

**REGULATION OF BANKS
AND OTHER
DEPOSITORY INSTITUTIONS
IN MALAYSIA**

A STUDY IN MONETARY, PRUDENTIAL
AND OTHER CONTROLS

LEE HOCK LOCK

Butterworths

REGULATION OF BANKS AND OTHER DEPOSITORY INSTITUTIONS IN MALAYSIA

**A Study in Monetary, Prudential
and Other Controls**

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PREFACE

After I wrote *Central Banking in Malaysia* in 1986, I thought I had said enough about the Malaysian financial system and should then move on to something else. But this was not to be.

Around this time, the Malaysian financial system was experiencing the extraordinary circumstances of having several banks and finance companies in deep distress – a situation that never happened before for institutions that are under the supervision and protective wings of the Central Bank of Malaysia. At about the same time, at the fringe of these major depository institutions, another upheaval was occurring where many of the deposit-taking co-operatives faced imminent collapse. These events contained the seeds of destabilization for the country's financial system. In the face of both these developments, attention naturally came to be focussed on the regulatory system centreing on the Central Bank. It was found wanting in several aspects. Piecemeal patching up of the system took place at a dizzy pace in an heroic attempt to restore confidence and maintain stability. The authorities finally decided to make a thorough review of the system with a view to its reconstruction. Out of this arose an omnibus piece of legislation of 157 pages, 131 sections and four schedules – the Banking and Financial Institutions Act 1989. It covers the commercial banks, finance companies and merchant banks, among other things. The other major legal props of the regulatory framework remained in place, namely, the Central Bank of Malaysia Ordinance 1958 and all its amendments and the Islamic Banking Act 1983. The former was further strengthened.

As I watched these developments, I thought it would be useful for someone to sit down and carefully examine this phase in reregulation of the financial sector. Three questions came uppermost in my mind then. First, what was the existing regulatory framework actually like with its three decades of existence and development since 1959? Second, what have been its shortcomings? Third, what does the reconstructed regulatory framework seek to do and how good is it?

Financial regulation is of course not just concerned with prudential objectives, that is, with matters that will help ensure safe and sound financial institutions and the financial system. Another important objective is monetary control, which is necessitated by the special characteristics of banks and other depository institutions. In Malaysia, regulatory measures towards this end have developed and expanded over the past three decades. In the light of the continuously challenging and changing financial environment, there is need to closely examine these measures for their content and efficacy. There are indications around that not enough has been done in terms of published materials to foster a wider and deeper

understanding of the regulatory measures for monetary control and their strengths and weaknesses or a fuller appreciation of their necessity.

Apart from these two major aims in financial regulation, I have further observed that the regulatory system in Malaysia has been employed to help achieve other important national objectives. How well have these fitted in with the two fundamental aims of financial regulation, namely, prudential and monetary control?

It was in response to these questions and concerns that I was initially moved to write this book. But there is one other compelling reason. The banking and depository institutions in this country are possibly the most highly regulated among business enterprises on account of their special characteristics and features. Regulations affecting them are not just matters of interest to the regulatory authorities and the financial institutions concerned. They are of as much interest to the rest of the economy as represented by the depositors of these institutions, their other creditors, their borrowers and the users of their other facilities and services. Yet the irony is that discussion and debate on the subject are confined to very small circles and published materials on it hardly exist. There are some obvious reasons for this. Many aspects of financial regulation are of course highly technical in nature. Furthermore, in a rapidly evolving financial environment such as in Malaysia, frequent and numerous amendments to the regulatory framework must be inevitable. By the end of about three decades of such developments, only few would or could keep track of all of them. On the other hand, the situation is not helped by the attitude and actions of the regulatory authorities. They have always maintained a tradition of saying little about the regulatory framework and any new regulatory measures, and even publishing less about them.

I believe this situation should be changed. There can and should be made available a comprehensive, convenient, well-discussed and easily understood work of reference on the regulatory system governing the Malaysian banks and other depository institutions. Everyone concerned with banks and other depository institutions is entitled to at least that. I hope this book will go some way to fill this gap.

In writing this book and preparing for its publication, I owe a debt of gratitude to many.

First, I wish to thank Professor Mokhtar Tamin and Professor Fong Chan Onn, the former Deans of the Faculty of Economics and Administration, University of Malaya, and Professor Stephen Chee, the current Dean, for their understanding and kindness in allowing me to be free of many non-teaching faculty responsibilities and activities. This has enabled me to give considerably more time and attention to this book.

I am grateful to the University of Malaya for the support provided me: first, for the grant of sabbatical leave of nine months during 1988/89 to work on, among other things, this book; second, for financial assistance to prepare the manuscript of this book for publication.

Several persons have helped me to acquire materials needed for writing this book. My thanks go to many of my ex-colleagues, friends and former students in the Central Bank of Malaysia for their assistance, but espe-

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Chapter 1

REGULATION OF BANKS AND OTHER DEPOSITORY INSTITUTIONS: AN OVERVIEW

SCOPE AND AIMS OF THIS BOOK

Among business enterprises, banks and other depository institutions are possibly the most heavily regulated. There are very compelling reasons for this, as will be discussed shortly. Often, the sheer mass and variety of the regulations which cover these institutions are sufficiently daunting to any attempt to make some sense out of them or even merely to keep track of them. This situation is not helped by the general tendency of these regulations to grow and widen, despite some attempts at deregulation.

Regulations, as understood in this book, refer to all forms of intervention by the authorities in the nature and activities of banks and other depository institutions. They seek to bring about changes or to limit, forbid or compel certain kinds of behaviour on the part of the regulated institutions in order to achieve certain goals. They constitute by far the most important group of regulations among all types of regulations.

In Malaysia, the emergence of a formal and comprehensive regulatory system for banks and other depository institutions can be traced to 1959, the year its Central Bank was established. With the setting up of the Bank, a regulatory system centring on the Bank and operated and fostered by it was put in place to control commercial banks, initially in Peninsular Malaysia and later in Sabah and Sarawak when these states became a part of Malaysia. From 1969, the regulatory system branched out to cover another group of depository institutions, the finance companies. Merchant banks came on the scene in the early 1970s. The Central Bank soon placed these under some measure of control and more formally from 1979. The regulatory system developed another branch of control from 1983 to cater for Islamic banks as they emerged. From the mid-1980s, some form of regulation was developed for the fringe depository institutions following widespread illiquidity and insolvency among the deposit-taking co-operatives.

This book attempts a detailed study of the Central Bank-based regulatory system in Malaysia as it applies to the above-mentioned banks and other depository institutions. More specifically, the study will examine all the important regulations individually with respect to each category of these institutions, their development over the years, the reasons underlying their introduction, implementation and change, their relevance and appropriateness and, their effectiveness.

The major source of regulations under the Central Bank-based regulatory system in Malaysia comprises the banking and financial laws and their amendments. To serve the above-mentioned aims of the book, all these laws and their amendments that have been enacted with and following the establishment of the Central Bank are carefully examined. The principal laws include the following:

- (i) Central Bank of Malaysia Ordinance 1958;
- (ii) Banking Ordinance 1958;
- (iii) Finance Companies Act 1969;
- (iv) Banking Act 1973;
- (v) Islamic Banking Act 1983;
- (vi) Essential (Protection of Depositors) Regulations 1986; and
- (vii) Banking and Financial Institutions Act 1989.

The amendments to many of these laws have been frequent and numerous. All the major amendments have been studied. Other sources of regulations have also been examined in this book. One of these comprises the policies of the Central Bank made from time to time under the laws and their amendments. Another source comprises the guidelines and directives issued by the Central Bank to banks and other depository institutions.

The Central Bank-based regulatory system in Malaysia is of course more extensive than as will be discussed in this book. It also covers discount houses and the representative offices of foreign banks, both of which are outside the purview of this study. Recently, a development occurred which further extended the sphere of its influence. In mid-1990, the Malaysian government introduced a number of laws to make Labuan the country's international offshore financial centre. Among these laws is the Offshore Banking Act 1990 which is intended to regulate and control the offshore banks that will eventually be established in this territory. Under the Act, the Central Bank has also been given a principal regulatory role. As offshore banks are a class by themselves as banking and depository institutions, they deserve separate study and hence have not been included in this book.

This book should be of interest to several groups. For managers and officers of banks and other depository institutions, it should offer an easily understood and accessible source of reference on the numerous regulations affecting their institutions. For those concerned with public policy, the study should throw light on the possibilities and limitations of monetary policy in Malaysia and the degree of safety and soundness of banks and other depository institutions. Members of the public and, particularly, the users of these institutions as depositors or borrowers, should find the latter of considerable importance. For students and researchers of banking and financial institutions, there is much in the study that they should find absorbing and useful, particularly in the development of the regulatory framework and the reasons underlying it. Finally, Central Bankers and supervisory authorities will find much of the book of interest and relevance to their vocations.

WHY REGULATE BANKS AND OTHER DEPOSITORY INSTITUTIONS?

(a) Special Properties of these Institutions

Possibly the most fundamental question that ought to be settled first and foremost in any study of regulation of banks and other depository institutions is: why should these institutions be regulated and, furthermore, be regulated so heavily? There are many good reasons. The more important reasons arise from the fact that banks and other depository institutions possess certain special properties which make them different from other business enterprises. A brief examination of these special properties should serve as a useful starting point.

For the purpose at hand, four of the special properties of banks and other depository institutions may be focussed upon. The first of these concerns only the commercial banks. They constitute a very important component of a country's payments system. The invention of money in human affairs is considered a requisite step for enabling a primitive economy based on barter to become a modern economy based on specialization with all its benefits of expanding production and higher efficiency. However, money, even when it reached the stage of evolution of currency notes and coin, could assist the transformation to a modern economy only to a certain extent. Currency notes and coin are generally convenient only for small payments. Problems of security and cost soon arose in respect of larger transactions and for payments involving long distances. From about the end of the 19th century, the writing of cheques on demand deposits with commercial banks for purposes of payment emerged to overcome these problems. Commercial banks thus became the source for this new medium of payment. Additional developments of the payments system occurred in the form of bills like bankers acceptances, facilities for the transfer of funds by wire and, more recently, the increasing use of electronic communications system for fund transfers. These also centred on commercial banks. The point to note here is that the banking system has entrenched itself as a very important component of the country's payments system. This has contributed to a lowering of the transactions cost of economic exchange and to an expansion in its volume. In other words, the banking system stands as a very vital part of any modern economy.

The second of the special properties of banks and other depository institutions is no less important. It refers to the unique powers of commercial banks to create and to extinguish money. A change in the money supply will affect the level of economic activity. These matters will be discussed more fully in the following chapter. But suffice it to say here that the ability of banks to increase or decrease the money supply will in turn depend on changes in the cash reserves they have in hand. In other words, each bank can create demand deposits by a multiple amount of the cash reserves that may have been added to its holdings or it can reduce such of its deposits by a multiple amount of the cash reserves that it may have lost. Demand deposits constitute an important part of the money

supply. Viewed from this standpoint, commercial banks are obviously very powerful institutions. Other depository institutions also have an important influence on the level of economic activity. These emanate from their credit operations.

Thirdly, banks and other depository institutions constitute the backbone of a country's system of financial intermediaries. As financial intermediaries, they provide two vital financial services. First, they are mobilizers of savings. They attract deposits from the public by providing in exchange financial assets which are liquid, safe, and attractive in terms of returns and convenient in amounts. As custodians of other people's money, a role which originates from serving as depositories for a very large number of depositors, they assume a formidable responsibility, namely, a fiduciary position over these funds. How they bear this responsibility directly determines the level of savings that will pass through the financial system.

The other financial service provided by banks and other depository institutions arises from their role as sources of credit. In lending out the savings mobilized by them, their credit operations have two kinds of impact on economic activity, namely, via the volume of the credit given and via the directions to which the loans are extended.

Fourth, all banks and other depository institutions rest on one very fragile condition for their viability, namely, public confidence in their integrity, liquidity and solvency. In other words, as deposit-takers, these institutions must at all times ensure that their conduct and operations do not in any way undermine this confidence. One important indication of the success of their efforts here is a ready ability on the part of such institutions to meet at any time all demands for withdrawals of funds by their depositors. A depository institution that gives grounds for the forfeit of this public confidence will unavoidably encounter runs with disastrous consequences for its credibility and viability as a financial intermediary. Under such circumstances, heavy losses of depositors' funds will be experienced by a substantial number of the institution's depositors. However, the possible damages may not end here. The loss of depositor confidence in one institution and the losses incurred by a large number of its depositors of their funds can raise doubts and anxieties among depositors in the other depository institutions generally, even though there are no valid reasons for them. This may lead to widespread panic and the eventual collapse of the whole system of depository institutions. In short, the whole system of depository institutions is as fragile as the individual institutions that comprise it. Attention to the problems of individual institutions in the system is necessary not only for its own sake but also for the sake of the viability of the whole system.

As elsewhere, Malaysian banks and other depository institutions also bear these four special properties.

(b) Rationale for Regulation

These four special properties of banks and other depository institutions constitute important areas of interest for public policy. As a consequence,

regulations take root, each representing an attempt by the authorities to intervene for a particular objective or reason. The underlying reasons for these regulations are often many and of wide variety and hence, may appear bewildering at first sight. On closer examination, however, most of them may be seen to fall easily into either of two categories, namely, regulations for monetary control and regulations for prudential control. However, in developing countries especially, including Malaysia, there are a few other regulations which are effected for reasons other than for monetary control or prudential control. A third category, 'other control', is thus proposed to take care of these.

Regulations for monetary control represent a strong assertion by the government, which has long been widely accepted, that the management of the monetary sector must remain its prerogative. This sector is deemed too important to be left unregulated in private hands. Control over the monetary sector means control over areas such as the growth and level of money supply, the amount and direction of credit that can and should be dispensed by banks and other financial institutions, the cost of credit, the supply of savings and the level of capital formation. With such control, the government is then in a position to influence the economy's price level, output, employment, growth and balance of payments.

The earlier discussion on the special properties of banks and other depository institutions should immediately indicate why these institutions attract so many regulations with monetary control as the overall objective. First, commercial banks are responsible for an important component of the total money supply in the form of demand deposits, as these deposits arise from the banks' credit-creation activities.¹ The government, through its Central Bank, already controls the currency component of money supply. As demand deposits with commercial banks constitute the other major component of money supply, it becomes a matter of necessity that this component should also be similarly controlled, if effective control of total money supply is to be achieved. Thus, the regulation of the credit-creating activities of commercial banks has long become one of the traditional functions of Central Banks all over the world. The control of money supply is of course not effected for its own sake but to regulate prices and the level of economic activity in an economy. Regulations are extended to cover also the credit operations of the other depository institutions, for such likewise affect economic activity. The Malaysian Central Bank has similarly extended its regulations to these depository institutions for such a purpose.

Second, as financial intermediaries, banks and other depository institutions attract a variety of regulations. There are regulations to ensure that these institutions play an effective role as savings depositories. These regulations include controls over the rates of interest payable, the development of attractive and safe financial assets, etc. Other regulations are directed to govern the level and cost of credit in relation to needs and the direction of credit to achieve economic or social goals.

1 This will be explained in the following chapter.

In Malaysia, as elsewhere, banks and other depository institutions are possibly the most heavily regulated of business enterprises. There are compelling reasons for this: these institutions form an important part of the nation's payments system; their operations affect the level of money supply and the level of economic activity; they constitute the backbone of the country's system of financial intermediaries; and, their viability rests on one very fragile foundation, namely, public confidence in their integrity, liquidity and solvency. With the establishment of the Central Bank of Malaysia in 1959, an increasingly intricate and expanding system of regulations has emerged to govern these institutions.

These regulations cover matters of immense importance to many. Yet the irony of the situation is that discussion and debate on these financial regulations have been very limited and published materials on them hardly exist. This book is an attempt to fill this important gap. It is a comprehensive and up-to-date survey and evaluation of the introduction, growth and development of all the major regulations affecting commercial banks, finance companies, merchant banks, Islamic banks and the fringe depository institutions in Malaysia since 1959. Financial regulation is a subject that is widely couched in technical and legal language but an attractive feature of this book is that it is discussed in a clear and readily understandable manner.

The book should serve as a useful and convenient work of reference for directors and those in senior management of banks and other depository institutions; Central Bankers, supervisory authorities and those concerned with monetary policy and the safety and soundness of financial institutions; users of banks and other depository institutions, especially as depositors and borrowers; and, researchers and students in the field of financial regulation.

This book also makes an appropriate companion volume to the author's earlier book, *Central Banking in Malaysia*.
