

## Role of Financial Institutions in Promoting Investment

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### INTRODUCTION

Financial institutions historically, have always played a pivotal role in stimulating economic growth and development. This role stems largely from their basic fundamental function in the 'capitalization' of savings through which surplus funds are mobilized in financing productive investments.

With the new Banking and Financial Institutions Act coming into effect on 1st October 1989, the connotation of "financial institutions" now includes a whole multitude of institutions ranging from commercial banks, finance companies, merchant banks, discount houses and money market intermediaries to institutions involved in credit, development finance, leasing and factoring. In this paper, the term "banks" is used very broadly and interchangeably with "financial institutions".

The expansion and development of the Malaysian financial system, has been fundamentally guided by the development of the domestic economy and the growing sophistication of its financial requirements. Over the years, the gradual transformation of the economy and shifts in national policies and priorities have exerted direct and indirect requirements on multitudes of services offered by the financial sector. The financial system has demonstrated that it can effectively intermediate over the nation's past five-year development plans. However, its strength was severely tested in the unprecedented economic downturn of 1985-86. As in all recessions, the fundamental weakness of a number of financial institutions were laid bare, in terms of banking practices and prudence, controls and procedures, professionalism and ethics.

While some banks were experiencing major loan defaults and incurred large losses, others experienced frauds, collapse or near collapse. The Government and the Central Bank have stepped in strongly to inject capital into the troubled financial institutions, bringing a host of new laws and regulations as a safety net over the system.

The banking system has in fact made a remarkable recovery. Since 1988 many banks have considerably strengthened their balance sheets. Nevertheless, the shakeout in some institutions continues to take place even as the economy recovers.

The role of the financial institutions is now even more profound as the economy moves forward towards a new era of economic restructuring that is to an era of accelerated industrialization and higher private initiative. Financial institutions are now not only under greater pressure to sustain themselves but also public confidence. Banks will have to play a more dynamic role, as the custodian of public funds and intermediary of surplus funds, and managing this financial resources to stimulate rapid economic growth and national development.

### CURRENT PERSPECTIVES

As 1990 approaches, the focus on industrialization as a strategy for growth and development gains increased attention. The nation's ambitious economic vision of joining the ranks of the Newly Industrialized Countries (NICs) by the early 1990s spells the need to strengthen the industrial sector through the development of a strong manufacturing base. But the transition is still by no means a foregone conclusion. What is needed now is investment, in particular, foreign and domestic private investment in the manufacturing sector. Indeed, over the short and medium term, private investors hold the key to the underlying growth trends. Supporting these changes will be a major focus of bankers today.

It can be said that banking in Malaysia is still focussing on traditional financing in that it lacks new technology-driven products and services. Such innovations came only recently and in a gradual phases, reflecting how cautious the banking industry is in Malaysia. However, as banks gear themselves to meet the growing needs of their customers and investors, one can now see the local banking industry moving more innovatively into new instruments of financing. Now in the market, there are instruments spawning from deposits to bills and bankers acceptances, note issuance facilities (NIFs) to currency swaps and forward rate agreements and also to the country's first ever mortgage bond – the Cagamas bonds. While the capital market is slowly deepening and a secondary bond market is entrenching itself, banks are now into stockbroking, unit and property trusts and venture capital. Indeed, the scene today is fast moving towards financial supermarkets

in a high-technology era. Against this scenario, what role can banks or financial institutions play in the current context of industrialization?

## THE ROLE OF FINANCIAL INSTITUTIONS

The role of financial institutions is wide and varying. It does not only encompass lending-out of money but includes a range of other financial services. Among the services are, extension of credit, promotion of small and medium industries, developmental role, role in corporate recovery, financial and investment advisor.

### EXTENSION OF CREDIT

The fundamental role of financial institutions as a supplier of funds for the promotion of investment is reflected in the volume of credit extended to the business community. Reflecting the economic recovery in 1988, renewed business confidence and consolidation efforts by all sectors of the economy, bank credit approvals expanded generally across the board. Total credit extended by the 38 commercial banks in the country grew by 8.8 percent in 1988 to \$56.4 billion. Total loans outstanding of the other major groups of financial institutions amounted to: \$15.9 billion for the finance companies, \$4.7 billion for the merchant banks, \$1.7 billion for industrial finance institutions, \$689 million for building credit institutions and \$1.8 billion for the rural credit institution and \$1.3 billion for the urban credit cooperative societies.

The Government's emphasis on lending to productive sectors of the economy has no doubt led to greater proportion of funds being channeled to the manufacturing sector which accounted for about 16.4 percent of total outstanding bank credit of the financial institutions. However, the broad property sector, by virtue of the long-term nature of such loans, continues to secure the largest portion of total loans outstanding (39.8 percent ) in 1988.

### PROMOTION OF SMALL AND MEDIUM INDUSTRIES

Consistent with the national socioeconomic objectives of the Government, Bank Negara has, since 1976 stipulated guidelines to commercial banks and finance companies on lending to certain priority sectors of the economy to ensure their ready access to bank credit at reasonable cost. These special groups include the Bumiputera

community, agricultural food production, residential housing and the small and medium scale industries (SMIs).

In this context, the role of financial institutions in the development of the latter group deserves mention. The current industrialization plans call for a bigger role of the small and medium scale industries in providing the vital supporting ancillary services and to create inter-industry linkages to strengthen the industrial base. It is generally felt, however, that the potential of SMIs has not been fully developed because of various handicaps. One of these is their lack of accessibility to institutional credit.

Admittedly, the commercial banks have traditionally been adverse to making credit facility to small scale enterprises because they consider such lending to be riskier and involving higher administrative costs. In line with the Government's emphasis, banks are now changing their attitudes and approach towards lending to this sector. Various credit schemes such as the Credit Guarantee Corporation's (CGC) Special Loan and Guarantee Schemes are now in the market. The past decade has also witnessed the introduction and implementation of a number of special low-interest financing schemes for the SMIs, among which are:

1. the \$1 billion New Investment Fund, launched in September 1985 for commercial bank lending has played an important catalytic role in promoting new investment. The fund, which was later topped up to \$1.7 billion, has been well utilized and exhausted by December 1987. A total of 400 projects were approved by Bank Negara, of which 75 percent was for the manufacturing sector,

2. the World Bank has also co-financed with the Malaysian Government in the later part of 1984, a special loan program for the development of the small-scale industries in the country. Credit facilities from the \$210 million fund are channeled through Malaysian Industrial Development Finance (MIDF) and Bank Pembangunan. Under the scheme, entrepreneurs with owners' equity of up to \$1.5 million qualify for loans to a ceiling of \$3 million, carrying interest rates of as low as 7.25 percent. Up to the end of 1988, a total of 1,022 loans were approved, amounting to \$202.4 million or 96.3 percent of the total allocation, benefiting 85.2 percent of the 1,200 targeted entrepreneurs,

3. with the Government's implementation of the \$895 million Association of South East Asian Nations (ASEAN)-Japan Development Fund (ADJF) loan scheme, the SMIs are further blessed with a new source of credit. SMIs are now able to secure loans for new investments

in manufacturing, agriculture and tourism from the four institutions which have been designated as disbursing agents, that is MIDF, Bank Pembangunan, Bank Industri and Bank Pertanian.

Besides merely providing finance, banks can contribute positively to SMI's development by bringing to these enterprises, the necessary technological change, management assistance and proper market knowledge, organizing workshops and seminars to help them acquire more sophisticated skills and promoting linkages where possible.

#### DEVELOPMENTAL ROLE: REORIENTATION IN LENDING

With the rapid pace of industrialization and Bank Negara's mandatory guidelines on priority sector lending, the banking system is now more developmental than before. Impact of the development finance institutions in the provision of medium and long-term finance is growing. The Malaysian development financing institutions which were created by the Government, are 'specialist' financial institutions with specific socioeconomic roles to perform. Some of the activities of these institutions today include the gearing for development by the MIDF, promotion of Bumiputera's participation in commerce and industry by Bank Pembangunan Malaysia, provision of long-term finance for the expansion of capital-intensive and high-technology industries with long gestation by Bank Industri, mobilization of resources for agricultural development by Bank Pertanian, and promotion of industrial and agricultural development, and supportive finance for other activities by Sabah Development Bank. This group of institutions, in their developmental approach, often assume higher risks greater costs and lower income spreads.

Commercial bank lending trends also reflect further inroads into term-loan financing with the granting of longer-term maturity loans for manufacturing enterprises. While this augers well for investments, banks can play a pro-active role in accelerating investment through a reorientation of lending practices.

Malaysian banks have, for far too long, depended on collateral-backed lending as a form of insurance against bad lending decisions. As some bankers would have found, even ample collateral is inadequate in times of severe downturns when property and share values take a tumble. It is rather short-sighted to continue to rely entirely on collateral-based lending especially since there is really no guarantee that the value of collaterals will not fall in the future. With the economy

now well on the road to recovery, banks should be able to consider reorienting lending policies towards project-based lending.

Banks can play this role by combining sound credit analysis based on project viability with collateral-backed lending or even at the other extreme, consider selective lending to businesses without collateral. There is no denying, however, that without a high level of integrity, any scheme to reorientate banking policies to project-based lending will inevitably meet with failure. Certainly, banks will need to upgrade training requirements to build up a pool of dedicated, honest and able staff, including top management, to provide the human resources input for such reorientations.

#### ROLE IN CORPORATE RECOVERY

In the aftermath of the last recession, corporate recovery and turnaround has received much attention not only from corporate managers and political leaders alike, but even more from bankers. Causes of corporate failures are many, and some even say that banks are equally responsible. Banks were accused of "taking away your umbrella during a rainy day" or "the first to run for cover when you are in trouble". On the contrary however, many banks, if not all, do spend a lot of time deliberating the "Do's" and "Don'ts" and the "cost advantages and disadvantages" before writing off a loans. Bankers today are caught in the horns of a dilemma. In order to protect depositors' funds and to maintain financial discipline, they have to act tough on non-performing loans. On the other hand, if banks were to foreclose indiscriminately, they could wipe out many desirable entrepreneurial activities. The most difficult decision especially, is regarding those companies in difficulty but with good management track records, whose profits are much affected by unbalanced capital structure, where operating profits are eaten up by high interest charges leaving nothing on the bottomline to support growth. Bank financing for such businesses becomes a life-support system rather than a discretionary option.

Various measures have been taken by banks to assist their ailing clients. Many have set up special rehabilitation units with corrective programs that stress on the need for intensive care. On a case-by-case basis, banks have also considered refinancing of debts, rescheduling of loans, lowering of interest rates, fresh injection of new capital and perhaps even new management. What is stressed here is that salvaging an ailing company is a more challenging proposition to the banker

than forcing liquidation. If all fails, then liquidation will be to everybody's benefit.

The crux of the issue is how banks and entrepreneurs can work together to salvage the remaining assets of failed enterprises. Banks have become more business-oriented in understanding the unique financing requirements of their customers. At the same time, borrowers must understand the need for financial discipline and interest-servicing requirements of the banks.

#### FINANCIAL AND INVESTMENT ADVISERS

The advisory role of banks as "financial doctors" transcend the financial and business fraternity, the community and the Government. On the one hand, the banker acts as corporate adviser to the business community in such areas as corporate restructuring, expansion of business activities and portfolio and investment management, to name but a few. On the other hand, while providing the linkage between businessmen and Government industrial development efforts, banks also provide the supporting advisory role for many Government development programs.

Central to the Government's strategy to promote private investment is the promotion of foreign investment in Malaysia. There is no doubt that banks have a special role to play. Bankers can act as the "marriage-broker" in bringing together two complementary parties for a hopefully, successful joint-venture.

Bankers are the ones best suited to 'sniff' out clients, whether in trading or other sectors, whom they feel have the financial and management capability as well as the interest to diversify into new industrial projects. They may be aware of clients with sufficient technical capability but who are in a state of excess capacity. These will be excellent contract manufacturers for foreign industrialists seeking new sources of supply. As investment advisers, bankers can represent their clients overseas and local investment programs and assist in bringing together potential foreign partners and the local investors.

Towards this end, there is a special role for foreign banks. Foreign banks operating here serve as the "window" to Malaysia. As the conduit between Malaysia and the rest of the world, they can draw on the connections of their overseas offices, associates and correspondents outside Malaysia to assist the country's drive to reach potential investors. Being independent institutions, the foreign banks have a certain credibility in the eyes of investors. Being independent



institutions, the foreign banks have a certain credibility in the eyes of investors and would be in the best position to give an unbiased evaluation of the prevailing investment outlook for potential foreign participation. The support of foreign banks will definitely supplement the Government's efforts in attracting foreign investments into Malaysia.

#### SUPERVISION AND REGULATION

The history of banking through the ages have been littered with examples of bank failures, resulting from imprudent lending, vested-interest loans, speculation with depositors' funds, fraud and swindle. The world over, Central Banks have evolved to regulate and supervise the system. In Malaysia, the evolution of a generally disciplined financial system has been attributable to Bank Negara's prudential regulations and measures to maintain stability in the system.

In the past, and of late, bankers have voiced out the need for greater deregulation and liberalization in the financial system. In Malaysia, the process of financial liberalization has seen the country going through various phases of regulation, deregulation and 're-regulation' in seeking to strike a balance between increasing the roles of market forces in determining interest rate and credit allocation while, at the same time, placing certain checks and controls over the financial system. The sad experiences of the last couple of years, however have brought to bear the fact that the Malaysian banking industry does need some form of regulation. The failure of a number of local banks which eventually led Bank Negara to take over their operation, had caused some loss of confidence in the country's banking system.

With the nation's industrialization now rapidly underway, it appears to be even more necessary not only to re-instill public confidence in the banking system but to provide a conducive environment for investment, especially, foreign investment. With the coming into effect of the new Banking and Financial Institutions Act which gives Bank Negara wider powers to monitor and control financial institutions more effectively, the scene is set towards ushering in "an era of controlled liberalization" from which, hopefully, a stronger and more stable financial system will evolve.

#### NEW DIRECTIONS

Change is the most important factor of life in the global economic scene today and new developments and trends in the banking industry



are in the forefront of this change. In introducing more sophisticated technology in the banking industry, banks must diversify and seek new financial mechanisms to complement their existing roles. An extended role for banks in industrial development activities can be found in two particular areas, of which are venture capital and banks participation in equity financing and promotion of entrepreneurship.

Venture capital is still a relatively new practice in the business communities of both developed and developing countries. Originally venture capital is thought of as only "the early-stage financing of new and young companies seeking to grow rapidly" however, today the concept covers a broad spectrum of interests involving all phase of business growth. This includes financing at either the early expansion, acquisition or buy-out stage. Besides the convention loan as start-up capital, bankers are now talking of equity investments. Venture capital is essentially risk capital in the form of equity.

Venture capitalization is fast catching on in Asia. Japan has the lion's share of regional venture capital funds. Hong Kong has entrenched itself as the focus of Asian venture capital activities outside Tokyo, boasting of at least thirty funds. In Korea, there are four major venture capital firms and fifteen minor ones. In Singapore, there are twelve and in Taiwan four. Venture capital participation by banks in manufacturing industries is allowed and encouraged in several countries including Japan, West Germany, the Philippines and Singapore.

In Malaysia, venture capital had already made a headstart with the establishment of a US\$6 million Malaysian Ventures Berhad established in 1984, of which Arab Malaysian Merchant Bank has a 30 percent stake. Despite the time span, Malaysia's venture capital business has not grown until early 1989 which saw the emergence of banks' involvement in venture capital. Southern Bank Berhad has set up a subsidiary, Southern Bank Venture Capital Sendirian Berhad to undertake venture capital investments. Other parties that have shown interest in setting up venture capital companies include Bank Industri and Amanah Merchant Bank. In a small way, Bank Pembangunan is also considering venture capital financing as another facility.

While allowing industries a relatively better access to funds, the catalytic role of equity participation, though not easily quantifiable, is indeed very significant. The 'critical mass' financial input and management expertise not only helps new industrial prospects get off the ground but also assist the expansion of existing ones. While venture capital funds in other countries have traditionally been geared towards

'high-tech' investment in Malaysia, venture capital will benefit mainly SMIs and industries of which inadequate funding, poor management, limited market and technology skills have always been their perennial problems. There is good potential for banks to play a bigger role in this area. The potential is big because this type of financing does away with collateral as has been the norm in obtaining bank credit. Entrepreneurs play a critical role in determining the success of a project. In the drive towards industrialization, priority will be on the development of new entrepreneurs to broaden the industrial base. Entrepreneur development programs (EDPs) in Malaysia, which proliferated after the launching of the New Economic Policy in 1970, have so far been carried out by government agencies and the development financing institutions, for example Bank Pembangunan. The thrust of these programs was the identification of potential entrepreneurs, the arrangement of the provision of necessary training and other inputs to assist them to make the transition from traders, employees and professionals into owners and managers of their own enterprises.

Entrepreneurial development requires sizable monetary investments though returns are slow, less tangible and even uncertain. The high costs involved, whilst creating a financial burden on the organization, may even frustrate the rapid development of such programs.

EDPs in Malaysia is still in its infancy stage. Much needs to be done. A possible new role for the local banks exists in the co-sponsoring and running of EDPs in the country. In the Indian experience, for example, the Entrepreneur Development Institute and three other similar institutes are all jointly funded and managed by development financing institutions in association with commercial banks and the Government. The role of banks in this regard can take the form, either as co-sponsors, or bilateral arrangements to provide the necessary inputs for the development of these programs or in the form of special loan schemes for participants.

## CONCLUSION

Challenges ahead as foreseen in the banking system will definitely require the nation's expertise and strength. The immediate challenge for bankers is to rebuild and strengthen their balance sheets. However, in the years to come, the banks will also have to be more innovative and competitive to serve the increasingly sophisticated demands of an

industrialized economy. The financial system must once again rebuild the old-fashioned values of frugality and moral discipline to gather the savings and to mobilize these funds towards industrialization and national progress. Given their many problems and constraints, financial institutions are needed to continue to play a vital role in promoting the level of savings and investments in the country.

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