Governor's Keynote Address at the National Credit Management Conference

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As the decade of the 1990s come to a close, we have seen the boom and bust of credit that has created economic turmoil in many countries. The organisation of such a conference is timely. The theme of the conference ? The Lesson of the 1990s: Credit Where Credit is Due ? is certainly pertinent, given the many lessons before us. As you know, the reason history repeats itself is because we do not learn the lessons of history. This gathering of professionals provides an excellent opportunity to examine what went wrong and what needs to be done to implement a good credit culture and good corporate governance.

As the pace of economic recovery picks up momentum, all of us have a responsibility to ensure that past mistakes are not repeated and that we are better-placed to meet the challenges of the future. I propose to first highlight the importance of the linkage between credit and economic activities. While the Government has put in place several initiatives to ensure economic recovery, any lack of momentum in the growth of credit can pose a drag to this initiative. As credit and debt management are really two sides of the same coin, I would then like to give some views on the importance of a sound credit culture for the banking institutions, and a sound debt culture on the part of the corporate sector.

There is now a growing body of economic and finance literature that stresses the importance of the linkage between credit and economic activities. Bank credit assumes particular importance when it is the major source of finance to business enterprises. Research by a number of leading economists has now strongly argued that the sharp contraction of the availability of credit was the main factor that had caused the depression in the 1930s. This literature stresses the importance of collateral in the credit market, which magnifies the traditional interest rate effect. In this regard, an increase in interest rates will not only directly lead to an increase in the cost of borrowing, but will also lead to a deterioration of the net worth of borrowers as the market value of the collateral declines. This literature also stresses the importance of informational asymmetries between lenders and borrowers. In particular, lenders might be unwilling to extend credit to borrowers when interest rates rise beyond a certain level because they cannot differentiate between good and bad borrowers.

Looking back, despite our strong economic fundamentals, the outbreak of the Asian financial crisis nearly two years ago has severely affected the Malaysian economy. The vicious circle started with the action of speculators which led a sharp depreciation in the ringgit exchange rate and decline in stock prices. This, together with continued volatility in the financial markets, adversely affected the health of businesses and the wealth of consumers, which in turn caused a rise in the non-performing loans of the banking institutions. As the banking institutions became concerned over their balance sheets and overly cautious in their lending activities, the availability of credit declined significantly and contributed to a decline in economic activities. This consequently caused a further deterioration in the health of the businesses and the wealth of consumers, initiating yet another cycle of causes and effects. The link between bank credit and economic activities is, therefore, very clear. The sharp decline in loan growth from 26% in 1997 to 1.3% in 1998 was accompanied by a decline in real GDP from a positive growth of 7.7% in 1997 to a negative growth of 6.7% in 1998.

It is important that we understand the factors that caused the decline in loans, so that appropriate and necessary measures can be formulated to overcome this problem. On the supply side, there are at least four factors that can be identified. Firstly, in early 1998, a small number of banking institutions, which were severely affected by a withdrawal of deposits, faced funding problems, adversely affecting the disbursement of their loan commitments. Secondly, concerned over the health of their financial position, banks became more cautious. Just when working capital requirements rose in tandem with the higher cost of inputs due to the ringgit depreciation, banks tightened lending activities and even withdrew credit lines to long-term customers. Thirdly, uncertainties surrounding the economic environment, domestically and externally, caused banks to be more concerned with the viability of projects so that they imposed stricter conditions on loan approvals. Fourthly, the on-going merger exercise among the finance companies led to the slowdown in their loan growth.

The demand for loans, on the other hand, is a derived demand which depends on the performance of the economy. As investor and consumer sentiments deteriorated amidst the prolonged financial crisis, activities in the real sector of the economy contracted. The negative wealth effect due to asset price deflation and the rising inflation rate in the first half of 1998 led to more cautious consumer sentiment and private spending. At the same time, the high interest rates prevailing increased the debt burden of borrowers, both individuals and companies. As there was a lack of demand, inventory levels of companies increased and capacity utilisation was lower, leading to a fall in the demand for loans for new investments.

On the part of Bank Negara, we have been active in addressing the supply constraints and during the course of the crisis, have taken several steps to alleviate the disruption in the intermediation process. Any disruption to the intermediation process could translate quickly into cash flow difficulties in the business sector that would disrupt trade and investment and, if widespread, could lead to systemic risks. To alleviate the uneven distribution of liquidity, Bank Negara injected liquidity (RM34 billion) into the banking system in 1998. Although external pressures prevented an earlier reduction in interest rates, BNM implemented other measures to reduce the cost of funds to banks and to improve the distribution of liquidity. The statutory reserve requirement of the banking institutions was reduced from 13.5% to 4% in September 1998. Several other policy initiatives were also taken to ensure an efficient intermediation process. This comprised the revision to the framework for the computation of the base lending rate, announcement of information on BNM?s daily operations in the money market and the implementation of the new liquidity framework. Subsequently, when inflation moderated, interest rates were eased. Following greater monetary independence accorded by the selective exchange controls, BNM reduced interest rates and the statutory reserve requirement in several rapid steps. The average base lending rate of the commercial banks now averages only 7.25% which is 225 basis points below the pre-crisis level.

As the demand for credit is a direct function of economic activity, it is imperative that the corporate sector responds positively to the recovery promoting measures initiated by the Government. The Government is using a combination of measures, including expansionary fiscal and monetary policies to promote economic growth, coupled with structural reform in the financial sector, and selective exchange controls and fixing of the exchange rate to provide an environment of stability to foster business activities. Increasingly, convincing signs are emerging that both consumer and investor confidence is returning - stock prices are strongly on an upward trend, while economic activities are on the upward trend. This has been translated into an increasing demand for loans, as reflected by the increase in total loans approved by the banking system. If the current trend continues, there should be no problem at all in achieving a positive real GDP growth for 1999.

In view of the importance of credit in supporting economic activities, Bank Negara will ensure the availability of adequate funds to investors at reasonable cost to promote private sector activity. Monetary policy has been accommodative. As inflation moderates, interest rates can be reduced further.

I would like to note here that, in the case of Malaysia, the Government does not rely solely on lowering interest rates and providing liquidity in its efforts to stimulate the economy. Consumer and investor confidence are equally important. However, low interest rates and sufficient liquidity are necessary ingredients, as it would be impossible to stage an economic recovery in an environment of high interest rates and unavailability of credit. It is for this reason that we are encouraging banking institutions with capacity to increase lending activities to achieve a minimum loan growth of 8% for the banking system as a whole. A loan growth of at least 8% is vital for real GDP to grow by one percent. In fact, should the private sector including the banking institutions respond more favourably to Government policy measures and prospects for the international environment improve, GDP growth could be higher than projected. Thus, Bank Negara is now closely monitoring the banking institutions to ensure that those with capacity will play a more positive role in promoting economic recovery.

Despite the strong emphasis on credit growth, Bank Negara will continue to be pragmatic in its approach. Banking institutions have been repeatedly reminded to continue exercising financial discipline at all times without compromising prudential standards. Proper credit evaluation procedures must be used in approving credit. This will ensure that the balance sheets of the banking institutions do not deteriorate further. Nonetheless, banking institutions have also been reminded not to unnecessarily complicate the credit process, making it difficult for borrowers to obtain credit. Any improvement in transparency and good governance by the corporate sector, which I will elaborate on later, will help banks in making their decision on the approval of loans by providing them with greater information on the borrowers, including their credit profile.

While it is important to ensure that credit is made readily available to support the economic recovery process, it is equally important to ensure that the extension of credit be made on sound principles. Banks are in the business of lending but while they do this, they are also obliged to provide an optimum return to depositors as well as their shareholders. This is why it is of utmost importance that banks practise good credit management and adopt a good credit culture.

What lessons can be drawn from the experiences of the 1990s? On its part, Bank Negara has stepped up efforts to promote a sound credit culture in the banking system. Several measures are being introduced to ensure that banks would have in place effective credit risk management systems. Firstly, Bank Negara will be issuing guidelines on minimum standards for credit risk management for the banking institutions. Secondly, Bank Negara is working with the industry in examining the feasibility of an agreed curriculum of training and a credit proficiency assessment in order to ensure that the industry would have a coherent set of programmes to upgrade the credit management skills of lending officers. This skill gap among the lending officers will need to be addressed. Thirdly, regulation on lending to connected parties will be tightened in order to disallow lending to controlling shareholders, who are not directors or officers of the banking institutions, from influencing the credit decisions of the banking institutions. Fourthly, in order to strengthen the corporate governance of banking institutions, Bank Negara will be periodically reviewing the appointment of directors and chief executive officers to ensure that they continue to be "fit and proper" well after their date of appointment. The Bank would like to ensure that the chief executive officers continue to steer the banking institutions to contribute meaningfully to the strengthening of the financial sector and hence, the development of the Malaysian economy.

To complement these efforts, banking institutions, on their part, should ensure that they have in place well-defined credit policies, encompassing areas including the loan portfolio mix, pricing and credit quality standards. Banks must revert to the fundamentals of creditworthiness and apply conventional lending standards. Good credit administration is also essential to ensure enforcement of the policy and the presence of and adherence to proper procedures. Equally important is robust credit risk management and good corporate governance. Underlying all this, banking institutions must be equipped by skilled staff with a high level of professionalism and training.

Banking institutions have also realized the importance of a thorough knowledge of their customers? business and of their real funding needs. Banks, however, are naturally disadvantaged compared to borrowers, who would have more information on the probability of the success of their projects. Consequently, bankers, who become more concerned with their credit risk, will inevitably reject loan applications if they are not sure of the degree of the viability of projects. Hence, in a situation where there is a lack of transparent information and disclosure, good borrowers will be denied credit simply because bankers have difficulty in distinguishing good borrowers from bad borrowers. Furthermore, in a situation where good and bad borrowers are seemingly similar, there will also exist cases where bad borrowers with projects which are not viable obtain credit at the expense of good borrowers. The overall quality of capital of the economy for future economic growth will also be affected.

This imperfection in the credit market can, however, be minimized by reducing the problem of asymmetric information. While banks need to undertake the proper financial review of their clients including the cash flow and ability to service debt in both normal and stress situations, corporations can play a vital role in helping banking institutions base their lending decision on the viability of projects by disclosing the necessary information.

While there have been quite a few key lessons for credit management from the perspective of the lenders, there are equally important lessons for the borrowers. The recent crisis has highlighted weaknesses in the debt management practices of some borrowers. Some corporations had overborrowed, and in the process, leveraged themselves to levels that were difficult to sustain. As a result, they became extremely vulnerable to increases in interest rates and the depreciation of the exchange rate. In addition to the high leverage, some of these borrowings had also been channelled into investments in the commercial real estate and stock markets. At the same time, bank credit was being used to finance long-term projects, investments that would generate income only after a long period, i.e. long after the need for the cash flow to service the borrowings. This created the problem of maturity mismatches in the funding structure. I need not elaborate on the consequences of these weaknesses, as you are well familiar with their adverse effects on the income statements and balance sheets of companies.

Good corporate behaviour cannot be legislated. Corporate players need to be pro-active and not view the rules and practices as onerous. Instead, they should view good corporate governance as a weapon to achieve greater competitiveness in an increasingly liberalised and global environment. The recent crisis has shown that creditors are increasingly viewing good corporate governance as an essential element in their lending decisions and I foresee this trend continuing in the future. As such, companies that exhibit good corporate governance will find it relatively easier to obtain financing at competitive rates, compared to their competitors that do not accord priority to good corporate governance.

I have already highlighted the role of information disclosure to enhance the ability of creditors to differentiate between sound and unsound companies. Information such as projected cash flows and the ability of borrowers to service their debts will allow banking institutions to move away from the excessive dependence on collateral and names to evaluate viability. It is absolutely essential that the corporate sector should make such information readily available on a timely basis. The need for the information to be reliable and comprehensive cannot be over-emphasised given that in this economic environment, corporations may be reluctant to reveal unfavourable information regarding their business performance.

As information will not only facilitate lending decisions but also investor decisions, measures have been taken to improve disclosure requirements. In this regard, public listed companies are now required to submit quarterly reports within two months from the end of every quarter and audited annual accounts within four months from the end of the financial year. One of the main objectives of these measures is to increase the amount and frequency of information to all the key stakeholders, so as to increase market discipline on corporate managers.

In managing their debt policies, companies should also strive to avoid the maturity mismatch problem by financing long-term projects with long-term borrowings. Corporations may also wish to consider, funding projects on a fixed-rate basis, to enable them to have more certainty in their planning as well as to avoid being caught with debt-servicing problems if interest rates rise sharply as a result of external shocks. In this respect, companies intending to undertake long-term capital investments should diversify their funding sources by tapping the ringgit bond market. Bank Negara, on its part, is committed towards the development of the ringgit bond market this year. Among others, efforts will focus on introducing a shelf registration scheme for private debt securities, deepening the repo market and broadening the investor base. It is hoped that the further development of the domestic bond market will increase the menu of debt instruments available for companies to enhance the management of their liabilities.

In our efforts to enhance practices to strengthen the financial system, accountants have an important role in improving the debt management practices of companies. Malaysia does have a high standard in accounting practices that are consistent with international norms. The challenge, therefore, is to maintain these standards and ensure close adherence to these standards, even in difficult times. While regulatory authorities ensure compliance with existing standards through effective surveillance and enforcement of regulations, accountants also can play a key role in encouraging the ethic of full disclosure and accountability. You can do this in your capacity either as members of management or boards of directors or as auditors.

On a more serious note, accountants have an instrumental role in promoting good corporate governance. The Malaysian Institute of Accountants and the Malaysian Association of Certified Public Accountants can be commended for their efforts in this respect, in particular their involvement in the Institute of Corporate Governance set up in March 1998 together with three other professional bodies. I hope the two Associations will continue to contribute towards the work of the Institute. As individual accountants, particularly in your role as auditors, you complement the board of directors by playing the instrumental role of enhancing the effectiveness of corporate governance through effective checks on how financial statements are prepared and presented.

Latest indications are that the economic recovery process has picked up momentum. Our trade account remains in surplus, amounting to RM15.7 billion in the first quarter of 1999. This has contributed to the build-up in our international reserves, which totalled RM108.7 billion at the end of April 1999, equivalent to 6.2 months of retained imports. In the meantime, manufacturing production continued to increase on an annual basis in March 1999. The inflation rate continues on its moderating trend, to 2.9% in April 1999. At the same time, since the end of August 1998, stock prices and the market capitalisation of the Kuala Lumpur Stock Exchange have increased substantially. The Composite Index which was at 262 points on 1 September 1998 is now above 760 points. The market capitalisation which was RM181 billion on 1 September 1998 is now RM474 billion. We are now in a bull market. And the bull is still young!.

The economy has turned around and we are now once again on the path of recovery and prosperity. We must ensure, this time around, that we do not repeat the mistakes of the past.

Dengan ini, saya dengan sukacitanya merasmikan Persidangan Pengurusan Kredit Kebangsaan Malaysia 1999.

Bank Negara Malaysia
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