CHAPTER 5: MALAYSIAN BANKING SYSTEM AND THE ROLE OF CREDIT IN THE ECONOMY

5.1.0 Banking System in Malaysia

The banking sector comprises of the Central Bank, licensed institutions, namely commercial banks, finance companies, merchant banks, the representative offices of foreign banks and the offshore banks in the International Offshore Financial Center of Labuan, discount houses and money brokers.

Bank Negara is at the apex of the monetary and banking system in Malaysia. With the exception of the offshore banks, Bank Negara has been entrusted with the regulation and supervision of the banking system in the country. This is provided under the Banking and Financial Institutions Act 1989 (BAFIA) and the regulations made thereunder. This will ensure that a sound and strong financial system is maintained which is essential to a steady and balanced economic and social development in the country. The offshore banks now come under the purview and supervision of the Labuan Offshore Financial Services Authority (LOFSA).

The financial institutions can be divided into two categories, namely a) the monetary institutions, which comprise Bank Negara and the commercial banks, and b) the non-monetary institutions, which comprise the finance companies, merchant banks and discount houses.

The Credit Guarantee Corporation or commonly known as "CGC" is also recognized as part of the banking system in Malaysia. Bank Negara set up the CGC together with the commercial banks to assist small-scale enterprises. The CGC is recognized as part of the non-monetary institutions.
5.2.0 Bank Negara Malaysia

The principal objectives of Bank Negara Malaysia as spelt out in the Central Bank of Malaya Ordinance 1959 (now the Central Bank of Malaysia Act 1958 (Revised 1994)) are:

✓ To be the sole issuing and distributing authority of the currency in Malaysia, which is the "ringgit" and "sen". In addition, Bank Negara maintains adequate external reserves to safeguard the value and stability of the currency.

✓ To be the banker and financial adviser to the government of Malaysia. As a banker to the government, it advises the government on the issues of new types of securities, loan programmes and provides temporary advances to the government to cover any deficit in the budgeted revenue. In addition, it provides facilities such as cheques, acceptance of deposits, effect payment on behalf of the government, which includes both the federal and state governments.

✓ To influence the credit situation to the advantage of Malaysia.
To lay down policies intended to promote sound monetary stability and a strong financial structure, to enhance economic growth in Malaysia. In addition, these policies are also intended to maintain a high standard of banking and governance necessary to instill confidence in the banking system.

✓ To act as a banker to commercial banks and other financial institutions in the country. It has always been recognized as the lender of last resort for these financial institutions.

✓ To issue licenses to commercial banks, merchant banks, finance companies and discount houses in Malaysia. Under section 4 of the BAFIA, it is clearly provided that no one shall carry on banking, finance company, merchant banking, or discount house business unless a valid license is granted by Bank Negara. Powers are also vested in Bank Negara to revoke such licenses if it deems necessary.
Bank Negara has been given powers under the BAFIA to issue guidelines, regulations and directives, which are directly related to credit and lending.

5.3.0 Commercial Banks, Merchant Banks, Finance Companies and Development Financial Institutions.

Financial institutions play a very important role in the economic development of the country. They provide an array of loan and credit facilities to all sectors of the economy. In particular, commercial banks and finance companies traditionally have been active in the promotion of savings. Such funds are readily mobilized, applied and distributed to finance viable economic projects. This will ensure that the economic development of the country can be sustained.

5.3.1 Commercial banks

The commercial banks have played a pivotal role in the banking system. They are the largest and most significant providers of funds in the banking system. Under the terms of the license granted by Bank Negara, they enjoy the widest scope of banking activities and businesses. However, in an attempt to avoid unhealthy overlapping of banking activities with other financial institutions especially the finance companies and the merchant banks, commercial banks are generally not allowed to engage in hire-purchase and leasing, factoring and corporate advisory activities.

The functions and the business of commercial banks in Malaysia are:

✓ Providing facilities for savings through current, savings and fixed/time deposit accounts and other financial instruments;
✓ Providing facilities to effect payments on behalf of its customers;
✓ Providing loans and credit facilities, both to individual borrowers and corporations;
✓ Financing the government through the purchase of government securities and treasury bills; and
✓ Providing a wide variety of other banking services such as remittances, facilitating foreign exchange transactions and the financing of both domestic and international trade.

Commercial banks have contributed immensely to the economic development of the country. This is done through their vast network of branches throughout the country.

5.3.2 Merchant banks

The functions of merchant banks are different from those of commercial banks. They provide more sophisticated and complex banking facilities. Whilst the commercial banks are focused on retail short-term credit and loan facilities for working capital and trade financing, merchant banks specialize in raising capital by way of syndication. They also provide corporate finance advisory services, arrange for the issue and listing of shares, and manage investment portfolios.

5.3.3 Finance companies

Section 2 of BAFIA defines “finance company business” as follows:

✓ the business of receiving deposits on deposit account, savings account or other similar account; and
✓ giving of credit facilities;
✓ leasing business;
✓ business of hire-purchase, including that which is subject to the Hire-Purchase Act 1967; or
✓ business of acquiring rights and interests in a hire-purchase, leasing or other similar transaction;
✓ such other business as the Minister, may prescribe.
5.3.4 Development finance institutions

The primary objective for the setting up of development finance institutions by the government is to promote development programmes in agricultural, industrial and international trade. They provide the necessary funds geared towards the achievement of these objectives. The main beneficiaries of the loans extended by these development finance institutions are those sectors engaged in manufacturing, construction, property, agriculture, transport and general commerce.

5.3.5 Discount houses

Traditionally, discount houses are set up to provide short-term money. They accept short-term deposits and funds from the banking sector, private sector and public authorities in the form of money at call, overnight money, and short-term deposit. In turn, such funds are reinvested generally in securities such as Government bonds and Treasury bills, banker's acceptances, negotiable instruments of deposit and Cagamas. In many ways the discount houses are recognized as keepers of liquidity for the banking system in the event of any liquidity strain in the system.

5.3.6 Savings institutions

Savings institutions are set up primarily to promote and mobilize savings in the country, particularly from the rural areas since they are generally not adequately served by the other banking and financial institutions. Among the prominent savings institutions in the country are Bank Simpanan Nasional and some of the co-operative societies. These co-operative societies comprise both the urban credit co-operatives and rural credit co-operatives. These co-operative societies are set up to promote savings, investment opportunities and participation in various economic activities. Bank Simpanan Nasional has a vast network of branches all over the country.
5.4.0 The Role of Credit in the Economy

5.4.1 The role of credit in economic growth

In Malaysia and other developing economies, credit by the banking sector is large as reflected in the high ratio of loans to the gross domestic product (GDP). In Malaysia, for example, the ratio of total loans outstanding to the GDP was around 142% at end of 1999. In most developing economies, sources of capital from non-banking institutions are relatively small. Because of this heavy reliance on the banking sector for financing facilities, credit is an important factor in terms of income generation and employment creation in these economies. Credit or loan base provides a major source of interest income to banking institutions.

There is a direct and positive relationship between credit and economic growth. In economic terms, economic growth is measured by changes in output levels or real gross national product of the economy. The higher the output level or the GDP, the higher the economic growth.

A general relationship between credit and economic growth can be shown using the income version of the Quantity Theory of Money. The theory can be expressed by the following identity:

\[ MV = Py \]

Where:
\[ M \] is the quantity of money,
\[ V \] is the velocity of money,
\[ P \] is the price level, and
\[ y \] is the real income or output level.

For a given level of \( V \) and \( P \), increases in money supply \( M \) (through credit creation) will lead to higher income and output, thus economic growth. It is
important to note that since $V$ and $P$ rarely remain constant in reality, there is no one-to-one relation between $M$ and $y$.

In general, credit affects growth through investment spending, and consumer spending.

### 5.4.2 Credit and investment spending

This relationship between credit and economic growth can be explained using a simple production function. For simplicity assume that an economy has a simple production function. In this production, output is determined by two factors of production: labour and capital. For a given amount of labour force, output can be increased if capital is increased. And, capital can be increased if more credit is made available to firms or entrepreneurs in this economy.

In a production process, firms or entrepreneurs require credit for several purposes. For example, they need credit for working capital such as to pay for raw materials and utility bills. They also need credit to buy equipment. Without this credit, these entrepreneurs or firms may not be able to spend and expand or in some cases start their business operations.

| Credit $\rightarrow$ Investment spending $\rightarrow$ GDP Growth |

### 5.4.3 Credit and consumer spending

The impact of credit on economic growth can also be traced to consumer spending. In most modern economies, consumer spending forms more than 40% of the GDP. Because of this, consumer credit is important in determining growth: with consumer credit, effective consumer demand will be enhanced and this will promote growth.

| Credit $\rightarrow$ Consumer Spending $\rightarrow$ GDP Growth |
Based on these relationships, we can see the impact of credit crunch on economic growth. If credit is tight or squeezed, investment and consumer spending will shrink. This consequently will reduce aggregate demand and economic activity and thus output growth. As a result, the economy can be dragged into stagnation or even recession.

5.4.4 Credit view of monetary policy

Usually two views are presented on the relationship between money and output. The views are credit view and money view. The money view provides a simple relationship between money supply and economic activity through interest rate. However, the money view assumed that financial intermediaries only play a passive role in the process, thereby reducing the importance of reducing information costs of borrowing and lending.

The credit view holds that bank loans or credit are important in determining output and interest rates. Based on the credit view, banks play an active role in the macro economy. The public regards bank loans as money.

When money supply increases through bank deposits, interest rate falls, at least in the short term. This will encourage bank-dependent and interest sensitive borrowers to borrow and spend. Eventually, this will translate into higher output in the economy.

Also, according to the credit view, access to credit from financial institutions helps both households and businesses reduce financial distress. When access to credit is good, households are more willing to invest in consumer durable goods and businesses are more willing to invest in new plants and equipment. This helps economic growth.
5.4.5 The simple deposit multiplier

A simple money supply process through a loan or credit process would start from an assumption that a bank (Bank A) has excess reserves of say RM100 after selling a bond to Central Bank. Assuming that the required reserves are 10%, then Bank A can lend RM90 to its customer. If this customer deposits this RM90 loans in Bank B, the Bank B will have RM81 to loan to its customer, after taking into account of 10% reserve requirement. The process of deposit creation (through loan or credit) will go on as shown below until the change in deposits reached RM1000.

Creation of Deposits

<table>
<thead>
<tr>
<th>Bank</th>
<th>Change in Deposits</th>
<th>Change in Loans</th>
<th>Change in Reserves</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>+100.00</td>
<td>+90.00</td>
<td>+10.00</td>
</tr>
<tr>
<td>B</td>
<td>+ 90.00</td>
<td>+81.00</td>
<td>+9.00</td>
</tr>
<tr>
<td>C</td>
<td>+ 81.00</td>
<td>+72.90</td>
<td>+ 8.10</td>
</tr>
<tr>
<td>D</td>
<td>+ 72.90</td>
<td>+65.61</td>
<td>+ 7.29</td>
</tr>
<tr>
<td>E</td>
<td>+ 65.61</td>
<td>+59.05</td>
<td>+ 6.56</td>
</tr>
<tr>
<td>F</td>
<td>+ 59.05</td>
<td>+53.14</td>
<td>+ 5.91</td>
</tr>
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<td>.</td>
<td>-</td>
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<td>-</td>
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<tr>
<td>.</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total for all Banks</td>
<td>+1,000</td>
<td>+ 900.00</td>
<td>+ 100.00</td>
</tr>
</tbody>
</table>

Assumption:
10% reserve requirement and a RM 100 increase in reserves
The multiple increases in deposits generated from an increase in bank reserves are called the simple deposit multiplier. In the example above, the simple deposit multiplier is 10. In a mathematical equation, the simple deposit multiplier equals to the reciprocal of the required reserve ratio. Based on this multiplier, the multiplier formula for the multiple expansions of deposits can be stated as follows:

\[ \Delta D = \left( \frac{1}{r} \right) \times \Delta R \]

Where

\[ \Delta D \] is the change in demand deposits in the banking system,
\[ r \] = the required reserve ratio, and

\[ \Delta R \] is the change in bank reserves.
Based on this simple deposit multiplier, when \( r \) (or the Statutory Reserve Requirements – the SRR for Malaysia) increases, the deposit and thus money supply decreases. The reverse holds when \( r \) decreases.

### 5.4.6 Credit and Stability of Financial Institutions

When banks give credit and loans to their customers, they face a credit risk, among other risks. Credit risk is simply the risk that the customers default, that is customers fail to comply with their obligation to service debt.

Default can either trigger partial or complete losses to banks to the extent of the amount lent to the customers. The banks also lost the opportunity to earn interest income from the loans. Because of this, banks are required to observe good and prudent management practices in granting loans.

For a bad credit or loan, banks have to make certain amount of provisions. The provisions will reduce the banks' profitability. Therefore, when a bank suffers a large amount of loan default, it can be under severe distress, particularly when the losses start to erode its capital position.

Credit risk is critical if the default can lead to insolvency of financial institutions. If the losses or insolvency is not contained, it could affect the stability and confidence in the financial institutions. This will undermine macroeconomic and financial stability of the economy and give rise to increased public policy concerns.

The reasons why difficulties at a bank may give rise to public policy concerns are many. Some of the reasons include:

(a) high probability of bank runs;
(b) high probability of a contagion effect;
(c) high cost of bailing out;
(d) high probability of widespread macroeconomic consequences from instability in the financial sector; and

(e) loss of confidence in financial intermediation, which may result in sub-optimal levels of saving and investment.