categories of assets are weighted according to their perceived level of risk.

2.6 Finance Companies Statutory Reserve And Liquidity Requirements

The operation of the finance companies have an important hearing on the monetary situation in the country. Consequently, the finance companies are also required to observe statutory reserve and liquidity requirement. This is to ensure that the strong and well -managed of finance companies. The statutory reserve ratio had been revised periodically to meet the liquidity position of market. Presently, finance companies are required to maintain 4% of the eligible liabilities (EL) base as statutory reserve with Bank Negara Malaysia which not earned any interest. The reserve requirement based on the average daily amount of eligible liabilities held over a fortnightly period, rather than eligible liabilities or a single base date.

Whereas, the finance companies are required to hold on average over a fortnight at least 10% of their eligible liabilities base in liquid assets. However, Bank Negara Malaysia, in December 1998, had abolished the present liquid asset ratio requirement and to replace it with a new method of accessing of finance companies liquidity position. The new method required the finance companies to project up to one year of the maturity profile of their assets, liabilities and off balance sheet commitments from a given position. The implementation of the new approach is to permit a more efficient and on going liquidity measurement and management for financial institutions.

[11] Money and Banking in Malaysia, BNM,1994 page:192-193

2.7 Local Finance Company Mergers After The Regional Crisis In Mid 1997

Most of the recent major development in the finance company industry is aimed at boosting the institutions' strength and efficiency. In view of the fragmented nature of the finance company industry, plans to merge the finance companies were first mooted in late 1980s. The onset of the regional crisis and the need to strengthen the industry provided an impetus to realise the merger plan. As at February 1999, only two mergers have been completed, that of RHB Bank is absorbing its subsidiary RHB Finance Berhad and the Bank of Commerce mergers with Bank Bumiputra Berhad has created absorbtion of its own subsidiary , Bumiputra Kewangan Berhad, in the mergers plan.

The other proposed mergers under the absorbtion method are, however, in the final stages. In the case of small finance companies merging with anchor companies, the majority of the company involved have either completed their due diligence or are in the final stages. In addition, tier-one finance companies, namely Arab Malaysian Finance Berhad and Maybank Finance Berhad have signed the sales and purchase agreement with their respective merger partner that is Abrar Finance Berhad and Amanah Finance Berhad. Moreover, the Hong Kong Shanghai Bank's Finance (M) Berhad(HSBC Finance) and Overseas Union Finance were absorbed by their respective parent banks and have closed thier operation on December 31,1998.

However, no concrete plans for approval have been submitted to Bank Negara Malaysia by finance companies under the strategic alliance scheme. With RHB Bank Berhad absorbing its subsidiary, RHB Finance Berhad, there are currently 39 finance companies operating in the country, of which ten are wholly-owned subsidiaries of domestic commercial banks and four are subsidiaries of locallyincorporated foreign commercial banks. As at the end of July 1998, there were 1,103 branches of Malaysian-owned finance companies and 13 branches of foreign owned finance companies[12].

[12] Economic report 1998/99, Ministry of finance Volume 27, page 165