CHAPTER 5 – THE CURRENT STATE OF MALAYSIAN BANKING SECTOR IN THE LIGHT OF FINANCIAL SECTOR MASTERPLAN (FSMP)

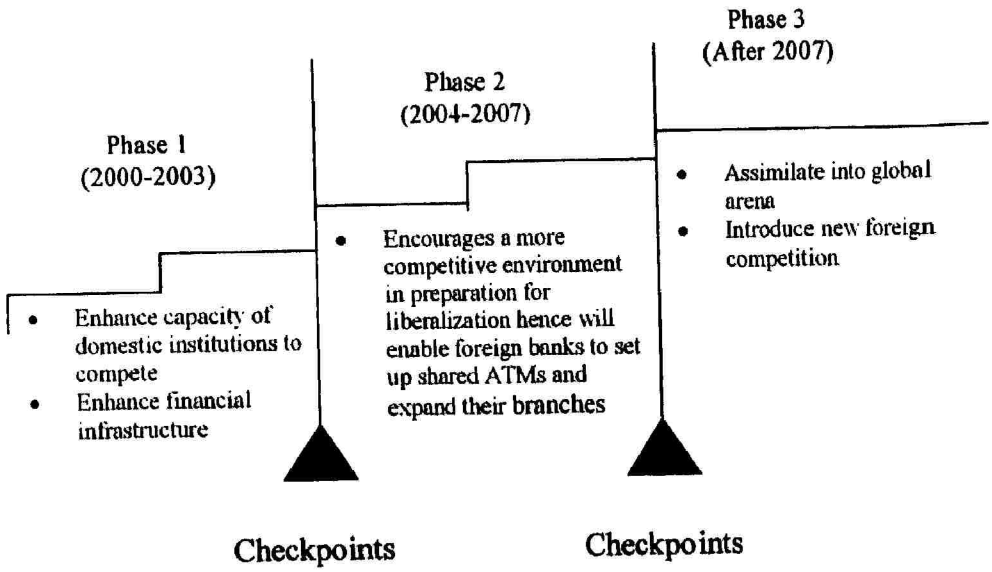
5.1 A Review of the Financial Sector Masterplan (FSMP)

The FSMP, launched in March 2001, is a comprehensive plan that charts the future direction of our financial system over the next 10 years through greater diversification, enhancing efficiency and maintaining a balanced economic system. FSMP outlines the strategies to be adopted in the transition for the development of the desired financial system.

In order to be competitive and resilient in a more opened and globalised financial environment, the recommendations in FSMP would focus especially in building the capabilities of domestic financial institutions, maintenance of financial stability, providing the framework for consumer protection and improving the financial landscape consisting of banking institutions, insurance companies, Islamic financial institutions, venture capitalists, offshore financial institutions and specialised financial institutions (FSMP, 2001).

While the financial sector will eventually become increasingly diversified, the banking sector will become more important in its role as a source of financing. As such, a change programme would be implemented over the next 8-10 years with the objectives of improving efficiency, innovation, flexibility, resilience and dynamism in the banking system.

Figure 4 : The 3 phases of development outlined under FSMP are :



Source : BNM Annual Report 2000

In the new global environment, Malaysian banking institutions need to strive to enhance their capacity and capability so that they will be at par with global players. Against this backdrop of socioeconomic objectives of Malaysia, the specific recommendations and strategies for building the capabilities of domestic banking institutions and increasing the incentive to improve performance are summarised in Appendix 5.

Generally, recommendations 3.1 to 3.20 of FSMP aim at improving the **Efficiency** and **Effectiveness** of domestic banking sector. Recommendations 3.21 to 3.30 are designed to promote financial stability of the banking sector hence are focused at achieving the desired characteristics of **Stability, Robust Financial Institutions** and **Prudential Regulations.** Finally, the remaining recommendations of 3.31 to 3.39 are geared at meeting socioeconomic objectives at large.

While the above mentioned recommendations outlined under FSMP are considered comprehensive and complete in identifying the building blocks for a strong and competitive banking sector in the next decade, the following issues for consideration are perhaps worth given some attention[21] :

- A sufficient legal framework should include not only laws on banks but also adequate laws on property rights, contracts, companies and bankruptcy. Effective bankruptcy procedures should be legally enforced and serve as part of the country's debt restructuring. An effective bankruptcy system will also create the appropriate incentives for creditors and debtors to reach out-of-court negotiations and settlements.
- International laws practices should be adopted in order to participate in global banking, international trade and investment.
- Accounting practices of banks should be revised towards a market price-based accounting for bank investments, standardized and transparent practices with regards to the allocation of expenses, classification of loans and fixed asset depreciation.
- A weak and fragile real sector affects the banking sector negatively. Banking reform should proceed alongside corporate sector restructuring, especially of state-owned enterprises.
- A stable macroeconomic environment will complement the achievement of FSMP's objectives. As such, BNM should continue to implement prudent and consistent monetary as well as banking policies that include measures to ensure

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[21] Nguyen Tan Dung, Deputy Prime Minister of the government of the S.R. Vietnam, "Reforming

the control of inflation as well as the foreign exchange. The experience of Singapore demonstrates that macroeconomic stability is an essential ingredient in its rapid and sustained economic growth.

In general, the FSMP[22] is regarded as a timely and appropriate initiative in building a more resilient and competitive banking sector in Malaysia. However, since the plan involves a revolutionary process and cannot be achieved within a short period of time, it is therefore still rather too early to comment on the effectiveness and achievement of FSMP in realizing its objectives. Nevertheless, if there are combined efforts from each banking institution in formulating their own strategic plans alongside the FSMP, then the probability of accomplishing these objectives will be enhanced.

5.2 The Desired Characteristics and Future Landscape of the Domestic Banking Sector Proposed under FSMP

The landscape of the Malaysian banking sector can be expected to evolve and change significantly in the next decade. The FSMP has outlined the future landscape of the Malaysian banking sector which are defined based on the following five core characteristics that are perceived as most desirable in developing a stable and competitive banking sector :

Vietnam's Banking System : Learning from Singapore's Model", 53th World Bank/IMF Meeting 1998.

[22] To date, 9 out of the 119 recommendations under the FSMP have been fully implemented while 22 recommendations are being implemented on an on-going basis.

Efficiency

The range of financial products and services should be offered at the lowest cost to both institutional and individual borrowers, investors, depositors and risk managers. As such, improvement in productivity and higher returns on assets for the banking institutions will need to be realized through greater penetration of efficient and low cost delivery channels, access to scale advantages in processing, procurement and other back-office functions and leveraging on world-class skills **(FSMP, 2001).**

Effectiveness

The availability of a broad range of differentiated financial products and services is essential to meet the specific demands of consumers that are expected to be increasingly more sophisticated. The degree of innovation of the banking institutions will determine the range of products and delivery channels offered **(FSMP, 2001).**

Stability

A safe, sound and stable banking system that is able to withstand sudden adverse economic and financial shocks that emanate from within and outside the system. To have a stable system, there must be efficient, effective and robust banking institutions, strong prudential regulations and supervision as well as reliable infrastructure. This will be achieved through institutional development and capacity building, increasing the competitive environment, the continuos improvement in the existing payments infrastructure while instituting a more market-driven consumer protection framework **(FSMP, 2001).**

Robust banking institutions

Improvements in credit skills, risk management and corporate governance among banking institutions by the greater use of financial models and application of risk management framework that is more comprehensive. Corporate Governance can be enhanced through improving the quality and accountability of the board of directors and management of banking institutions (**FSMP, 2001**).

Prudential regulations

The implementation of effective prudential regulations and supervision is essential while balanced with the provision of an environment that is conducive to the development of an efficient and innovative financial system (**FSMP, 2001**).

Guided by the above characteristics, FSMP has outlined the future landscape of the Malaysian banking sector which is shown in Appendix 6.

5.3 The Current Position of Malaysian Banking Sector in the Light of FSMP

Despite the trend towards a more diversified financial sector, the banking sector has continued to be the most significant component of the financial sector. As at the end of 2001, the banking sector provided 83% of the total financing to the economy, with total credit provided by the banking sector accounted for 133.9% of our Gross Domestic Product (GDP) (BNM Annual Report 2001). Profitability of the banking sector has continued for the third consecutive year since the Asian crisis. Profits for the calendar year 2001 amounted to RM7.5 billion (BNM Annual Report 2001).

Notwithstanding all these positive signs, much needs to be done to further improve the current Malaysian banking system towards the development of a well-diversified and resilient banking sector that is structured by the five desired characteristics outlined in FSMP. As such, it is important that we know the current position of Malaysian banking sector and how much we have achieved in terms of the five characteristics under FSMP. Table 14 below shows the analysis of the current state of our Malaysian banking system mirrored against the five desired characteristics while explanations are given for such analysis by studying the performance of the banking system over a period of years to find out if its performance has indeed improved over the years. Relevant data were collected for the Malaysian banking sector for the period of 1996 to 2001. Several ratios such as the ROA, ROE, cost-to-income ratio and others will be calculated and extracted from BNM Annual Reports 1996 to 2001. The reason for focusing on these years is because this period shows the changes in the growth of the banking sector with the boom in 1996 to 1997, then the negative growth due to financial crisis in 1998, the recovery stage in 1999 to 2000 and finally the consolidation stage in 2001 in response to globalization.

Table 14 : The Current Position of Malaysian Banking Sector in the light of FSMP

Desired Characteristics Proposed under FSMP	The Current State of Malaysian Banking Sector
Efficiency To remain competitive, cost and operational efficiencies should be achieved while improvement in productivity will be of high priority.	1. The performance of Malaysian banking sector in general has been rather satisfactory with improvements in various aspects of the banking system. Nevertheless, there is a sign that the banking system is becoming less efficient and extra effort would be needed to achieve the desired efficiency level. In fact, the role of banking system as the largest financial intermediary is slightly deteriorating with the decline of its share of total assets held in the financial system (Figure A). In addition, the top three banks in Malaysia currently capture only 42% of the country's total asset size in 2001, compared with 85% in Singapore, 83% in Hong Kong and 75% in China (ASLI, Highlights of the Malaysian Banking & Financial Services Summit, May 2002).

Figure A : Total Assets of the Malaysian Banking System (RM billion)

Year	1996	1997	1998	1999	2000	2001
	631.8	812.0	766.7	803.9	848.4	865.9
% held in the financial system	68.7%	68.8%	70.0%	68.7%	67.8%	66.9%

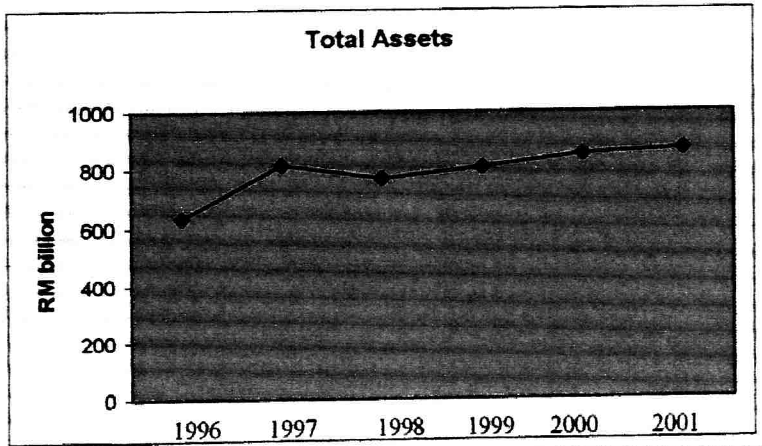


Chart A: Total Assets of the Malaysia Banking System

Source : BNM Annual Reports 1996-2001

Efficiency

Figure A above shows that the total assets of the banking system has been increasing except for 1998. The total assets of the banking system has increased by RM180.2 billion or 28.5% in 1997, partly due to the rapid economic growth in Malaysia. However, in 1998, there was a sharp decline in the assets of the banking system by 5.6%. Such decline is due to the regional financial crisis which had resulted in a fall in loans and advances, following the tight liquidity conditions in early 1998. The various post-crisis measures implemented had seen positive results when the total assets of the banking system rose by 4.9% to RM803.9 billion in 1999, marking a year of recovery in the banking system. The higher economic activity in 2000 was reflected in the growth of the total assets of the banking system with an increase of 5.5%. The assets of the banking system continue to rise to RM865.9 billion in 2001. During the period from 1996 to 2001, despite remaining as the largest financial intermediary and the increase in its total assets, the banking system's share of total assets in the financial system has declined from 68.7% in 1996 to 66.9% in 2001. This could be a hint that the other financial institutions are becoming more and more efficient and popular in mobilising deposits and in granting loans and advances, hence slowly replacing the role of bank as the major financial intermediary in the financial system.

Figure B : Profitability of the Malaysian Banking System (RM billion)

Year	1996	1997	1998	1999	2000	2001
	8.7	7.7	-5.7	4.7	9.3	7.5

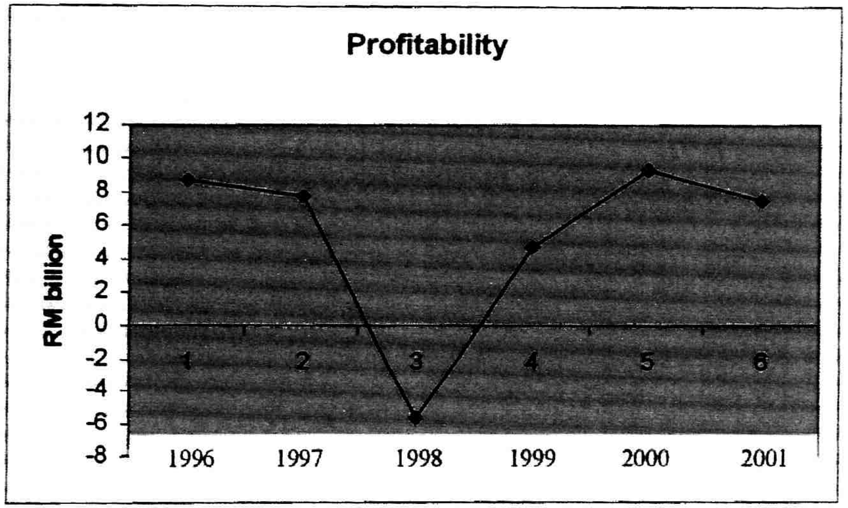


Chart B: Profitability of the Malaysian Banking System

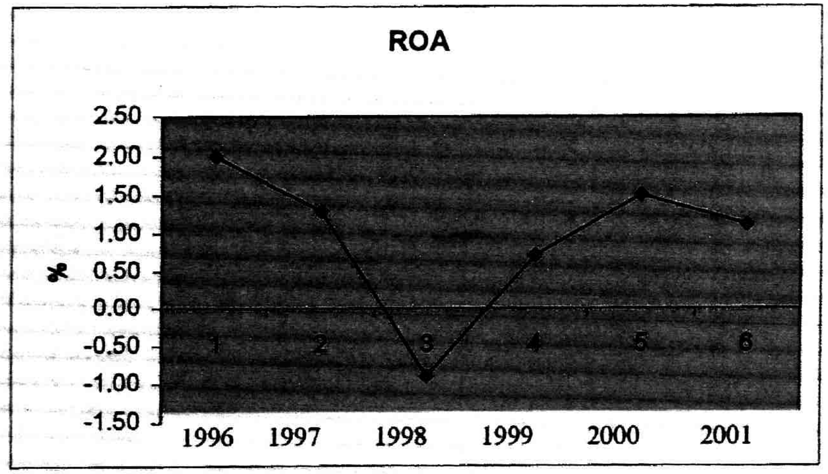
Source : BNM Annual Reports 1996-2001

Efficiency	Figure B shows that during the economic boom in 1996, the pre-tax profit for the banking system recorded a high of RM8.7 billion and declined slightly by 11.5% in 1997. The banking system recorded a pre-tax loss of RM5.7 billion in 1998 compared with a pre-tax profit of RM7.7 billion in 1997. This huge loss in the banking system was due to the economic contraction and rising NPLs, resulting from the financial crisis. Profitability improved to RM4.7 billion on 1999 though still considerably lower than the levels enjoyed during the pre-crisis period. This is an encouraging sign indicating that Malaysia is fast recovering from the financial crisis and that the various measures implemented are appropriate and timely. Banking sector profits continue to grow to RM9.3 billion, reflecting the strong economic performance and higher lending activities. Malaysian banking sector continues to record profitability though at a lower rate, in fact, pre-tax profit fell by 19.4% from RM9.3 billion in 2000 to RM7.5 billion in 2001. In general, Malaysian banking sector has been efficient as evident by the impressive profitability and it is expected that profits should increase in the future with the implementation of FSMP.

Figure C : Return on Assets ratio (ROA) (%) of the Malaysian Banking System

Year	1996	1997	1998	1999	2000	2001
	2.0	1.3	-0.9	0.7	1.5	1.1

Chart C : ROA of the Malaysian Banking System



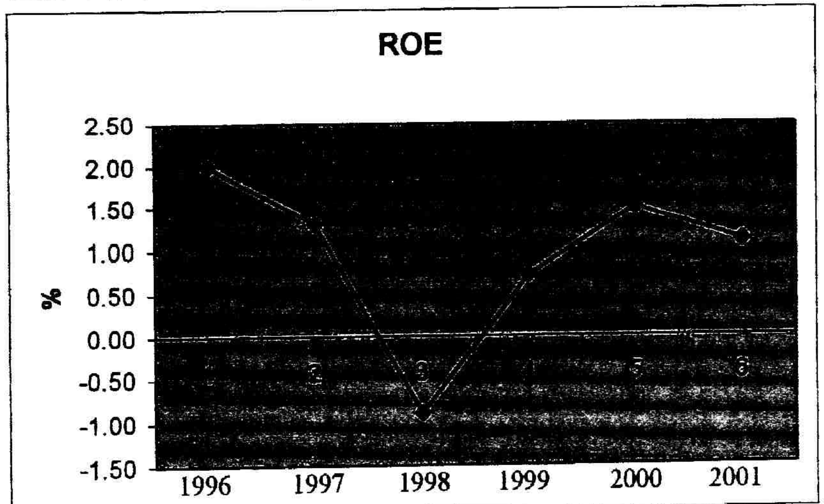
Source : Extracted from BNM Annual Reports 1996-2001

Efficiency	Since high ROA ratio indicates high profitability, it is gathered from Figure C above that pre-crisis ROA ratios were high indicating high profitability and efficiency of banks in employing assets to generate income. ROA started to deteriorate from 1.3% to –0.9% in 1998, which was reasonable in the context of the prevailing economic environment following the regional financial crisis. ROA had later improved to 0.7% in 1999, 1.5% in 2000 and 1.1% in 2001 respectively. Despite a negative ROA in 1998, Malaysian banking sector has generally been efficient in employing its assets to generate income as shown by the positive ROAs over the years. Since the banking sector had once achieved an impressive ROA of 2.0% in 1996, it is therefore envisaged that it has the potential to attain this height or perhaps better in the near future, especially when FSMP is devised specifically to improve the performance of Malaysian banking sector.

Figure D : Return on Equity ratio (ROE) (%) of the Malaysian Banking System

Year	1996	1997	1998	1999	2000	2001
	27.5	17.5	-12.3	9.8	19.5	14.5

Chart D : ROE of the Malaysian Banking System



Source : Extracted from BNM Annual Reports 1996-2001

Efficiency

Figure D and Chart D show that the Malaysian banking system had consistently recorded good ROEs for the period under study except for 1998, during which the economic situation was badly affected by the financial crisis. ROE was the highest during the pre-crisis period from 1996 to 1997, indicating high profitability but not necessarily high efficiency since high ROE gives an indication of high leverage and the riskiness of the banking business given the low equity portion of the bank balance sheet, resulting from which banks became vulnerable to external shocks and the presence of moral hazard problem in the banking industry. That was perhaps why the Malaysian banking sector was hard hit by the financial crisis in 1997/1998. Despite recording a negative ROE in 1998, Malaysian banking sector was fast to recover and improve by recording a positive ROE of 9.8% in the following year. Subsequently it was able to continuously portray positive ROEs of 19.5% and 14.5% in 2000 and 2001 respectively. This is an indication of the efficiency of Malaysian banking system in generating profit return for every ringgit of shareholders' fund and ROE should be maintained at a high but manageable level, striking a balance between efficiency and sufficiently high equity in the banking industry.

2. On the surface, cost-to-income ratios of leading Malaysian banks look impressive at 40% as highlighted in the 2001 BNM Annual Report. However, when 'normalized' margins are factored in, Malaysian banks are far less efficient compared to their regional peers at a cost-to-income ratio of 62% (ASLI, highlights of the Malaysian banking & financial services Summit, May 2002). In order to improve efficiency through scale advantage, 22 (BNM Annual Report 2001) banking institutions have outsourced some of their non-core business activities to third party service providers and 6 (BNM Annual Report 2001) banking institutions are engaged in cross-selling financial products and services of entities within the same group. Such practice is aimed at improving the efficiency of banking institutions and in gaining greater strategic focus. Despite all these efforts, the efficiency is still yet to achieve the expected level. It is therefore obvious that Malaysian banking institutions have yet to improve in managing cost. This can be explained by the cost-to-income ratios presented in figure 9 below. Banking institutions in Malaysia are considered late in embarking outsourcing exercise when the US banks had actively outsourced their activities since the 1980s.

Figure E : Cost-to-income ratio (%) of the Malaysian Banking System

Year	1996	1997	1998	1999	2000	2001
	37.6	38.7	44.1	37.4	36.7	38.8

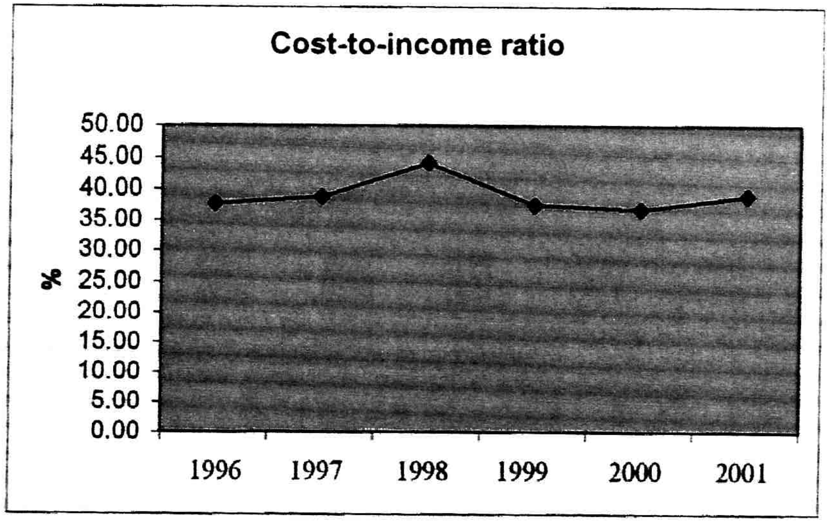
Source : BNM Annual Reports 1996-2001

Figure E above and Chart E below show that the cost-to-income ratio has been in an upward trend since 1996 to 1998. However, these ratios had been maintained at a manageable level despite reaching a peak at 44.1% in 1998, which was partly due to the Asian financial crisis. There was an improvement with a decline in the ratio in 1999 and followed by 2000. The upward trend of the ratio from 2000 to 2001 was partly due to the heavy merger-related expenses in the banking system. However, this may also indicate that the banking sector's efficiency and productivity is worsening and proper measures in improving cost efficiencies should be implemented.

Efficiency

Nevertheless, it is expected that the cost-to-income ratio should reduce in the subsequent years following the completion of the merger exercise in the banking sector.

Chart E : Cost/income ratio of the Malaysian Banking System



3. Following the consolidation exercise, the banking system is now left with 10 anchor banking groups instead of the earlier 55 financial institutions. The banking system now consist of 10 commercial banks, 10 finance companies and 9 merchant banks (Figure 10). While Malaysian banks are still relatively small compared to the major global players, it is anticipated that the merged banking groups will be able to benefit in terms of reduced number of employees, closing down of unprofitable branches, upgrade of information technology systems and reducing processing costs, all of which would help banks to operate more efficiently. Nevertheless, despite such effort, there is still ample room for improvement whereby banks are still not fully leveraging on the opportunities presented by the consolidation to exploit economies of scale, diversity and strengthen their earning base. Compared to some other Asian markets, Malaysia should further intensify its effort in consolidating the domestic banking sector and creating regional contenders.

Efficiency

Figure F : Number of Banking Groups After Merger

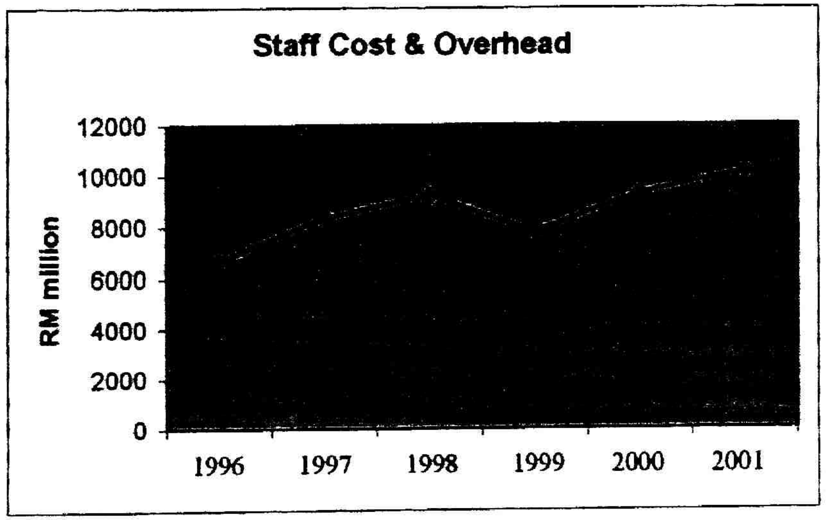
Bank	Pre-Merger number	Post-Merger number
Commercial banks	17	10
Finance companies	19	10
Merchant banks	12	9
Discount houses	7	to merge with finance companies

Source : BNM Annual Report 2001

Figure G : Staff Cost and Overhead (RM Million)

Year	1996	1997	1998	1999	2000	2001
	6685	8376	9209	7841	9303	10162

Chart G : Staff cost & overhead of Banking System



Source : Extracted from BNM Annual Reports 1996-2001

Efficiency	Figure G shows that the staff cost and overhead are increasing over the years. Staff cost and overhead rose by 25.3% to RM8376 million in 1997. Such increase is partly due to the administrative expenses incurred by the opening of new branches in line with the economic boom and rapid credit extension. Costs continue to rise to RM9209 million in 1998. Staff cost and overhead decreased to RM7841 million in 1999, a reduction of 14.9% was due to lower staff cost incurred during the year as a result of a 4.4% reduction in the number of employees in the banking sector, as well as a decline in overheads (-8.2%) (BNM Annual Report 1999). In 2000, staff costs continued to rise by 26.1% to RM4600 million following the upliftment of the wage moratorium. Concurrently, overheads rose by 16.1% to RM4800 million partly due to merger related costs (BNM Annual Report 2000). Consequent to the merger exercise, overhead costs continued to rise as rationalisation and systems integration efforts were undertaken (BNM Annual Report 2001). The rising trend of staff costs and overhead indicate that Malaysian banking sector is still yet to achieve the desired level of efficiency in controlling costs though it may be argued that the rising costs are necessary in completing the bank consolidation exercise while the results and benefits of consolidation has yet to be seen within the short time frame since the consolidation exercise only completed in 2001. Generally, we would expect costs to greatly reduce in the next few years as banking sector reap the benefits from mergers in terms of cost savings through economies of scale as well as efficiency through the rationalisation of branches and operations (RAM Focus, Issue 19, August 2002). As such, analysis of the banking sector's staff costs and overhead of next few years will be important in assessing whether the merged banking groups do improve their efficiency and take full advantage of the benefits of consolidation. Otherwise, other measures would perhaps need to be devised. 4. The domestic banking institutions are still relatively less efficient when compared to the foreign banks. A comparative study of the performance of domestic-owned and foreign-owned banks in Malaysia indicates the latter are more far-sighted and innovative (Murakami 1998) (Figure H). The superb growth recorded between 1990 and 1997 boosted the domestic banks' profits but not their productivity, capital strength and financial technology. Currently, there are still many restrictions on the entry of foreign banking institutions to the Malaysian banking sector. Foreign equity investment in banking institutions is limited to 30% and there are restrictions on branch expansion, despite the fact that all these foreign banks have been operating in Malaysia for a very long time. Although the ultimate intention was to protect the local banks, such restrictions will not do any good to our domestic banks but will only pamper them and preventing them from improving their competitiveness. In fact, greater participation of foreign banks in the banking sector will promote institutionalization of the shareholding structure in the banking institutions through new entry or mergers of strong foreign banks with domestic banks, while enhancing the efficiency of domestic banks through healthy competition. In order to examine the relative competitiveness of foreign banks in Malaysia, a brief comparison is made between a sample of 10 local commercial banks and a sample of 3 major foreign banks (Citibank, HSBS and OCBC) in Malaysia on profitability (ROA and ROE), management efficiency (Cost/Income), capital adequacy (RWCR) and asset quality (NPL/TL). The relevant data are extracted from the banks' annual reports for years 2000 and 2001 and presented in Appendix 5. Ratios are then computed from these data and summarized in Figure H below.

Efficiency

Figure H : Comparison of some key performance ratios between domestic commercial banks and 3 selected foreign commercial banks in Malaysia

	ROA(%)		ROE(%)		Cost/Income(%)		RWCR(%)		NPL/TL(%)	
	2000	2001	2000	2001	2000	2001	2000	2001	2000	2001
Local Banks (Appendix 7)	1.19	0.87	13.3	9.8	39.1	44.3	11.91	12.09	6.55	9.51
Foreign Banks (Appendix 7)	1.97	1.83	26.8	25.2	40.7	41.5	12.94	12.39	5.6	5.1

Figure H above clearly shows that foreign banks in Malaysia are far more competitive and efficient than Malaysian local banks in various aspects. In terms of profitability and earnings, foreign banks had recorded a much higher ROA and ROE in both the years. In 2000, foreign banks recorded an ROA of 1.97% compared to only 1.19% for local banks. Subsequently in 2001, foreign banks continued to score high ROA at 1.83% while local banks only recorded 0.87%. Though deteriorating slightly from year 2000, ROA for foreign banks was much higher than local banks hence indicating the profitability of foreign banks and their relative efficiency in employing assets to generate high returns. Similarly for ROE, foreign banks in Malaysia had shown very high ROE ratios compared to Malaysian local banks. In 2000, ROE for foreign banks was 26.8% while local banks' ROE was 13.3%. Subsequently in 2001, ROE for foreign banks continue to be much higher than local banks' though declining a little. In fact, foreign banks shareholders' equity are not too high compared to Malaysian banks but the profits generated were indeed very much higher, signifying the relative competencies of foreign banks in generating high return for their shareholders. Such impressive ROA and ROE ratios would definitely increase the shareholders as well as depositors' confidence.

In examining management quality, foreign banks' cost/income ratio was slightly higher than local banks in 2000 at 40.7% while the later recorded a lower ratio at 39.1%. However, in 2001, both foreign and local banks had higher cost/income ratio compared to year 2000 with local banks recording a higher ratio at 44.3% while foreign banks' was 41.5%. This had again shown the relative efficiency of foreign banks in managing costs and in generating income.

Foreign banks had relatively higher RWCR at 12.94% and 12.39% in 2000 and 2001 respectively while local banks only recorded 11.91% and 12.09% in both the years. The higher ratios recorded by foreign banks clearly indicate the ability of foreign banks to absorb losses and higher RWCR also mean the lower probability of these banks having solvency problems. On the other hand, local banks had maintained a lower RWCR indicating their relative vulnerability as proven by these banks badly affected by the 1997/98 Asian financial crisis.

As shown in Figure H, foreign banks had a much lower NPL/TL ratio of 5.6% in 2000 and 5.1% in 2001. Comparatively, local banks had higher ratio of 6.55% in 2000 and 9.51 in 2001. Clearly, foreign banks maintain a better asset quality due partly to their competent credit officers in approving loans hence minimizing the probability of bad loans. Conversely, credit officers of local banks were generally less competent in evaluating and granting loans.

Efficiency	In general, Malaysian local banks are still relatively less competitive compared to the foreign banks. Only a few large local banks such as Maybank and Public Bank can compete with these foreign banks while the other smaller banks would most likely lose out to these foreign banks when more of them are allowed to enter the domestic banking industry comes 2005. Local banks should urgently improve themselves or another alternative would be to further consolidate the existing 10 anchor banking groups so that the resultant fewer banking groups would be bigger in terms of capital and assets, hence stronger and better in competing in the global market. 5. There is currently a shortage of well-trained professionals in the banking industry and among the supervisory authorities due partly to the relatively less competitive remuneration scheme offered. The knowledge gap is largest in treasury and credit operations. Realising the importance and strength of manpower capabilities, BNM had abolished the Guideline on Wage Moratorium thereby giving banking institutions greater autonomy to determine the most appropriate remuneration package. 6. In an effort to enhance the level of efficiency in the banking sector, the commissions previously paid by finance companies to car dealers on every successful hire-purchase financing cases had been abolished and will be absorbed by the finance companies. This is to ensure greater cost savings to the consumers as these commissions were translated into higher costs for the consumers as reflected by the higher rates charged by the finance companies.
Effectiveness The availability of highly differentiated financial products that meet specific demands of the customers and increased innovation as well as improved services would be essential.	1. Generally, Malaysian banking sector has still yet to achieve its desired level of **Effectiveness**. In an attempt to encourage innovation, banking institutions are actively adopting 'what is not prohibited is allowed' regulatory philosophy and phase-out product pre-approval requirements to remove impediment to innovation (BNM Annual Report 2001). However, there is still plenty of room for financial innovation in Malaysia since banking institutions especially domestic institutions are still not investing enough in conducting market researches and customer needs analysis which are essential in designing services that will meet specific demands of the consumers. Domestic banking institutions are also not prompt enough in reacting and adjusting to the rapidly changing trends in global banking services, hence often losing out to the foreign banks. 2. Following the completion of the consolidation exercise of the banking sector, it is expected that the effectiveness of the banking sector would improve with greater intra-group "cross-selling". This idea of marketing and offering different products within the same financial group is becoming fairly common. Savings accounts offered by commercial banks which are combined with insurance products is a typical example of cross-selling. 3 While interest income will continue to dominate the Malaysian banking sector's gross income profile, global banks are becoming less reliant on margins and traditional interest-based income as the main source of revenue. Many banking groups in Malaysia are currently gearing towards fee-based income through the provision of value-added services and undertaking cross-selling activities in an effort to generate more non-interest income, as evident by the increasing non-interest income in the banking system (Figure I). In addition,

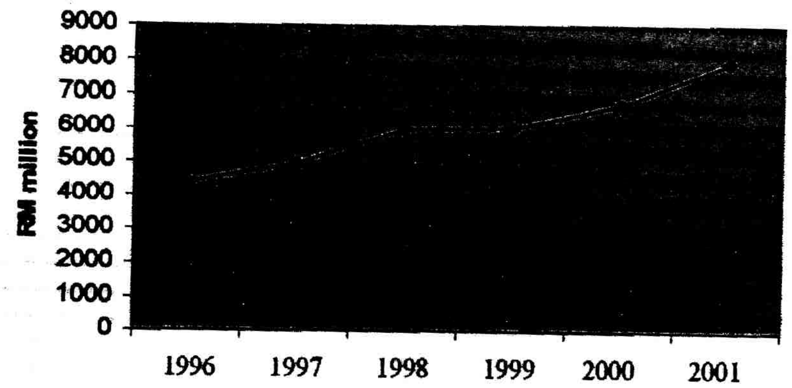
Effectiveness

merchant banks are also gradually diverting their emphasis towards investment banking. Broadly put, investment banks are shifting away from lending and move into non-interest related or fee-based activities, their natural forte (RAMFocus, Issue 19, August 2002).

Figure I: Non-interest Income (RM million)

Year	1996	1997	1998	1999	2000	2001
	4406.5	4943	6017	6079	6700	7917

Chart I : Non-interest income of Banking System



Source : Extracted from BNM Annual Report 1996-2001

Figure I and Chart I above show the continuous growth in non-interest income from 1996 to 2001 especially fee-based income which constitutes a major share of total non-interest income. Fee-based income registered an increase of RM17.9 million to RM3 billion (BNM Annual Report 2001), reflecting the greater attention by banking institutions on the provision of fee-based services to complement traditional fund-based income. Despite this encouraging growth, Malaysian banking institutions are still far from reaching this objective wherein retail banking profits are still very much dependent on traditional businesses. While fee-based income has jumped to almost 50% of banking revenues for US, Europe and Japanese banks, fee-based income constitute only less than 30% of

Effectiveness	Malaysian banking revenue (ASLI, Highlight of the Malaysian Banking & Financial Services Summit, May 2002). As such, continuous attention must be placed in this area in order to be more effective in providing more differentiated and value-added services to the customers. It is important that Malaysian banking institutions continue to focus on improving efficiency and effectiveness by stimulating non-interest income as the global trend now is towards revenue growth rather than cost-focused efficiency. 4. In addition to the existing delivery channels and the increased usage of tele-banking, there are currently eight domestic banking groups offering the full range of banking services through internet, marking in an effort to improve effectiveness in terms of new delivery channel (BNM Annual Report 2001). In order to ensure the most effective use of internet banking services, the "Minimum Guidelines on the Provision of Internet Banking Services by Licensed Banking Institutions" is issued by BNM to govern the provision of banking products and services over the internet. Complementing internet banking, the facilities of ATMs and its networks should be enhanced whereby routine and simple transactions such as cheques and cash deposits can be carried out via ATMs without having to be performed over the counter, hence avoiding long queues. Currently only foreign banks and a few domestic banks provide such convenience via ATMs. While electronic and on-line banking had been practiced in Malaysia, the development of TV/broadband banking should perhaps be the next target. Meanwhile, greater and continuous attention to the development of Information Communication Technology (ICT) is essential to ensure the formulation of appropriate ICT strategies.
Robust Financial Institutions Strong risk management capabilities and credit skills as well as sound corporate governance.	1. Malaysian banks generally tend to be conservative in terms of granting loan, mainly extending loans on the basis of collateral rather than project viability (Hing, 1987). Such emphasis on loan security has favoured loans to the real property sector and for share purchases and consumption, which will cause severe problems when these vulnerable sectors collapse as evidenced in the East Asian financial crisis. Although home and car loans have experienced lower and more stable default rates[23] compared to other sectors but over concentration of loans on a particular sector will be risky. As such, banks should be extra cautious when granting loans especially when house prices appreciate rapidly. In such a scenario, banks should learn from their past experiences and adjust their margins of financing to build a greater buffer against the potential property bubble (RAM Focus, Issue 19, August 2002).

[23] Sector NPLs/Sector Exposure

Robust Financial Institutions

Figure J : Direction of Loans and Advances by Sector, 1996-2001 (% share)

Sector	1996	1997	1998	1999	2000	2001
Manufacturing	8.6	11.1	9.7	9.4	9.0	8.0
Agriculture	1.6	1.5	1.6	1.7	2.1	2.0
General Commerce	4.1	5.1	5.5	3.0	3.0	2.8
Purchase of shares	3.6	6.1	4.8	3.9	3.6	2.9
Broad property *	22.2	25.8	26.7	26.3	26.1	28.0
Consumption Credit	8.7	9.0	8.5	8.5	8.8	9.8

** Comprises construction, real estate and housing*

Source : Extracted from BNM Annual Reports 1996-2001

Figure J above shows that the highest loan were directed to sectors prone to volatile asset-price cycle, such as broad property and speculative activities. The increase of credits for the purchase of residential properties was most significant in 2001 when many banks have offered housing loans on a 0 + base lending rate (BLR) basis for the first and second year, which had indeed attracted many house buyers. In addition, the government had undertaken to boost the property sector in an effort to boost the domestic economy by holding several "Home Ownership Campaigns" (HOCs) and granting several incentives to house buyers such as the waiver of stamp duty for residential properties purchased during HOCs. Loans extended for the purchase of shares had also been increasing , particularly when the share market was booming with Kuala Lumpur Composite Index (KLCI) reaching its peak in 1996 and 1997. Generally it can be summarised from figure J that broad property accounts for the largest share for commercial banks and merchant banks, while consumption credit – primarily lending for hire-purchase activities – represents the largest component in the loan portfolios of finance companies.

2. In managing credit risk, BNM currently adopts the Basle Core Principles for Effective Banking Supervision 1997. Despite the formation of Guidelines on Best Practices for the Management of Credit Risk, the Malaysian banking institutions' achievement in credit risk management is still relatively limited due to the incompetence of credit assessment personnel, many of them lack the necessary experience and understanding. Besides, credit risk management information system is generally inadequate to help banking institutions identify potential areas of vulnerabilities among borrowers. In addition, the absence of a comprehensive and up-to-date centralised database that houses credit information of previous and present borrowers have further crippled the credit assessment and monitoring process. The following weaknesses in credit skills are currently observed in the Malaysian banking institutions :
- Few domestic banking institutions use credit scoring for retail and small business lending, leading to over reliance on collateralized lending, high costs, wide margin and customer dissatisfaction (FSMP).
- Few banking institutions separate credit assessment from credit origination, leading to an inherent conflict in objectives (FSMP).

Robust Financial Institutions	- Few banking institutions monitor customer accounts across products, one of the key elements of an effective early warning system, apart from being an effective marketing tool (FSMP). BNM was quick in addressing these problems hence had intensified the holdings of industry seminars and training programmes in credit risk management. While not being able to achieve the desired credit risk management, the industry is even more lagging in managing the market and operational risks. Systems are only currently being upgraded to cover these risks and are only due to complete in another 2 to 3 years time. 3. BNM currently implements risk-based supervision approach which encompasses the following : (BNM Annual Report 2001) - Dynamic off-site surveillance for early detection of problems in banking institutions - Effective planning to customize on-site examinations in relation to the size and activities of banking institutions - Concentration of supervisory resources on areas that expose banking institutions to high degree of risks. This supervision approach is considered suitable and should be continued and intensified in view of the more competitive economic environment now. 4. In improving the banking institutions corporate governance, BNM has issued the Guideline on Duties and Responsibilities and Appointment of Chief Executives. Great emphasis is currently placed on cultivating the awareness among banking institutions on the importance of improving best practices. Focused training have also been conducted to raise the level of awareness of best practices and enhance understanding of chief executive officers and directors of banking institutions on emerging trends and issues facing the banking industry. Despite all these efforts, the practice of "connected lending" (lending to bank directors, managers and their related businesses) is still very common causing bank capital to be inadequate relative to the riskiness of banks' operating environment. As such, continuos attention should be placed to further improve the quality of corporate governance in the banking industry while eliminating the practice of "connected lending". 5. Amidst the economic slowdown in 2001, although the asset quality of the banking system has deteriorated marginally during the year, it is slowly stabilizing with the industry's net NPL ratios starting to flat-line from 3Q 2001 (RAMFocus, Issue 19, August 2002). Besides, the industry's asset quality is also underscored by a stable and strong capital adequacy position (Figure J). BNM conducts regular stress tests to assess the NPL levels and capital positions of banking institutions and the results of these assessments indicate that the banking system continues to be resilient even under the worst case scenario. The pre-emptive initiatives that were taken to accelerate the pace of corporate debt restructuring have started to yield positive results in enhancing the asset quality of banking institutions and significantly reduced risks to the banking system.

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<u>Figure K : Net NPL ratio (%)*</u>

<table>
<tr><td>Year</td><td><u>1998</u></td><td><u>1999</u></td><td><u>2000</u></td><td><u>2001</u></td></tr>
<tr><td></td><td>9.0</td><td>7.4</td><td>7.2</td><td>9.3</td></tr>
</table>
* Net NPL ratio = (NPL less IIS less SP) / (Gross loans less IIS less SP) x 100%
IIS = Interest-in-suspense SP = Specific provisions
Source : BNM Annual Reports 1996-2001

Figure K shows that NPLs had been increasing over the years. Despite the increase, the institutional and regulatory framework put in place by BNM over the years and the prudent policies of the banking institutions had positioned the sector on a sound footing to respond positively to these pressures.

6. In promoting robust financial institutions, benchmarking programme was initiated in 2000 which aims to provide a powerful tool for banking institutions to assess their competitive position vis-a-vis their peers within the domestic banking sector as well as foreign banks. Benchmarks include indicators on operating and financing ratios, broad indicators on customer service and ratios to gauge operational efficiency within banking institutions. The CAMEL framework is currently expanded to further refine the general performance indicators to allow banking institutions to better assess their competitive position and identifying gaps and opportunities that can be capitalised in enhancing returns in areas in which they have comparative advantage.
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<tr>
<td>Prudential Regulations
Implementation of effective prudential regulations and supervision.</td>
<td>
1. The major weaknesses of the Malaysian banking sector were mainly caused by lack of appropriate prudential regulations and adoption of best practices, as highlighted by the 1997/87 financial crisis. As such, the implementation of structural and policy reforms embracing global standards of banking practices will be essential in improving competitiveness in a globalized world (So-Nam Oh, 1999).

2. BNM's achievement in improving prudential regulations has not been too good. Although steps were taken to strengthen the disclosure and reporting requirements for banking institutions wherein data on income and operating expenses, total loans, NPLs and provisions are required to be published on a quarterly basis. However, BNM does not publish disaggregated NPL figures by substandard, doubtful or loss categories which are essential to be made publicly available given the rapid changes in asset quality. Data on collateral exposure of banking institutions are also not published (So-Nam Oh, 1999). The institutional weaknesses in terms of an underdeveloped banking infrastructure is still inherent with poor legal transparency and accounting standards resulting from the lack of information reporting. As such, the quality of public disclosure and transparency is considered poor and improvement would be necessary.

3. Despite BNM's effort in intensifying its supervisory focus on bank holding companies and their subsidiaries in the supervision process, success is limited in strengthening the supervisory framework over banking institutions whereby closer monitoring and supervision should be conducted to maintain the overall stability.
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Stability

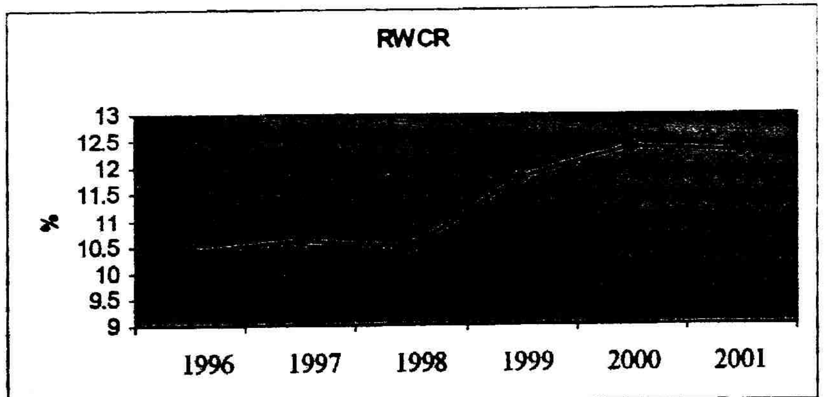
The availability of strong infrastructure through institutional development and capacity building.

1. One encouraging fact is that the Malaysian banking sector has emerged from the East Asian crisis significantly strengthened. Malaysia has taken full advantage of the conducive economic environment over the last two years to implement financial restructuring and structural reforms in the banking sector and is well placed to chart the medium and long-term agenda for the financial system as embodied in the FSMP[24]. The risk-weighted capital ratio (RWCR) of the banking system has remained at a healthy level of 12.5% as at the end of the first quarter of 2002 (BNM Annual Report 2001).

Figure L : RWCR (%)

Year	1996	1997	1998	1999	2000	2001
	10.4	10.6	10.5	11.8	12.4	12.3

Chart L : RWCR of Banking System



Source : BNM Annual Reports 1996-2001

Figure and Chart L show that Malaysian banking system continues to maintain a strong capital position with RWCR well above the Basle recommended rate at 8%. In certain years, RWCR had in fact achieved well above 12%. RWCR was gradually increasing from 10.4% in 1996 to 10.6% in 1997 and subsequently dropped slightly to 10.5% in 1998. RWCR increased rapidly to 11.8% in 1999, probably due to the bad experience it had with the financial crisis in 1997/98, hence realising the importance to maintain a strong and healthy capital position against external shocks. Thereafter, RWCR was kept at above 12% recording a 12.4% in 2000 and 12.3% in 2001. According to a report by RAM[25], banks have resorted to raising their Tier II capital in the form of subordinated debts though strengthening of a bank's capital structure to emanate from Tier I capital would be preferred. This is due to the current low financing costs which

Stability	renders Tier II capital a cheaper form of funding compared to equity. Generally, the strong capital position of Malaysian banking system will ensure its stability and resilience against sudden changes in the world economy , hence supports the continuous growth and competitiveness in the era of globalization. 2. Although some Malaysian banking institutions such as Maybank, Public Bank and Hone Leong Bank have expanded their operations abroad, these institutions have still yet to become fully global in terms of operations as their operations are confined to a few countries mainly in the ASEAN region. As mentioned, domestic banking institutions lag behind foreign banks in financial technology, information and product development. Moreover, investment in foreign countries is constrained by factors such as lack of experience, human capital and money. The managers in these local banks generally lack the business and managerial skills required to manage foreign operations.

[24] Zeti Akhtar Aziz, Gavenor Bank Negara, Opening Speech at the Malaysian Banking Summit 2001, Kuala Lumpur, "Scaling New Heights After the Banking Consolidation, 17th May 2001.

[25] RAMFOCUS, Issue No. 19, 28 August 2002

5.4 Summary of Analysis

In examining the current position of the Malaysian banking sector benchmarked against the FSMP as illustrated in Table 14 above, it can be summarized that Malaysian banking sector is generally strong and sound but still relatively distant from achieving all the 5 desired characteristics proposed under FSMP.

In terms of efficiency, there has been positive improvement for Malaysian banking sector over the period 1996-2001. Many ratios under study such as ROA, ROE and Cost/Income ratio had been improving over the years indicating improving performance and efficiency among these banks. Generally, Malaysian banking sector's efficiency had been improving but not yet achieved the desired level of efficiency as proposed under FSMP. Continuous efforts would be necessary to further improve the efficiency of the banking sector.

Malaysian banking sector's effectiveness had also been improving over the years as evident by the increasing non-interest income which indicate that banks are less reliant on traditional interest-based income as the main source of income. In addition, there had also been an expansion in delivery channels as well as an improvement in financial innovation following a tremendous increase in the usage of IT. Generally, the effectiveness of banking sector had been encouraging but not yet achieved the desired level.

In promoting robust financial institutions, various efforts were undertaken by BNM in improving risk management and credit skills. However, the increasing net NPL ratio and the concentration of credit towards property sector had somehow delayed the achievement of this objective.

Many prudential regulations had been introduced and are currently implemented in the Malaysian banking industry. However, success is limited as the inherent weaknesses are still present and the regulations were not implemented and supervised properly. As such, increased effort and attention would be needed to achieve this desired characteristic.

The Malaysian banking sector had been rather stable as demonstrated by the steady RWCR over the years. Recovering from the Asian financial crisis, RWCR of Malaysian banks had been maintained at a healthy level though there is still ample room for improvement.

Overall, the 5 desired characteristics are present in the Malaysian banking sector but when comparing the foreign banks to local banks in the industry, it is clear that foreign banks are much better and more competitive in the various aspects. As such, though possessing the 5 desired characteristic, they are not yet achieved at a satisfactory level and increased effort would be necessary to be at par with these foreign banks. Otherwise, the local banks will face major threat of losing out to these foreign banks come year 2005.