UNIVERSITI PUTRA MALAYSIA

A Case Study on the Strategy of Bank Negara Malaysia to Curb Loan Growth

Radzuan bin Mohd. Kassim

GSM 1997 31

A Case Study
on the Strategy of Bank Negara Malaysia
to Curb Loan Growth

By Radzuan bin Mohd. Kassim
Matric 45168

A case study to be submitted to the Faculty of Economics and Management of Universiti Putra Malaysia as partials fulfillment of the requirement for the Degree in Masters of Business Administration

Acknowledgement

I would like to thank Yang Berbahagia Profesor Madya Dr. Zainal Abidin Mohamed for supervising me with this case study; and to my colleagues and my parents especially for giving me moral support in completing my MBA.

Executive Summary

1997 was a challenging year for the conduct of monetary policy. The first quarter of the year saw high levels of monetary growth driven by rapid growth in credit, which had also prevailed during the most part of 1996. In addition, loans were increasingly channelled towards less productive activities. Such developments raised several concerns. High levels of monetary expansion, if left unchecked, would have inflationary implications on the economy. Furthermore, the rise in loans to the property sector and to stock market-related activities increased the exposure of banking institutions to these sectors, raising the potential risk to the soundness of the institutions. Given these concerns, Bank Negara Malaysia (BNM) has to introduce strategic measures, to ensure that the stability of the banking system was not undermined by excessive exposure to the relatively more volatile sectors of the economy.

A Case Study on

Bank Negara Malaysia Strategy to Curb Loan Growth

List of Tables/ Diagrams

PART ONE: CASE

1. An Overview of the Malaysian Financial System

1.1 Up to the point when the Central Bank (Bank Negara Malaysia, BNM) was established in 1959, the Malaysian financial system was a simple structure, comprising mainly commercial banks (predominantly foreign banks), provident, pension and insurance funds, the post office savings bank and a few other minor financial intermediaries.

1.2 The present financial system in Malaysia has evolved into much broader and diverse system. The genesis of the present financial structure, which is considered modern and rather sophisticated, began with the institutional building undertaken since the early 1960s by the Central Bank.

1.3 BNM had consciously and systematically developed and established institutions in the Malaysian financial system in order to provide the basic infrastructure for effective monetary management. The institutional framework was recognised as an important starting point in meeting the objectives of BNM.

1.4 The Central Bank of Malaysia Act 1958, provides for the Central Bank to promote monetary stability and a sound financial structure, and to influence the credit situation to the advantage of the country. The present Malaysian financial system can be broadly structured into three main segments, the banking system, the non-bank financial intermediaries and the financial markets.

1.5 The banking system has bank Negara at the apex, serving as the supervisory authority of the banking institutions. The banking institutions comprise the commercial banks, finance companies, merchant banks, discount houses, the money and foreign exchange brokers as well as the offshore banks.

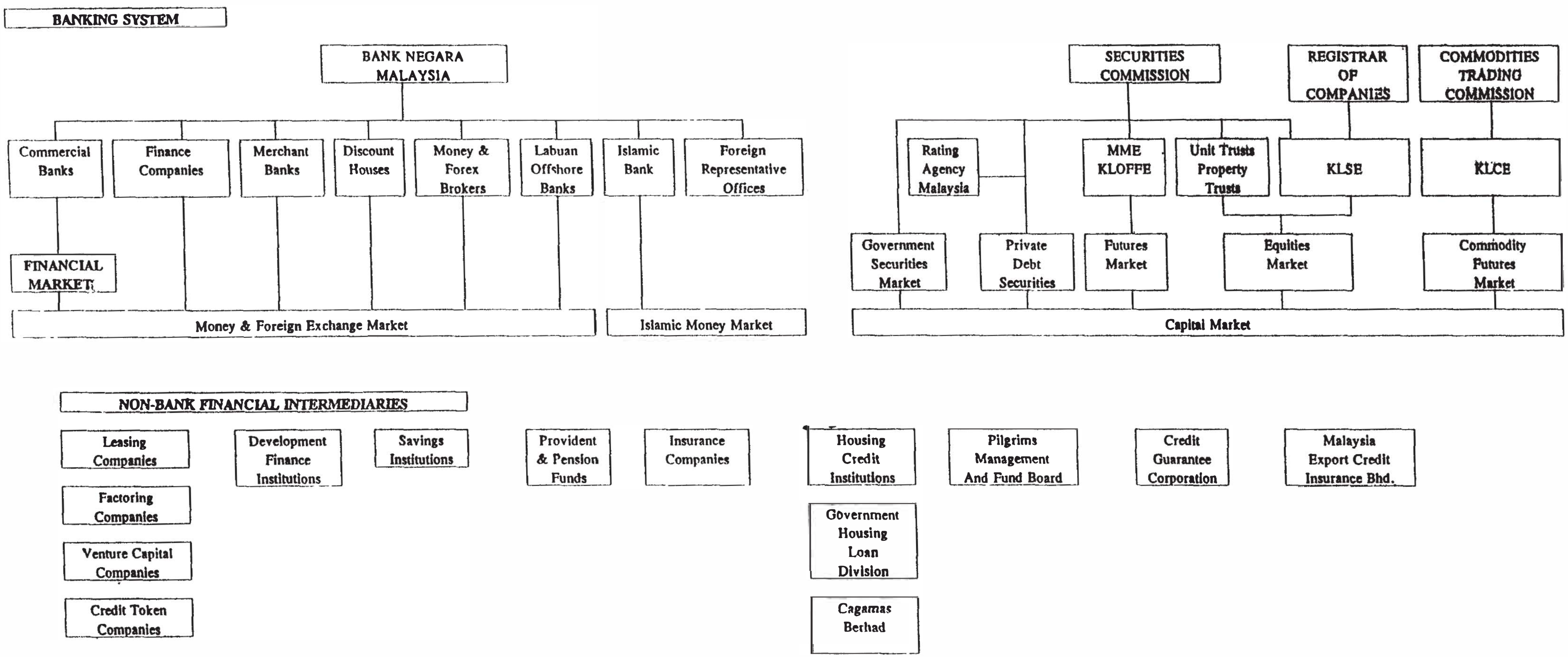
1.6 The banking institutions accounted for 69% of the total assets of all the financial institutions in the system as at the end of 1996. The total assets of the banking system expanded from RM2.4 billion in 1960 to RM915.2 billion as at end-1996. The rapid growth of the banking system over the past three decades was achieved through the rapid build-up of branch network by the domestic banks in the country.

1.7 Over the 38 years since BNM's establishment, the branch network of the commercial expanded more than ten-fold from 111 (of 26 banks with total assets of RM1.1 billion) in 1959 to 1,624 as at the end of July 1997 (37 banks with total assets of more than RM350 billion), of which 1480 were branches of domestic banks.

1.8 The total assets of the finance companies also increased very significantly from less than RM390 million in 1969, when they were first brought under the supervision of the Central Bank, to RM119.6 billion as end-1996.

1.9 Similarly, the merchant banks, which were licensed specifically to offer wholesale banking and corporate finance services, built up their total assets aggressively from RM130 million in 1973 (when the first merchant bank was opened) to RM34.0 billion as at end-1997.

THE MALAYSIAN FINANCIAL SYSTEM



Loans by the Banking System

	Monthly change		As at end of	
	1997			
	Sep.	Oct.	Sep.	Oct.
	RM million			
Broad property sector[1]	3,149	1,919	100,454	102,373
Manufacturing	819	2,365	62,406	64,771
Agriculture	117	426	7,319	7,745
General commerce	751	1,524	32,019	33,543
Finance, insurance and business services	1,051	1,767	59,479	61,246
Transport and storage	364	1,616	9,972	11,588
Consumption credit	340	1,983	48,542	50,525
Purchase of stocks and shares[2]	248	828	18,166	18,994
Electricity	181	224	4,337	4,561
Mining and quarrying	56	31	1,257	1,288
Others	1,707	– 4,797	40,845	36,048
Total	8,783	7,886	384,796	392,682

[1] Excluding housing loans sold to Cagamas Berhad.
[2] Refers to loans extended to individuals. Includes units of unit trusts.

Deposits with the Banking System[1]

	Monthly change		As at end of	
	1997			
	Sep.	Oct.	Sep.	Oct.
	RM million			
Federal Government	– 484	633	8,821	9,454
Financial institutions	– 469	– 199	73,529	73,330
Business enterprises	4,257	4,018	127,130	131,148
Individuals	– 1,575	1,701	163,548	165,249
Others[2]	– 239	– 1,252	34,273	33,021
Total	1,490	4,901	407,301	412,202

1 Including repos.
2 Comprising State and local governments, and statutory authorities.

2. Bank Negara Malaysia : Roles and Objectives

2.1 The Central Bank of Malaysia was established in 1959 under the Central Bank of Malaysia Ordinance 1958 which entrusted the Bank with four principal objectives:

i. To issue currency and to keep reserves safeguarding the value of the currency;

ii. To act as a banker and financial adviser to the Malaysian Government;

iii. To promote monetary stability and a sound financial structure; and

iv. To influence the credit situation to the advantage of the country.

2.2 In carrying the latter two functions, BNM was empowered to regulate and supervise the operations of the commercial banks, finance companies, merchant banks, discount houses and money-brokers under the Banking and Financial Institutions Act 1989 (BAFIA).

2.3 The Islamic bank is regulated under the Islamic Banking Act 1983; and the insurance companies under the Insurance Act 1963 and the Takaful Act 1984. In addition, Bank Negara also administers Exchange Control Act 1953.

3. Role and Operations of the Component Institutions in the Banking System

3.1 Commercial Banks

3.1.1 The commercial banks are the largest and most important group of banking institutions in the country. As at end of July 1997, the number of commercial banks operating in the country was 35, of which 22 were domestic banks and 13 were foreign-controlled banks. However, the foreign banks are all locally incorporated as required by the BAFIA.

3.1.2 The total number of branch offices of domestic banks increased from 1,442 at the end of July 1996 to 1,480 at end of July 1997, while that of foreign-controlled banks remained unchanged at 144. The commercial banks accounted for 67.0% of the total deposits placed with the banking system and extended 67.8% of total loans granted by the banking system at the end of July 1997.

3.1.3 To ensure that certain priority groups, such as the Bumiputera community, small-scale enterprises and low-cost house buyers, have access to bank credit at reasonable cost, the commercial banks are required to observe certain guidelines in their lending to these groups.

3.1.4 Commercial banks provide retail banking services, including acceptance of deposits, granting of loans and advances to businesses and individuals and discounting of trade bills. Commercial banks are the only banking institutions allowed to provide current account facilities and until very recently, they

Commercial Banks: Deposits

	Change During Period				As at end of July 1997
	1996 January-July		1997 January-July		
	RM million	%	RM million	%	RM million
Demand deposits	4,625	12.7	–60	–0.1	44,475
Savings deposits	2,159	9.2	–1,504	–5.2	27,290
Fixed deposits	10,310	10.1	11,824	9.1	142,436
NIDs[1]	1,371	5.6	7,515	27.4	34,982
Repos	1,587	16.5	3,144	26.6	14,962
Others[2]	–4	–0.5	1,224	164.9	1,966
TOTAL	20,049	10.2	24,396	10.0	268,364

[1] Negotiable instruments of deposit.

[2] Include New Investment Fund and special deposits.

Source: BNM.

Commercial Banks: Direction of Lending

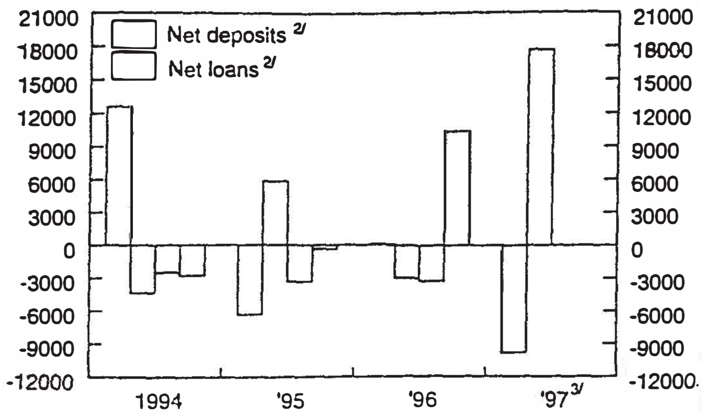
	Change During Period				As at end of July 1997
	1996 January-July		1997 January-July		
	RM million	%	RM million	%	RM million
Agriculture	548	14.2	907	19.9	5,457
Mining and quarrying	274	30.9	66	11.0	677
Manufacturing	2,978	7.0	4,139	8.6	52,089
Finance, insurance and business services	6,170	26.0	9,196	27.1	43,089
Construction	2,586	18.4	5,518	28.6	24,814
General commerce	1,566	8.2	4,068	18.3	26,259
Transport and storage	500	16.7	2,013	48.4	6,174
Real estate	1,830	11.5	1,364	6.5	22,449
Housing[1]	238	1.4	1,392	7.5	19,931
Miscellaneous	6,861	19.3	4,274	9.4	49,828
TOTAL	23,551	13.5	32,937	15.1	250,757

[1] Excluding loans sold to Cagamas Berhad.

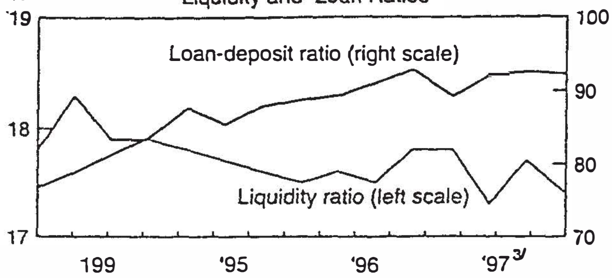
Source: BNM.

Commercial Banks

Loans and Deposits [1/]
(change over preceding quarter)



Liquidity and Loan Ratios [1/]

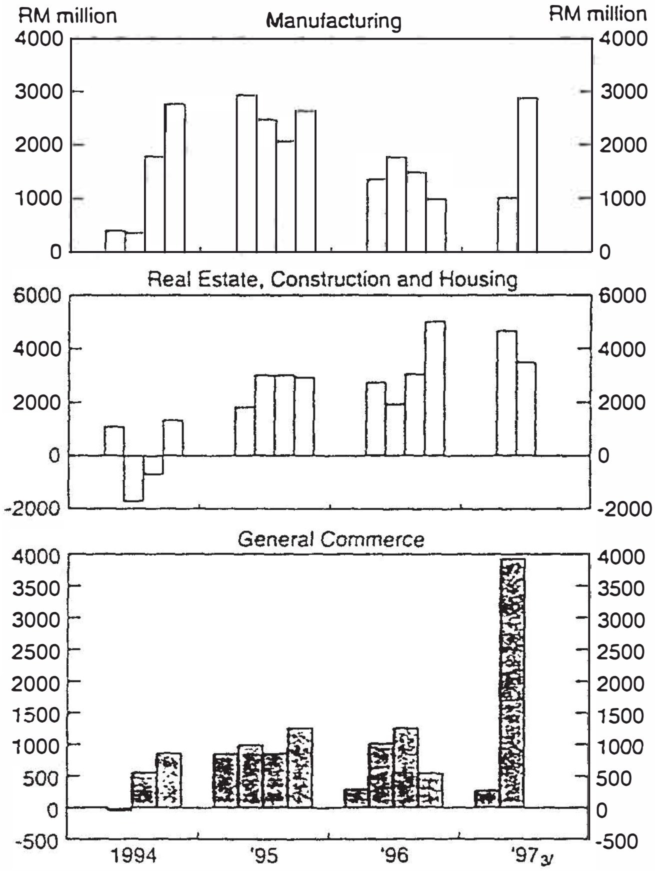


1/ Including Repos.

2/ Net deposits refer to the excess of commercial bank deposits over loans in each quarter while net loans refer to excess of loans over deposits

3/ As at the end of July 1997.

Lending to Major Sectors
(change over preceding quarter)



(together with Bank Islam and merchant banks) are the only authorised dealers in foreign exchange.

3.1.5 Many of the commercial banks are also credit card issuers. In their deposit-taking activities, the commercial banks can accept a variety of deposits, including demand deposits, fixed deposits with different maturity periods, savings deposits as well as issue negotiable instruments of deposits (NIDs) at a fixed or floating rate basis.

3.1.6 They can also raise funds through repos (repurchase agreements) of money market instruments. The deposits mobilised would, in turn, be channelled as loans to various sectors of the economy. In March 1993, BNM decided to increase the number of institutions offering Islamic banking services by allowing the commercial banks to offer interest-free banking facilities (IBS).

3.1.7 The IBS was aimed at providing the public with sophisticated banking facilities based on Islamic principles. The IBS would initially cover 3 broad categories of products, namely, deposits, consumer-financing and commercial-financing.

3.2 Finance Companies

3.2.1 The finance companies are the second largest mobiliser of funds in the country. Total deposits of the finance companies increased by 15.9% to RM105,257 million as the end of July 1997, compared with 16.9% in the corresponding period of 1996, reflecting primarily the higher interest rates offered for fixed deposits.

3.2.2 The lending operations of finance companies also expanded during the first seven months of 1997. Total loans extended to the various sectors of the economy grew by 18.4% to RM97,651 million at the end of July 1997 compared with a growth of 14.8% during the same period of 1996.

3.2.3 The number of finance companies operating the country as at the end of July 1997 declined to 39, of which 11 were wholly-owed subsidiaries of domestic commercial banks. During the first seven months, finance companies established another 23 branches.

3.2.4 Unlike the commercial banks, finance companies are not allowed to accept demand deposits, (current accounts), deal in foreign exchange or grant unsecured loans in excess ofRM10,000 each. They are only allowed to accept savings and fixed deposits from the public. Traditionally, finance companies specialise in consumption credit, comprising mainly hire purchase finance and personal loans.

3.2.5 Consumption credit is still the mainstay of finance company lending and accounted for about 54% (up to July 1997) of total credit granted by the finance companies. Increasingly, however, more of their lending is channelled to the business community. As at end of July 1997, loans to finance business activities in the manufacturing, broad property sector and general commerce is 27% of the total credit granted.

3.2.6 With deregulation and technological advances, the traditional demarcation line between the commercial banks and finance companies is becoming less distinct. For example, selected finance companies have, since 1987 and 1990 respectively, been

Finance Companies: Deposits

	Change During Period				As at end of July 1997
	1996 January-July		1997 January-July		
	RM million	%	RM million	%	RM million
Savings deposits	44	0.9	-375	–6.8	5,117
Fixed deposits	7,212	13.3	13,309	19.8	80,597
Special deposits	1	1.6	15.1	172.4	238
NIDs[1]	3,724	42.7	470	3.1	15,444
Repos	833	44.6	910	30.3	3,911
TOTAL	11,814	16.9	14,465	15.9	105,307

[1] Negotiable instruments of deposit.

Source: BNM.

Finance Companies: Direction of Lending

	Change During Period				As at end of July 1997
	1996 January-July		*1997 January-July*		
	RM million	*%*	*RM million*	*%*	*RM million*
Agriculture	136	14.2	–18	–1.5	1,149
Mining and quarrying	3	1.4	107	35.2	412
Manufacturing	409	10.2	372	7.4	5,371
Construction	1,093	25.0	1,752	31.6	7,305
Real estate	794	23.5	603	11.2	5,965
Private individuals of which:	3,943	11.0	8,854	19.6	54,114
Consumption credit	3,930	17.0	8,224	25.7	40,180
Purchase of stocks/ shares	–235	–4.5	899	15.3	6,781
Housing*	248	3.4	–269	–3.6	7,153
General commerce	224	14.5	1,426	63.0	3,689
Miscellaneous	2,676	21.3	2,058	11.7	19,646
TOTAL	9,278	14.8	15,154	18.4	97,651

* Excluding loans sold to Cagamas Berhad.

Source: BNM.

allowed to source funds from the interbank money market and to issue NCDs to augment their funding.

3.2.7 They have also been permitted to accept from any person, fixed deposits of one-month maturity, subject to a minimum size of RM5,000 per deposit, with effect from October 1991. More recently, finance companies have been permitted to issue financial guarantees and to conduct money changing activities.

3.2.8 In addition, since July 1993, they are also permitted to provide interest-free banking facilities. The advent of the ATM has also enhanced the competitiveness of the finance companies in offering various services to the customers. A few of the companies are also credit card issuers.

3.2.9 The on-going process of consolidating the industry by merging smaller and weaker units with the stronger entities is expected to result in a leaner industry which can play a much greater role in the development of the economy in the years ahead.

3.3 Merchant Banks

3.3.1 As at end of July 1997, the number of merchant banks operating in the country remained at 12 with 24 branch offices operating in the country. Total assets of the merchant bank increased by 28.2% from the end of 1996 to RM43,605 million at the end of July 1997, compared with 7.2% during the same period of 1996.

3.3.2 They function primarily as specialists in the money and capital markets, with particular expertise in the provision of fee-based services which must form at least 30% of their annual net income. The services provided by the merchant banks, inter alia, include all aspects of finance and corporate advisory services.

3.3.3 Other services include underwriting of new issues of shares and bonds, assisting customers to fund suitable partners for joint ventures, mergers and takeovers and the conduct of feasibility studies and industry studies for potential investors.

3.3.4 In line with the wholesale nature of their business, the merchants are not allowed to accept deposits from individuals, sole proprietorships and partnerships. They are permitted to issue NIDs within the limits prescribed by BNM and to accept deposits denominated in foreign currency from non-residents as well as borrow/ lend in foreign currency from/ to non-residents.

3.3.5 They are only allowed to accept deposits of minimum maturity of one month from banking institutions (such as commercial banks, finance companies and other merchant banks), other approved financial institutions, corporations, clubs, associations, trust companies, trust funds and pension funds, where the amount should not be less than RM200,000 per deposit receipt.

3.3.6 However, with effect from October 1995, Tier One merchant banks will be allowed to accept deposits from individuals, subject to a minimum of RM1 million per deposit. In addition, they will be allowed to undertake foreign exchange