MALAYSIA

BANKING

SUMMARY

Malaysia's banking and financial system came under increasing stress with the onset of the regional financial crisis in mid-1997. Despite a generally well-developed supervisory and regulatory framework and an accelerated effort in early 1998 to strengthen finance companies through mergers, deflation in property and other asset markets by mid-1998 had placed a number of commercial banks and finance companies at risk and in need of recapitalization. Non-performing loans rose steadily from roughly 6.8 percent for the banking system in 1997 to 10.8 percent in July 1998, and were projected to increase to between 20-25 percent by year-end 1998.

Following a significant credit crunch in early 1998, precipitated in part by a "flight to quality" by depositors, Bank Negara Malaysia (the central bank) announced it would guarantee all principal and interest in Malaysian banking institutions. However, the economy continued to worsen and credit growth fell well below central bank targets. At the end of June, the government of Malaysia reversed measures it had put in place in 1997 to reduce the current account deficit and to curtail strong credit growth. It began a significant easing of monetary policy and announced new fiscal stimulus packages totaling RM12 billion (US$3 billion). It established an Asset Management Corporation (Danaharta) to purchase non-performing loans from the banking sector, created a special purpose vehicle (Danamodal) to recapitalize banking institutions, established a corporate debt restructuring committee to facilitate loan workouts, and strengthened bankruptcy laws.

On September 1, 1998, as part of a broader effort to reflate the economy, and stabilize its currency, the government of Malaysia took drastic action by fixing the exchange rate of the ringgit to the U.S. dollar at 3.8 RM/US$ and instituting selective capital controls. Malaysia's principal objectives in instituting the controls are to eliminate offshore trading in the ringgit and insulate the domestic economy from external risks posed by short term capital flows. Overseas trading of Malaysian securities will cease and investors must now hold Malaysian securities, or the ringgit proceeds from their sale, for at least one year. The government of Malaysia has stressed that the measures maintain general convertibility of current account transactions, and do not impair repatriation of interest, profits and dividends and commissions on investments.

Following the September 1 actions, the central bank rolled back certain provisioning and disclosure standards that had been in place since January 1998. It also relaxed some prudential lending restrictions on property and share purchases that had been imposed prior to the onset of the financial and economic crisis.

As of June 1998, there were 13 foreign banks operating in Malaysia out of a total of 35 commercial banks in the country. Despite sustained efforts by the government of Malaysia to develop the domestic banking industry and limit foreign competition, foreign banks retained a respectable 21.2 percent share of banking sector assets at the end of June 1998.

Malaysia has issued no new commercial banking licenses other than those restricted to offshore activities since 1979. Acquisition of existing domestic banks is not a viable option for foreign banks. Individual ownership in domestic banks is limited to 10 percent for an individual and 20 percent for others, with aggregate total foreign investment in any one entity limited to 30 percent. Banking regulations in place since 1994 require all existing foreign branch banks to incorporate locally, a rule that has increased costs for foreign banks and led to less efficient forms of organizational structure. Finally, foreign banks continue to be affected by immigration regulations that limit cross-border entry of expatriate banking personnel.

In addition to limitations on entry and hiring of expatriate workers and forced incorporation, there are other important restrictions on expansion and operation by foreign banks. All nonresident controlled companies are required to source at least 60 percent of their domestic credit needs with a Malaysian-owned bank, although the government of Malaysia has agreed to relax this limit to 50 percent by the year 2000. Foreign banks are also prohibited from establishing new branches. For regulatory purposes, any off-premises automated teller machine is considered a separate branch.

DESCRIPTION OF THE MARKET

Structure of the Market

The banking system in Malaysia consists of seven types of institutions: commercial banks, finance companies, merchant banks, an Islamic bank, discount houses, foreign bank representative offices, and offshore banks (see table for percentage of banking sector assets, loans and deposits). Commercial banks, finance companies, merchant banks, and discount houses are required to be licensed under the Banking and Financial Institutions Act of 1989 (BAFIA) and form the core of the banking system. As of December 31, 1997, the licensed banking system in Malaysia included 35 commercial banks, one Islamic Bank, 39 finance companies, 12 merchant banks, and 7 discount houses. Total banking sector (comprising the commercial banks, finance companies, and merchant banks) assets were RM677.8 billion (US$174 billion) at end-1997. The banking sector remains the largest financial intermediary in the country, accounting for almost 61 percent of the total assets of the financial system.

An important differentiation in the treatment of large versus small banks was established in December 1994. Under the new regulations, BNM reclassified both foreign and domestic banks into two tiers. Tier-1 banks are defined as well-managed and well-capitalized banks whose equity exceeded RM500 million (US$125million) in December 1994 and RM1 billion (US$261 million) by end-1998. Only tier-1 banks are allowed to participate in equity derivatives, undertake securities borrowing and lending, and expand into regional operations. The tiering process was intended to encourage voluntary mergers of smaller banks but in practice has served to encourage smaller institutions to grow, in order to reach tier-1 status. As of December 31, 1997, there were 10 tier-1 commercial banks, of which 4 were foreign-owned, and 25 tier-2 banks, of which 9 were foreign-owned.

Domestic Banks

The six largest domestic banks are Maybank, Bank Bumiputra Malaysia, RHB Bank, Public Bank, Bank of Commerce, and Sime Bank. Bank Bumiputra has 100 percent federal government shareholding. The majority shareholders of Maybank are a unit trust fund and the National Equity Corporation. The six largest banks account for more than 65 percent of domestic banking assets as at end-June 1998. The largest bank, Maybank, with consolidated assets of US$43.8 billion in mid-1997 is a publicly listed company whose two largest shareholders – a unit trust fund and a foundation established by the government of Malaysia to assist indigenous Malaysians and promote their ownership of share capital – own approximately 55 percent of the bank's equity. Maybank is more than twice the size of the next largest bank, wholly government-owned Bank Bumiputra, which is subject to a greater degree of directed policy lending, given its charter to serve the needs of indigenous Malaysians. The regional economic downturn has affected the profitability of all major banks and has played a role in the 1998 acquisition of troubled Sime Bank by Rashid Hussain Bank (RHB). Further mergers and reorganizations within the banking sector are likely in the year ahead.

Foreign-owned Banks

Sustained efforts by the government of Malaysia to develop the domestic banking industry have eroded foreign banks once dominant share of the market. Long-standing regulations have prohibited foreign banks from expanding their branch networks since 1966. Therefore, all foreign banks granted licenses after 1966 have had to remain one-branch banks. The last foreign bank allowed entry into the market was Bank of Nova Scotia in 1973. Bank of China was promised a license for a subsidiary in 1996, but has yet to set up an operation in Malaysia. By 1997, foreign banks represented less than 10 percent of the branch network, compared to 78 percent in 1960.

Regulations enacted in 1989 required each of the then 16 foreign bank branches to locally incorporate within five years as Malaysian banks. Their foreign parent banks, however, were permitted to retain 100 percent ownership in the new subsidiaries. By September 1994, the end of the local incorporation exercise, there remained 14; two of the original foreign branches had been sold to Malaysian interests to become domestic banks. Later, two of the 14 subsidiaries merged, leaving 13 as of June 30, 1998. Twelve domestic banks were partially foreign owned as of June 30, 1998, the same number as four years earlier on June 30, 1994.

Despite restrictions on their growth, the thirteen wholly foreign-owned subsidiaries operating in Malaysia as of June 1998 have managed to retain a 22 percent share of total banking system assets, a 21.2 percent share of deposits and 22.2 percent share of loans, largely due to high levels of service and superior international financial linkages (U.S. banks hold 2.9 percent share of commercial bank deposits and 3 percent share of loans). While foreign and domestic banks are permitted to undertake the same types of banking activities, those banks that had branch networks established before 1966, including Hong Kong and Shanghai Banking Group, Overseas-Chinese Banking Corporation, and Standard Chartered Bank are the foreign banks with the most substantial retail and consumer presence. With the exception of Citibank which is a strong retail player with only three branches, the remaining foreign banks focus on wholesale and international banking. Bank Negara has not imposed any new restrictions on foreign banks' operations since the 1994 National Treatment Study. All commercial banks in Malaysia are now permitted to open foreign currency accounts for their customers and allowed to deal freely in foreign currencies and enter into forward transactions to hedge their positions. All foreign banks were exempted in 1996 from rules which preclude banks from sharing credit information with their foreign parents.

Finance Companies

After banks, the 39 finance companies listed as of early 1998 were the second largest group of financial institutions in the country with a 22 per cent share of the banking sector's assets. Four were 100 percent foreign controlled, while five others had at least some foreign equity participation. The focus of finance company lending has been in the area of consumer credit, especially fixed-rate hire purchase loans (i.e., auto loans). A high concentration of business among a few companies, as well as severe losses resulting from the tight liquidity and high interest rate environment of the latter part of 1997, are leading to a major shake-up of this sector. The consolidation of the finance company industry will be in the form of: (1) merger of smaller finance companies with six identified anchor finance companies; (2) absorption of finance companies by parent commercial banks; or (3) strategic alliances. Upon completion of the consolidation exercise, there will be eight core finance companies, comprising six anchor finance companies and another two finance companies which have formed strategic alliances with other banking institutions.

Merchant Banks

The 12 merchant banks comprise the third largest set of financial institutions with a six percent share of the banking sector's assets. Formed in the early 1970s to provide more specialized financial services unavailable through commercial banks, merchant banks offer a wide range of activities, including syndication of loans, corporate advisory services, underwriting, and portfolio management. Of Malaysia's twelve merchant banks, all are owned by commercial banks except one.

Islamic Banks

An Islamic banking system has been established in Malaysia as an alternative to the conventional banking system. It offers interest-free services including leasing and hire purchase, profit-sharing, and joint-venture financing. Bank Islam is the only purely Islamic bank, although since 1993 commercial banks have been allowed to offer Islamic banking services. At the end of 1997, four foreign banks offered Islamic banking services.

Offshore Banking

The offshore banking market came into being with the establishment of the Labuan International Offshore Financial Center (IFOC) in 1990. Currently, there are over 1,000 offshore companies, of which 54 are offshore banks and 17 are offshore insurers operating in Labuan IOFC. The government intends to continue efforts to effectively promote and market Labuan. To date, Labuan has not attracted the scale of foreign currency operations anticipated by the government of Malaysia, primarily due to competition from more accessible and developed offshore centers in Singapore and Hong Kong.

Regulatory Structure

Bank Negara Malaysia (BNM) is the principal regulatory authority. Established in 1959, BNM's principal objectives are to issue currency and keep reserves safeguarding the value of the currency; to act as a banker and financial adviser/agent to the government of Malaysia; to promote monetary stability and a sound financial structure; and to influence the credit situation to the advantage of the country. Monetary policy, banking policy, and bank supervision are the responsibility of the central bank. BNM is run by a board of directors, usually five to eight members, who are appointed by the King of Malaysia. The chief executive officer is the governor of Bank Negara who presides over meetings of the board. The Bank Regulation Department formulates regulatory policy for the banking industry while the Banking Supervision Department conducts periodic investigations into banks' activities.

Although BNM is the primary regulatory authority, on certain issues it must refer to or seek the approval of the Minister of Finance. BNM can recommend the granting or revocation of an operational license to a bank, for example, but cannot approve it. That authority rests with the Minister of Finance. Other actions that require the approval of the Finance Minister include the granting of loans to rehabilitate troubled banks, and the assumption of control over troubled banks. The Minister of Finance remains the more powerful authority, but in practice usually exercises such authority only after receiving a BNM recommendation. On rare occasions, the Ministry of Finance will act on its own initiative, as it did in 1993 when it directed BNM to halt trading in forward foreign exchange markets.

Commercial banks are required to comply with a minimum risk-weighted capital requirement of 8 percent formulated along the lines of the Basle Capital Accord. Commercial banks are also required to comply with a minimum capital funds requirement of RM20 million. Credit to a single customer is restricted to 25 percent of a banks capital base, reduced from 30 percent effective April 1, 1998. Large loans (credit facilities which in aggregate exceed 15 percent of a bank's capital) are limited to 50 percent of total credit facilities. Banks are generally prohibited from granting loans, advances and credit facilities to their directors and staff; corporations where they are interested as director, manager, agent or guarantor; corporations in which they have an interest in the shares; firms in which the directors or staff are interested as partner, manager or guarantor; or close family members. At present, banks are restricted from lending more than 20 percent of total loans to the broad property sector and 20 percent for the purchase of shares. Bank Negara has issued guidelines on money laundering which require banks to determine the true identity of customers, develop transaction profiles, and establish document retention policies to identify inconsistent transactions. Bank are also required to identify a single reference point in their organizations to which unusual or suspicious transactions can be reported.

Capital Controls

On September 1, 1998, the government of Malaysia took what it described as "drastic measures" by imposing capital controls and fixing the value of the ringgit at RM3.8/US$1. The government of Malaysia stated that the objectives of the controls were to eliminate manipulation of ringgit exchange rates, stabilize short-term capital flows, and to protect Malaysia from the contagion effects of external developments. The measures reduce the ability of nonresidents to engage in ringgit transactions among themselves, require settlement of imports and exports in foreign currencies, discourage short-term capital inflows by requiring them to remain in country for at least one year, restrict Malaysian investments overseas, and limit the amount of foreign currency individuals and corporations can take out of the country. The government of Malaysia has stressed that the measures maintain general convertibility of current account transactions and free flow of foreign direct investment; and that they do not impair repatriation of interest, profits and dividends and commissions on investments. The government of Malaysia has stated that the controls are temporary measures which will be retracted once stability is restored in the international financial markets and there is an international consensus to reform the international financial infrastructure to address the problems associated with destabilizing capital flows, which it believes in large part caused the recent economic difficulties.

U.S. PRESENCE IN THE MARKET

As of mid-1998, three U.S. commercial banks were licensed to operate in Malaysia. All three entered as branches. The largest U.S. bank in Malaysia is Citibank N.A. (licensed since 1959) with three branches and assets, as of June 1998, of US$2.8 billion. Bank of America N.T. & S.A. (also licensed since 1959) has a single branch and assets of US$447 million and Chase Manhattan Bank N.A.(licensed 1964) has a single branch and assets of US$194 million. Citibank is the only U.S. bank in Malaysia that offers full retail and corporate services. Bank of America and Chase Manhattan Bank serve primarily corporate clients. U.S. banks currently hold 17 percent of the foreign-controlled commercial bank assets in Malaysia, a percentage that has remained relatively stable for the last 20 years.

The government of Malaysia has not ruled out further liberalization of the financial sector. However, its focus now is to further strengthen prudential and supervisory standards and increase transparency and disclosure in the banking sector. The government of Malaysia believes that all the measures that have and will be put in place to this end will pave the way for further liberalization in the future.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Since no new bank licenses are being awarded outside of the Labuan IOFC, the only means of entry into the Malaysian banking market, other than through a representative office, is through the purchase of an existing institution. Under current Malaysian law, ownership in domestic banks is limited to 10 percent for an individual and 20 percent for others. The maximum permissible aggregate foreign shareholding allowed in a licensed banking institution remains 30 percent. In addition, since 1994, banking rules have required all existing foreign branch banks to incorporate locally, a rule that has increased costs for foreign banks and has resulted in less efficient forms of organization.

U.S. financial institutions also continue to be adversely affected by limits on cross-border movement of banking personnel through immigration regulations. Malaysia has shown flexibility in allowing more than the current limit of two expatriate employees per bank. However, such decisions are made on a case-by-case basis and are frequently subject to time-consuming delays.

U.S. banks, as well as all other foreign banks, also face discriminatory treatment with respect to expansion and operations. All nonresident controlled companies are required to source at least 60 percent of their domestic credit needs with a Malaysian-owned bank. Foreign-owned companies are estimated to comprise about 10 percent of the total market for domestic banking credit. This credit sourcing requirement is scheduled to decline to 50 percent by the year 2000.

Foreign banks, unlike domestic banks, are prohibited from establishing new branches, a regulation that severely constrains the ability of U.S. banks to attract depositors. For regulatory purposes, any off-premises automated teller machine is considered to be a separate branch. These restrictions were not alleviated by the local incorporation of existing branches.

Foreign banks are afforded the same treatment as domestic banks with regard to money market instruments, access to the central bank discount window, and availability of offshore capital via swaps. Nevertheless, while the rules governing Malaysian financial and capital markets are generally transparent, the substantial discretionary power of financial authorities creates a degree of uncertainty when approvals are required. Although, in general, Bank Negara policy is to respond to queries or applications within two weeks, U.S. banking officials report continuing problems in getting important paperwork through Bank Negara channels. They cite unanswered queries and long delays as substantial impediments to doing business in Malaysia.

Malaysia's GATS schedule of commitments with respect to the banking sector binds Malaysia to maintain current policies affecting foreign participation (i.e., the commitments were made on a standstill basis whereby the government of Malaysia gives an undertaking that the current policy affecting foreign participation will not be reversed). Malaysia's WTO financial services commitments provide for a significant easing of current restrictions on expatriate workers increasing from three to five the number of foreign specialists or experts each institution can bring in to manage activities related to trade financing, corporate finance, treasury management, and information technology. The government of Malaysia has shown on occasion considerable flexibility, on a case by case basis, with regard to its bound limits on expatriate workers

Malaysian Banking Sector
Assets and Liabilities, January 1, 1998
(RM billions)

	Commercial Banks	Finance Companies	Merchant Banks
ASSETS			
Cash	3.1	0.2	0.1
Central Bank	47.2	16.1	3.5
Amounts Due	63.7	5.7	6.2
Securities	40.6	12.2	5.0
Loans	276.1	102.5	23.0
Other	50.4	15.7	6.5
TOTAL	481.1	152.4	44.3
LIABILITIES AND CAPITAL			
Amounts Due	79.6	25.5	10.8
Deposits	300.4	106.5	26.4
Other Liabilities	61.3	10.4	2.8
Capital	39.8	10.0	4.3
TOTAL	481.1	152.4	44.3

Source: Bank Negara Malaysia
Note: Deposits do not include negotiable certificates of deposit.
U.S. Embassy estimate for average 1998 RM/US$ exchange rate: 3.8 RM/US$1.

Top Five Commercial Banks in Malaysia
January 1, 1998

Bank	Start-Up Year	Assets (RM millions)	Branches
Malayan Banking Berhad	1960	98,814	249
Bank Bumiputra Berhad	1966	45,970	195
RHB Bank (Formerly DCB Bank)	1966	37,886	140
Public Bank Berhad	1966	30,095	173
Bank of Commerce Berhad	1973	19,535	50

U.S. Embassy estimate for average 1998 RM/US$ exchange rate: 4.0 RM/$.
Source: Bank Negara Malaysia

Financial Sector Assets, Loans and Deposits
Held by Finance Companies, Merchant Banks and Islamic Banks
(as of December 31, 1997)

	TOTAL ASSETS		DEPOSITS		LOANS	
	RM billions	% of total	RM billions	% of total	RM billions	% of total
Commercial Banks*	450.1	72.3	292.9	69.2	299.2	71.3
Finance Companies	134.3	21.6	105.3	24.9	98.2	23.3
Merchant Banks	38.0	6.1	25.0	5.9	22.5	5.4
Banking System	622.4	100.0	423.2	100.0	419.9	100.0
Islamic Bank	5.1		3.5		3.2	

*Excludes the Islamic Bank
Source: Bank Negara Malaysia

Bank Profitability, Capitalization & Asset Quality
(Percentages)

	December 1994		June 1998	
	Foreign-owned Banks	Malaysian Controlled Banks	Foreign-owned Banks	Malaysian Controlled Banks
Non-performing Loans	6.1	15.4	3.5	7.5
Risk-weighted Capital Ratio	18.2	10.3	13.0	10.6
Return on Assets	2.2	1.2	n/a	n/a

Source: Bank Negara Malaysia