CHAPTER 1

INTRODUCTION

The introduction chapter gives an overview of the background information on the Effect of Credit Crunch on the Banking Industry in Malaysia, the definition of the research problem and the purpose of the study. The significance and scope of the study are also discussed in this chapter. The organization of the report structure of the thesis is presented at the final part of this chapter.

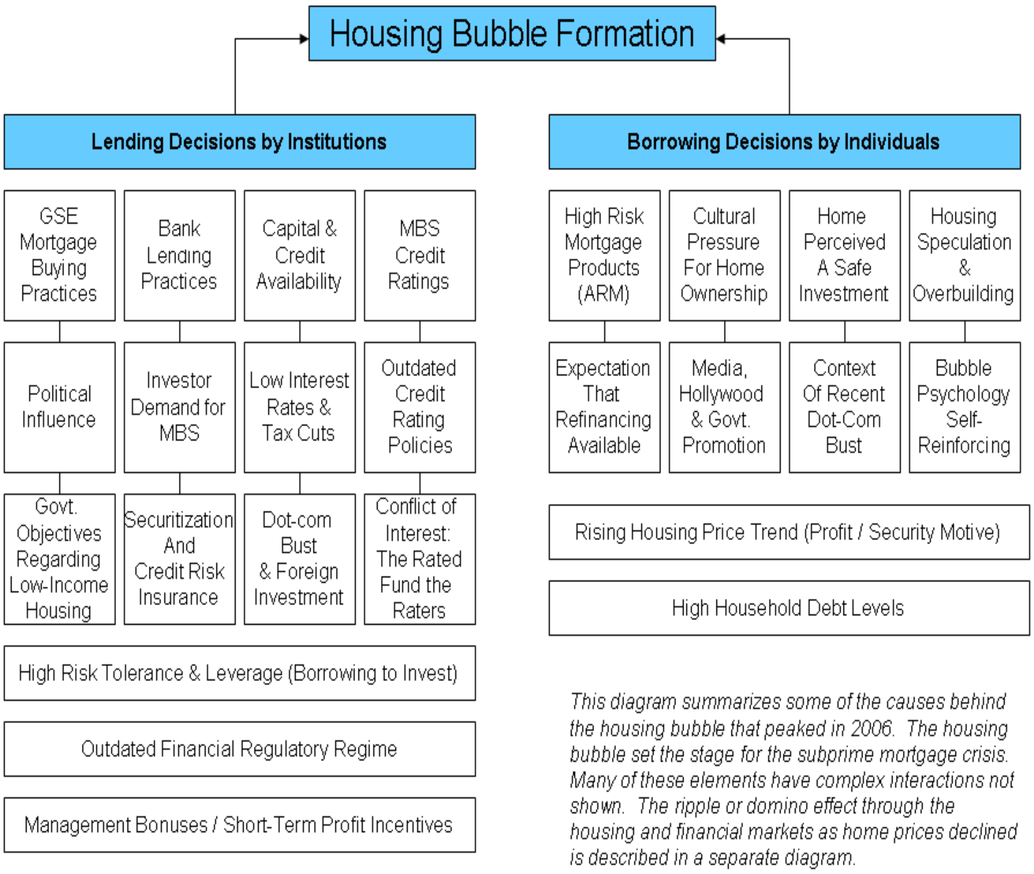
1.1 Overview of Credit Crunch

The financial market turmoil in 2007 and 2008 has caused the most severe financial crisis since the Great Depression. The housing bubble burst and banks wrote down billions of bad loans arising from delinquent mortgages. An Illustration of an overview of the Credit Crunch is appended under Appendix I – Figure.1.1.1

The overall mortgage losses were still relatively bearable compared to the $8 trillion of U.S. stock market loss between October 2007 and October 2008. Market deteriorated and liquidity dried up giving rise to defaults and bailout that became pertinent.

Figure 1.1.2

Housing Bubble



The banking system transformed from the traditional banking model where the issuing banks hold loans until they are repaid to originate and distribute banking model. This new model involved pooling of loans tranche and resold via securitization. The creation of these new securities facilitated the large capital inflows from abroad. This was a form of financial innovation where risk was off loaded to those in the position to bear it to stabile the financial system. This innovation, paved the way to an unprecedented credit expansion that fueled the boom in housing prices.

1.1.2 Effect of the financial Crisis

The effect of the Financial Crisis is as follows :-

When asset prices deteriorate, financial institution's capital erodes simultaneously. This lead to lending standards and margins tightening which pressured prices downward and tightened funding even further.

When banks are faced with uncertainty about future accessibility to capital markets, banks will avoid lending even if their customers' credit worthiness remain intact causing the lending channel to dry up..

A run on financial institutions that occurred at Bear Stearns, Lehman Brothers, and Washington Mutual that caused a sudden erosion of bank capital.

When financial institutions are lenders and borrowers concurrently, a gridlock can occur resulting in a situation where multiple trading parties fail to cancel out offsetting positions because of concerns about counterparty credit risk. To protect themselves against the risks that are not netted out, each party has to hold additional funds.

1.1.3. The Effects of the Global Recession on Malaysia

The global financial crisis and the deleveraging activities in the advanced economies led to disposal of assets worldwide causing sharp decline in the regional equity and bond markets. There was a large reversal in short-term capital flows in the second half of 2008 as these funds were remitted back to the US. This sharp reversal of funds flows was, however, well absorbed by the domestic financial markets owing to the liquidity in the financial system coupled with sound banking system.

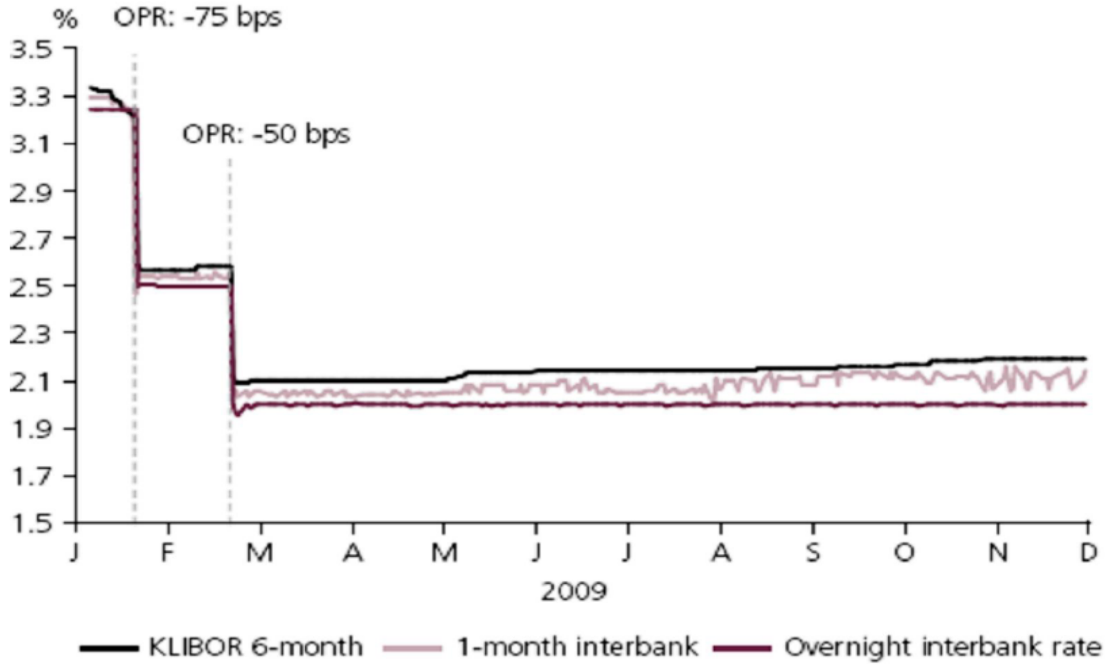
Malaysia’s strong reserves position also acted as a buffer for US dollar liquidity and exchange rate movements during this turbulent period. In addition, reforms undertaken following the Asian financial crisis had increased the financial sector’s resistance to the financial turmoil. The exposure of the domestic banking system to the sub-prime assets was also limited.

The domestic economy has sustained expansion in private sector activity in the fourth quarter of 2010. However, external demand has been dampened by deteriorated global growth. Malaysian economy is expected to grow at a steady pace in 2011, supported by firm domestic demand and moderate external demand. In line with this, the Overnight policy rate (OPR) was revised three times by 75 basis points between March and July 2010. However, Domestic inflation rose towards the end of 2010 and stood at 2.2%. The increase was attributed to higher food and energy prices.

The monetary policy is accommodative and supportive of economic growth. Banking liquidity management framework for banking institutions has been intensively enhanced by embarking into diversified funding structure, accurate assessment of the future economic outlook and effective management of short-to medium-term liquidity needs and availability.

Figure 1.1.3.1

Money market Rates



***Source Bank Negara Malaysia Annual report and Economic Report 2010/2011**

Banking institutions' main source of funds is derived from Customer deposits. Malaysians genuinely subscribe to the savings culture. This deposits are mobilised to finance real sector activities and support domestic loan growth (ratio of loans-to-deposits averaged around 87.6% since 1997).

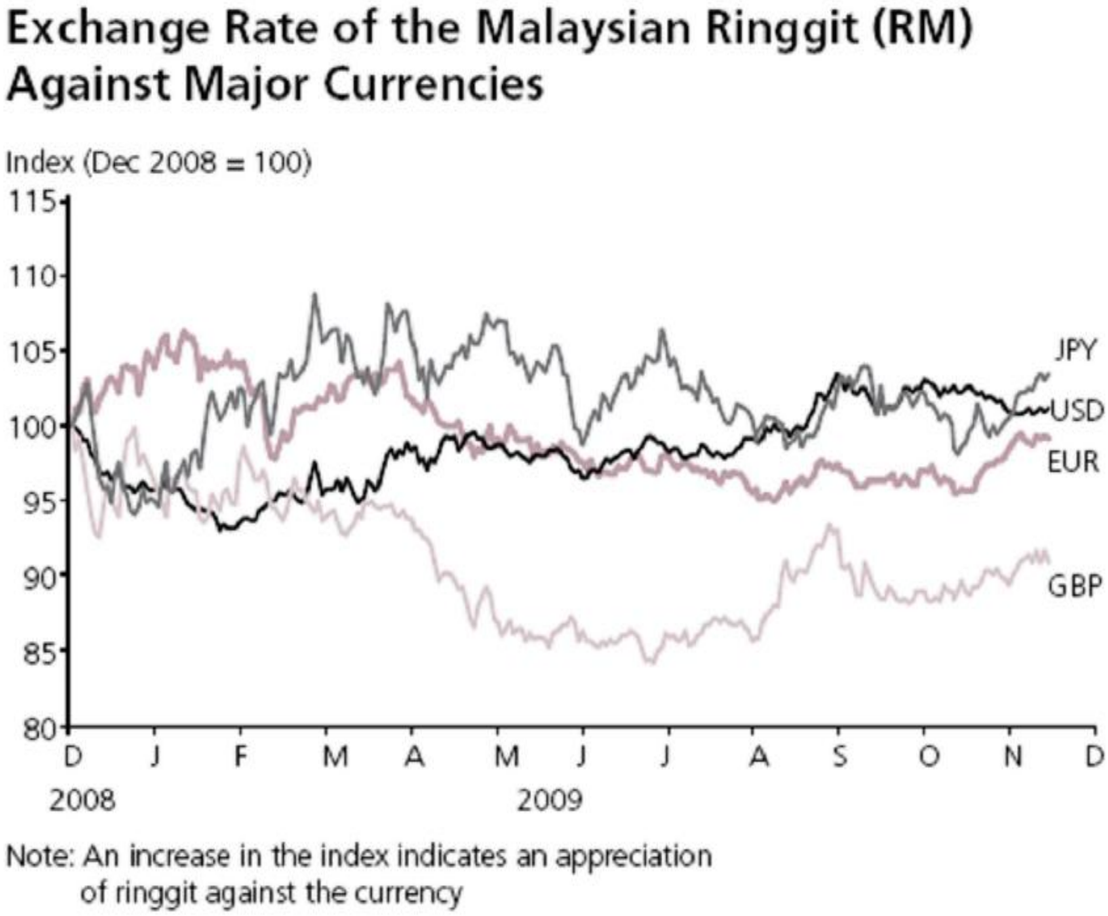
The deposit components are fairly distributed between retail (37.5%) and business (37.1%)of total deposits at the end of 2009. Fixed deposits constituted 62.4% of total deposits. 74% of these fixed deposits have maturity period more than 1 year. Almost half of the deposits placed in Islamic banks comprises General Investment Accounts (GIA). These Islamic instruments are stable in nature compared to fixed deposits offered by conventional banks.

Banking institutions have stepped away from relying on interbank and other market-based funding (includes securitisation, bankers' acceptances, negotiable instruments of deposits and debt securities issued). This is partly attributed by the ample liquidity in the economy and strong growth in savings and deposits.

The domestic securitisation market is mostly driven by Cagamas Berhad. Housing loans from financial institutions and government (employees housing loans) are sold to Cagamas Berhad.

Figure 1.1.3.2

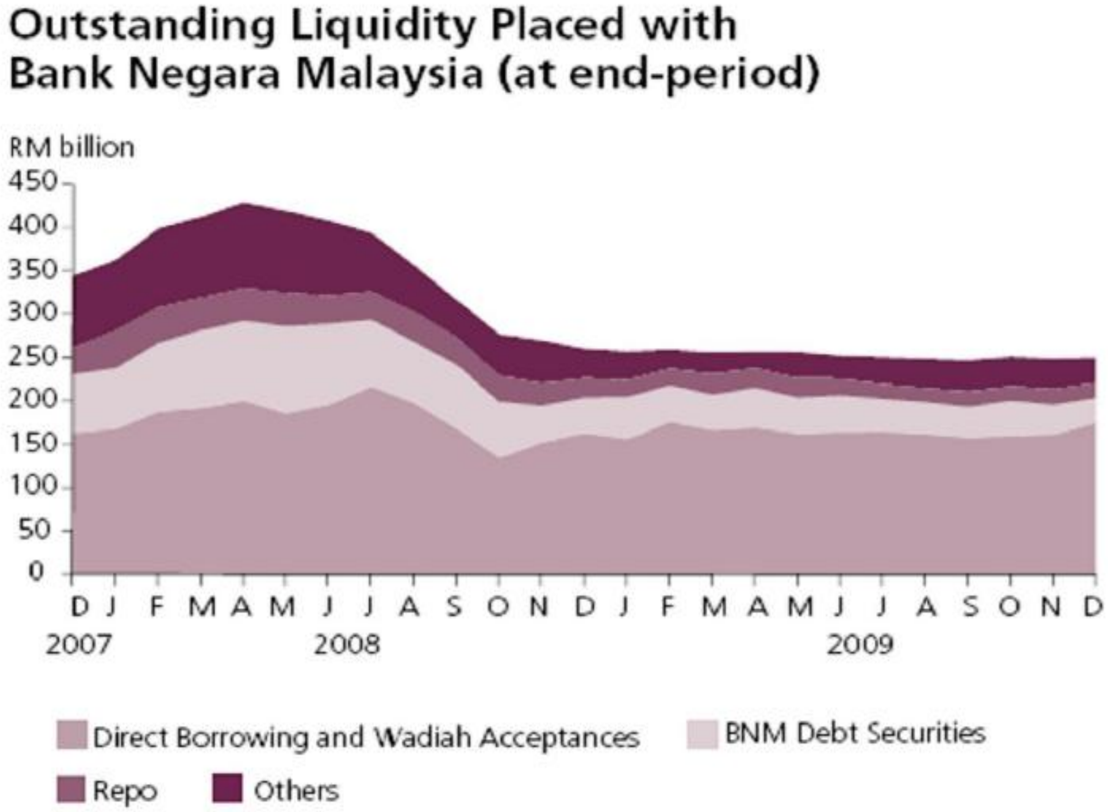
Exchange Rate Fluctuation



*Source Bank Negara Malaysia Annual report and Economic Report 2010/2011

Seventy percent of Malaysian banking institutions' exposure to foreign currency assets and liabilities were USD-denominated, and had been steadily increasing. Low exposures minimise foreign currency funding liquidity risk and the potential direct impact of exchange rate fluctuations on balance sheet and profitability. Foreign currency liabilities are essentially managed via currency swaps, interbank market and foreign currency deposits. Banks had timely narrowed the negative foreign currency liquidity mismatches during the period of global tightening of US dollar liquidity in late 2008.

Figure 1.1.3.3
Liquidity With Bank Negara Malaysia



*Source Bank Negara Malaysia Annual report and Economic Report 2010/2011

Domestic conventional and Islamic money market rates were stable across all maturities during the recent crisis as interbank borrowings were controlled. This included repos which remained under 6% of total banking system liabilities over the past ten years. There was a decline of liquidity in the commercial paper market and in the corporate bond market but was well-contained with no spillover effects to the financial system.

Furthermore, banking institutions are able to convert the large stock of ringgit liquidity surpluses to meet foreign currency liquidity shortfalls during distressed periods

1.1.4 Islamic Banking Industry

Islamic banking is a banking system that complies with Islamic law known as Shariah law. The underlying principles that govern Islamic banking are sharing of mutual risk and profit. These principles subscribe to Islamic banking's core values that cultivate entrepreneurship, trade and commerce. Activities that involve interest (riba), gambling (maisir) and speculative trading (gharar) are prohibited.

Financial institutions have the flexibility, creativity and choice in the creation of Islamic finance products incorporating concepts such as ijarah (leasing), mudharabah (profit sharing), musyarakah (partnership). Islamic banking stresses on premium investments standards coupled with accountability and risk mitigation.

Islamic finance has grown since the 1970's. Malaysia's Islamic finance industry has matured for over 30 years. Malaysia’s first Islamic Bank was established after the enactment of Islamic Banking Act 1983. Malaysia's Islamic finance grows steadily coupled with product innovation, broad range of innovative Islamic investment instruments and a comprehensive financial infrastructure.

Today, Malaysia has emerged as one of the most developed Islamic banking markets in the world with a significant number of full-fledged Islamic banks including several foreign owned entities.

1.2. Research Problems

Research problems are associated with the following areas:

The off balance sheet data that results in inaccurate risk information data in which sizable risks may be mounting. As a result of this, Banks would be subjected to unexpected risk exposure arising from derivative and foreign currency exposures.

Complexities in analyzing the spread and transfer of risk through credit default swaps and derivatives also pose problems. Additionally, structured products such as collateralized debt obligations and asset-backed securities post inherent risk which are difficult to measure .

Dynamic housing prices and markets and their impact on the economic behavior of households and Financial Institutions were not easily available to keep abreast and monitor.

High levels of leverage (assets to capital) that built up in the economic system arising from financial cross-border activity also contributes to this problem as when the flow of capital dries up, remaining maturity measures needs to be alerted to identify rollover risk and avoid maturity lapses.

1.3 Research Objectives

The main objective of this study aims to shed some light on the risk of bank failure in Malaysia arising from the impact of the global financial crisis using four simple ratios as the predictor. The risk of bank failure is analysed based on three types of Banks, Local Conventional banks., Foreign Conventional banks and Islamic Banks. This study also attempts compare the impact of the global financial crisis between the Local Conventional, Foreign Conventional Bank and Islamic Banking respectively in terms of risk of bank failure.

1.4. Research Questions

Based on the objective of the study, three research questions and issues have been identified as listed below of which the findings is presented under the Chapter 4 of the results and analysis.

1) To what extent is Malaysia is affected by the Credit Crunch arising from the Global Financial Crisis in terms of risk of Banks failure?

2) What is the effect of the Credit Crunch on the Banking System in Malaysia?

3) Any differences in effect of Credit Crunch arising from the global financial crisis between Local Conventional, Foreign Conventional and Islamic Banking?

1.5 Significant of Study

A good understanding of the effect of credit crunch on the Malaysian Banking Industry in respect to risk exposure of bank failure is important. This is crucial as money and credit markets are important sources of capital for banks. In a credit crunch where risk premiums have reached abnormally high levels in both markets, it will become more expensive and difficult for banks to obtain credit may lead to an unstable financial system.

Large losses and write-downs requires banks to restore capital adequacy levels by raising new equity or by reducing debt which would result in reduced loan portfolio by adopting tighter credit standards. This will result in businesses and households shelving some investments or current expenditures for which funding is no longer available or has become too costly which in turn would slow down economic activities.

Estrella et al. (2000) research study emphasizes that bank failures can be predicted with the help of two simple capital ratios i.e. leverage ratio and gross revenue to capital ratio.

The study will also highlight effect of Credit crunch on Local Conventional, Foreign Conventional banking in comparison to Islamic Banking to give academicians an extension of knowledge about deploying these concepts into conventional banking to insulate the Banking system from imported financial crisis.

1.6. Scope of study

The study investigates the significance of leverage ratios and capital ratios of Conventional and Islamic Banks as predictor of bank failures. Capital requirement is based of Basel Committee's capital classification. The focus on capital ratios is relevant in light of the changes in banks 'balance sheets due to significant write offs that caused the credit crunch. Therefore, capital ratios constitute a reliable tool to test how the banks were affected by the current financial crisis

The ratios analysed are

- leverage ratio, calculated as tier 1 capital divided by total tangible assets;
- gross revenue ratio, calculated as tier 1 capital divided by total revenue. Total revenue includes total interest and noninterest income before any expense

Estrella et al. (2000) stressed that leverage ratio and the ratio of capital to gross revenue predict short term (1 to 2 years) bank failures whereas risk-weighted ratios tend to perform better over the long run.

A secondary set of analysis is based on profitability ratios of conventional and Islamic banks respectively for the same period.

- return on assets ratio, calculated as net earnings divided by the total assets. This is a profitability ratio displaying volatility of earnings which is useful in understanding risk of bank failure.
- return on equity ratio, calculated as net earnings divided by owner's equity (shareholders funds). This one of the most important profitability ratio to indicate volatility rate of return for shareholders.

1.7 Organization of the report

This report consists of five chapters which are organized as below:

Chapter 1: The introduction chapter comprised the background information on foreign exchange exposure, the definition of the research problem and the purpose of the study. This chapter also presents the significance and the scope of the study and summarizes and gives the reader the overview structure of the study at the end of this chapter.

Chapter 2: The chapter reviews previous literature and articles that motivate and support this study that relates to the foreign exchange exposure. The chapter starts with the overview of the exposure then followed by the attributes related to the exposure and type of methodologies applied by the researchers. Finally, the summary of the literature review is presented.

Chapter 3: This chapter discussed the research methodology employed in the study. First, the research framework is developed to connect the variables where in this study, the main variables are stock return and foreign exchange rate changes. Then, the hypothesis is established to express the relationship between the variables in the form of testable statement. Finally, the research model is determined to analyze the data collected.

Chapter 4: This chapter documents the ratio results of Conventional and Islamic Banking and discusses all the findings of this study. First of all, the results and analysis will be presented based on the hypothesis of the study. Summary of the results will be presented at the last of this chapter.

Chapter 5: The final chapter presents the conclusion and summary of this research. Firstly, an overview of the study including the research objectives will be presented. Then, the conclusion of the research results and findings are discussed. Thereafter, valuable and insights recommendation together with the implications are shared. Finally, this chapter ends with suggestions for further research.

1.8 Conclusion

This first chapter discussed the introduction of the study. The introduction covers the research problem, research objectives, research questions, significant of study and scope of study. Lastly, the chapter presents the structure or organizations of the remaining chapters in this study. In the following chapter, the literature related to the effect of the credit crunch on the Malaysian Banking Industry in terms of risk exposure towards bank failure. This study also attempts to compare the inherent risk of bank failure of Local Conventional bank, Foreign Conventional Bank and Islamic Banks.