Masters of Science (Banking)

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Banks' roles in preventing financial crisis

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Abstract

This paper focuses on the critical role of banks play in preventing financial crisis. Banks have always been viewed as playing a crucial role in financial markets. A country's economy would be unable to function properly without the many forms of bank services. However, Banks were blamed as the cause of 2008 U.S financial crisis due the excessive competition in the banking sector that stimulated banks to extend too much credit (over-lending). Thus, this paper is to identify the banks' roles in preventing financial crisis and how far Malaysian banks have played their roles in preventing financial crisis. The analysis is done from three perspectives i.e long term financial integrity, banks' capital adequacy and prudent supervision. Analysis method used in this analysis is content analysis.

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JEL Classifications:E02
Key words: Institutions and the Macroeconomy

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1.0 INTRODUCTION

The principal objective of this paper is to examine the Malaysian banks' roles in preventing financial crisis.

The banking industry plays an important role in every economy. A country's economy would be unable to function properly without the many forms of bank services. Banks extend loans to businesses and individuals, making it possible for them to invest. Besides, banks also handle payments and securities transactions, manage savings, and advise and guide enterprises when they go public.

Banks have always and historically been viewed as playing a special role in financial markets for two reasons. First, they perform a critical role in facilitating payments. Second is that they have long played an important, although arguably less exclusive, role in channelling credit to households and businesses. Commercial banks, as well as other intermediaries, provide services in screening and monitoring borrowers; and by developing expertise as well as diversifying across many borrowers, banks reduce the costs of supplying credit.[1]

The 2008 subprime and financial crisis has raised a lot of important issues recently. It is believed that as going forward, the deterioration of the global financial environment will have an adverse impact on the global economic activity. Global growth is weakening and several major developed economies are sliding into a recession. Despite the aggressive injection of liquidity into the financial markets and recapitalisation of the large financial institutions in major industrial countries, international financial markets have not normalised and will continue to remain highly volatile.

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[1] Samolyk Katherine (2008), *The Future of Banking in America, The Evolving Role of Commercial Banks in U.S. Credit Markets*. Retrieved December 13, 2008, from World Wide Web: http://www.fdic.gov/bank/analytical/banking/2004nov/article2/br16n1art2.pdf

Amongst the issue raised, one of the questions raised is the factors of the banking sector and financial liberalisation in contributing to financial crises and what roles do banks play in preventing the problems from started and how far have Malaysian Banks played their roles in preventing financial crisis?

2.0 OBJECTIVES AND JUSTIFICATIONS

Banks play a central role in promoting healthy economy through banks' activities. The banking system plays a central role in mobilizing domestic savings and funding private investments to ensure continuous economic growth. However, in the recent financial crisis, banks are blamed for over-lending and some even blame that banks are the main cause of 2008 financial crisis. Thus, the objective of this paper is to study the roles of banks in preventing financial crisis and how far Malaysian banks have played their roles in preventing financial crisis.

During the recent economy crisis, it has been proven that the American economy is built on credit. Credit can be used to start and expand a business. It can also be used to purchase long term assets such as houses or cars. Jobs are created and people's needs are satisfied. However, during the past few years, credit went unchecked in America and it was now out of control.

In 2008, in the havoc of the world financial crisis various explanations are provided in an attempt to try to curb it and avoid similar crises in the future. The crisis is now global and t it started from the US. Some economists search for the reasons in the US economy. To them the main reason for the crisis lies in the dramatic structural adjustments the US economy is undergoing and the spectacular shifts in the US real sector. In the last several years just on the eve of the crisis, the US has exported an enormous number of jobs to countries like China and India without accommodating further for that loss of jobs. Without protectionist measures many sectors in the US economy have faced a decline which has further led to the impossibility of those employed in them to serve their credits and mortgages. The result has been their massive defaults and the follow-up wave of bank runns. [1]

Others blame the excessive competition in the banking sector that stimulated banks to extend too much credit. Indeed, credit expansion in many countries suffering now from the world financial crisis had in the last several years reached an unprecedented high. Economists though have not credibly explained the reasons behind this dramatic credit expansion worldwide. The fact that there has been too much competition in the banking sector has led many to think that when markets are too free, they are not good or even that capitalism should be abolished and in its place a Marxist type of an economy should come, an attempt that has already proven to be unsuccessful.[2]

3.0 LITERATURE REVIEW

Majority of banks' losses was mainly due to default by customers' i.e inability of customers to meet obligations in relation to lending, trading, settlement and other financial transactions. Besides that, banks also face losses as a result of a fall in financial value of their assets due to actual or perceived deterioration in asset credit quality during recession or crisis. In addition to that, bank losses could also because of unethical behaviour of banks' staff which had happened from time to time as in Leeson at Barings and recently, Kerviel at Societe Generale. [3]

The recent sub-prime mortgage crisis has caused huge losses in U.S. and European banks and they have to seek capital injections from Middle East, China and Singapore investors. The world financial market has evolved with instruments that

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[1] Discuss Economics.com (2008) The Role of Bank Managers in the World Financial Crisis. Retrieved December 2, 2008, from the World Wide Web: http://www.discusseconomics.com/global-economics/the-role-of-bank managers-in-the-world-financial-crisis/

[2] Ibid

[3] Catherine S F Ho & Nurul Izza Yusoff (2008). *A Preliminary study on Risk Management Strategies of Selected Banks in Malaysia.* Retrieved December 15, 2008 from world wide web: http://www.unimas.my/2008mfac/parelelsessionspapers/SESSIONIIIC.pdf

banks and financial institutions have lost track of their real identity and roles and have caused real chaos in the market.

3.1 Long term financial integrity:

The main reason for the crisis seems to be no one else but the banks and financial institutions' managers involved. It appeared to be the symptoms of behavior so wrong it has provoked the most serious crisis the world has seen in the last century after the Great Depression. Banks must address the mismatch between the desire from investors for the captains of capitalism to take a long view, and the short-termist hustler mentality that the banks' cultures and reward systems foster. Some greed is good; but it also needs to be tempered by other values.[1]

One would ask why banks would give credit so vehemently when the long-term sustainability of such an action might be dubious. It was due to that bank managers rarely have long-term incentives – their goals are more often based short term profit basis. This has led to the standard principal-agent problem where the interests of the principal and the agents are breached. In the context of banks the principals are the owners and creditors of the bank who have a vested interest in maximizing the present value of their bank. Bank shareholders thus have the long-term goal of creating a solid and stable institution. [2]

The principal is generally interested in the reputation of his firm or value of his property since he would receive a continuous stream of incomes reaping the fruits of that reputation but reputation takes time to build. The numerous depositors in the banks generally also aim the long-term health and stability of the bank. Depositors, for the most part, also have long-term incentives – stable banks provide them with

[1] Times online (2008) Bankers must take long-term view of their reputation. Retrieved December 18, 2008, from World Wide Web: http://business.timesonline.co.uk/tol/business/columnists/article3248651.ece

[2] Discuss Economics.com (2008) The Role of Bank Managers in the World Financial Crisis. Retrieved December 2, 2008, from the World Wide Web: http://www.discusseconomics.com/global-economics/the-role-of-bank-managers-in-the-world-financial-crisis/

continuous returns on long-term deposits but even if a depositor makes a short-term deposit he would still be worried, if his bank or the entire banking system is shaky.[1]

Bank managers usually have short-term horizons and goals which often conflict with those of their principals. Bank managers as agents usually try to maximize their own wealth which is short-term incentive. By excessively giving out credit bank manager actually create money and increase money supply. This process known in economic theory as the money multiplier is a successful tool for bank managers to enrich themselves at the expense of everybody else in the economy. By increasing money supply banks cause a dramatic increase in aggregate demand. Increased aggregate demand further pumps up the real estate or other bubbles, pushing up prices and making the respective industry highly profitable in the short run. The simple economic principle is that demand without money is no demand and that someone's desire to buy becomes real demand only when backed with income. The availability of funds thus creates true demand and drives people's desire to own expensive houses and luxuries, which otherwise they would not be able to afford. Without money in their pockets ordinary consumers would not be tempted to buy or undertake such costly projects. The desire to own a flat plus the ability to pay is what constitutes the demand in the housing market and makes it look highly profitable and attractive to invest in. Stimulated prices make investment projects look highly profitable but that is exactly what bank manager's bonuses depend on. Bank managers' remuneration and bonuses depend on the short-term profitability of investment projects, not on their long-term sustainability. Long term most of these projects would look like a failure. However, their short-term returns, given the money multiplier process, are extremely high.[2]

To curb with this problem, directors' continuous training development is important as the central bank knows that in the long term, banks will be managed more effectively through a responsible board. *StarBiz* learnt that this major effort is

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[1] Discuss Economics.com (2008) The Role of Bank Managers in the World Financial Crisis. Retrieved December 2, 2008, from the World Wide Web: http://www.discusseconomics.com/global- economics/the-role-of-bank-managers-in-the-world-financial-crisis/

[2] Ibid

undertaken with high-level local and international inputs and will also help build up a future pool of qualified and independent bank directors.[1]

3.2 Banks' capital adequacy:

Why does bank capital have a crucial role in crisis prevention? This question here has two aspects: first, it is the importance of capital itself; and second, it is the special role that banks play in the economic system.

Capital has a vital two-fold role. First, capital - or rather equity capital - acts as a buffer against insolvency. It helps to protect the system and limit calls on the safety net. Secondly, equity capital helps to align the objectives of the firm's owners with the objectives of the authorities. Where the owners of firms invest only pinpoint capital, or see their investment erode to the point where the firm is only marginally solvent, owners have an incentive to "gamble for resurrection", because with limited liability, taking on extra risk has substantial potential upside but no extra downside for owners.[2]

Banks may hold a prudential level of bank equity for several reasons. First, it serves as a buffer against unexpected losses that a bank might suffer. It also acts as a signal to investors and depositors of a bank's health. Finally, it serves as a source of funding for assets. Because obtaining additional bank equity can be difficult and expensive, especially for banks that are having problems, reductions in the level of bank equity may lead banks to reduce their supply of real assets including bank loans. Given that a particular bank has reduced its supply of credit because of its deficient capital level, are borrowers of this bank able to find financing for their consumption and investment projects elsewhere? If a borrower were in some way dependent on this bank lending, then real activity would be depressed.

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[1] The Star Online (2008), Intense training for directors. Retrieved December 18, 2008, from World Wide Web: http://biz.thestar.com.my/news/story.asp?file=/2008/9/24/business/2104350&sec=business
[2] David Clementi (2000). *Prevention and resolution - two aspects of financial stability, Speech by Mr David Clementi, Deputy Governor of the Bank of England, at the Inaugural Lecture at the South Bank University Centre for Monetary and Financial Economics, London, on 6 September 2000.* Retrieved December 2, 2008, from World Wide Web: http://www.bis.org/review/r000911b.pdf

3.3 Prudent Supervision

Commitment to prudent lending is an important and current issue of discussion in the global banking system today. Banking prudence and efficiency to manage their risks in different business cycle and environment would help to alleviate crises and losses. The effective management of credit risk is an essential component of a comprehensive technique to risk management and critical to the long-term success of all banking institutions.[1]

The financial system of a country has to be constrained such that a crisis is unlikely to start or to be reinforced. This involves setting standards for commercial banks, investment banks and other financial institutions. Reliable accounting, auditing and risk management are relevant issues. The financial sector needs to be robust so that an economy is not easily affected by shocks. Solid fundamentals are needed because without them inflationary expectations and expectations of a depreciation start to develop.

Prudent supervision is an important aspect of preventing bank failures and financial crises. When a bank run happens and when customers lose confidence in the reputation of a bank and withdraw their deposits as quickly as possible in order not to lose their funds, it will be too late.

Regulation of the financial market includes a broad spectrum of policy instruments, ranging from capital adequacy requirements, margin requirements and bank reserve requirements to restrictions on financial products, price controls and even governmental fees. Rules intend to improve information for the investor and to assure the stability of the system over time. Apparently, they also involve costs for banks and ultimately for the customer. Consequently, banks tend to develop new products in order to avoid the control of regulators.

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[1] Catherine S F Ho & Nurul Izza Yusoff (2008). *A Preliminary study on Risk Management Strategies of Selected Banks in Malaysia.* Retrieved December 15, 2008 from world wide web: http://www.unimas.my/2008mfac/parelelsessionspapers/SESSIONIIIC.pdf

Regulators compete with each other since financial institutions and investors can avoid a regulatory regime by doing their transactions in another country. In this case, regulation may drive the financial industry or a financial product out of a country. Regulation should make use of the self-interest of market participants to monitor and control the performance of financial firms, for example, through credit ratings and specialized media. This approach of market supervision relies on the attention of market participants who want to prevent potential losses through improved information. The approach may also help to control offshore markets that are less regulated.

In the recent financial crisis scenario, Banks lost sense of the risk that they were dealing in, creating complex securities that they are now incapable of valuing accurately. Everyone relied on the rating agencies to determine whether the securities were risky or not--even major law firms set their debt/equity determinations based on the credit rating granted. Yet the rating agencies were just assigning ratings based on information fed to them by issuers, who paid the rating agencies bills. A cozy arrangement that left investors out in the cold. What if more of these securities had been labelled equity by the tax lawyers writing the options, because of the high risk in them? Pension funds wouldn't have bought them, and banks sponsoring the securitizations might have taken their lending business more seriously. [1]

Eduardo Porter has an op-ed on this issue in the Jan 28 NY Times, Should Bankers Pay for their Mismanagement? He supports improved regulation of banks, but notes that the "otherworldly" compensation paid big bank personnel is a major part of the problem as well. Here's a key point about the folly of banks' recklessness·

"There's nothing like a smart banker motivated by an otherworldly bonus to get around the most carefully written regulatory limits on his or her ability to make money. Say regulators demand that banks maintain a big cushion of capital as a share of their loans, as a form of insurance in case the bets go bad. All a wily banker has to

[1] Ataxingmatter (2008), The banks' role in the economic downturn (2008). Retrieved December 10, 2008, from World Wide Web: http://ataxingmatter.blogs.com/tax/2008/01/the-banks-role.html

do is move the risky investment to a "structured investment vehicle" and claim it is not on the balance sheet. And there are other tricks.[1]

Bankers' recklessness would merely be a problem for shareholders to solve if banks lost only their shareholders' money. But banks, as we painfully relearn every few years, spread the damage widely. That's why the government not only explicitly guarantees bank deposits, but also offers implicit guarantees that banks will be bailed out in times of trouble.[2]

Strengthening regulatory and supervisory frameworks is an important issue. Since the crisis, Asian countries have fortified prudential regulations on banks, such as capital adequacy requirements and large exposure rules. They have also strengthened supervisory authorities, and put in place internationally accepted accounting standards, financial disclosure rules, and economic legal infrastructure including insolvency laws. Even if regulations are introduced in line with international standards, they cannot be expected to operate well if commercial practices in that country are different from those in the international community. In order to make such regulations and supervision truly operational, it is necessary to put in place procedures and manuals to fill the gap between the framework and reality.[3]

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[1] Ataxingmatter (2008), The banks' role in the economic downturn (2008). Retrieved December 10, 2008, from World Wide Web: http://ataxingmatter.blogs.com/tax/2008/01/the-banks-role.html
[2] Ibid

[3] Dinner speech by Mr Haruhiko Kuroda (2002) , Vice Minister of Finance for International Affairs, Japan at the Financial Conference on *"How to Strengthen Banks and Develop Capital Markets in Post-Crisis Asia"* Tokyo, Japan, 6 June 2002. Retrieved December 13, 2008, from World Wide Web: http://www.mof.go.jp/english/if/vmi020606e.htm

4.0 RESEARCH METHODOLOGY

This analysis is done from three perspectives:

- Long term financial integrity
- Banks’ capital adequacy
- Prudent Supervision

Analysis method used in this analysis is content analysis. Materials used are:

- 2007 Banks’ annual reports
- Bank Negara Reports
- Fitch Ratings Reports
- Documents published in Website.

5.0 FINDINGS

Malaysian banks’ roles in preventing financial crisis.

Long term Financial Integrity	**Banks' capital Adequacy**	**Supervision**
Banks' ratings - Stable Return on equity - Positive	Risk Weighted CAR: > 8% Tier 1 CAR : >4%	Internal audit policy Internal risk management Policy
Continuous directors' training developments		Internal credit policy management
Long term investment – regional expansion of business		Anti-fraud policy
		Anti-money laundering policy
		Registered member of PDIM
		Compliance on Malaysian Code of Corporate Guarantor

The above table was the analysis of Malaysian banks’ roles in preventing financial crisis. Three perspectives studied here are long term financial integrity, banks’ capital adequacy and prudent supervision.

5.1 Long term financial crisis

In playing their roles in maintaining long term financial integrity, banks' ratings, return on equity, continuous directors' training developments and long term investments are analysed here.

A Bank's rating is an indication of banks' position in the industry and the reputation of a bank to the investors. Malaysian banks ratings were overall stood at stable position with Maybank at evolving watch outlook due to the recent three regional banks back-to-back acquisitions and Ambank at positive outlook as at June 2008. Results were shown as below:

Malaysian Banks' Ratings

Banks	**LT/IDR**	**Individual ratings**	**Outlook**
Maybank	A-	B/C	Evolving watch
PBB	nr	B/C	
CIMB	BBB+	C	Stable
HLB	BBB+	C	Stable
RHB	BBB	C/D	Stable
Ambank	BBB-	C/D	Positive
Eon	BBB-	C/D	Stable
Alliance		C/D	
Affin Bank		D	

Source: Fitch Ratings

Besides banks' ratings, return on Equity (ROE, Return on average common equity, return on net worth) is also measured here. ROE measures the rate of return on the ownership interest (shareholders' equity) of the common stock owners. ROE is viewed as one of the most important financial ratios. It measures a firm's efficiency at generating profits from every dollar of net assets (assets minus liabilities), and shows how well a company uses investment dollars to generate earnings growth. In 2007, Malaysian banks reported positive and healthy ROE except Ambank reported a negative ROE of -9.66. Total average ROE for the nine commercial banks were reported at comfortable level of 14.84%.

Malaysian banks' ROE and continuous directors' training

Banks	ROE (2007)		Continuous Directors' Training
Maybank	Positive	17.09	√
Public Bank	Positive	22.42	√
CIMB	Positive	15.01	√
Hong Leong Bank	Positive	15.39	√
RHB	Positive	14.79	√
Ambank	Negative	-9.66	√
Eon Bank	Positive	7.01	√
Alliance Bank	Positive	16.80	√
Affin Bank	Positive	9.72	√

To maintain long term financial integrity, directors should have a common value and goal as those of shareholders' which is to emphasize on long-term value. It is well-practiced among the nine commercial banks in Malaysia as shown in the table above. Continuous training developments for directors are important to help to build up a future pool of qualified and independent bank directors as it helps to ensure directors perform their tasks properly and emphasize on common shareholders' long term value and goals instead of merely focus on short-term profit.

Maybank, CIMB and Public Bank have made several significant long term investments in the Asia Region in these recent years. Their goals of these investments long term growth of the banks. It is believed that these long term investments would bring long term benefits to the banks as well as the investors and thus the sustainability of the banks look promising.

5.2 Banks' capital adequacy

Malaysian banks capital adequacy ratio in 2007 is overall stood at comfortable level as shown in the table below. All the nine Malaysian commercial banks maintained more than 8% capital adequacy requirements. Tier 1 capital adequacy ratio also reported to be more than 4% as per BNM requirements. Malaysia's strong capital position provides adequate capacity to the banking system to continue to perform its intermediation function healthily and to meet its financial commitments as well as the demand for financing and financial services in supporting domestic economic activities.

Malaysian banks risk-weighted capital adequacy ratio at as December 2007

Banks	Risk Weigthed CAR > 8%	Risk Weighed CAR	Tier 1 CAR>4%	Tier 1 CAR
Maybank	√	13.88	√	9.73
Public Bank	√	12.4	√	7.6
CIMB	√	12.45	√	9.34
Hong Leong Bank	√	16.67	√	13.39
RHB	√	13.42	√	7.89
Ambank	√	12.02	√	6.34
Eon Bank	√	12.88	√	11.68
Alliance Bank	√	16.36	√	10.76
Ambank	√	13.88	√	10.56

5.3 Prudent Supervision

Prudent supervision by Malaysian Banks

Banks	Internal audit policy	Anti-Fraud Policy	Anti-money laundering policy	Internal Risk Policy	Internal Credit Policy	Member of PDIM	Malaysia Code of Corporate Governance
Maybank	√	√	√	√	√	√	√
Public Bank	√	√	√	√	√	√	√
CIMB	√	√	√	√	√	√	√
Hong Leong Bank	√	√	√	√	√	√	√
RHB	√	√	√	√	√	√	√
Ambank	√	√	√	√	√	√	√
Eon Bank	√	√	√	√	√	√	√
Alliance Bank	√	√	√	√	√	√	√
Ambank	√	√	√	√	√	√	√

Overall, our country's local commercial banks practice business dealings under prudent supervision as reflected on the above table. Our banks maintained their own internal audit policy, anti-fraud policy, anti-money laundering policy and risk management policy to ensure banking operation is well regulated. Besides, all the nine commercial banks are also the registered members of Perbadanan Deposit Insurans Malaysia (PDIM). PDIM guarantees all deposits maintain with the banks with effective from 16 October 2008 until 31 December 2010. This PDIM guarantee scheme has reassured investors that the banking system is strong and can withstand the financial turmoil and that banks will continue to be responsible in their lending. Besides, it is observed that all the nine commercial banks also comply with Malaysian Code of Corporate Governance issued by Securities Commission in October 2007. The positive effect of good corporate governance on different stakeholders ultimately is a strengthened economy, and hence good corporate governance is a tool for socio-economic development and preventive of financial crisis.

Besides, all banks in Malaysia were supervised by Bank Negara Malaysia. BNM is vigilant to any potential emerging risks and challenges to the Malaysian financial system. Bank Negara Malaysia ensures adequate liquidity in the banking system at all times and it also guarantees interbank obligations of banking institutions and facilitate efficient access to capital for banking institutions to maintain capital adequacy at target levels well above the minimum standards.

BNM always ensure that regulatory framework remains responsive to market conditions and maintains appropriate incentives for prudent risk management on the part of financial institutions. All this is to maintain the orderly functioning of the intermediation of the financial system and financial market. In short, Malaysian banks are well regulated by BNM and internal regulatory framework.

6.0 CONCLUSION

It would be difficult to overstate the importance of a stable banking system to economic health and growth. Banks play an important role in intermediating savings and credit and they are at the heart of the payments system. Most companies in most economies are heavily reliant on banks for finance. Banks retain important roles as providers of payment facilities, short-term credit, and backup liquidity.

Besides the three roles as mentioned in the analysis, Malaysian banks have also played their roles in reducing lending interest rates in order for businesses can continue servicing their loans and consumer demand can be kept up or increased in order to maintain or increase effective demand. Besides, Malaysian banks also maintain their staff employment and meeting of social needs such as welfare and corporate social responsibility despite the global economy downturn.

Malaysia's better resilience lies in the established strong fundamentals that have been built-up over several years. Not only that Malaysian banking systems is heavily regulated, the continued significant current account surplus, low external debt, large international reserves and well-capitalised banking system, will place the economy in a stronger position to weather this challenging period. Strategies going forward will aim at sustaining domestic demand, reducing Malaysia's external vulnerabilities and ensuring that financial intermediation to proceed uninterrupted.

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