

CHAPTER 2 LITERATURE REVIEW

2.1 Studies Related to Banking Sector

The banking sector remains at the core of the Malaysian financial system. A well functioning and efficient banking system is vital for achieving robust economic performance.

2.1.1 The Role and Significance of the Banking Sector

Banks have critical roles to play in view of their importance in the development and economic well-being of the country. The primary role of a bank is to act as a financial intermediary between the depositors and the borrowers by mobilizing funds for productive and economically viable enterprises and industries. Primarily, due to their dominant market share, the strength of the domestic banking institutions is an important element of financial stability that contributes to the long-term resilience of the economy. Within the context of the economy, the banking sector performs three main functions⁴ :

- Banking sector is essentially the intermediation of funds from savers to borrowers⁵.
- Banks play a special role in the credit delivery system wherein banks would expand their loan base and the availability of financing would enhance the growth prospects of the economy⁶.

⁴ Speech by Dr. Zeti Akhtar, at the opening of the Malaysian Banking Summit 2001, KL, 17 May 2001.

⁵ In performing the mobilisation of savings, depositors need to be assured of the safety of the deposits and the efficiency in the manner the funds are mobilised. Banks then channel these savings to productive investments.

- Banking sector provides a means of payment both nationally and internationally⁷.

2.1.2 Banking Sector Efficiency and Competitiveness

The efficiency of the financial services industry has long been a focus of banking research since their findings have important implications for bank management who seek continuous improvement.

Efficiency is measured as the difference between those firms that are on the frontier and those that are below it (Triplett, 1990). The concepts of efficiency relate to how well a bank employs its resources relative to the existing production possibilities frontier – how an institution simultaneously minimizes costs and maximizes revenue, based on an existing level of production technology (Oster and Antioch, 1996).

Some important measures of efficiency are :

- (i) Input Efficiency which concentrates on the degree of efficiency with which banks combine their inputs to produce a given level of output at minimum expense.
- (ii) Output Efficiency measures banks' efficiency in pricing and achieving levels of output.

In studying cross-border banking performance, Berger, DeYoung, Genay and Udell (1999) review the literature that provide international comparison of banking

⁶ Banks should achieve a balance between pursuing sound banking practices and having the proactive role in disbursing loans to promote growth. Since loans are central to the profitability of the banking system but excessive risk aversion among bankers would restrict the flow of credit in the economy and adversely affect the profitability of the banking system and economic growth

⁷ The banking system facilitates an efficient and safe means of making and receiving payments. Public confidence in the banking system is therefore vital to ensure payments can be made on a safe and timely basis

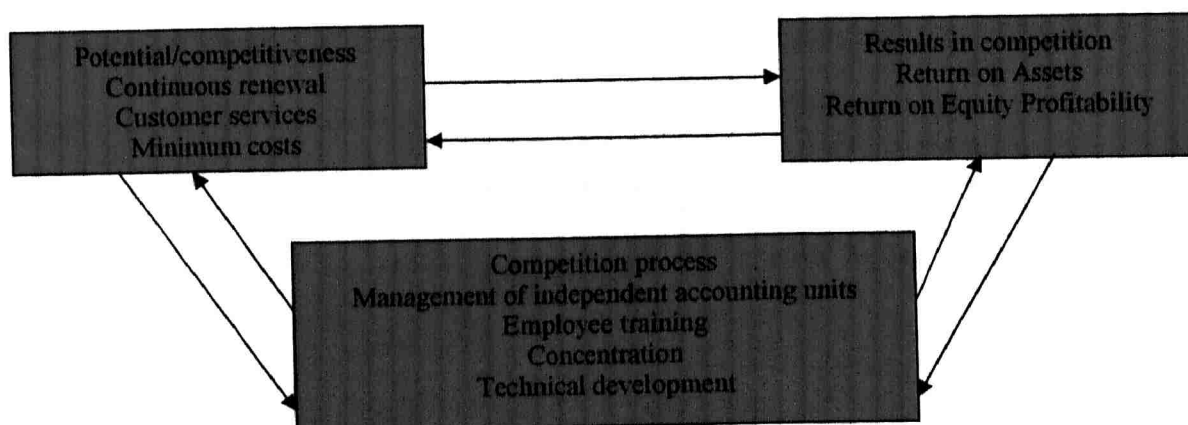
efficiency while **Altunbas, Liu, Molyneux and Seth (2000)** study the efficiency and risk in Japanese banking. In short, studies on the efficiency and competitiveness of Asian banking institutions are relatively few, compared to researches on U.S. and European banking.

Tronh Quoc Trung (2000) provides that banks will be operating in a harsh competition under globalization and are therefore required to comprehend their capacity and efficiency to win in the competition. The assessment of competition factors depends on the following criterias :

- Operational results based on the return on asset (ROA) and the return on equity (ROE).
- Competition potential based on technology transfer and innovation, new products and services continuously supplied to customers.

Tronh further explains that the measurement of competitiveness in the banking sector can be shown in Figure 1 below.

Figure 1 : Measurements of Competitiveness in the Banking Sector



(Source : <http://www.hcmueco.edu.vn/tcptkt/english/2000/thang6/Determ.htm>)

2.2 Studies Related to Globalization

An extensive review of the literature on Globalization demonstrates that a wide range of theoretical and empirical studies has been done on their attempt to define Globalization. Globalization is a set of economic, political and cultural processes of linkage and integration, both global and regional. There is also a rapidly rising cross border financial activity leading to increased share of financial activity between people of different countries.

Empirical studies support the view that liberalization of banking will have favourable results. Recent studies by **Ozkan-Gunay (1996, 1998)**, **Mahmud and Zaim (1998)**, **Yildirim (1999)** and **Mercan and Yolalan (2000)**, concluded that liberalization increased efficiency in the banking sector. **Claessens and Glaessner (1998)** also compare bank performance across several Asian countries in their study of the internationalization of financial services.

Banks may be affected by liberalization and globalization in the following ways: profitability, development and market share, pricing policy, levels of risk and the quantity and quality of financial services. Other accompanying symptoms include large increases in interest rates, under-capitalization, a noticeable increase in the level of risk and a rapid deterioration in the quality of loan packages (**Jabsheh, 2000**). Inevitably, banks that are unable to stay abreast will lose out in the more competitive world.

2.2.1 Impact of Globalization on Malaysian Banking Sector

Globalization will involve the greater integration of a country's local financial system with international financial markets and institutions, the internationalization of financial services and an increased presence of international financial intermediaries, mainly foreign banks in local market. Globalization has made financial markets in open economies like Malaysia closely integrated with global finance (Sieh, 2000). Thus, domestic banks and non-banks need to be more resilient, innovative and up-to-date than before as they are exposed to greater risk (IMF, 1998).

As changes in the global financial industry continue to accelerate in the new millennium, the Malaysian financial system particularly domestic banking institutions will face more pressure, hence are forced to open up and liberalize in order to be more competitive and efficient. If we do not respond to greater competition fast enough, Singapore, Thailand and even Indonesia will be our major rivals.

2.2.2 The Opportunities faced by Malaysian Banking Sector

It is recognized that globalization will bring both opportunities and challenges to the Malaysian banking sector. Hence, it is essential that we manage globalization well such that our banking sector can take full advantage of the opportunities it generates, while minimizing the risks it implies.

Under globalization, Malaysian banking sector will be more opened and can expect new types of capital because in a financially integrated world, funds can flow freely from countries with excess funds to countries where the marginal product of capital is

high (**Schmukler and Lobaton, 2001**). As such, the Malaysian banking sector should grasp this opportunity to increase their role as financial intermediaries since borrowers and lenders will have more financial alternatives with new source of funds and availability of capital as they need not only depend on domestic assets, but can also borrow from foreign countries.

Globalization too provides an opportunity in reducing asymmetries hence, problems of adverse selection and moral hazard. This is because banks are increasingly adopting international accounting standards which can increase transparency (**Schmukler and Lobaton, 2001**). Besides, globalization also tends to improve corporate governance (**Stulz, 1999**).

Globalization will entail in increased foreign bank entry, which will bring some opportunities to our banking sector. **Claessens, Demirguc-Kunt and Huizinga (1998)** argue that increased foreign bank entry will create competitive pressure on domestic banking institutions thus leading to improvements in banking system efficiency in terms of lower operating costs and improved services. Besides, costs are reduced as globalization allows banks to achieve economies of scale when smaller banks merge to form a larger group.

Another opportunity that domestic banks should seize is the chance to learn and adopt the more advanced technology and best practices in risk and bank management with the greater presence of foreign banks. Many of these globally active banks are likely to introduce improved management and information technologies to the domestic

banking market (**Focarelli and Pozzolo, 2000**). Entry of foreign banks is one way to quickly transfer the best practices currently in use in more developed banking markets (**Levine, 1996**), thus improving the efficiency and range of intermediation services in our banking sector.

4.3 Challenges of Globalization on Malaysian Banking Sector

Despite the many opportunities and benefits that globalization offers to Malaysian banking sector, it also poses new challenges to this sector.

One key challenging task confronting Malaysian banking system is how to stay competitive, efficient and sound in the new global banking system linked by information technology (IT). Individual banking institutions need to exploit the advances of IT to increase efficiency and create new products. The challenge is for domestic banking institutions to source for new capital to finance the investment on new technology so as to ensure that performance gaps do not widen as technology continues to drive global trends in financial services.

It is also recognized that domestic banks may not be as competent as foreign banks as the foreign banks usually have a wider choice of experts and training exposure for employees, foreign banks' superior knowledge of and capital investment in information technology places them in a better competitive position than domestic banks (**Sieh, 2001**).

Several studies have found that foreign entry in the banking sector results in lower interest margins and a reduction in profitability of domestic banks (**Clarke, Cull, D'Amato and Molinari, 1999; Claessens, Demirguc-Kunt and Huizinga, 1998**). As such, there is a challenge for the domestic banking institutions to improve their efficiency and effectiveness to be at par with the best international players.

Another challenge is the possibility that globalization can increase the vulnerability of countries to crises. Generally, countries with open economies are subject to the reaction of both domestic and international markets, which can trigger fundamental-based or self-fulfilling crises. Moreover, the cross-country transmission of crises is characteristics of open economies. When a country integrates with the global economy, it becomes exposed to contagion effects as well as foreign shocks. Contrary, in a closed economy, only domestic investors monitor the economy and react to unsound fundamentals (**Schmukler and Lobaton, 2001**). **Frankel and Schmukler (1998)** and **Kaminsky and Reinhart, (2000)** argue that the contagion of Argentina and Brazil from Mexico in 1994, and that of Indonesia from Thailand in 1997-98 are best explained by financial sector linkages among these countries, especially banks and international capital markets. **Van Rijckeghem and Weder (2000)** argue that banking spillovers were particularly relevant in the aftermath of the Mexican and the Asian crisis.

According to **Peek and Rosengren (1997)**, the regulatory and monetary authorities will face the challenge of having less control in making the banking system an instrument for government credit allocation schemes, with lending directed to priority

sector if the banking sector is more opened and has a sizable foreign bank presence. This is because foreign entities are usually more concerned on the expected financial returns from a transaction and less sensitive to domestic goals promulgated by the government.

Given the fact that potential opportunities and benefits of globalization on Malaysian banking sector can be large, the scope is for Malaysian banking institutions to strengthen their competitiveness in order to seize the opportunities of globalization for much larger gains.