WHY BANK SCANDALS HAPPENED FREQUENTLY IN MALAYSIA?

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According to internationally accepted standard, the General provision for non-performing loan in a well managed banking institution is between 1% to 1.5% of total loan. In 1988, using the three month classification, the non-performing loans ratio in the banking sector in Malaysia is 30% and in 1998, the ratio is 20.4% (Tusha 2005). In 1998, the government spend RM12 billion to rescue various troubled banks in the country. This paper attempts to explain some of the causes for the frequent bank scandals in Malaysia. Section I discusses the definition of non-performing loan. Section II explains the effect of a non-performing loan on the balance sheet of a commercial bank. Section III lists the major bank scandals in Malaysia. Section IV explains some of the characteristics of the Malaysian banking system which causes frequent occurrence of bank scandals. Section V is conclusion.

I. Definition of Non-performing Loan

Non-performing loans are sometimes called doubtful or problem loans. The borrower is unable to pay the contractual interest or principal as they become due. According to internationally accepted standard, a loan is classified as non-performing loan when the principal and the interest have not been paid over 3 months from the due date specified in the contract.

When a loan is classified as non-performing, the bank concern must write off from the outstanding balance depending on the classification. This is 20% off for sub-standard category; 50% off for doubtful category and 100% off for lost category.

To recover the loan, a bank may sell the collateral or petition for the borrower firm to be placed under receivership. After accounting for the expenses, the recovery rate is usually 50% or less.

II.Effect of non-performing loan on the Balance Sheet

Banks are by nature firms. They are set up by their owners for profit. The revenue of a Banks comes mainly from the interest paid by borrowers (interest receipts). Main expenses of a bank is interest paid to depositors (interest expenses), and operating expenses such as rentals, salaries of employees and various utilities. A simple profit equation is given below:

Profit = Interest received from borrowers– interest paid to depositors – operating expenses.

However, part of the loans given out by the bank may become non-performing. Non-performing loan reduces the profit of the bank. The simple profit equation can be modified to account for the effect of non-performing loan on the profit of the bank.

Profit = Interest received from borrowers– interest paid to depositors – operating expenses – lost loans

Suppose in the calendar year of 2005, Bank ABC received RM10 millions as interest receipts from the borrowers. It paid RM3 million as interest expenses to depositors, operating expenses for the year (rental, salaries of employees etc) is RM3 million and lost loans is RM1 million. This is a viable bank. The bank has made for its shareholders a profit of RM (10-3-3-1) = RM3 million. The rate of return to the investors in that year (assuming an equity of RM10 million and no tax) is RM3m\RM10m = 30%. The hypothetical profit and lost account and balance sheet of the bank are given below, assuming all profits have been paid out as dividends:

Profit & Loss in year 2005

Revenue	**Expenditure**
Interest Receipts RM10 m	Interest Expenses RM3 m
	Operating Expenses RM3 m
	Lost loans RM1 m
	Profit: RM3 m

Balance Sheet on 31st Dec 2005

Asset	**Capital**
Loans RM100 m	equity RM10 m
	Liability
	Deposits RM90 m

However, bank XYZ is not as fortunate as Bank ABC.
Due to mismanagement, fraud, embezzlement and cheating, many loans became non-performing. Lost loans in the bank for the calendar year 2005 is RM20 million. Given that the two banks are identical in other aspects, Bank XYZ lost RM (10 – 3 – 3 – 20) million = - RM 16 millions. With the loss, the bank has become insolvent. It has negative capital, and its liability exceeds assets. The bank owes RM 90 million to depositors. However, the Asset of the bank is only RM84 million.
Insolvent banks may be closed down by the central bank of the country. . In this case, the shareholders will lose all their investment and the depositors will receive only a fraction of their deposits. Based on internationally accepted standard, the minimum

capital to risk weighted asset ratio of a bank (called risk weighted capital adequacy ratio) is 8%. When this ratio is below 8%, the central bank of the country may request for recapitalization (injection of new capital), merger, or a change in management.

III. History of Bank Crisis in Malaysia

Below are some of the major bank scandals which had happened in Malaysia in the past 20 years.

(1) In 1975, the Chairman of Bank Rakyat and also Menteri Besar of Selangor Datuk Harun bin Idris misused Bank Rakyat fund totaling RM7.5 million to finance the Muhammad Ali – Joe Bugne fight in Kuala Lumpur. He was convicted (on charges of forgery and criminal breach of trust) and was jailed for three years (Milne 1990).

(2) In 1983, Bumiputra Malaysia Finance (BMF), a subsidiary of Bank Bumiputra Malaysia, lost RM2.5 billion (or US $1 billion in Hong Kong). Large sum of loans was given to a businessman George Tan of the Carrian Group to speculate in the property market. Many of the loans were either unsecured or secured with assets in inflated prices. Bribes were paid to Bank Bumiputra Malaysia directors for the granting of loans. The chairman of BMF Lorrain Osman and the executive director of Bank Bumiputra Malaysia Hashim Shamsuddin were both convicted and jailed in Hong Kong.

(3) In December 1985, the Kuala Lumpur and the Singapore stock exchange were closed for three days due to the collapse of Pan Electric. The controlling shareholder of the conglomerate was the former president of MCA Tan Koon Swan. He manipulated the prices of Pan Electric in the stock exchange so that he can use its shares as collateral to obtain large bank loans for the company. The fund was partly misappropriated for his personal gain and partly used to fund his political ambition in the MCA. When the prices of Pan-Electric collapse, banks petition for Pan Electric to be placed under receivership on 30th November 1985. The company has a total debt of S$450 million. Stocks of the company become worthless and total loss to shareholders was estimated to be S$ 230 million. 6 Singapore stock broking houses became bankrupt, leaving behind them a bank debt of S$1 billion. Prices of other stocks in Singapore, Malaysia and Hong Kong plunged, causing large losses to other investors. . Tan Koon Swan was charged and pleaded guilty to criminal breach of trust and was jailed for 2 years and 18 months in Singapore and Malaysia respectively (Sullivan 2005).

(4) The Central co-operative Bank was taken over by Bank Negara after large amount of loans granted to a small number of powerful politicians became non-performing. The chief executive and the general manager were charged with criminal breach of trust.

(5) On 8th August, 1986, 24 illiquid deposit taking co-operatives in Malaysia were suspended and later placed under receivership. These co-operatives had a total of 588

thousand members, 630 branches and RM1.5 billion deposits. The assets of their directors and principal office bearers were frozen. They were also required to surrender their passports to the director of Immigration.

(6) Sime Bank, formerly United Malayan Banking Corporation, was owned by the Sime Darby group. In 1996, it was the fifth largest commercial bank in Malaysia. It has a total of 60 branches in the country. In 1998, the bank suffers huge losses (RM1.57 billion) with provisions for non-performing loan totaling RM1.8 billion. It was then sold to RHB Capital and merged with the RHB Bank on 30th June 1999. Its chief executive officer, Datuk Ismail Zakaria was charged with criminal breach of trust.

(7) The 1997 East Asia financial crisis invaded the economies of Thailand, Indonesia, Malaysia and South Korea. In Malaysia, the stock market lost 80% of its value. The Kuala Lumpur Stock Exchange composite index plunged from a height of 1271 on 25th February 1997 to a low of 262 on 1st Sept 1998. Also, the ringgit compared to the US dollar lost more than one third of its value. Non-performing loan ratio in the banking sector reached 20.4% in 1998.

(8) Bank Islam Malaysia was established in July, 1983. The bank is largely government owned. In 2005. the bank recorded a loss of RM456 million, Total non-performing loan of the bank was RM2.2 billion, most of the non-performing loan came from its subsidiary in Labuan's offshore financial centre. Many of the bad loans were given to companies in Sarajewo and South Africa. Some of the borrower firms no longer exist.

The Agency Theory and its application in explaining bank scandals in Malaysia

According to the agency theory, there are two parties in a corporation (such as a bank). These are the principals and agents. The shareholders are the principals because they are the owners, receiving the corporation' profit or bear its loss. The agents are the managements because they are employed by the shareholders to run the day to day task of the corporation and paid salaries for their services.

In principle, the agents are supposed to make decisions in the best interest of the principal. To ensure that agents are effective will required the principal to monitor the agent. Unfortunately, monitoring is costly. In most public listed companies, shareholders are numerous, diffuse and disorganized; there is little incentive for a single shareholder to spend costly resources on monitoring the behavior of managements. Without monitoring, most managers will diverge from the principal's objectives. They will make decisions which enhance their interest at the expense of the shareholders. The tendency for agents to act in their own interest instead of the principal is called the principal-agent problem. In many cases, the managers could even gain power by entrenching themselves in the corporation (Hassanuddeen 2005).

According to the agency theory, Agency cost if the sum of monitoring cost, bonding cost and residual loss. Monitoring cost is borned by the principal. It is the cost of the principal monitoring the agent, including establishing appropriate incentives. Bonding cost is borned by the agent. It is the cost of the agent developing bonding with the principal. Residual loss is borned by the principal. It is the cost when agent deviates from principal's objective. In most circumstances, low monitoring cost will result in high residual loss.

According to the agency theory, the principal-agent problem can be reduced by better monitoring and establishing more appropriate incentives for managers. These are lacking in Malaysia for the following reasons. Firstly, market take-over of poorly managed firms by raiders is more difficult in Malaysia because of various government restrictions concerning ownership of corporate equity. Market takeover serves as a check on the behavior of managers. Secondly, many major banks in Malaysia are owned by the government through various agencies. The principal-agent problem becomes worse when a bank is owned by government. This is because the principal of the bank now is the government which in turn is an agent. Thirdly, stock options are rarely used in Malaysia to award bank managers. When bank managers are given remuneration in terms of stock options they will make decision which will increase the price of the company in the stock market. Fourthly, managers' horizon is short in Malaysia because their gratuity is not tie to the long term performance of the bank (Hassanuddeen 2005).

Conclusion

Bank frauds happened frequently in Malaysia. This is because of the greater seriousness of the principal-agent problem. Many major banks in Malaysia are government-owned, and as such the management of these banks could be viewed as agents without a principal. Monitoring mechanism through take-over and tying management's remuneration to stock prices are also lacking in Malaysia.

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