

### Foreign Banks in Emerging Economies: Malaysia's Perspective

In the recent two decades, the financial sectors of many countries have become more internationalised, driven by the forces of global economic integration, new technology and increased financial sector liberalisation. This trend is more pronounced in the emerging economies where foreign bank representation in the banking systems has increased from 18% to 36% between 1995 and 2009, compared to an increase of only 19% to 24% for OECD<sup>1</sup> countries over the corresponding period. The number of banks from the emerging economies that have expanded beyond domestic borders has also increased from 147 in 1995 to 279 in 2009<sup>2</sup>. The internationalisation of finance has brought about benefits by enabling greater cross-border trade and investments, facilitating more efficient mobilisation of funds as well as creating new business and employment opportunities.

Nevertheless, there continues to be a plurality of views regarding the impact of foreign bank presence in the emerging economies. While potentially contributing to financial sector development and growth through fostering increased efficiency, market discipline, access to credit, as well as more sophisticated products and services, the preference of some foreign banks to operate only in high-value, high-return customer segments have reduced the overall benefits of liberalisation. In particular, the lower-end segments would be excluded from enjoying the same access as other segments to the products and services that are being offered by such foreign banks. Excessive competition could also encourage unhealthy practices in price competition and risky lending behaviour, thus affecting the soundness of banks and increasing the risks to financial stability.

Views also differ on the impact of foreign bank participation on the stability of the domestic financial system. Research on financial crises has found that emerging countries with less developed deposit insurance systems showed evidence of reduced cross-border 'flight to quality', with depositors shifting funds to the foreign-owned banks with a local presence, instead of repatriating funds out of the country. However, there are also views that the presence of foreign banks amplifies the effects of a domestic financial crisis. Observations show that foreign banks without a strong deposit base in the host economy tend to reduce lending more than their local counterparts during periods of stress, thus exacerbating the impact of a domestic financial crisis.

The recent Global Financial Crisis also exposed new sources of risks arising from a more internationalised financial system. One channel of risk transmission that has potentially adverse implications for the host economy is deleveraging activities by foreign banks in response to losses and the contraction of lending activity in their home economies. The increased interconnectedness of emerging markets with the global economy from trade and financial linkages has amplified the speed and scale of the transmission of external shocks, thus posing a significant challenge for countries in managing and mitigating cross-border contagion risks, especially where domestic financial markets are less developed. These developments hence reinforce the importance of having clear accountabilities and cooperation mechanisms among home and host regulatory authorities in overseeing the operations of foreign banks, especially on information sharing, supervision and surveillance, institutional failure resolutions and burden sharing. This would contribute towards bridging the differences in approaches and practices of home and host regulators, which would facilitate speedier and more effective management of cross-border contagion risks.

#### Considerations for Foreign Bank Participation: Malaysia's Perspective

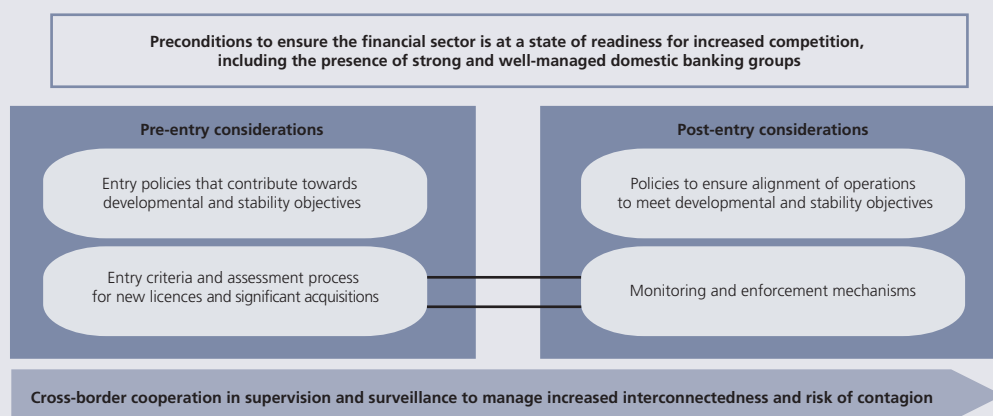
Taking these views together, a key question that requires careful consideration by the emerging economies in developing policies on foreign bank participation is the extent of net benefits accruing to the local economy. A key objective of the Bank in this regard has been to minimise the risks, while allowing maximum benefits to be gained from financial sector liberalisation and ensuring that the

<sup>1,2</sup> Classens, K. and van Horen, N. (2012) 'Foreign Banks: Trends, Impact and Financial Stability', IMF Working Paper, International Monetary Fund.

growth of the financial sector as a whole is commensurate with real economic growth. This entails consideration on both stability as well as developmental objectives. The remainder of this article will discuss Malaysia's experience and policy considerations in liberalising the financial sector. This is summarised in Diagram 1.

**Diagram 1**

### Key Policy Areas in Financial Sector Liberalisation in Malaysia



The Malaysian financial system has long been home to foreign-owned banking institutions, with foreign banks being pioneers in the development of the Malaysian financial system more than a hundred years ago. The oldest bank in Malaysia was a foreign bank that was established to meet the financial requirements of the early European traders. Other major foreign banks followed suit as the strong prospects for growth in trade drew keen interest in establishing presence in Malaysia. Since then, foreign banks have become key players with a significant contribution to the Malaysian economy. Today, foreign banks account for approximately 27% of market share in the assets of the banking sector. Several foreign banks with a sizeable presence in Malaysia have also acknowledged Malaysia's growth potential and connectivity with other economies, and have positioned Malaysia as a priority market within the Asia-Pacific region.

Malaysia has always adopted an approach towards liberalisation that takes into consideration the capacity and readiness of the financial sector to benefit from it, while promoting orderly growth and development of the financial sector in a liberalised environment. Greater foreign participation has been sequenced and managed following the establishment of the necessary preconditions (Diagram 2), as articulated in the Financial Sector Masterplan 2001-2010. Central to this approach is a continued presence of strong and well-managed domestic banking groups and a comprehensive financial safety net. In this regard, efforts to strengthen the resilience and competitiveness of domestic financial institutions have led to the emergence of strong Malaysian-owned banking institutions, with significantly improved performance indicators over the years (Table 1).

A key expectation from increased liberalisation is that strong and well-managed foreign banks will contribute to the orderly growth and development of the Malaysian financial sector. The new Financial Services Act 2013 and Islamic Financial Services Act 2013 further elaborate and provide greater transparency on the criteria for market entry by codifying the key expectations on the prudential soundness and quality of the value propositions put forward by prospective entrants (Diagram 3). These considerations are common across many countries that have liberalised and open financial systems, including developed economies.

Diagram 2

## Preconditions to Financial Sector Liberalisation in Malaysia

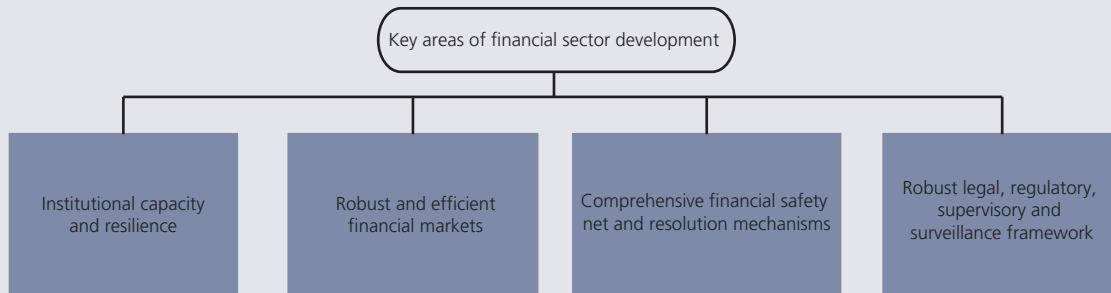


Table 1

## Improved Performance Indicators by Domestic Commercial Banks

|                                 | 2000     |         | 2010     |         | 2012     |         |
|---------------------------------|----------|---------|----------|---------|----------|---------|
|                                 | Domestic | Foreign | Domestic | Foreign | Domestic | Foreign |
| <b>Capitalisation</b>           |          |         |          |         |          |         |
| Risk-Weighted Capital Ratio (%) | 11.7     | 14.0    | 14.2     | 14.6    | 15.0     | 16.1    |
| <b>Asset quality</b>            |          |         |          |         |          |         |
| Net Impaired Loans Ratio (%)    | 9.2      | 5.7     | 2.6      | 1.2     | 1.5      | 1.2     |
| <b>Profitability</b>            |          |         |          |         |          |         |
| Return on Assets (%)            | 1.1      | 2.1     | 1.6      | 1.6     | 1.7      | 1.5     |
| Return on Equity (%)            | 13.3     | 26.4    | 16.7     | 19.6    | 17.4     | 17.7    |

Note: Beginning January 2010, loans are reported based on Financial Reporting Standard (FRS) 139. The adoption of FRS 139 requirement is based on the financial year of the banks

Source: Bank Negara Malaysia

Another key requirement for foreign commercial banks, which equally applies to domestic banks, is to locally incorporate in Malaysia. This is to provide a greater degree of protection to Malaysians through having a permanent commitment of capital that safeguards the sustainability and continuity of the domestic operations, and having a dedicated board of directors with accountabilities and fiduciary duties that are specific to the local entity. Throughout the Global Financial Crisis, the operations of the locally-incorporated foreign banks in Malaysia have remained resilient, with high capitalisation levels, sustained credit quality and positive levels of profitability.

Foreign banks have been accorded operational flexibilities to expand their network through electronic channels, agent banking and the establishment of a further number of physical branches. This has enabled the foreign banks to have an important role in the financial intermediation process and contribute to the functioning and growth of the economy. Moving forward, similar to domestic banks, foreign banks will be allowed to expand their branches more freely, while maintaining a balanced distribution of branch locations by all banks to support the needs of the underserved areas. This would be implemented with measures to further accelerate the development of alternative delivery channels which would promote greater convenience and efficiency in the provision of financial services to consumers.

Diagram 3

## Assessment and Evaluation of New Licences and Significant Shareholders

**Prudential criteria:**

- Character and integrity of applicant or reputation for operating with good governance and integrity standards;
- Soundness and feasibility of applicant's business plans;
- Nature and sufficiency of the financial resources of the applicant;
- Business record and experience of the applicant;
- Transparency and supervisability of the applicant's group structure;
- Whether the institution will be operated by persons with suitable competence and experience; and
- Whether the business is detrimental to public interest.

**Best interest of Malaysia criteria:**

- The effect of the investment on the level and nature of economic activity in Malaysia;
- The contribution towards enhancing international trade and investment linkages between Malaysia and other countries;
- The effect of the investment on the stability of the financial system; and
- The degree and significance of participation of Malaysians in the financial sector. This includes the continued presence of strong and well-managed domestic banking groups that continue to mobilise more than 50% of resident deposits.

In view of enhanced foreign participation in the financial sector, the pace of cross-border cooperation in surveillance and supervision has intensified over the last few years. Malaysia proactively collaborates with home country supervisory authorities to ensure that pre-emptive actions can be taken to preserve financial stability in the event of an imminent shock. This includes developing arrangements for information exchange and supervisory cooperation through memoranda of understanding, as well as participating in supervisory colleges relating to these internationally-active banks. These efforts are consistent with the broad principles recommended by the Financial Stability Board on cross-border cooperation in the management of financial crises.