

**STUDENT PRACTICE 1**

1. What does the financial system comprise? (para 2)
2. What does the intermediate function involve? (para 2)

**3. STRUCTURE OF THE MALAYSIAN FINANCIAL SYSTEM**

The Malaysian financial system is made up of two components, the financial intermediaries and the financial market.

BNM and the banking industry consisting of commercial banks, Islamic banks and investment banks make up the **banking system**. In Malaysia, Islamic and conventional banking systems coexist and operate in parallel.

In addition, non-bank financial intermediaries (NBFIs) complement the banking system in mobilising savings and meeting the requirements of specific sectors. These institutions play an important role in the development of the capital market and in providing social security. The NBFIs comprise:

- a. other financial intermediaries, such as
  - i. Unit trusts,
  - ii. Cooperative societies,
  - iii. Leasing and factoring companies, and
  - iv. Housing credit institutions.

The financial markets in Malaysia comprise:

- a. Money market,
- b. Foreign exchange market,
- c. Equity market,
- d. Derivatives market, and
- e. Bond market.

Details of the assets of the financial system are presented in **Appendix I**.

**3.1 Financial Institutions**

The total assets of the financial system stood at **RM2,475.9** billion as at 31 December 2007<sup>1</sup>. In terms of structure, financial institutions can broadly be divided into two components, i.e., the **banking system** and the **NBFI**. Of the total assets of RM2,475.9 billion, the banking system accounted for about 67% or RM1651.8 billion of the total assets. NBFIs accounted for the balance of RM824.1 billion (33%).

<sup>1</sup> P preliminary

A brief discussion of the individual institutions within the banking system and non-bank financial institutions is given below.

### 3.2 The Banking System

Historically, the banking system has been the largest financial intermediary in terms of total assets. The system comprises the following:

- a. BNM,
- b. commercial banks,
- c. investment banks, and
- d. Islamic banks.

Within the banking system, commercial banks accounted for about 42% of the total assets of the financial system as at end-2007<sup>P</sup>. The various components of the banking system are elaborated below:

#### 3.2.1 BNM

BNM, as the central bank, is at the apex of the banking system. BNM's objectives are to:

- a. promote monetary stability and a sound financial structure;
- b. act as banker and financial adviser to the government;
- c. issue currency and keep reserves to safeguard the value of the country's currency;
- d. promote the reliable, efficient and smooth operation of national payment and settlement systems and to ensure that the national payment and settlement systems policy is directed to the advantage of Malaysia; and
- e. influence the credit situation to the country's advantage.

In meeting these objectives, BNM is guided by the principle that it should act only in the economic interest of the nation and without regard to profit as a primary consideration.

Hence, the functions of BNM are carried out within the context of the broader goals of promoting economic growth, a high level of employment, maintaining price stability and a reasonable balance in the country's international payments position, eradicating poverty and restructuring society.

In particular, BNM ensures that the availability and cost of money and credit in the economy are consonant with national macroeconomic objectives. In this respect, BNM acts as the banker for currency issue, keeper of international reserves and safeguarding the value of the ringgit, banker and financial adviser to the Government, agency responsible for monetary policy and management of the financial system and banker to the banks.

BNM accounted for 17.2% of the total assets in the financial system as at end-2007<sup>P</sup>. As the country's monetary authority, it is responsible for maintaining monetary stability, i.e., the stability of the value of the Ringgit. In addition, BNM conducts its monetary policy by influencing the level of interest rates. BNM is

also responsible for the regulation and supervision of all financial institutions under the Banking and Financial Institutions Act 1989 (BAFIA), with the exception of the Labuan IOFC which comes under the purview of the Labuan Offshore Financial Services Authority (LOFSA). As at May 2008, there were 22 commercial banks (of which 13 are locally incorporated fully foreign-owned), 13 Islamic banks (of which three are foreign-owned), and 14 investment banks. (Please refer to **Appendix II** for details.)

### 3.2.2 Commercial Banks

#### a. Role

Initially, commercial banks in Malaysia were governed by the Banking Act 1973. This was subsequently replaced by the BAFIA in 1989. The BAFIA combined the Banking Act 1973 and the Finance Companies Act 1969 under a single legislation. Following the merger of local banks and finance companies into 10 local banking groups (as at May 2008, there were nine local banking groups), the functions of finance companies, such as hire purchase and leasing activities, have been incorporated into commercial banks. The main functions of commercial banks are as follows:

- i) Mobilise savings through current, savings and fixed deposit accounts and other financial instruments;
- ii) Grant loans and advances
  - in the form of providing various credit facilities to business enterprises and private individuals for working capital, investment and consumption;
- iii) Provide trade financing facilities
  - to assist in promoting cross-border international trade and domestic financing facilities;
- iv) Provide treasury services
  - dealing in government securities and treasury bills and other money market instruments as well as foreign exchange transactions;
- v) Facilitate cross-border payment services
  - providing fund transfers and remittance services within Malaysia and overseas for business as well as personal needs;
- vi) Provide custody services, e.g., safe deposits and share custody;
- vii) Provide wealth management services and sales of investment and insurance products and financial planning services,
- viii) Provide hire-purchase and leasing facilities; and
- ix)** Provide any other such business that BNM, with the approval of the Ministry of Finance, may prescribe from time to time.

## **b. Compliance with BNM Requirements**

As custodians of public moneys, commercial banks are required to comply with the statutory reserve requirement and other requirements as stipulated by BNM. This includes the following:

### **i) Statutory Reserve Requirement**

The SRR is governed by section 37(c) (1) of the Central Bank Ordinance 1958 (CBO). Commercial banks are required to observe the statutory reserve requirement (SRR) expressed in relation to pre-defined eligible liabilities (EL). The EL components basically comprise all types of deposits and interbank borrowings. Commercial banks' capacity to generate loans and advances will depend on the SRR ratio as determined by BNM. Any changes, i.e., either an increase or decrease in the SRR, will affect the excess cash reserves for lending and thus the liquidity situation in the economic system. The SRR deposited with BNM earns no interest.

### **ii) Liquidity Framework**

In order to service customers' financial needs, commercial banks need to maintain sufficient liquidity. In June 1998, BNM introduced a new Liquidity Framework as a more effective way of managing commercial banks' funds. This new framework recognises banks' weaknesses in managing their liquidity and funding requirements. The framework requires banks to make projections on the maturity profile of their liabilities as well as off-balance sheet commitments so as to assess potential future liquidity requirements.

The new framework aims to:

- create awareness among banks of their funding structures and their ability to handle short to medium-term liquidity problems;
- permit more efficient and on-going liquidity measurement as well as management; and
- provide BNM with a better means of assessing the present and future liquidity position of banks.

### **iii) Risk-Weighted Capital Ratio**

The risk-weighted capital ratio (RWCR) was implemented with the aim of rebuilding and strengthening commercial banks' balance sheets through management of capital adequacy positions. All banks are required to adopt a minimum standard of capital adequacy called the Capital Adequacy Ratio (CAR). The CAR is set at a minimum of 8% to prevent banks from going overboard in granting loans. The RWCR requires capital to be provided for both on- and off-balance sheet assets according to a perceived level of counterparty credit risk. The current rule is, the weightage (ranging from 0% to 100%) increases with the risk level of the bank's assets. When the principles of Basel II Accord are implemented, the weightage can range from 0% to 150%.