

Malaysia banking system consisted three mainly finance essay

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Malaysia banking system consisted three mainly types of institution, which are commercial banks, finance companies, and merchant banks. Commercial banks included domestic and foreign. Domestic commercial banks had the largest share in the market. The largest banks controlled by government is Maybank, second largest is Bumiputera and the three smallest banks were controlled by public entities. Foreign commercial banks covering banking sector more than 90% in 1957, when Malaysia became independent in 1997 by controlled banking assets had been increase to 16. 7% only. Government deliberately develops the domestic financial sector to a decline of progressive in foreign banks. In addition, government prohibits foreign banks to open new branches since 1971 and the last license to a foreign institution was granted in 1973. Most of the small financial company has provided installments credit to consumers and small businesses, with funding provided from time and savings deposits. Merchant banks were a minor presence in Malaysia banking system. The stability of financial system is significantly important when country's economic facing crisis. The financial crisis not only phenomenon in recent decades, thus it is important to concern about it. Based on researchers Racickas and Vasiliauskaite (2010), there are many types of financial crisis are group into certain types, such as macroeconomic policy-induced crisis, financial panic caused crisis, collapse of financial bubble, moral crisis, forced termination, " Wider" economic crisis, debt crisis, international financial crisis, banking crisis and balance of payment crisis, currency crisis and systematic financial crisis. Thus, banking crisis is a part of financial crisis. As shown in research of Rioja, Avila & Valev (2011), there are 156 banking crises occur in 110 countries from 1963 to

2007. The range of the banking crises seems to have an upwards trend. Starting from 1960 to 1975, there were only three cases of banking crises occur. However, about 35% of all crisis have occurred in 1980s and 45% occurred in the 1990s. Good news from 1995 onwards, the reduction of the crises occurred and only covers 16% of all crises. Besides that, the researchers also prove that different areas have been affected differently by banking crisis. For instance, Argentina, Brazil and Bolivia have experienced more than 3 crises each. In addition, many countries in Sub-Saharan Africa, Eastern Europe, and Central Asia also suffered from multiple banking crises. While the thirteen countries have been experienced two crisis, there are only a quarter of the countries in these regions have not experienced any banking crisis. Banking crisis can be called as bank runs, bank panic or bank fails. A bank fails when it is unable to meet their obligations to its depositors. Generally, banks fail for either illiquidity or insolvency. Illiquidity is an institution is profitable but still has possibility to become illiquid. It is because there are too many depositors withdrawn at once, the loan demand exceeds planned funding ability or there are too many long-term assets funded with short-term liabilities. Insolvency when investments lose their value or loan default, thus bank capital can be eroding. Based on the Bank's executive director Andrew Haldane, the banking sector had been suffered a series of crises and scandals. Loans were made to borrowers. However, many borrowers are not able to pay back then sold the assets or property around the global banking system, thus sub-prime crisis started lead to freeze the willingness of banks to lend to customers. Nowadays, banking crisis becomes an important issue in today's financial sectors. It will bring a lot of serious

consequences in the international economic. Thus, the understanding of the structure of banking crisis is very important, because it can help every country to adopt appropriated resolution policies in order to solve the spread of banking crisis. Otherwise, the bank also can be returned to healthy condition and the economic-wide effects of the banking crisis also can be limited.

2. 0 History of Banking Crisis

Historically, banking crises have occurred many times all around the world and influence the whole economy. Goldsmith bankers is a well-known banking firms, it is a private bankers in London that have an efficient system. After 16th century, goldsmith gives off bank notes but encounter to serious failures that cause by the poor harvests and economy downturn in the country. The first shock of banking occurs in 1672 which is when Charles II borrowed a lump sum from the goldsmiths and promptly denies his loans. In the past, bank run also act as blackmail to individual or government. For instance, bank runs in 1832 that take place in United Kingdom. This bank runs due to the Duke of Wellington, Wellesley that tries to prevent reform, his action have annoyed reformers, and cause many reformers protest by threatened a banks run. Some other most remarkable event includes the Dutch Tulip manias in 1634-1637, the British South Sea Bubble in 1717-1719, the post-Napoleonic depression in 1815-1830 and the Great Depression in 1929-1939. During pre-Civil War period, bank debt liabilities mainly included circulation of bank notes. There are few events can be consider as panics during this period which is the obstruction in the years of 1814, 1819, 1837, 1839, 1857, and 1861. Most of these events are related

closely to the banking instability. The Panics of 1814 and 1861 are believed to be caused by the depreciation of government securities during the war period. This is related to unfavourable news with respect to the likelihood of government repayment. This news arises at a time when there is a large amount of government bonds in the hands of central banks. Banking panic is one of the factors that cause the United States' economic downturn. Following one year of the collapse in the stock market, in October 1929, a banking panic started. This was initiated by the failure of the relevant linked part in banking, and this situation deteriorated since financial institutions in New York and Los Angeles were unable to conceal their scandals. After the stock market crash in October 1929, people were more and more concerned about their money's security. Richmen were tried to take out their investment assets out of the economy, and overall consumer expenditure decreased. In general, bankruptcies increased, and public confidence in financial institutions such as banks decreased. Hence, this condition led to bank failures. At the time of the stock market crash, around 650 banks failed. Within the following year, the number of failures grew up to more than 1,300. In December 1930, a small merchant in the Bronx, New York, went to a branch of the United States' bank to sell his stock. However, he was persuaded not to sell the stock because it was a profitable investment by the bank official. He started to propagate rumours that the bank did not want to sell his stock after leaving the bank. Then, a cluster of public had assembled outside the bank within hours; many depositors withdrew their funds from the bank. The bank sustained an illiquidity problem due to the sudden withdrawal of a lump sum from depositors. In the United States, the Great Depression started as a general economic downturn in the almost

end of 1929, but worsen in the following year and continue until 1933. Its result in a negative effect to industrial production in the United States lead to increase in the total unemployment rate and significantly affect consumer spending bring to decrease in the real gross domestic product (GDP). It is one of the examples of large-scale bank run in the country since many bank facing bankruptcies at that time. During this period, bank had lent out a large amount of money and the country is been in the over-indebted condition. A lot of money was invested in the stock market, so when stock market crashed, many investors unable to repay their loans, nonperforming loan increase. Consequently, many banks turn into bankruptcies and the bank runs began. Furthermore, investors will be unwilling to invest because of the poor profits estimation, lower the money supply even more. This situation was worsening by deflation that put more tension on the remaining debt. When reduce in money supply and expansion in existing debt, consumer consumption and investment fall sharply, and cause great depression in the whole economy. Financial liberalization in the year 1970 also contributes to banking crises. Global economy downturn due to the disruptive in the Bretton Woods system of fixed exchange rates and the sharp decrease in oil prices cause difficulties to financial sector. A decrease in global commodity prices and high volatility of interest rates of U. S in 1980 shows a significant effect to the banking and sovereign debt crises in the economy, most prominent effect occur in Latin America and Africa. In early 1984, United States suffer from savings and loan crisis. Nordic countries undergo the worst banking crises due great waves in capital inflows and real estate prices between 1980 and 1990. In 1992, Japan facing with a long term

banking crisis which is a result from its credit booms and asset bubbles. Meanwhile, a few countries in Eastern Europe that originally is a communist country also having a problem in banking system since the collapse of the Soviet bloc. These crises simultaneously spread to Mexico and Argentina in 1994 to 1995, soon after is the Asian crisis in 1997 to 1998, and next propagates to Russia and Colombia. Afterward, Argentina and Uruguay join in the banking crisis respectively in 2001 and 2002. In 2007, subprime crisis engulf in the United States, shortly it transformed into a global financial crisis.

2. 1 Types of Banking Crisis

2. 1. 1 Bank Run

Bank run is an issue that involve single bank, in which a great number of depositors required a sudden demand of withdrawal. It also included withdrawal of a grand amount of deposits that claim by depositors into cash. The amount of cash has to be huge enough for bank to suspend their customer's withdrawal. This suspension shows that the banks unable to fulfill the demand of their depositors to cash out the deposits. Once the banks cannot meet the large demand of withdrawal, it will come out with illiquidity problem and cause bank run. In 1999, one of the most significant banks runs in Malaysia that cause by financial crisis is MBf Finance Bhd (MBf). MBf Finance Bhd which is the Chinese nation enterprise dynasty and also the biggest finance company in Malaysia has been take control by Bank Negara Malaysia. Formerly, the originator of this company have claim that he want to make MBf to become an international financial institution that can monopolize the world trade. It has around 120 branches outstanding and <https://assignbuster.com/malaysia-banking-system-consisted-three-mainly-finance-essay/>

their total deposits were in billion dollars. However, the Asian financial crisis has been collapse the MBf. Bank run in MBf consist of two factors. During this crisis, most of the MBf loans have changed into bad loans since it concentrate on real estate buyer and stock market investor. Other than that, it also invest in stock broking, imported cars assemblage and property development, as which can be consider among the hurtful industry when crisis. Next is because of the info regarding to an originator's ill-health. To prevent further deterioration of this situation, Bank Negara Malaysia lend a hand and take over the MBf. In Netherland, there is a bank run occur on Dirk Scheringa Beheer bank (DSB) in October 2009. This ban run was cause by a man, called Pieter Lakeman. He is the one that act on behalf of the unsatisfied DSB's customers. He incite depositors of DSB to withdrawal their deposit because he think that it is good for public as it's provide mortgage loans that is difficult to accept by borrowers. At that day, many depositors has been line up in front of the bank to withdrawal their money. Afterward, there is more and more depositors demand for withdrawals. One day, DSB has been informing by De Nederlandse Bank (DNB) to stop all the withdrawal. This indicates that DSB is insolvent and continuous of this situation will cause the bankruptcy to DSB. De Nederlandse Bank and another five bank attempt to seek for the solution to solve DSB's problem, however, they fail owing to the high risk of the operation. Finally, DSB went to bankruptcy.

2. 1. 2 Banking Panics

A banking panic is a financial crisis that occurs when there are a lot of banks suffer runs at the same time. In other words, many worried depositors from

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many banks sudden convert their threatened deposits into cash or try to get out of their domestic banking system altogether causing banking panic. In the past, banking panics were treated as examples of irrational and unpredictable behavior. However, in recently they have been treated as response of rational depositor to an asymmetric information deficit. Banking panics may be occurs at any time and any place, no matter local, regional or national. However, the impact on economic does not prevent as the banking panics occurred from being extended to local, regional or national geographical. During the period from 1863 to 1913, the National Banking has experienced banking panics were accompanied by stringency of money market, the collapse of the stock market, shrinking of loans and deposits, bank runs, bank failures, the issue of Clearing House certificates and termination part of cash payment. The most direct effect of termination part of the cash payment included business firm facing difficulties in payrolls, dislocation or perturbation of the domestic exchange, the emergence of currency premium. The interruption of the payments mechanism led to an increase in real transaction costs, factory temporarily closed down, job cuts, and the creation of an alternative currency. The domestic exchanges were affected due to bankers were heavy to make remittances. For those who fail to remit on time, encouraged firm demand cash payment by reduce their transaction. Generally, publics were lacked of the information or no direct experience regarding to bank runs. Thus, a large number of bank closure (more than 500) and bank runs were serious through highly concentrated in these small number of cities. A bank suspension may refer to the bank closing which might be temporary or permanent. Once a bank failed means

that permanent closure, usually called as receivership, which could be a lengthy legal procedure. For the pre-1914 banking crisis was mainly restricted with New York money market which is related with bank suspension in other country. However, the impact of the national country in certain situation on the money market could not be ignored. Thus, we can conclude that, the impact of banking panic on economic activity and expenditure had become hard to measure.

2. 1. 3 Systemic Banking Crisis

A systemic banking crisis is related to either one where all or almost all of the banking capital in a country is eliminated. The reason of bankruptcy is due to a long economic recession that causes domestic banking system shut down and thus lead the domestic businesses and consumers are facing shortage of capital. Mostly, economic damage was caused by bank runs (Bernake, 1983). A systemic banking crisis can solve, but it requires a huge cost for the settlement. Thus, fiscal costs that occupy in average of 13% of gross domestic product (GDP) and economic output that loss accounted for an average of 20% GDP to cover the crisis in between 1970 and 2007.

Besides that, tightening fiscal policies can use to maintain the crisis.

However, if a crisis is caused by unsustainable fiscal policies, tightening fiscal policies would typically not useful. As a result, the non-performing loans substantial increase and almost all the banking system capital had been exhausted. In other words, most of the crisis is caused by depositors' runs on bank although in more instances, it is a realization that significantly important to financial institution trapped in distress (Laeven & Valencia, 2012). A silent run occurs when the implicit fiscal deficit from a government

unexpected the risk of losses to zombie banks that avoid other banks depositors. A zombie banks is a bank or financial institution which have negative net worth. Although the zombie banks have a negative net worth, but they still can continue to operate with the rescue from the government allow banks to meet debt obligations and avoid bankruptcy. Based on Kane (2000), the longer time the silent runs, the more benefits and advantages from healthy banks and tax payers will be transfer to zombie banks. The article of Rothacker shows that, silent runs also can used when a large number of depositors in countries withdrawn their deposit insurance which is below the minimum amount. During crisis, the ways to recover from crisis are increase the liquidity and restore the confidence of depositors and investors. Thus, central bank is important to provide liquidity to support those banks is facing illiquidity. With the increasing of liquidity, the depositors can get protection and continuously restore their confidence in banking system. Although increased the aggregate bank liquidity is expensive, but this is the fastest way to recover from the recession. Interventions often delayed because everyone brings a hope that recovery will occur, but the delay brings more pressure to the economy. There are few effective ways to restore the banking system after occur a systemic banking crisis. There are create the scale for the problem, target the relief programs to those borrowers who are problematic, restructure the programs of corporation, recognize the actual amount of bank losses and fully utilize the capital of bank. In addition, the speed of intervention is critical, it could not be delayed as often. The program needs to be planned, and clearly stated

rules which is restrictions on priority assistance and contain significant capital regulatory standards, easier to achieve the successful goal.

2. 2 Causes of Banking Crises

2. 2. 1 Illiquidity

Illiquidity is which the condition that a financial institution shortage of cash or liquid asset, unable to meet their short-term liability. It also can be consider as distortion in a financial institution's cash flow where its disable to cover it debt. A bank can have illiquidity problem although it is solvent. Most of the bank service such as deposit and checking account are highly liquid. The bank must cash out the deposit when depositors are request for withdrawal. Since banks are offering liquidity services to borrowers and depositors, they are bear with two liquidity risk. First risk is abrupt withdrawal of deposit from depositors. Second is unanticipated demand for borrowing. Large quantity of sudden withdrawal due to depositors anxious about bank's fault and begin to withdrawal their deposits. Once the bank unable to meet the demand of withdrawal, then the bank are facing illiquidity problem. Systemic illiquidity may lead to bank failures, conversely, bank failures may also lead to systemic illiquidity. Failure of a bank may decrease liquidity in the banking system; the effect may spread to other banks, increase the possibility of other bank failure. Consequently, disturb the entire banking system and cause banking crises (Guilherme Carmona, 2007).

2. 2. 2 Insolvency

Insolvency is which a condition that a financial institution' debt excess its asset, they do not have sufficient asset to meet their liabilities. A bank

become insolvent may due to increase in the default rate by borrowers or reduce in the asset price. When borrower unable to repay their mortgage loan, bank can obtain the ownership of the asset, but if the value of the asset depreciates, bank will still facing losses. Initially, if some of the borrowers default in their loans, it will not cause a big problem to the bank since the bank still can absorb the amount of default without cause any losses on their depositors. However, if there are more and more borrowers default or unable to repay their loan on time for long term, then the nonperforming loan may increase. These bad loans will remove from the bank's balance sheet, thus the value of bank's asset will less than its liabilities. If a bank facing insolvency problem, it may unable to cover their debt although they made sale on their entire asset and withdraw all loans since it is not a cash flow problem. Once the bank are suspected to be insolvent, many depositors will line up in front of the bank to withdrawal their money as they afraid that they may not get their money back, this can cause a bank run.

2. 2. 3 Exchange rate regime

Exchange rate regime is the way a country control its currency related to other country currencies by using exchange rate. According to Domac and Peria (2003), exchange rate is one of the macroeconomic factor that cause banking crises. Fixed exchange rate will reduce the possibility of banking crises, especially in developing countries. Fixed exchange rate can diminish instability and randomness policy making that lead to domestic shock which will contribute to banking crises. While previously, floating rate is being said that can used to stabilise the economy, however it is no longer being useful in absorb economy shock. Depreciation in exchange rate is a concern for

borrower and lender as it can cause liabilities and lead to bankruptcies to borrower. Successively, it may create banking problem with the increases in bank's non-performing loan. Floating exchange rate may increase moral hazard problem since some borrower are look forward to borrow in foreign currency. It also stimulates hedging by borrower and restrain capital inflow, so, by fixed exchange rate can demotivate them to hedge and attract capital inflow by decreasing the floating risk of exchange rate.

2. 2. 4 Credit booms and asset bubbles

According to Klomp J. (2010), the credit growth rate are positively correlated to possibility of banking crises, which is when growth rate increase by 1% then it will contribute to the increases of likelihood of banking crises by 0.3%. Banking crises may occur due to the rapid credit expansion and this often accompanies with asset price bubbles. Sharply growth in money supply is the key for the occurrence of asset bubbles. When more money supply, it provide incentive for public to own asset. Increase in the demand on asset will cause increases in the asset price. Increases of the asset value promote more and more lending toward these assets, stimulate demand and these asset price will further increase lead to asset price bubbles. Asset price bubbles are sharply increases in asset price. When reach some time, asset price will decrease. Bank will start reduce the supply of credit and asset's demand reduce hence the asset price will decrease dramatically. This situation will cause distortion in the asset market. This in turn will accompany with increases in default rate on mortgage loan and affect the banking system. Rises in non-performing loan, credit losses and illiquid problem are the issue to bank. Accumulation of non-performing loan cause

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credit contraction and lead to illiquidity problem. Supply of credit increase result from credit boom will sometimes bring to lower lending standard, banks are less thoughtful to the borrower's ability to repay the loans and this will cause the default rate to increase. Stock and real estate bubbles and growth of private sector debt are significant causes to the banking crises (Roy S., Kemme D. M., 2012).

2. 2. 5 Weak prudential regulation and supervision

Weak prudential regulation and supervision of banking system viewed as a factor that contributes to the bank failure (Dekle R. and Kletzer K., 2003). Weak regulation and supervision will cause excessive risk taking by bank and lead to crisis. Generally, bank will provide deposit insurance, bailout by government and also lender-of-last-resort facility in order to safeguard their shareholder and stakeholder. However, this guarantee also will be the factors that give rise to banking crisis due to weak prudential regulation and supervision. Deposit insurance can increase moral hazard problem and as an incentive for banks to engage in the excessive risk activities when regulation and supervision are not strict and caused credit contraction. Bank will congest deposit insurance claims through accumulate non-performing loan and take the income from performing asset as a dividend owing to lack of regulation and supervision by government on the loan loss reserve and bank loan portfolio. After some time, when the bank unable to meet its demand of withdrawal, it will contributed to illiquidity problem and consequently cause banking crises.

2. 2. 6 Lack of transparency

Lack of transparency increase the likelihood of banking crises (Giannetti M., 2007). Without transparency, it can increase the chances of adverse selection due to the bank do not have detail information about applicants. It is risky if the bank is less informed to the applicant because it will raise the cost of borrowing. Information differences between banks will raise the risk of bank. Some of the bank has different information about some group of borrower, information sharing between banks can lead the manager to have a better decisions. Lack of transparency also will provide less motivation for the borrowers to repay the loan. They did not care to be a lower-grade borrower since it is limited information sharing. So, transparency can push them to try their best to prevent from being an impression of a part of low-grade borrower by outsider, also being high-grade borrowers can benefit in lower interest rate. Besides that, bank can avoid from giving loan after a specific amount in order to prevent too much debt and also prevent their borrower exceed indebted with numerous banks, with transparency. Credit information sharing decrease the possibility of banking crises (Buyukkarabacak B. and Valev N., 2012). Bank's risk management will become more difficult due to information asymmetry and moral hazard. Thus, credit information sharing decrease moral hazard and increase borrower's discipline. This will reduce the default risk of borrowers that need to be bear by bank. Rapid credit expansion that causes the banking crises can be reducing by credit information sharing. When credit and lending boom, it will lower the lending standard and cause the default rate to rise.

2. 2. 7 High real interest rate

Increase in the real interest rate cause increases in the likelihood of banking crises (Klomp J., 2010). According to Klomp, 1% increase in the real interest rate will raise 0. 1% probability of banking crises to occur. In case the bank cannot respond to the lending rate at once, it will unfavourable to the bank balance sheet. Large amount of capital inflow and outflow will influence the financial and banking sector's stability as the interest rate in the world level have big impact on capital flow. Capital inflow decrease cause a decrease in the growth of banking funding due to the rapid growth of interest rate lead to a slow progress in economic and degeneration of trade, thus it will result in banking problem. Besides that, high interest rate will increase borrower's burden in loan repayment as high interest rate blow up the money they need to repay for loan. This may increase the default rate and create illiquidity problem to the bank. It also rise the interest rate that bank need to pay to the depositors. This situation will cause reduction in bank's profit since most of the bank asset is long-term loan with fixed rate and they cannot revise the rate of return on asset at the short period of time.

2. 2. 8 Financial liberalization

Many countries move toward financial liberalization to enhance their financial growth and economic expansion. However, inappropriate implementation of financial liberalization can lead to financial instability and cause banking crisis since banks has even more chances to involve in risk-taking activities. Bank will feel that they are losing protection on prescribed interest rate structure due to the liberalization in interest rate, volatility of interest rate increase. When interest rate decreases during financial

liberalization, it will increase the lending rate and rapid credit expansion. This will raise the risk of banking system. Liberalization of capital inflow cause credit boom and bust crises in banking system, banks that deal with asymmetric information will faced illiquidity problem. Liberalization in reserve requirement also causes banking crises. Reserve requirement is an amount of fund that bank must hold as reserve for prudential purpose. It acts as a monetary instrument that bank used to control nation money supply and interest rate. Changes in reserve requirement will influence the amount of fund that bank can lend out. Lower the reserve required ratio, higher the amount of money that bank can use for lending purpose. Yet, reserve required ratio is less likely to changes because it will lead banks that consist of less excess reserve to suffer illiquidity problem. Financial liberalization as one of the factor that causes banking crises has been show by Mariassunta Giannetti (2007).

2. 3 Impacts of Banking Crisis

Based on the research of Kroszner, Laeven and Klingebiel (2007), banking crisis would reduce the real growth and disproportionately so for industries that are financial dependent. As shown by Gupta (2005), there are almost three-fourth of the members of International Monetary Funds experienced the significant problems in their banking sectors. Generally, banking crisis occurs due to illiquidity or insolvency. The effects of banking crisis are significant to economic growth, investment, employment, financial market and so on.

2. 3. 1 Economic Growth

An economy can be represent by four agents, which are households, banks, firms and the government. The household consume the final goods by using cash and demand deposits for liquidity. The firms produce the final goods by using an imported input and finance the bill through loans from the banks. Thus, the banks accept the deposit from household and borrow for those firms to create a perfect competitive industry. Lastly, the government returns the receipts from the inflation tax and interest income to households in each period. Although the impact of banking crisis depend on the period of crisis is short or long. However, the short lived of banking crisis will temporally delay their consumption and thus lead to decline the demand of liquidity, availability of credit and output.

2. 3. 2 Investment

In a healthy economy, it needs a banking system that can be borrowed and invested by the company. Therefore, investment becomes one of the major components of GDP. During crisis, consumers will simultaneously increase their savings and corporations were chosen to reduce their investment. The frequency of occurrence banking crisis leads to affects the confidence of population in banking sector (Rioja, Avila & Valev, 2011). With the decline of the frequency in investment, banking crises could not be ended. Accelerator effect is a well-known and important determinant of investment. Accelerator effect is the level of investment associated with the rate of change of the GDP. Thus, the increase in the rate of economic growth will lead to have a corresponding larger increase in the level of investment. However, the decrease in the rate of economic growth will have a lower investment levels.

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2. 3. 3 Financial Market

A successful investment requires each investor in the financial markets emphasizing or predict what actions other investors will do. However, self-fulfilling prophecies may occur. Some of the person or firm has incentives and adequate capital to create the same shadow, others people will follow as their hope. In other words, if investors or depositors expect the value of the Yen (¥) to grow up, this may lead the value to grow up, similarity with the investors predict the value of Yen (¥) grow down, it could be follow too (Diamond & Dybvig, 2000). Based on Obstfeld (1996), banking crisis sometimes can be called as a vicious circle, which is the investor try to avoid from some institution or property due to the expect others to follow as then expect. One of the history's most successful market speculators, and one of the world's richest men, George Soros, called this action as reflexivity which means guessing other motive or intension. Due to the information that available to investor is opaque and asymmetric, therefore any negative press regarding to bank will causes bank runs, banking panics, banking crisis and lastly investor choose to withdraw their funds from financial market (Bulow, Geanakoplos & Klemperer 2004).

2. 3. 4 Subprime Mortgage Crisis

The subprime mortgage crisis occurs caused by homeowner disabilities to make their loan or mortgage payments, overbuilding during the boom period, approve the risky mortgage products, high debt levels in personal and corporation, bad monetary and policies, international trade imbalances and so on. Based on the BBC News, the crisis have start to affect the financial sector in February 2007, when 2008 the world's biggest bank HSBC, <https://assignbuster.com/malaysia-banking-system-consisted-three-mainly-finance-essay/>

featuring the subprime-related MBS holdings facing losses of \$ 10. 5 Billion. Top management no one could escape from these doom, CEO of Citigroup and Merrill Lynch both resigned within a week in end of 2007. When the crisis become gradually deterioration, more and more financial firm start to or seeking for a merger partner to maintain the company operation. Besides that, based on article of Yuxia, the financial derivatives market collapse caused financial speculation in commodity futures such as world food price and oil price increase. This circulation called as commodities super-cycle. The research of fact box prove that, the mortgage and provisions for future defaults caused the USA depository institution decline for 98%, which is insured by Federal Deposit Insurance Corporation. In addition, in November 2008 the International Monetary Fund's estimate that financial institution around the world facing loses about \$750 Billion. During September 2008, Lehman Brothers and other important financial institutions failed and the crisis hit a key point. When the crisis recession, USA money funds had been withdrawing \$150 Billion and thus the money market was subject to bank runs. The money market was the main sources of financial and non-financial firms. The shortage of credit brings the global financial system collapse. Lastly, the International Monetary Fund's predict that large United States and European banks bear more than \$1 trillion on losses assets and from non-performing loans in between January of 2007 to September 2009. The research from fact box shows that, U. S. banks will estimate to loss about \$1 trillion and European bank will loss around \$1. 6 trillion.

3. 0 Suggestions and Recommendations

The latest US subprime mortgage crisis is one of many in the current economic history of both emerging and advanced economies. Each crisis has its own unique and is triggered by the different events and processes. Thus, different government will do different responses to assist banking industry return to health and to solve the economy-wide effects of crisis. Thus, each country will use a variety of policies for banking crisis to handle the bank problems. After 19 century, no method can maintain the banking stability for a long period due to the complicated structure in today's financial sector. Thus, banking crisis becomes a popular and important issue for today's banking system. The occurrence of banking crisis can't be prevented; this circumstance allows the bank fail but providing substantial liquidity to the markets to avoid and prevent contagion. Therefore, we will recommend and suggest some solution and management for banking crisis in order help countries to solve banking problem.

3. 1 Government Direct Support

During the periods of banking crisis, government plays an important role to solve the banking problem. Therefore, government will do a variety of direct support to solve the banking problem in financial sector. The political direct support for the measure is very important. For instance, if the government has disagreed the direct support for the measure, the disagreement will have attracted attention abroad and the support also have been delayed. Then, the action of disagreement from government also will bring the serious consequences and destroy the confidence in financial sectors. Thus, central banks must tend that provide liquidity to the banking system in order to

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carry out monetary policy. In addition, government also needs to implement programs that give more direct support to particular industries and occasionally to particular institutions. So, these programs are more thoroughly associated with the fiscal policy intervention. Government commonly will apply many resolution policies with the large-scale government intervention in financial sector, such as nationalization, mergers, bank closure, sales to foreigner, bank restructuring, assets management and recapitalization. The actions will be accompanied by forbearance that provides the reduction or suspension of loan payments under specified circumstances and for particular lengths of time. Besides, government also allows the changes of loan classification and the loan-loss provisioning. Government directly supports to unhealthy financial institutions in order to take the process of recapitalization. The process will reorganize the amount of assets and debt of a specified entity in order to achieve the financial goal. The goal is attempt to control the amount of tax owed on the assets in hand in order to avoid bankruptcy. Government recapitalized the financial institutions by applying a variety of techniques, such as government bonds, cash transfer, issuance of subordinated debt, government purchase of the bad loans, issuance of preferred shares, and the purchase of ordinary shares. According to the information of IMF economists, governments intervened with the process of recapitalization in 32 of the 42 banking crises between 1970 and 2007. During the financial and banking crisis of 2007, some countries also opted for outright recapitalization in order to combine a variety of the liquidity programs and asset guarantees. Thus,

government intervention is very important for financial institutions to help them recover from banking crisis.

3. 2 Deposit Insurance Fund

The occurrence of banking crisis can't be avoided and prevented easily. Thus, the efficient resolution of banking crisis is very important, because it can provide substantial liquidity to the whole market in order to prevent contagion. Thus, we also recommend the bank use deposit insurance fund to solve the banking problems. Deposit insurance is needed due to it is a strict commitment to protect depositors. This commitment can't be destroyed for both economic and political reason. Therefore, this technique can solve the banking crisis efficiently. People often expect that their money will be safe with the banks that have a banking license. If a bank bankrupt, it is damaging for the government to allow depositors to suffer the losses. Some depositors will lose money, but this is not quite inevitable. Besides, deposit insurance fund also is an explicit scheme when facing banking crisis, because this scheme can state exactly and clearly who is protected and give appropriate compensation. This clarification can solve the political pressure to produce an appropriate bailout of uninsured depositors, creditors, and shareholders. This insurance guarantee will be large enough to help and protect a little over 90% of the depositors. Banks should pay premia into the deposit insurance fund on a regular basis based on their insured deposit liabilities. Thus, this scheme will provide sufficient financial resources for bank to deal with the bank crisis immediately. This scheme requires maintaining the deposit insurance funds at a stable percentage level of total amount of insured deposit. During the benign period, the fund's resources

will become sufficient and these premia can be decreased to the level needed in order to preserve the ratio of the fund assets to the insured deposits. In addition, the fund also should be invested in some safe and riskless assets such as government securities. Through the guaranteed first line of credit, central government must further support the deposit insurance. Thus, this scheme can deal with the bank crisis bigger than the amount in the deposit insurance funds. The fund is forced to employ this line of credit during the events of a call, and the insured bank also will be required. The bank must pay high deposit insurance premia after the events in order to restore the funds. The explicit financial backing from the government also will be required by the deposit insurance fund in the form of the open-ended second line of credit. There is no explicit obligation on related insured institution to pay back this second line. After resolving the banking crisis, the government will absorb the liability. These funding schemes will prevent the principal issue of private sector deposit insurance, by assembling the assets in the fund and with the lines of credit from government. Deposit insurance fund will provide a large contribution on bank, when the bank capital is under pressure and the economy is weak. During the first establishment, or after any call on the fund's resources, bank must rapidly to build the fund to the desired level in order to provide the necessary and sufficient funding. Thus, every banks must save the sufficient depositor insurance funds in order to solve banking crisis.

3. 3 Bank Support

Bank support is a significant solution for bank to solve banking problem, but bank support must be implemented and managed carefully. In order to deal

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with the banking problem, the procedures for the provision of the bank support must be limited strictly. The offering of bank support is not the lender-of-last resort action, because this action does not provide liquidity to the whole market in order to avoid a run for cash. Thus, the option of making many banks in liquidity difficulties fail may cause the systemic problems and inefficiency. Systemic problem occurs due to the failure to offer short-term support can impact on other financial institution. The systemic problem will destroy the confidence of uninsured depositors and also will increase the spread in the interbank markets. Inefficient occurs due to the rejection to offer a short-term liquidity to the institution that can't get the credit from the private sector coerces solvency. If the private sector arrangement can't solve the problem quickly, the reorganization of the bank can cause the substantial loss of the value. Therefore, the support to the troubled banks must be offered strictly in order to complete reform. Thus, the bank support must be offered against the sufficient collateral in order to reduce the risk of credit loss occurring from the operation of bank support. This collateral can include nonstandard securities or loan, but the value of this collateral must be conservative. In addition, the support also must be offered at a penalty cost over the market rates for the collateralized borrowing. Thus, the provision of the government liquidity is not same with liquidity subsidy. Lastly, the support also must have a limited duration for the transfer of the control from stockholders to the financial authorities.

3. 4 Prompt Closure and Pay-out

If the bank causes the serious banking crisis, the banking problem can't be solved easily. The bank must be forced to closure and also pay out to

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depositors. Thus, the provision of banking crisis resolution needs some special procedures for intervention in the financial sectors to solve the financial distress and provide a pay-out to the depositors. If the bank passes the maximum duration of bank support operation, or the net value of the bank decreases below the minimum level and also short of balance sheet insolvency, the bank must prompt closure and pay-out to depositors.

According to Alistair Milne and Geoffrey Wood (2008), different circumstances will use different mechanisms for such intervention to solve the banking crisis. In order to prepare it for the private sector sale, the bank can work continuously by using the cash flow subsidy from deposit insurance funds. Besides, the shareholders also can be reimbursed if the procedures of the private sector sale exceed the amount needed for reimbursed fund. In opposite, the bank can transfer deposit and deposit insurance fund together to other financial institution. The assets of the bank can be sold or reorganized to pay out the debt holders with the deposit insurance fund first and then the stockholders last. The last mechanisms, the bank also can attempt to transfer deposits with the performing assets to the " Bridge Bank" and then prepare and sell this bank. The deposit insurance fund will get a claim from the remaining non-performing assets, with the stockholders receiving payment when these realize more than the delivery from deposit insurance funds. Prompt closure and pay-out to depositor are one of the methods to solve the serious banking crisis. But the method also consists of some tricky technical problems about account transfer. After 19 century, depositors no longer required cash pay-out for the bank rescue. This is because the depositors need to continue holding their deposit in order to

make and receive payments without using cash. For instance, the wages and other payments will be used to direct debit and other related payment arrangements transferred. Thus, depositors expect to have efficient services either reorganization of the troubled bank or a clean transfer of their banking arrangements to the new institution in order to obtain continuous banking services.

3. 5 Managing Systemic Banking Crisis

Many countries all around the world experienced systemic banking crises in recent decades. According to Leaven and Valencia (2012) updated banking crises database, there are total 147 systemic and non-systemic banking crises in about 110 countries over the period 1970 to 2011. In the effort of restructuring the financial systems, it often costly to society, as sometimes it will exceed 50 percent of GDP. To minimize the costs of banking crises, appropriate policies should be followed. A rapidly designed banking strategy has to be efficiently implemented. Fail to react quickly and implement efficiently will increase the costs and prolongs the banking crises. (Hoelscher & Quintyn, 2003)A systemic banking crisis is a condition where the banking system has a significant signs of financial distress and banking policy intervention measures. Creditors lost confidence in quality and stability in a large portion of a banking system. Such disruption will affect the credit flows, entire payment systems, destruction of asset values and the country's economic growth. Managing and resolving a banking crisis is a complex, multiyear process. A banking crisis is chaotic event that usually emerged suddenly and are intertwined with social and political problems. Overall, managing banking crisis is much challenging in emerged market than

industrial countries as emerged market have weaker institutions and their crises are often larger. (Claessens et al.) Resolve a systemic banking crisis involves many policies including fiscal and monetary policies from macroeconomic aspect to corporate governance requirements and capital adequacy rules from microeconomic aspect. To limit the public costs that cost by the systemic banking crises, private funds should be the prior source for the bank to restructure. The use of public resources in managing the systemic banking crisis should be subject to transparent and clear rules. By adopting appropriate techniques, the eventual costs of the crisis can be ease. It is a challenging process for governments to implements policies to resolve the systemic banking crisis. The banking crises are complex since there is no time and governments have to take action quickly, the conditions of banks are hard to trace and remain unknown at the beginning and there are legal and institutional limitations. The treatment of systemic crises is way far different from the treatment to resolve individual bank failures. It is said that the measures that suitable for one may aggravate the others. Stanley Fisher, the First Deputy Managing Director of IMF outlined four phrase of a systemic banking crisis. The three phase including stabilization, restructuring, asset management and recovery phase.

Phase one: Stabilization

The beginnings of systemic banking crises are typically triggers by some common weaknesses. For example, poor macroeconomic management, poor and too much excessive risk taking in banking practices, balance sheet problem and lastly, weak regulation and supervision. It is all started when some specific events triggers the crisis and large scale of depositors and

creditors started pull off and withdraw their funds that invested. The specific events can be any internal or external aspect, like some external shock, political difficulties or policy slippages. At this stage, central bank will response to provide either monetary or information support to banks that experience banking system problems. Under stabilization or crisis containment phase, the systemic banking crisis is still unfolding. There is a need that government has to gain back or restore market confidence. As the priority, government needs to establish credible macroeconomic policies and announce extraordinary measures to minimize the adverse effects, limit overall losses and contain the crisis. Some policies may take place such as implement open market operation. Available and suggestion tools to come over this banking crisis are emergency liquidity assistance, immediate bank intervention, blanket guarantees and administrative measures. Liquidity support is vital in this stage. It helps to restore depositor and creditor's confidence. Regaining public confidence is crucial to minimize the repercussions on the real sector. Central bank plays the role " lender of last resort" and helps to keep the certain banks payments system operating. There are three options under emergency liquidity, accounts as sterilize liquidity injections, introduce liquidity triggers and enhanced monitoring on recipient banks. This action may require relatively high money market interest rates. However, these may cause losses to the central bank, some macroeconomic pressure, prone to abuse and at the same time, will increase monetary aggregates. Blanket guarantee is an essential confidence-boosting measure. Its aims are to stabilize creditor fear and buy the authority some time to develop and design policies and strategy to restructuring the

systemic banking crisis. However, it will not work if government's fiscal position is weak. In case of large solvency, there will be relatively high cost too. Blanket guarantees usually raise public concerns about moral hazard. For example, United Kingdom implement blanket guarantee on Northern Rock and Bradford & Bingley wholesale deposits in 2008 as an effort to stop the falls. Early interventions are relatively important to stop the flow of financing to loss-making banks and financial institutions who gambling for survival. Intervened bank indicates bank that may be closed or stay open but under control of the authorities that is running on appropriate resolution strategies. The "strategies" may refer to merger or sale, liquidation, recapitalization by government, sales or transfers assets and liabilities or transfer to a bridge bank. The impact of late intervention can be seen when the closing of 16 banks happened in Indonesia in late 1997 that eventually triggered a depositor run which is similar to the case of Thailand crisis in 1997. Administrative measures aims to stop liquidity outflow when public confidence is not regained yet. Some of this measurement types are deposit freezes, capital and exchange controls and deposit restructuring. Nevertheless, these treatments may cause some pitfalls where it is highly disruptive to the payment systems, exemptions, unwinding process, private sector confidence and the country's economic activity. It is view as the last and final measure to stop the crisis if all of the other tools are failed.

Phase two: Bank Restructuring

Once the market is stabilized, second phase will be taken over. In this stage, policy makers need to take concern many issues. Restructuring refers to several steps: diagnosis and triage financial losses, restructuring banking

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system (resolution of unviable banks and restructuring of viable but undercapitalized banks). The aim of bank restructuring is to restore the profitability and solvency of banking system. Diagnosis and triage helps to identify the banks that are in need to restructuring and resolution and eventually resolve the crises. By identify the losses in banks helps the authorities focus more on recapitalization. Banks diagnosis then evaluate the whether a bank is viable or not. Banks that are not viable will come to bank resolution while banks that are viable will continue under MOU. Under diagnosis and triage steps, audits and supervisions are common. Bank classification is important as it can clearly tell the status and needs of a bank. There are four types under the bank classification which is sound and solvent, undercapitalized, insolvent but viable and lastly insolvent and non-viable. However, data limitations is the problem that need to solve prior this steps taken. Bank restructuring tend to remove non-viable banks from the banking system and help viable banks to turn profitability. Basically, non-viable banks need to be resolved and the viable banks should be recapitalized under the authorities help. It is costly if this measurement is misused and can cause moral hazard.

Phase three: Asset Management

Asset management helps bank to concentrate on the banking systems. This stage has to be carefully coordinated with bank restructuring stage. Asset management can be done by choosing private asset management companies (AMCs) or centralized AMCs to help manage or dispose of assets. It helps to resolving insolvent and non-viable banks and sells off their assets. These AMCs are mostly professional management and politically

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independence. In the process of manage or dispose the banks' asset, they have to be skilled resources, knowledgeable and having adequate information and management systems. Authorities may face some difficulties when handling the assets. Market demand for used and bad assets is relatively low and weak. Poor loan documentation and weak legal framework will also drop out the scheduled asset management. Lastly, the related authorities should be realistic on the recovery rate, instead of some unrealistic expectations.

Phase four: Recovery

After a long and painful restructuring process, nationalized banks can now reprivatize. Government takes over the ownership of failed banks and institution since the old owner has lost their stake. During the systemic banking crisis, government becomes the capital-provider of last resort. The whole banking systems can now exit from the crisis mode. Blanket guarantee that applied can be revoked. Government that found proper and suitable new owner can pull back government ownership of banks. Bad assets are sold and taken over. All prevention measure will take place and continue restructuring will implement to avoid the second wave crisis.