Asia-Pacific Research and Training Network on Trade
Working Paper Series, No. 40, July 2007

Services Trade in Developing Asia:

A case study of the Banking and Insurance Sector in Malaysia

By

Muthi Samudram*

*Multhi Samudram is Associate Professor at Monash University, Malaysia. The views presented in this paper are those of author and do not necessarily reflect the views of Monash University, ARTNeT members, partners and the United Nations. This study was conducted as part of the Asia-Pacific Research and Training Network on Trade (ARTNeT) initiative, aimed at building regional trade policy and facilitation research capacity in developing countries. This work was carried out with the aid of a grant from the IDRC. The technical support of the United Nations Economic and Social Commission for Asia and the Pacific is gratefully acknowledged. Any remaining errors are the responsibility of the author (email: muthi.samudram@buseco.monash.edu.my).

Table of contents

Executive Summary

This study reviews the development of the banking and insurance sectors in Malaysia since the 1980s, with a particular attention to the effects and sequencing of the various reforms as well as the impact of services trade liberalization and related commitments.

Over the 31 years since independence in 1957, the Malaysian economy transformed itself from an agriculture based, to a manufacturing one. This was the result of maintaining an open and liberal trading regime with responsible economic policies to meet the challenges of internal and external imbalances. Malaysia achieved rapid economic growth largely due to the implementation of market oriented policies and reforms within the context of several 5 year-plans for the development of the economy.

Malaysia introduced a program to promote industrialization in order to insulate the economy from over-dependence on primary commodities. To promote ancillary industries, Malaysia diversified into heavy industries during early 80s. The First Industrial Master Plan (1986-95) was introduced to develop a broad based manufacturing sector with emphasis on export led industrialization. The role of government in the economy prior to the introduction of the First IMP led to heavy budget deficits. In that IMP the private sector was given incentives to more actively participate in the economy. There was significant increase in private investment due to liberalization and deregulation.

With the shift in policy in the 80s, much of the financing was intermediated through banks. The financial system was strengthened after the recession of the 80s and the Asian financial crisis of 1997/98. The central bank was empowered through the Banking and Financial Institutions Act 1989 (BAFIA) to modernise and streamline laws relating to banking and other financial institutions under one supervisory and regulatory legislative regime. This led to a healthy growth of the economy with reduction in NPLs (non-performing loans) which were as high as 8.8% of total loans in 1990 to 1.9% in 1996. Bad debt provisions and interest-in-suspense declined, and banks have enjoyed a period of record profits.

It was also during this period that prudential measures were introduced to liberalize the commercial banking sector. In 1991, the base lending rate was freed from administrative control. Other reforms included investment by the commercial banks in equity and private debt securities, streamlining the classification of NPLs, and provisioning for bad and doubtful debts and guidelines for internal auditors.

One of the major policy measures introduced during the period was the two tier banking system for the commercial banks with the objective of developing highly capitalized and strong institutions. Although this measure was dropped in 1999, it set in motion the process of consolidation among the commercial banks. Policies were in place to consolidate the banking system into highly capitalized commercial banks (including finance companies) and investment banks (including merchant banks, discount houses and stock broking firms)

Malaysia also introduced Islamic banking through the enactment of the Islamic Banking Act of 1983. There are 6 Islamic Banks which offer the full range of Islamic banking products. Even the conventional banking system was authorized to offer similar products

Malaysia remains committed to further liberalization of the financial sector through successive rounds of negotiations as provided under GATS. Under GATS, Malaysia has made substantial commitments to progressively liberalize its financial system.. Among the commitment made were that foreign participation in the equity of domestic banks is limited to 30%, while equity in the investment banks can rise up to 49%. Foreign banks that were operating in Malaysia prior to BAFIA 1989 can hold 100% equity if they were incorporated as domestic entities. There are restrictions on other modes of supply of services in the banking industry.

A number of measures were implemented to enhance the competitiveness of the banking system. The BLR base lending rate) was freed from administrative control. Each financial institution was allowed to set its own BLR based on its own cost structure. There were guidelines issued regularly on banks' investment in equity and bond markets. Other guidelines focused on improvements in corporate governance. Prudential guidelines governing risk concentration, asset values, risk management, disclosure and accounting standards were constantly reviewed to ensure that they were consistent with international standards.

With the conclusion of the Uruguay round in December 1993, and with Malaysia's commitments under GATS, it was evident that the domestic banking sector has to be progressively liberalized to compete in the international arena. Therefore the strategy of consolidation of the banking system began earnestly by introducing a two tier system until BAFIA was enacted in 1989.

The assessing of the impact of the liberalization of trade in services on the domestic economy - in particular the banking system - conducted in this study suggests two way causality between trade liberalization (defined as openness of the economy) and the deepening of the financial system (defined as change in domestic credit) during the period of 1982 - 2005. This period was associated with increased dominance of the manufacturing sector in the economy. Over the longer period of 1970 to 2005, the causality seems to run from trade liberalization to financial deepening. Overall, empirical evidence shows that greater liberalization of services trade has significant effects on financial deepening and economic growth. The estimates suggest that when we consolidate the banking system, we should also liberalize the trading environment to maximize the strengthening of the banking system.

I: Introduction

Since independence in 1957, Malaysian economy was sustained at a high rate of growth up to 1980. But the pace of growth slowed to an average rate of 6% during 1981-90 as a result of global recession which began in the latter part of 1980. Malaysia is a trade-oriented economy and during the first two decades after independence, the economy was based largely on agriculture. The agricultural sector contributed about 40% of real GDP, provided two-thirds of the total employment, and contributed much of the export earnings. By 1987, the manufacturing sector surpassed agriculture as the premier sector in the economy (Table 2).

The first priority of the central bank (Bank Negara Malaysia- BNM) in the early 60s was to create the basic infrastructure and develop the domestic banks to complement the already strong foreign banking presence in the economy. In the 70s, the central bank introduced other financial intermediaries, including merchant banks and development finance institutions to provide other services that were not provided by the commercial banks. New legislation provided more powers to BNM to supervise all banking institutions. The Finance Companies Act 1969 was enacted to bring the finance companies under the supervision of BNM. In addition, the Banking Ordinance 1958 was amended and replace by the Banking act of 1973, which provided BNM with regulatory powers over both the commercial and merchant banks.

The later part of the 1980s was a period of prudential re-regulation and significant structural change in the banking system. One of the most significant weaknesses highlighted during the crisis of 1980s, was the absence of a comprehensive legislative framework governing the deposit taking institutions in the financial system. The enactment of BAFIA in 1989 widened the supervisory and regulatory powers vested in BNM.

In 1990s, strong economic growth created different challenges to BNM. It became necessary to create a core of strong banking institutions which are highly capitalized and well managed to meet the challenges of liberalization and development of the financial sector.

1.1 Definition of the Sector

According to definitions provided in the Annex on Financial Services (the Annex) of the GATS(the General Agreement on Trade in Services), " a financial service is any service of a financial nature offered by a financial service supplier of a Member." The term "financial service supplier" does not include a public entity that provides services in the exercise of government authority.

Financial services include the following activities:
(a) Insurance and Insurances-related services
This covers (i) direct insurance (including co-insurance), both life and non-life; (ii) reinsurance and retrocession: (ii) insurance intermediation, such as brokerage and agency; and (iv) services auxiliary to insurance, such as consultancy, actuarial, risk assessment, and claim settlement services.

(b) Banking and Other Financial services (excluding insurance)

This covers deposit taking; lending; leasing; payment and monetary transmission; guarantees and commitments; financial trading (money market instruments, foreign exchange, derivative products, swaps, forward rate agreements, transferable securities, and other negotiable instruments); money brokering; asset management; settlement and clearing services; provision of financial information; and advisory services.

1.2 Research Questions and Scope of the Study

The most important research questions to be addressed by the study will be as follows:

(i) How have banking and insurance sector liberalization policies been pursued in Malaysia? Are the reforms accompanied by a stronger regulatory system, and more efficiency in the delivery of services?.
(ii) Has the banking and insurance sector liberalization enhanced competition and efficiency to promote domestic business and augment international trade? Are there any adverse employment effects as a result of foreign participation in both banking and insurance sectors?
(iii) Has the expansion of banking and insurance increased access to credit by all sectors of the economy?

This study critically assesses the liberalization polices pursued by Malaysia in banking and insurance. It examines the strengths and weaknesses of these sectors in terms of efficiency and competitiveness, and explores the possibility of enhancing trade arrangements with other countries.

1.3 Methodology and Data Sources

It is difficult to estimate the impact of liberalization in services trade on the domestic economy. Nevertheless, there are studies which have derived competition indices and used them to estimate the impact of liberalizing the services sector of the economy. This paper analyses the impact of liberalization on financial deepening in Malaysia, Nepal and Bangladesh. As the study focuses on liberalization of banking and insurance, the study attempts to evaluate the impact of liberation on the development of the financial sector. The estimates are given in the Appendix 1. The data and its sources are in Appendix 2.

1.4 Structure of the Report

The report is structured as follows:

Section 2: A brief review of the Malaysian economy.

Section 3: Policy reforms and changes in the Banking system

Section3.1.1 Two-Tier Regulatory System

Section3.1.2 Securitization of assets

Section3.1.3 Credit, financial derivatives and risk management

Section3.1.4 Sectoral loan exposure

Section3.1.5 Strengthening the supervisory framework

Section3.1.6 Merger program for the banking sector

Section3.1.7 Corporate Governance