

## **CHAPTER 2**

### **OVERVIEW OF THE FINANCIAL SYSTEM IN MALAYSIA**

#### **2.1 Introduction**

The financial sector is a critical sector in the Malaysian economy. A strong and resilient financial sector is vital to the sustained economic growth for the country. Many of the economic and social policies are implemented through the financial sector. Priority industry sector development, small and medium scale industry development and housing ownership targets are some of the program that needs a very strong and efficient financial sector. The country's monetary policy is also conducted through the financial system.

The financial sector in Malaysia can be divided into three parts namely the banking system, the non-bank financial intermediaries and the financial markets. Some of the critical functions of the financial system in the economy are the intermediation function, the role in the payment system and as a channel for the transmission of monetary policy.

The intermediation function involves proper mobilization and usage of resources particularly in relation to savings and investment decisions that have a strong influence on economic growth. Financial intermediation involves the transfer of

funds from agents in the economy i.e. those with surplus funds to those with financial deficits. The financial system enables funds to move from those who have excess funds and do not have investment opportunities for the funds to those who lack funds but have investment opportunities. The financial system also performs a maturity transformation role. The financial system converts short-term funds in the form of deposits and savings funds to long-term funds that are on lent to individuals and corporations. Banks, insurance companies and pensions funds all carry out this intermediation function. By virtue of having economies of scale, standardization and specialization, the cost of the intermediation is kept very low. Thus, efficient intermediation enables borrowers to obtain funding at lower cost and at the same time provide savers a reasonable return for forgoing current consumption through their saving activities.

The role of the financial system in the operations of the payment system is equally critical. The payment system facilitates the efficient clearing and settlement process and hence has a significant effect on the economic system. Payment system essentially refers to a network of services that facilitates trade and business transactions. It involves the exchange of means of payment in return for goods and services. For the payment system to function efficiently, the financial system has to be efficient and strong. The role of the Central Bank is thus crucial in ensuring the development of a effective system of clearing, settlement and payment services.

A strong and well functioning financial system is also required for the efficient operation of monetary policy as monetary policy is basically transmitted through the banking system. The statutory reserve requirements and the setting of base lending rates are some of the mechanisms to influence monetary policy in Malaysia. These policies are effected through the banking system. In addition, directed lending and subsidized lending to priority sectors are also accomplished through the banking sector. These activities play an important role in achieving the goals of national economic policies.

## **2.2 Structure of the financial system**

The structure of the financial system in Malaysia is as in Figure 1: -.

Figure 1 : Structure of the Financial System in Malaysia

Financial Institutions	Financial Markets
<p><b>Banking System</b></p> <ul style="list-style-type: none"> <li>• Bank Negara Malaysia</li> <li>• Banking Institutions               <ul style="list-style-type: none"> <li>- Commercial Banks <sup>1</sup></li> <li>- Finance Companies</li> <li>- Merchant Banks</li> </ul> </li> <li>• Others               <ul style="list-style-type: none"> <li>- Discount houses</li> <li>- Rep. Office of Foreign Banks</li> <li>- Offshore Banks in Labuan IOFC</li> </ul> </li> </ul> <p><b>Non-Bank Financial Intermediaries</b></p> <ul style="list-style-type: none"> <li>• Provident and Pension Funds</li> <li>• Insurance Companies <sup>2</sup></li> <li>• Development Finance Institutions</li> <li>• Savings Institutions               <ul style="list-style-type: none"> <li>- National Savings Bank</li> <li>- Co-operative societies</li> </ul> </li> <li>• Other Non-Bank Financial Intermediaries               <ul style="list-style-type: none"> <li>- Unit Trusts</li> <li>- Pilgrims Fund Board</li> <li>- Housing Credit Institutions</li> <li>- Cagamas Berhad</li> <li>- Credit Guarantee Corporation</li> <li>- Leasing Companies</li> <li>- Factoring Companies</li> <li>- Venture Capital Companies</li> </ul> </li> </ul> <p>1- Including Islamic Banks 2- Including Tafakul</p>	<p><b>Money &amp; Foreign Exchange Markets</b></p> <ul style="list-style-type: none"> <li>• Money Market</li> <li>• Foreign Exchange Market</li> </ul> <p><b>Capital Markets</b></p> <ul style="list-style-type: none"> <li>• Equity Markets</li> <li>• Bond Market               <ul style="list-style-type: none"> <li>- Public Debt Securities</li> <li>- Private Debt Securities</li> </ul> </li> </ul> <p><b>Derivatives Markets</b></p> <ul style="list-style-type: none"> <li>• Commodity Futures</li> <li>• KLSE CI Futures</li> <li>• KLIBOR Futures</li> </ul> <p><b>Offshore Market</b></p> <ul style="list-style-type: none"> <li>• Labuan International Offshore Financial Centre (IOFC)</li> </ul>

Source: Bank Negara Malaysia

### 2.3 The Banking System

The banking system comprises the monetary institution and non-monetary institutions. Monetary institutions refers to those institutions whose principal liabilities are generally accepted as money consisting of BNM as the sole

currency issuing authority and the commercial banks as the only institutions allowed to operate current accounts. BNM, the Central bank is responsible for regulating this sector. In addition, BNM has control/influence over money supplies and interest rates.

For the non-monetary institutions, principal liabilities are generally accepted as near- money such as savings account and fixed deposits. These institutions comprise finance companies, merchant banks and discount houses. As at end of 1999, there were 25 finance companies with a network of 1005 branches, 12 merchant banks and 7 discount houses in the country. Foreign banks' representative offices and offshore banks in the International Offshore Financial Center are also part of the banking system. As at end of August 1999, there were 35 representative offices of foreign banks and 63 offshore banks in Labuan IOFC.

## **2.4 The Non- Bank Financial Intermediaries**

These can be divided into 5 groups namely: -

### **2.4.1 Development Finance Institutions**

These are institutions that are designed to provide medium and long-term funds for providing industrial and agricultural investment and growth. Examples of such institution are Bank Pertanian, Malaysian Industrial Development Fund and Bank Industri Malaysia Berhad.

#### **2.4.2 Saving Institutions**

The major saving institutions are Bank Simpanan Nasional (BSN) and credit cooperatives. Its role is to promote and mobilize private saving especially of the small savers in the lower income group in the rural areas.

#### **2.4.3 Provident and pension funds**

The provident and pension funds (PPF) are a group of financial schemes designed to provide members and their dependents with a measure of social security in the form of retirement, medical, death or disability benefits. These funds serve as important mobilizer of long-term savings in the economy for rechanelling into both the public and private sectors to finance long-term investments. The Employees Provident Fund accounted for 85% of the total assets of PPF's as at end of 1998.

#### **2.4.4 Insurance companies (including offshore insurance companies)**

Insurance companies constitute another source of mobilizing savings. Most of the insurance companies are involved in the life and general insurance.

#### **2.4.5 Other financial institutions**

This comprises building societies, share unit trusts and property unit trusts, leasing companies, factoring companies, credit token companies, venture capital companies, special investment agencies, National Mortgage Corporation and Credit Guarantee Corporation

## **2.5 The Financial Markets**

The financial market comprises the money and foreign exchange markets, the capital market and derivative market.

### **2.5.1 Money and foreign exchange markets**

Most banking institutions operate in these markets. The money market comprises inter-bank money market (which deals in short term funds including overnight money, 7-day money and funds for periods of one, two, three and six months) and non-bank money market (which deals in short term funds and financial instruments). Foreign exchange market is the market for the trading of foreign currencies against the Ringgit or against other foreign currencies.

### **2.5.2 Capital market**

The capital market comprises of a primary and securities market that offers new issues of corporate securities to the public and institutions and a secondary market that deals in trading of these securities. It is a market for raising long-term bonds and comprises the equity and bond markets. Corporations raise funds in the equity market by issuing stocks and shares. Electronic secondary trading of shares takes place in KLSE that also regulates trading members and listed companies. The bond market allows both the private and public sector to raise funds by issuing private debt securities (PDS) and Government securities and trade in them.

### **2.5.3 Derivatives markets**

The derivatives markets are for trading instruments that provide contingent claims on underlying assets and whose values depends on the price of underlying assets and securities. Examples of derivatives are forwards, futures, options and swaps. These markets allow firms and individuals to hedge the financial risk of the underlying assets. The development of the derivatives markets will allow for better and sophisticated risk management practices among Malaysian companies.

### **2.5.4 Offshore market**

The offshore market was set up with the establishment of the Labuan International Offshore Financial Center in October 1990. It was set up to promote the economic development of Labuan and also enhance Malaysia as a regional financial center. As at end of 1999, there were 63 offshore banks, 50 insurance and insurance related companies, 20 trust companies, several offshore leasing companies and 6 fund managers operating in Labuan IOFC.

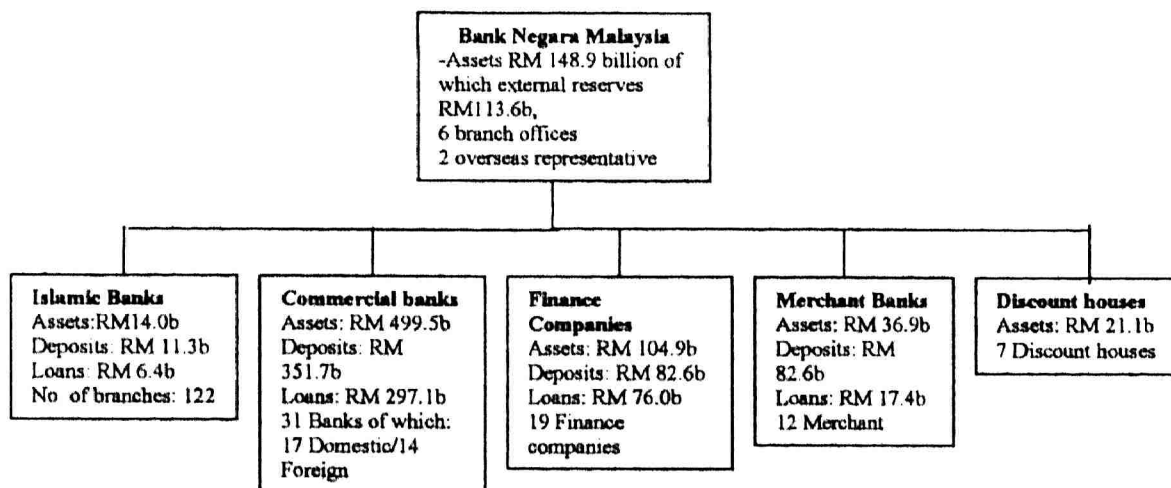
## **2.6 The role and significance of the Banking System**

The banking system is the largest component and core of the financial system accounting for about 70% of the total assets of the financial system. The share of total financial system held by the banking system (excluding offshore banks in Labuan IOFC) had risen from 69.5% at end of 1987 to 73% at end of 1997 before moderating to 70.1% at end of 1998. This increase was mainly due to expansion



of assets in the banking institutions that grew at an annual rate of 19.7% during the 1988-1997. These underscore the fact that Malaysian economy is a bank led economy despite the strong growth of the capital markets in recent years.

**Figure 2 : Assets of the banking system**



Source : Bank Negara Malaysia (Figures as at 31/12/2000)

Commercial banks that are the oldest established financial intermediaries have remained the largest institutions within the banking system with total assets worth RM499.5 billion or 73% of the total assets in year 2000 (BNM). As at end of December 2000, there were 31 commercial banks with 1742 branches across the country. The local foreign ownership of banks was 17:14. There were 19 finance companies with 930 branches across the country, all locally owned.

A well functioning and efficient banking system is important for achieving good economic performance. The primary function of the banking system is the intermediation of funds from savers to borrowers. Efficiency in the way the funds

are mobilized and safety of deposits are important in mobilization of funds. Banks are also entrusted to channel these savings to productive investments and in disbursing loans to promote growth. The banking sector also provides a means of payment both nationally and internationally. The banking system facilitates an efficient and safe means of making and receiving payments. A strong, efficient and resilient banking system is needed for sustainable economic growth as only then can resources be allocated and mobilized efficiently and effectively in the economy. Banks through specialization are in a better position to assess credit risk, and through the close relationship they forge with borrower are able to monitor the performance of the borrowing companies. Firms look up to banks during business downturns to help them ride out short-term cashflow problems. These additional functions of the banks help to keep the business operations lean and efficient.