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BANKING SECTOR REFORMS AND BANK CONSOLIDATION: THE MALAYSIAN EXPERIENCE

By

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I. Introduction

Banking sector reform and consolidation, n particular, has been an on–going phenomenon. It has, however, recently intensified due to forces of globalization, which are guiding the integration of the world's financial markets and economies. In the United States of America alone, the number of banks declined steadily due to consolidation from about 14,000 in the mid-80s to 12,212 in 1990 and further to 8,252 a decade later. The first wave of the mergers/acquisitions in the 1980s was precipitated by attempts by stronger banks to acquire weaker and undercapitalized ones, while the second resulted from a response to a legislation that liberalized interstate branching. Banking sector reforms, incorporating consolidation, have also been implemented in Europe, Asia, Latin America and Africa at different times for different reasons.

The Malaysian banking sector reform, which resulted from the Asian financial crises of the 1990s, is the subject of this study. The purpose of this paper therefore, is to share the Malaysian experience in light of the on-going banking sector reform and consolidation in Nigeria. The rest of the paper is divided into three sections. Conceptual issues in banking sector reform and bank consolidation is covered in Section II. The Malaysian experience in banking sector reforms and bank consolidation is discussed in Section III, while lessons for Nigeria and concluding remarks are presented in Section IV.

II. Conceptual Issues in Banking Sector Reform and Bank Consolidation

Banking sector reforms and its sub-component, bank consolidation, have resulted from deliberate policy response to correct perceived or impending banking sector crises and subsequent failures. A banking crisis can be triggered by the preponderance of weak banks characterized by persistent illiquidity, insolvency, under-capitalisation, high level of non-performing loans and weak corporate governance, among others, as observed in the Nigerian case. Similarly, highly open economies, especially, those with weak financial infrastructure, can be very vulnerable to banking crises emanating from other jurisdictions through the contagion effect as experienced in Asia (Thailand, Indonesia, South Korea and Malaysia) and South

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America (Brazil) in the 1990s.

Banking crisis usually starts with bank's inability to meet its financial obligations to its stakeholders. This, in most cases, precipitates runs on banks as they and their customers engage in massive credit recalls and withdrawals. Quite often, this situation necessitates central bank liquidity support. In some acute cases, governments, through the collaboration of international finance institutions such as the International Monetary Fund (IMF), intervene to stem the crisis from widening and deepening. The intervention mechanisms may occur in the form of consolidation (mergers and acquisitions), recapitalisation, use of bridge banks, establishment of asset management companies to assume control and recovery of bank assets, and outright liquidation of non-salvageable banks.

Bank consolidation, which is at the core of most banking system reform programmes, occurs, some of the time, independent of any banking crisis. Irrespective of the cause, however, bank consolidation is implemented to strengthen the banking system, embrace globalization, improve healthy competition, exploit economies of scale, adopt advanced technologies, raise efficiency and improve profitability. Ultimately, the goal is to strengthen the intermediation role of banks and to ensure that they are able to perform their developmental role of enhancing economic growth, which subsequently leads to improved overall economic performance and societal welfare.

Despite the above expected benefits, banking sector reforms have their associated costs. Apart from job losses which could have, nevertheless, occurred if remedial measures were not taken, gross country cost estimates to national economies resulting from banking sector reforms are enormous, ranging from a low 12 per cent of GDP for Malaysia, 15 per cent of GDP for Korea to 45 per cent of GDP for Indonesia. Merrill Lynch independently estimated the recapitalization costs component as per cent of GDP for commercial banks to be as high as 42 for Indonesia, 10 for Korea, 11 for Malaysia and 26 for Thailand. In spite of the huge sums spent on banking sector reforms, the benefits always far outweigh the costs in the medium to long term.

III. The Malaysian Experience

The Malaysian financial crisis which occurred in the 1990s and the ensuing banking sector reforms have generated tremendous public/ research interest because of the extent of the resilience of the financial system and the economy as a whole in withstanding the impact of the Asian financial crisis that ravaged its neighbours. One account of the crisis by the IMF indicates that the Asian crisis started on March 3, 1997 when Thailand announced that it was facing financial difficulties as a result of massive capital flight. The country then introduced some remedial measures, which did not stop the crisis from quickly spreading to other Asian countries. To ward off the contagion effects, Malaysia initiated policy measures in April and July of 1997 to curtail banks exposure to the real estate sub-sector and capital markets, and aggressively defended the national currency (ringgit) exchange rate, which it eventually floated. This was followed by a series of other policy interventions in 1998 and 1999 which included instituting a blanket guarantee for all bank depositors, a programme of bank recapitalization, establishment of an asset management company and bank restructuring and recapitalization agency as well as the introduction of capital controls.

Specifically, the key elements of the Malaysian banking sector reform centered on beefing up prudential regulations and the establishment of Danamodal Nasional Berhad and Danaharta Nasional Berhad to consolidate, recapitalize and rationalize finance and banking institutions by applying least cost solution principles to minimize the injection of public funds. Accordingly, between 1999 and 2001, 54 banking institutions were consolidated into 10 banking groups. By the first quarter of 1999, Malaysia had spent 5 per cent of its GDP or $4.0 billion to purchase non-performing loans (3 per cent) and recapitalize banks (2 per cent) compared to 25 per cent of GDP or $34 billion in Thailand made up of liquidity support (15 per cent), recapitalization (8 per cent) and interest costs (2 per cent); and 50 per cent of GDP or $US85 billion in the Indonesian case, broken down into liquidity support (12 per cent), recapitalization, including deposit guarantee fund (23 per cent), purchase of non-performing loan or capital for asset management company (12 per cent) and interest cost (3 per cent). In addition, Korea spent at least 13 per cent of its GDP or $US46 billion to respond to the Asian financial crisis.

A major reason why Malaysia may have better withstood the impact of the crisis and spent less in weathering the problem was attributable to its strong macroeconomic fundamentals at the time. Prior to the Asian crisis in 1997, inflation rate in Malaysia as at end 1996 was 3.5 per cent, compared to 7.9 per cent in Indonesia, 4.9 per cent in Korea, 8.4 per cent in Philippines and 5.9 per cent in Thailand. Furthermore, most of the capital inflows into Malaysia were of longer term nature in the form of foreign direct investment, while the borrowing of foreign currency above certain level was restricted by government. Malaysia, also had only one large government-owned commercial bank compared to the other countries where their banking sector was highly dominated by government ownership. Besides, Malaysia's well developed capital market was reported to have limited banking sector financing exposure.

Buoyed by its strong economic fundamentals and guided by a well laid out Financial Sector Master Plan implemented since 2001, Malaysia has recovered from the negative impacts of the Asian crisis. Real GDP growth rate which contracted to -7.4 per cent in 1998 from 7.3 per cent in 1997, grew by 5.6, 8.9, 0.3, 4.1, 5.3 and 7.0 per cent between 1999 and 2004 and is projected to grow by 6 per cent in 2005. During the same period, inflation was subdued. Rising from 2.7 per cent in 1986 to 5.3 in 1997 inflation declined to 2.8, 1.5, 1.4, 1.8, 1.1, 1.4, per cent between 1998 and 2004 with 2.5 per cent estimated for 2005. Similarly, net non-performing loans, based on a 6-month classification which peaked at 7.5 per cent in 2002 from 6.4 per cent in 1999, declined steadily to 5.4 per cent in April 2005, while other prudential ratios remained strong during those periods.

IV. Lessons for Nigeria and Concluding Remarks

While the Nigerian banking sector reform was a proactive response to the weakening of the banking system, the Malaysian experience, resulted from the contagion effect from the Asian financial crisis. In both cases, the authorities identified the need to take decisive policy actions to revamp their banking systems. The 13-point reform agenda adopted by Nigeria on 6th July, 2004 as part of the broader National Economic Empowerment and Development Strategy (NEEDS) programme was intended to stem the slide in the Nigerian banking system and to refocus it to play its intermediation role more effectively. Two very important components of the reform agenda were the requirements for banks to increase their shareholders' funds to a minimum of ₦25 billion and to consolidate their operations through mergers and acquisition before the end of 2005.

To fast-track the implementation of the programme, the CBN issued a number of circulars to guide stakeholders, granted amnesty to banks for past misreporting of their financial positions and liaised with the IMF for technical support. It also granted the following forbearance on April 11, 2005 to a group of weak banks to further enhance the banking sector reform:

- a write-off of 80 per cent of the long outstanding debts owed to the CBN by weak banks under strict pre-conditions
- conversion of the balance of 20 per cent of the debt to a long term loan of 7 years at 3 per cent per annum including two years moratorium
- a further forbearance of 20 per cent of the debt if the new owners of the banks meet the new ₦25 billion capital base.

While there has been measurable progress towards the realization of the goals of the reform programme, of which its appraisal is outside the scope of this paper, there are lessons that can be learnt from the Malaysian experience. An important lesson discernable from the Malaysian experience is the need to build an economy based on strong economic and institutional fundamentals. This is a key precondition for economies to absorb and withstand external shocks with minimum cost, especially in an integrated global economy where advances in information and communication technology help to transmit disturbances very fast and widely. Similarly, the overall policy package implemented to restore financial and banking system stability after the out-break of a crisis is also complementary to ensuring a favourable outcome. The prompt creation of a separate restructuring agency (Danamodal Nasional Berhad) and Danaharta Nasional Berhad (an asset management company) to handle the Malaysian crisis immensely aided the implementation and success of the banking sector reform and restructuring programme. It is hoped that the CBN would hasten efforts in the establishment of an AMC as proposed in the reform agenda.

In addition, the design of a Financial Sector Master Plan provided the Malaysian authorities with a long-term roadmap for the revival of the financial sector. In recognition of its peculiar operating environment, Malaysia developed a viable Islamic financial services industry which integrated seamlessly with the traditional banking system. In this regard, Nigeria needs to understudy the Malaysian experience in operating an Islamic financial system in order to imbibe areas of relevance into the Nigerian system.

One policy introduced by Malaysia during the crisis which was criticized by a segment of the international financial community at that time was limited capital controls. The policy was believed to have contributed to limiting the damages of the financial crisis. In retrospect, such bold policies should be implemented on a case by case basis if well thought out and in the national interest.

In conclusion, the paper reviewed the response of the Malaysian authorities to the Asian financial crisis and identified the strength of the Malaysian financial and economic system as well as robust policy response as key factors which enabled the country to minimize the negative impact of the Asian financial crisis of the late 1990s. Thus, the Malaysian experience in responding to financial crisis and implementing banking sector reform and bank consolidation provides an enduring legacy for Nigeria to emulate.

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