chapter six

development financial institutions

Background

In Malaysia, development financial institutions (DFIs) have been established and funded by the Government to develop and promote certain strategic sectors of the economy, and to achieve social goals.

The important sectors of the economy currently supported by the DFIs is to promote industrialisation, particularly the high-technology industries, export-oriented industries, infrastructure development and highly capital-intensive investments and the agriculture sector. The DFIs also play a crucial role in the development of SMIs and housing sectors.

DFIs are expected primarily to fill in the gaps in the supply of financial services that are not normally provided by the banking institutions. Such development institutions are generally specialised in provision of medium and long-term financing of projects, which require specialised skills and focus, and may carry higher credit risks or market risks due to the longer investment tenures. In some cases, the mandated roles of the DFIs include the promotion and achievement of Government's specific social and economic objectives.

The DFIs have in varying degrees contributed to the development and growth of the targeted industries and strategic sectors of the economy. The DFIs are expected to provide support to these sectors without resulting in losses or incurring a direct cost to the Government. To enable them to perform these functions, such DFIs have generally been accorded special benefits in the form of funding at lower rates, implicit Government guarantee to the institutions' debts, special status for their debt instruments and favourable tax treatment. As at end-1999, the share of assets of the large DFIs in Malaysia was 3.8% of the total assets of the banking sector. Total loans extended by the large DFIs as a group amounted to RM11.0 billion, representing 2.9% of total loans of the banking sector. Of the total loans extended, 31% was channelled to the manufacturing sector, 17% to the construction sector, 13.4% to agriculture, 12.1% to transport and storage, and 10.3% to the real estate sector.

While some DFIs have evolved and expanded their specific original roles for which they were established, others have evolved to engage in commercial activities that are less developmental in nature. Although such expansion in commercial activities was undertaken to complement the earnings potential of the DFIs, it has contributed to strains in the resources of these institutions, putting pressure on their organisational capacity, management capability and technical expertise. In addition, it has resulted in inadequate coordination among DFIs and the relevant authorities in areas such as policy formulation, strategic planning and funding requirements. These have to some extent affected the DFIs in performing their roles effectively.

Presently, an effective and integrated legal, regulatory and supervisory framework for the DFIs has yet to be formulated. As such, the roles, functions and responsibilities of the regulatory authorities have not been specifically defined and mandated, and the prudential regulations have not been adequately formulated and enforced.

Vision and Objectives

It is envisaged that DFIs would continue to progress and assume a significant role in addressing the development strategies of the nation by complementing the established banking institutions to meet financing requirements of the changing economy. The DFIs would continue to provide financing to promote the industrial sector, the services sector and the modernisation of the agriculture sector, thus providing support to the development of these sectors. The DFIs would also continue to maintain their role as niche providers of capital financing for projects which require medium to long-term financing in the industrial, manufacturing, services and agriculture sectors.

As the banking institutions enhance their capacity and capability, it is anticipated that they will venture into new areas, including those, presently served by the DFIs. DFIs would need to review their areas of comparative advantage and complement rather than compete with the banking institutions. This will ensure the continued relevance of DFIs and their effectiveness in this changing environment.

To enhance their competitive edge, investment in new technology, is the key for DFIs in increasing their capacity, effectiveness and efficiency providing the specialised financial services. Processes and procedures will be better managed through greater use of information and communication technology.

Good corporate governance structure has to be embedded in the legislation to enhance the performance of the DFIs. This would be demonstrated through appointment of qualified and experienced Board of Directors (BOD), reinforced with proper checks and balances through an effective audit function. Furthermore, the accountability of DFIs will be enhanced by a legal framework in which the institutions will be required to disclose appropriate financial performance and activities to the relevant authorities and the public.

The supervisory process, functions and roles of a single supervisory authority responsible for DFIs need to be clearly defined and specified. The primary objective of supervision is to ensure that the DFIs' roles and functions are in accordance with the objectives for which they were established and that their activities are carried out prudently, efficiently and effectively. Prudential regulation, as well as the supervisory process, both in terms of on-site and off-site surveillance and monitoring of DFIs, need to be put in place. A single regulatory agency would not only supervise to ensure the safety and soundness of the DFIs but also needs to be in a position to assess the extent to which the DFIs have met the objectives for which the institutions were established as well as the economic implications of the DFIs' activities.

In summary, the objective is to achieve the following:

- Efficient and robust DFIs to support identified priority sectors of the economy not adequately serviced by the banking institutions;
- Development and evolution of specialised DFIs dedicated to financing infrastructure projects, agriculture sector, capital intensive and high-technology industries and the services sector;
- Effective and dynamic supervision of DFIs by a single regulatory authority;
- Emergence of DFIs as lead advisers, consultants and/or management service providers to the targeted sectors of the economy; and
- Intensification of the use of technology to build up infrastructure and communication network to provide easier and wider accessibility.

Recommendations

As part of the strategies to promote improvement in the efficiency and effectiveness of the DFIs, a number of recommendations are proposed focusing on measures to build the capabilities of the DFIs and to improve the supervisory framework. These are elaborated below:

Recommendation 6.1:

Define clearly the strategic focus and role of the DFIs

To ensure that the DFIs complement the existing banking institutions effectively, in providing financial services to those activities not serviced by the banking institutions, the role of the DFIs should be clearly outlined and defined. It is proposed that the focus of the DFIs be as follows:

- As **development institutions**, DFIs should continue to meet the socioeconomic and developmental goals set by the Government;
- As **financial intermediaries,** the DFIs should not be involved in sectors that have matured and are able to obtain financing on their own from the banking system or the capital market. DFIs should complement the banking sector through extension of credit in:-
    - Priority and/or new growth areas specified and identified by the Government, such as, information technology and high technology ventures, infrastructure development, services and agriculture;

- Sectors which banking institutions are not equipped with the expertise to appraise, including projects involving complex industrial and agricultural technology;
- Sectors or projects which require lenders to assume venture-type risks which should not be funded from depositors' funds; and
- Projects requiring longer term funding which are not normally provided by the banking institutions.

- As **specialised institutions**, the DFIs should enhance their range of facilities through product and service innovation to sustain growth in the specialised areas. Emphasis should also be given in providing value-added advisory, consultancy and technical assistance supported by strong research capabilities.

Recommendation 6.2:

Enhance institutional capacities and operational structure

In order to achieve the objectives and meet the challenges successfully, the DFIs' operational capabilities and capacities need to be further strengthened and improved with the following measures to be taken:

- Formulate comprehensive policies and operational procedures in line with the organisational objectives. DFIs' financing policies should ensure that loans and investments are provided with the proper viability study, credit evaluation and risk assessments;
- Address credit risk needs appropriately. A comprehensive risk management system with appropriate management oversight to identify, measure, monitor and control risks needs to be established. Stress tests would be useful to provide indication of capital requirements in alternative economic scenarios and business strategies;
- Incorporate adequate organisational controls with strong checks and balances. To minimise management and operational risk, clear lines of responsibilities and management structures need to be established, and both internal and external audit procedures need to be instituted;
- Identify human resource requirements and develop the appropriate recruitment policy for selection and placement of competent personnel. Professional training should be conducted in a systematic way to continuously enhance the staff skills and competencies especially in the area of financing;
- Increase the use of technology to enable efficient dissemination of information and to improve consumer access to financial services and facilities, e.g. through a financial service portal. Manual processing and procedures should be automated to enhance operational efficiency. A comprehensive management information system should also be developed.
- Set up research and development department to facilitate DFIs in assisting targeted groups in the provision of consultancy and advisory services;

- Establish network with overseas counterparts to keep abreast with latest developments in the DFIs' activities; and
- Set up a unit to formulate coordination with relevant ministries, authorities and agencies, as well as to facilitate achievement and assessment of Government objectives.

Recommendation 6.3:

Enhance performance measurement

A comprehensive performance measurement framework to gauge DFIs' ability in meeting Government policies, goals and targets should be put in place. Due to the unique role of DFIs, the framework should not be solely based on financial performance indicators. The performance measurement of DFIs should encompass the following:

- Quantitative and qualitative indicators that evaluate the economic and social contributions arising from DFIs' activities;
- Quantitative operational programme or budget set annually or on periodic basis; and
- Financial performance indicators.

The following action plan should be taken to facilitate the assessment on the performance of DFIs:

- Formalise annual performance plan for DFIs based on their primary developmental roles and objectives;
- Establish appropriate measures and benchmarks to determine the efficiency and effectiveness of DFIs toward achieving these objectives; and
- Report performance results to the Government and public.

Recommendation 6.4:

Introduce a systematic framework for sourcing funds

A systematic framework to ensure adequate funding for DFIs' operations should be introduced. The framework should comprise the following elements:

- Funds obtained from the Government for development and social programmes would be allocated through a budgetary process, where funds are allocated and accounted for in the Government's annual budget;
- The Government funds intended for development and social programmes should be kept separate from the DFIs' own funds and administered separately in the manner of trust funds;
- Government support will be needed to facilitate DFIs to raise funds from the capital market for the DFIs' own lending activities; and
- DFIs are encouraged to raise funds from the capital market for their own lending activities when possible.

Government funding support for development and social programmes should be protected with a system of close supervision and controls, together with strong corporate governance to ensure these funds are used for their stated purposes.

DFIs' access to the capital market needs to be enhanced to provide an efficient means of financing capital intensive and long gestation projects. Government support may be needed to enable DFIs to obtain favourable funding rates, which ultimately would make the projects more viable.

Recommendation 6.5:

Continue Government's support to the DFIs

In order for DFIs to successfully meet their objectives, Government support and effective coordination among relevant ministries is essential. The coordination and strong rapport with the relevant ministries can be achieved through the following measures:

- Adopt a consultative approach to facilitate coordination and communication among the regulatory and supervisory authority, the Government, the DFIs and industry experts through regular meetings and consultation to ensure smooth transmission and implementation of Government policies. This consultation process can promote coordination among Government agencies for the effective policy development and implementation by the DFIs;
- Relevant ministries to clearly specify the role and objectives of DFIs in line with the changing needs of the nation and developments in the economy;
- Apply annual budgetary allocation processes as tools to determine DFIs' scope of activities and funding sources;
- Establish measures to address ad-hoc development and social projects which are not budgeted for in Government allocation to DFIs and incorporate performance review and accountability criteria; and
- Formulate and agree on the performance plan, targets, benchmarks and measurement criteria for DFIs' operations.

Recommendation 6.6:

Strengthen corporate governance

Corporate governance centers on an effective BOD, strong corporate responsibility, accountability and transparency in line with best practices. The corporate governance in DFIs can be improved by undertaking the following measures:

- Increase clarity of Government's expectation as the main stakeholder by determining the role and objectives of DFIs in line with the nation's developmental policies and goals;
- Appoint qualified BODs with sufficient skill and expertise, and with appropriate balance of executive and non-executive directors;
- Establish effective audit committee supported by strong internal audit function;
- Ensure sufficient review and measurement of directors' performance on periodic basis;
- Provide external checks and balances in DFIs' operations; and
- Increase disclosure requirements of DFIs' activities to render greater transparency and accountability.

Recommendation 6.7:

Establish a legislative framework to provide for regulation and supervision of DFIs

It is proposed that a legal and regulatory framework be established for the DFIs. A single legislation to regulate the DFIs with due consideration of the unique roles and function of each individual DFI. The new legislation will ensure that DFIs' policies and objectives are consistent with the Government initiatives and direction and that Government policies are implemented effectively. The regulatory framework will take into account that DFIs are

expected to serve public purposes and would be given special benefits and privileges to do so to achieve the national interest and the socio-economic agenda. The regulatory framework will be concerned with the safety and soundness of the DFIs so as to minimise the need for financial assistance from the Government. The legislation should also incorporate prudential rules, disclosure and reporting requirements, rules on corporate governance, as well as powers to be granted to the regulatory and supervisory authority in the case of mismanagement or malpractice in the DFIs.

Recommendation 6.8:

Establish a single Regulatory and Supervisory Authority (RSA) to strengthen the supervision of DFIs

An effective RSA should have the following attributes:

- Ability to regulate and supervise activities of DFIs in meeting their strategic focus towards achievement of Government developmental objectives and goals;
- Ability and capacity in terms of manpower, skills, knowledge and expertise, and system capabilities to implement regulatory and supervisory measures to ensure the safety and soundness of DFIs. This includes capacity for ongoing supervisory efforts, both off-site supervision and on-site examination;
- Competency in evaluating and measuring the performance and impact of DFIs' activities and in assessing DFIs' achievement of the Government developmental goals;
- Formulate sufficient reporting requirements for DFIs to facilitate supervision as well as coordinate overall DFIs performance reporting to Government and public; and
- Facilitate effective coordination and communication among policy makers and the DFIs.

The RSA needs to play a strong coordination role in the overall supervision by carrying out the supervision process. In supervising the DFIs, efforts should be focused on enhancing the corporate governance practices supported by strong commitment and active participation of the relevant ministries. In addition, external checks and balances from external auditors and the budgetary process can be incorporated as part and parcel of the supervisory process. The RSA should address the safety and soundness of the DFIs, individually and collectively, as well as public purpose and the economic implications of the activities of the DFIs on the financial system and economy.

Approach to Implementation

DFIs will continue to be relevant and important in pursuing Government policy goals for strategic, social and economic development. Towards achieving these goals, the role of DFIs needs to be clearly mandated to ensure such institutions stay focused on their core activities to complement rather than compete with existing banking institutions. The approach will be to enhance the capacity of the DFIs to enable them to meet these objectives efficiently and effectively and to formulate the regulatory framework aimed at strengthening the supervision of DFIs to enhance its safety and soundness. The former will include operational reengineering to be undertaken by the individual DFIs to gear themselves towards meeting their expected roles more efficiently and effectively, while the latter will ensure that this will be achieved without resulting in financial problems and minimising the cost to the Government.