CHAPTER II

A THEORETICAL PERSPECTIVE

2.1 INTRODUCTION

The Malaysian financial sector has continued its advancement in the deregulation process, and the reformation and modernisation of its financial markets. To complement these developments, it has strengthened and consolidated its supervisory framework to ensure a stable financial environment whereby this progress could take place. The 1960s and 1970s essentially saw the building-up of the basic financial infrastructure in Malaysia's money and capital markets in terms of the expansion of existing institutions and the emergence of new domestic institutions and instruments. In the 1980s, the deregulation process was accelerated, financial reforms and measures were implemented which were designed not only to enhance competition, but also to add depth to the money and capital markets.

The Malaysian financial sector has thus experienced profound evolutionary changes during the past decade in response to the changing economic and financial environment. This is evident from the proliferation of new products in the financial sector, market determined prices and rates, the securitisation of financial operations, cost reduction in the production and delivery of financial services, restructuring and technological advancements, together with new regulations to produce a sound and efficient banking system.

2.2 *BANKING LEGISLATION*

Prior to 1959, the operations of commercial banks in Malaysia came within the ambit of the Companies Ordinance, 1948. With the establishment of Bank Negara Malaysia in 1959, commercial banks were brought under its supervision through the Banking Ordinance, 1958, which was subsequently amended to become the Banking Act, 1973. This Act was replaced in October 1989 by a new omnibus legislation, the Banking and Financial Institutions Act (BAFIA), 1989.

BAFIA covers wider regulatory powers on the Central Bank, covering a comprehensive scope on banking and finance including governing the professional conduct of those involved in the banking industry. The BAFIA also provides for the issuance of banking licences; the financial requirements and duties of banks; the protection of depositors; the operational policies of banks; ownership, control and management of banks; loans to directors; advances for shares and loans for immovable properties; penalties for offences; and powers of supervision and control over banks. The new Act essentially consolidated the laws governing the supervision of the Malaysian financial system.

2.3 *COMMERCIAL BANKING IN MALAYSIA*

In Malaysia, commercial banks constitute the largest and most important group of all financial institutions. The country's banking history can be traced back to more than a century ago when a branch of the Chartered Bank was set up in Penang in 1875. Originally known as "exchange banks", these predecessors of modern commercial banks had their activities centred on the financing of external trade, involving foreign exchange transactions and trading in commercial bills. Hence, these pioneering banks, mainly branches of British and other foreign banks, were found in the trading ports and commercial centres of Penang and Malacca. The first local bank to appear in the Malaysian banking scene was Kwong Yik Bank which commenced operations in Kuala Lumpur in 1913 followed by a few other locally-incorporated banks.

Today, commercial banking in Malaysia is dynamic and competitive, complemented by a well-structured network of inter-linked institutions. Presently, Malaysia can boast of having 37 commercial banks established here --- 23 of which are domestic banks and the remaining 14 being foreign banks[1]f, with an impressive network of 1164 branches as at June 30, 1993. Malaysia's buoyant economy and its

1. After the selling off of Security Pacific Asian Bank Limited to Arab-Malaysian Banking Group and United Overseas Bank Limited to PhileoAllied Berhad and renamed as Arab-Malaysian Bank Berhad and Allied Bank Berhad.

stable political scenario have encouraged the steady growth of an active money and foreign exchange market, a well organised stock exchange and a range of specialised financial institutions providing credit for agriculture, industry and housing, and a growing market for long-term funds.

The banking industry has also witnessed the increasingly significant impact of computer and telecommunication technologies. Easy access to ATMs, especially with the link-up of shared ATM networks and Electronic Funds Transfer at Point-Of-Sale (EFTPOS), has enabled bank services to be extended outside bank premises and beyond normal banking hours. In line with advances made in retail banking, the cheque payments system was enhanced with the launching of the Kuala Lumpur Clearing House (KLACH) in 1984 and further improved in 1987 with the implementation of the Automated Cheque Clearing System or SPAN. In March 1989, 24 domestic banks and 10 foreign banks[2] were linked to SWIFT (Society For Worldwide Interbank Financial Telecommunication) network, enabling them to transmit among themselves international payments, statements and other transactions associated with international finance in place of the conventional use of telexes.

2. Bank of America is a participating member of SWIFT, its code is BOFA MY K.

2.3.1 Foreign Banks And Local Incorporation

The new legislation has now also formalised the policy that requires all branches of foreign banks operating in Malaysia to be incorporated locally, that is to transfer their operations to Malaysian corporation. The 14 foreign banks in Malaysia, all of which are basically operating as overseas branches of their foreign parents (inclusive of Bank of America Malaysia), were given a time period of five years (that was up to September 30, 1994) to exchange their licences in view of the provision requiring them to incorporate locally in order to continue banking business in Malaysia or their operating licences would be forfeited. The foreign banks have a combined network of 144 branches all over the country. The 14 foreign banks accounted for 28 % of total assets and 24 % of total deposits of all commercial banks, while their share of total loans extended by all commercial banks amounted to 34 % (as at December 31, 1991). In terms of trade financing, which is the forte of foreign banks, their market share was well over one-third. Hence, the foreign banks have a sizeable presence in the Malaysian banking sector.

The requirement to locally incorporate is not a backdoor means to nationalise the foreign banks. The move towards local incorporation is really not a recent development. In the 1980s, the government had urged foreign banks in Malaysia to incorporate locally and then comply with the country's New Economic Policy which, among other, calls for the transfer of at least 30 % of equity to Bumiputeras. But, in 1983, the plans were shelved by the authorities due to the unfavourable economic conditions then prevailing. The foreign banks will be allowed upon local incorporation to maintain 100 % foreign ownership of the new entity to maintain the status quo of foreign control. In essence, therefore, the local incorporation exercise merely changes the legal form of the foreign bank's presence from that of a branch to a wholly-owned subsidiary. As for Bank of America Malaysia, the process of locally incorporation was completed successfully on September 1, 1994 and will operate under the name of Bank of America Malaysia Berhad (See Appendix D). This formalisation of the policy by Bank of America Malaysia was aimed at achieving a banking system that reflected a more positive and permanent financial commitment towards the growth of the banking institution in Malaysia.

However, policies adopted by Bank Negara had curbed the expansion of foreign banks. Foreign banks are no longer given operating licences or allowed to open branches in the country. In fact, the last foreign bank to be granted a licence to operate in Malaysia was The Bank of Nova Scotia, a Canadian incorporated bank, in 1973. Bank of Nova Scotia was only allowed to operate a branch in Kuala Lumpur which also serves as its headquarters. The policy of not issuing licences for new foreign banks to operate in the country is not based on any parliamentary act but is an administrative fiat designed to serve a national objective (Chin,1983). This is because government does not want further competition to the local banks by foreign banks.

While the change in incorporated status will not affect the way these banks do business with their customers, there will be significant changes relating to the legislative framework in which these banks operate. These banks will no longer be directly supervised or regulated by foreign monetary authorities. They come under the supervision of Malaysian authorities only, which puts them on par with Malaysian domestic banks. Another benefit for these banks would be the 2 % reduction in their capital adequacy requirement. They would now be subject to the same ratio as the domestic banks. Currently the capital adequacy requirement for foreign banks is 10 % of loans and other assets (risk assets), whereas domestic banks need to hold only the equivalent of 8 % of risk assets. The reduction in capital adequacy requirement would give the banks additional funds which could be used to generate income.

While the dominance of the foreign banks had since diminished, they continue to play an important role in Malaysia and enjoy a significant share of the market. Being a small open market economy, Malaysia relies heavily on international trade as well as foreign capital and technology. Foreign banks, with their extensive international linkages, particularly with Malaysia's major trading partners, can facilitate quick and reliable settlement of international trade finance. Foreign bankers with first-hand knowledge of the country are also well placed to act as a conduit for foreign investment. In addition, foreign banks can also act as a catalyst for the transfer of financial innovations and new banking technology. The government recognises the important role played by the foreign banks in the development and modernisation of the Malaysian economy and banking industry. Their importance is reflected in the foreign banks' continued significant presence in Malaysia.

2.4 MALAYSIA RETAIL BANKING ENVIRONMENT

Malaysia is a relatively small country with a population of approximately 18 million. Penetration by banks is extremely high, and is dominated by the "Big Four" domestic bank, i.e., Maybank, Bank Bumiputra, Public Bank, and UMBC which control 64 % of domestic deposits and 62 % of domestic loans. They have domestic branch networks varying from 205 branches (Maybank) to 73 branches (UMBC). In addition, the National Savings Bank (BSN) has a very large deposit base of RM3.3 billion with a 452 branch network.

Local banks belong to three shared ATM networks --- ABC, MEPS, and GREAT which also has an extensive point-of-sale network, with the result that the Malaysian consumer has become accustomed to near-universal ATM accessibility. Lately overall deposit growth has been low due to low interest rates and diversion of funds to the property and stocks markets, the latter driven partly by government privatisation efforts. In recent years banks have moved aggressively to develop and expand retail lending activities in residential mortgage loans, personal unsecured loans and revolving lines of credit, with much of this growth coming at the expense of local finance companies.

There are quite a large number of foreign banks operating in Malaysia under various forms of licences --- 32 offshore banks and 14 commercial banks. Only the commercial banks have the deposit and lending authorities that make any form of a retail banking strategy viable. The most active foreign banks in retail are Citibank (3 branches), Hongkong Bank (36 branches) and Standard Chartered Bank (35 branches). Foreign banks have not been allowed to join the local ABC, MEPS, and GREAT shared ATM network or to expand their branch networks. These competitive hindrances in deposit-gathering activities have been countered through telephone banking installations and efforts to differentiate themselves based on service quality and regional Asian capabilities. Quick response time and convenience appear to be the major factors in distinguishing service quality. Hongkong Bank and Standard Chartered Bank have followed more narrowly focussed retail lending strategies with emphasis on residential mortgages and consumer loans; while Citibank has adopted a more aggressive strategy including major efforts in expanding unsecured revolving credit lines for credit cards, mortgage lending, and share margin financing.

2.5 LITERATURE REVIEW

A survey on the theory of banking by the Bankers' Magazine in the United States, in 1982 showed there was a well developed literature of how banks operate in conventional deposit, lending operations, electronics banking, and bankers-customers relationship of which activities roughly corresponding to what we call retail banking. However, when it comes to creating, nurturing, and defining a retail banking culture, the leaders are clearly in the minority. Let's start with Deryk V. Weyer's (1982) definition, contained in The Economics Of Retail Banking In The Future, "the characteristics which distinguishes the retailer from the wholesaler or manufacturer is that the retailer has direct contact with the public --- over a shop counter, by post, through mail order, even by television. The same is true of retail banking. It involves direct contact with the public --- through a branch, by post, by plastic card, in some cases by computer terminal at home". Banking professors Lewis and Davis (1987) adds,

> "retail banking refers to the provision of services to individuals and small businesses where the financial institutions are dealing in large volumes of low-value transactions. This is in contrast to wholesale banking where the customers were large, often multinational companies, governments or governmental enterprises, and the institutions deal in large-valued transactions, usually in small volumes".

As paradigm shifts and for banks to survive they must return to basics, reassess their operations and focus on a customer-led strategy. Many are critical of banks' product-led approaches. Services must be more tailored to meet people's needs and less hooked on new products. Timewell (1994) reports, "customer focus stands out as the critical success factor of the 1990s; the new challenge is to get the right service to the right customer at the right price, rather than trying to provide all services to all customers". In his article, Listen To The Customer, Timewell too highlights the findings of Adege's European bank research between 1991 - 1993 which shows that many banks' focus on selling new products has simply not borne fruit, it has merely churned accounts. The research shows that new customers attracted during the year brought about 6 % increase in assets but former customers who left the bank removed just about the same. He concludes that customers will be better off when banks are a little less high-tech and a little more humane.

The developed world is in a midst of a revolution in retail banking services which will drastically transform the face of personal banking, as reported on an international study by Patrick Frazer and Dimitri Vittas, two senior consultants with the London clearing banks research group. According to them, the main forces at work are increasing competition, deregulation, and new electronic technology.

From the study, Frazer and Vittas say that now, at a time of crisis for wholesale banking, banking managements are beginning to appreciate the contribution of retail operators to profitability. They remarked, "it is now more readily accepted that interest margins are much wider in retail banking while it is also recognised that the higher operating costs of retail transactions can be recovered, if necessary, by applying more appropriate pricing policies. Marketing objectives have now replaced cost containment and systems effectiveness as the primary goals of retail banking".

The authors rate Sweden as the most efficient retail banking system in the world, followed by the Netherlands and Germany. The United Kingdom is rated fourth, but the United States --- so often regarded as a highly sophisticated market, comes in seventh place, followed by Japan, Australia and Italy.

In another survey involving 13 banks in five countries (Belgium, France, Luxembourg, Spain and Switzerland), as reported in The Banker, July 1993 issue, the survey concluded that too many products, duplicated and underused, may cost the banks dearly and is leading banks to ruin. The survey with a sample covering data on 40,000 customers which related purely to the retail area and to households, showed that in Europe, one third of customers of a bank hold only one product at the bank. This contrasted with the average number of retail products offered by banks. In the same report, it quoted an European strategy consultant, Saurais as saying, "banks cannot continue to pursue the idea of doing the same thing, but more of it". Saurais insists that a bank must specialise, select targets and define its own individuality. By "thinking customer" and "acting customer", he hopes the bank will gain loyalty and bring improved returns in costs and efforts. He adds, the result of product-orientated policies is that banks devote a great deal of time and energy to managing scarcely used products and they have to bear all the costs.

On the local front, a survey by Omar Marashdeh on the retail banking competition concluded that the competition in retail banking sector can be viewed in two forms --- price competition and services competition through the introduction of new products to meet the changing needs of the customers. The report noted that banks are starting to offer products which shift funds automatically from a checking account to a savings account and vice versa. This arrangement is equivalent to a form of fund management provided by retail banks for their customers. The findings by Omar found that each bank tried to distinguish its product feature from others either by services offered with the product or the low fees on the product. See Table 2.1 for some of the retail products offered by banks in Malaysia. A review of the products offered by banks show that, basically, these products are similar.

Previously some commercial banks have ignored the retail market and its profit potential. Now is the time, though, for all banks to identify what this market wants and whether they can deliver it. If they can't they should get out of banking now, before they become extinct. Recognising the customer's needs will lead to a considerable segmentation in the banks' approach to the market. It will be services which will hold the key to the survival of the retailing network. Only those banks prepared to commit themselves fully to the retail market will succeed in it.

TABLE 2.1 : Some Retail Products Offered By Banks In Malaysia

BANK OF COMMERCE

Commerce Link Account

1. The balance of over RM1,000 in the current account automatically swept to savings account.
2. Free ATM card.
3. Easy deposit.
4. Easy withdrawal.
5. Payment for new public share issue without charge.
6. Extended banking hours via ATMs from 7am to 11pm daily.
7. Monthly statement.
8. Cheque book convenience.
9. Amount above RM1,000 earns higher daily interest.
10. Auto - sweep feature.

Golden Saver Account

1. Minimum deposit of RM5,000.
2. Higher daily interest.
3. Golden Saver ATM card.
4. Statement detailing transactions.
5. Easy cash deposit and wothdrawal.
6. Payment for new public issue without charge.
7. Extended banking hours via ATMs.

Commerce Time - Deposit Account

1. A pre - approved overdraft line.
2. Cheque book convenience.
3. Competitive interest rates.
4. Monthly statement.
5. Access to ATMs through MEPS network.
6. Payment for new public share issue without charge.
7. Minimum deposit of RM5,000.
8. Extended banking hours via ATMs.

Commerce Statement Savings Account

1. ATM card which functions like a passbook.
2. Higher interest rates calculated daily.
3. Quarterly statement detailing the transactions.
4. Electronic banking without a passbook.
5. Access to 920 ATMs through the MEPS network.

A Commerce Passbook Account

1. A passbook.
2. Daily interest.
3. Optional Commercecard.

BANK BUMIPUTRA

Savings & Premium Savers Accounts

1. Competitive rates.

ESP - Education Savings Plan

1. Prize of a trip to Disneyland.

MAYBANK

Business Plus

1. A credit line equal to the amount of money deposited.
2. Offers 15% bonus rebate on commission for trade facility and interest margin exceeding BLR for overdraft.
3. Higher interest rates.
4. Fund management.
5. Minimum deposit RM50,000.

Premier Account (Features were not advertised.)

1. Savings account with checking facility.
2. Current account with multi - tiered interest rates.

STANDARD CHARTERED

Money - Master Current Account

1. Minimum deposit of RM1,000.
2. Master sweep facility which transfers money from savings to current account.
3. A fee for each time the sweep facility is used.
4. No joining fee.
5. No monthly fee.
6. Consolidated statement once a month for current, savings, fixed deposit, mortgage, personal loan account, and credit card account.

Money - Master Savings Account

1. No joining fee.
2. No RM5,000 minimum deposit.
3. No monthly fee.
4. One consolidated statement once a month for current, savings, fixed deposit, mortgage and personal loan account, and credit card account.
5. Daily compound interest.
6. Insurance against accidents of a maximum protection of RM20,000.

HONGKONG BANK

Partner

1. Joining fee for this service is RM38.
2. Monthly fee is RM12.
3. The monthly fee will be waived if the combined average balance for a month is above RM50,000.
4. Customer service representative.
5. Access to funds through a phone or fax.
6. List a nominated beneficiaries of a maximum of RM5,000 daily.
7. Multi - tiered interest rates.
8. Personalised financial update.
9. Interest - free overdraft facility of RM200.
10. Auto save facility from savings to Partner Flexi Time deposit every month.
11. Discount on commission for traveller's cheques purchased.
12. Special foreign exchangerates for overseas remittances.
13. No commission charged for the demand draft or cashier's order for new share issue application
14. A series of financial guides.
15. Partner Card recognised at all Hongkong Bank branches worldwide.
16. Auto cheque book reordering.
17. Auto renewal of Flexi Time.
18. Express service.
19. Overnight auto - sweep facility from current to savings account.
20. Personal financial statements.
21. Free financial publications.
22. Direct credit and automatic payment to beneficiaries.

CITIBANK

Time Deposit

1. An automatic cover draft facility that covers deposits of more than RM50,000 with a minimum maturity of six months.
2. Personalised service of courier pick - up on deposits of over RM30,000.
3. Higher deposit interest rates.

Source : Banker's Journal Malaysia, December 1993.