Diversity and Stability of the Funding Structure of the Malaysian Banking System

The significance of maintaining stable funding sources and strong balance sheet liquidity has long been recognised in Malaysia. This reflects the maturity transformation nature of banking business and its intermediation role in the economy as well as the experience of banking institutions during the Asian financial crisis. The risk of an over-reliance on wholesale funding was clearly demonstrated during the global financial turmoil. The liquidity management framework for banking institutions that has been progressively enhanced since 1998 has created greater recognition of the need for diversified funding structure, forward-looking assessment and robust management of short-to medium-term liquidity needs and availability. More than a decade after the financial crisis in the late 1990s, the Malaysian banking institutions are well-positioned to effectively mitigate inherent vulnerability to liquidity mismatches through robust liquidity management infrastructure and practices.

This article presents the state and key characteristics of the funding structure of Malaysian banking system that contribute to its overall resilience over the years.

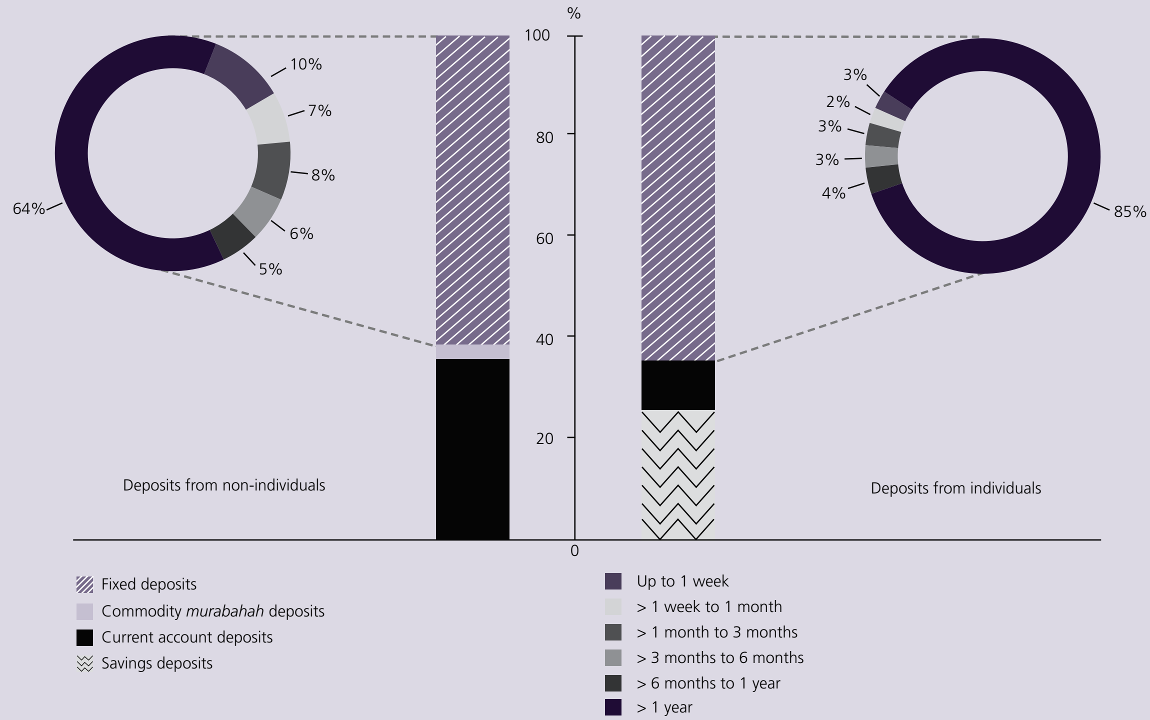
Stable deposit-based funding structure

Customer deposits represent the single largest source of funds for banking institutions, accounting for more than 65% of banking system liabilities and 73% of total funding. This reflects the savings culture of Malaysians (gross private and public savings accounted for 31.3% of Gross National Income) and the extensive outreach of financial services to the population. These deposits, which registered a compounded annual growth of 8.5% over the past decade, are mobilised to finance real sector activities and continued to support domestic loan growth (ratio of loans-to-deposits averaged around 87.6% since 1997). The deposit components are fairly distributed between retail and business (35.7% and 37.1% of total deposits respectively as at end-2009) thereby providing diversity and stability to depository funding across the different types of banking institutions. Moreover, fixed deposits constituted 62.4% of total deposits accepted from individuals and businesses, with 74% of these fixed deposits having more than 1 year maturity (Chart 1). Almost half of the deposits placed in Islamic banks comprised General Investment Accounts (GIA). These Islamic instruments are rather stable in nature with analogous characteristics to fixed deposits offered by conventional banks. Although GIA is a type of Islamic profit sharing investment product, the expectations on the recourse of claims on the losses of such investments tend to fall on the deposit-taking institution instead of the investment holders that have no influence on the investment strategy of the funds.

Unlike investment banks in advanced economies that are reliant on market-based and wholesale funding, investment banks in Malaysia have direct access to large corporate deposits with a minimum threshold of RM500,000 and are therefore subject to similar regulatory requirements as the commercial banks. Corporate deposits constituted 46.2% of total funding of investment banks as at December 2009. As these deposits have higher sensitivity to returns and corporate depositors are relatively more sophisticated in the assessment of counterparty risks, corporate placements are inherently more volatile compared to smaller retail deposits and transactional accounts. However, empirical data suggests that corporate deposits have historically been fairly stable and not as volatile as money market funds. In the more recent period, the temporary government deposit guarantee that was put in place in October 2008 has further moderated the volatility of such deposits, hence ensuring greater funding stability for banking institutions.

In addition, the presence of regulatory framework and internal policies for overseas investments by residents ensure that large shifts of wholesale deposits sourced from non-financial corporations, governments and public sector enterprises are unlikely to occur in a fully-synchronised manner. Although such regulatory requirements have been progressively liberalised over time, prudential or internal limits are still applied on the size of foreign currency assets held by institutional funds such as insurers. In addition, some of these institutional funds such as the Employees Provident Fund and Kumpulan Wang Persaraan (retirement fund for government employees) are used to mobilise large portions of household savings through mandatory

Chart 1
Composition of Banking System Deposits and the Behavioural Maturity Profile of Fixed Deposits



Note: Fixed deposits include General Investment Accounts and Specific Investment Accounts

Source: Bank Negara Malaysia

savings programmes, hence making such funds less volatile in nature. Meanwhile, businesses with limited international trading activity may choose to hold assets only in local currency in order to avoid bearing foreign exchange risk.

Limited risk of contagion due to low reliance on interbank funding and securitisation
Drawing from the lessons of the Asian financial crisis, banking institutions are now more cautious in over-relying on interbank and other market-based funding (includes securitisation, bankers' acceptances, negotiable instruments of deposits and debt securities issued). This form of funding constituted between 10-16% of total liabilities over the past decade. Partly due to the ample liquidity environment and strong growth in savings and deposits, banking institutions also have low reliance on securitisation as a funding source. The domestic securitisation market is mostly driven by Cagamas Berhad from housing loans purchased from financial institutions and the government (employees housing loans). The recent global turmoil also underscored the damaging effects of counterparty concerns on funding and liquidity risks positions. On the domestic front, there were no funding shocks that propagated through the interbank money market. Domestic conventional and Islamic money market rates remained fairly stable across all maturities during the recent crisis. This reflected the minimal interbank borrowings including repos which remained under 6% of total banking system liabilities over the past ten years. The decline of liquidity in the commercial paper market and briefly in the corporate bond market was well-contained with no spillover effects onto the rest of the financial system.

In addition, stress test on bilateral interbank linkages that incorporated simultaneous credit shocks (hypothetical defaults on interbank credit exposures) and funding shocks (inability to replace interbank funding from defaulted institution that subsequently triggers the fire sale of assets) demonstrated the limited scope for interbank contagion domestically. Potential domino effects via the credit and funding channels remained minimal and the interbank stress test results show that the RWCR of potentially affected banking institutions remained well above the minimum level under the most severe scenario.

Limited foreign currency liquidity and funding risks

The exposures of the Malaysian banking institutions to foreign currency assets and liabilities, of which approximately more than 70% were USD-denominated, had been on an increasing trend in the recent decade, albeit accounting for less than 15% of total assets (including off-balance sheet exposures in nominal terms). These low exposures minimise foreign currency funding liquidity risk and the potential direct impact of significant exchange rate fluctuations on balance sheet and profitability. Foreign currency liabilities are essentially managed via currency swaps, interbank market and foreign currency deposits. The dynamic management of liquidity was clearly demonstrated by the swift actions of banking institutions in narrowing the negative foreign currency liquidity mismatches during the period of global tightening of US dollar liquidity in late-2008. Moving forward, the funding needs of banks across various currencies are expected to grow in tandem with the regional expansion of domestic banks and the further deepening of domestic foreign exchange market. In anticipation of this direction, management of liquidity risk will be undertaken in accordance to specific currencies as part of the enhancements to the Liquidity Framework. This will contribute towards a more robust management of liquidity risk.

Strong balance sheet liquidity with sizeable holding of liquid assets

Domestic banking institutions maintained strong balance sheet liquidity whereby on aggregate, total liquid assets (comprised Class-1 and Class-2 liquefiable assets[1]) could cover more than 8% of total short-term liabilities at any given month. These unencumbered liquid assets (accounting for 11.5% of total assets as at end-2009) can be easily converted into cash at short notice with minimal transaction costs thus providing temporary relief from potential funding pressures. Investment banks naturally held larger proportion of marketable securities for capital market operations which accounted for 26.2% of short-term liabilities as at end-2009. Although Class-2 liquefiable assets and formal credit lines are recognised as a source of reserve liquidity, the core inventories of banks' liquidity reserves continue to largely consist of Class-1 liquefiable assets which accounted for 74% of total liquid assets as at end-2009. Banking institutions have maintained an average of RM128.8 billion of projected liquidity surplus (based on the behavioural profile of cash flows) since 2006 that was adequate to sustain unexpected withdrawals of 12% of total deposits up to a period of one month. Banking institutions also hold liquid assets denominated in foreign currency that commensurate with the modest foreign currency funding liabilities. This portfolio consists mainly of high-rated sovereign and corporate debt securities and accounted for 7.8% of total foreign currency deposits and interbank borrowings as at end-2009. Furthermore, banking institutions are able to convert the large stock of ringgit liquidity surpluses to meet foreign currency liquidity shortfalls during distressed periods.

In summary, the stable and diversified funding structure of the banking system has contributed to its resilience over the years. The ability of banking system to withstand potential liquidity shocks is also underpinned by regulatory and structural factors that have created strong incentives for banks to manage liquidity risk in a dynamic and effective manner. Moving forward, further enhancements to the regulatory requirements on liquidity risk management will take into account the proposals by the Basel Committee on Banking Supervision. The direct and indirect implications of such new requirements will be thoroughly analysed, with due consideration to the different dynamics and characteristics of domestic structure and markets, risk-taking behaviour and liquidity risk management practices of banking institutions as well as the potential balance sheet and structural adjustments arising from such reforms.

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[1] Class-1 liquefiable assets include RM marketable securities/papers issued or guaranteed by Federal Government or the Bank, Cagamas bonds (issued before 4 September 2004), RM-denominated bonds issued by Multilateral Development Banks or Multilateral Financial Institutions and ABF Malaysia Bond Index Fund. Class-2 liquefiable assets include highest-rated Bankers' Acceptances, NIDs, RM corporate bonds, residential mortgage-backed securities and undrawn portion of formally available credit lines.