



**THE RELATIONSHIP BETWEEN VARIATIONS IN INTREST SPREAD  
PRICING (ISP) AND PROFITABILITY OF BANK'S OVERDARFT (OD)  
FACILITY BUSINESS BORROWERS**

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**MAY 2008**

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Do hereby, declare that,

- This work has not been previously accepted in substance for any degree, locally or overseas, and is not being concurrently submitted for this degree or any other degrees.
- This project paper is the result of my independent work and investigation except where otherwise stated in the project paper.
- All verbatim have been distinguished by quotation marks and sources of my information have been specifically acknowledged.

Signature: \_\_\_\_\_

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*09/05/2008*

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## ABSTRACT

Lending is the primary function of banking. Loans and advances comprised bulk of a bank's assets which shall provide the major portion of earnings and profits. Losses on loans granted to borrowers (deficit units in banking terms) can marginalize the margin of safety provided by the bank's networth (capital + accumulated profits) and may jeopardize the bank's ability to honour its depositors (surplus units in banking terms) for funds. Hence, being the custodian of both public and private funds, banks must at all time practise sound and prudent banking practices. This means that banks must never put the depositors' trust at risk by taking unmitigated risks when granting loans and advances to its business borrowers.

Interest spread pricing (ISP) is part of the 4Ps of the marketing mix (product, price, place and promotion). Hence, in banking, price represents the ISP. In banking, ISP like in marketing mix is the only revenue generating "P", whereas the other 3Ps are costs (product, place and promotion).

Similarly, in banking ISP it is the single most important factor in determining the profitability of the bank as it is the main revenue or income generator. Hence, a suitable ISP must be oriented towards increasing the profitability of the bank. An ISP over the effective cost of funds or Base Lending Rate (BLR) of the bank will provide the desired net interest income for the bank.

This project paper will attempt to establish the relationship between the variations in interest spread pricing (increase or decrease) and the bank's profitability (increase or decrease). Simulated data for 3 top OD business borrowers will be used in this project paper.

# THE RELATIONSHIP BETWEEN VARIATIONS IN INTEREST SPREAD PRICING (ISP) AND PROFITABILITY OF BANK'S OVERDRAFT (OD) FACILITY BUSINESS BORROWERS

## 1.0 INTRODUCTION

### 1.1 Background of study

The Malaysian banking services industry has certainly undergone major structural change since the early 1990s starting with mergers and acquisitions (M&A) to form eventually 10 anchor banks merged or acquired with the view of the making the 10 existing anchor banks (with more mergers and acquisitions expected) to be well capitalised to face stiff competition from the imminent opening up of the banking sector to foreign banks. We have now seen a few foreign banks (Kuwait Finance House, Al-Rahji to name a few that have been granted licences to operate in Malaysia). In addition, since the banking services are distinguished from the normal goods in terms of intangibility, inseparability and perishability, and these characteristics will continue to dominate in banking services. Amongst the three mentioned characteristics, intangibility appears to be the main distinguishing feature, since banking services are processes or experiences rather than physical objects and hence, cannot be possessed.<sup>1</sup>

Secondly, the growing bond market where big corporations or multinationals have preferred to issue bonds to raise capital at competitive rates and lower cost if compared to ordinary bank borrowings. Hence, the days of traditional banking where the banks collect deposits then lend to potential borrowers are numbered as more and more complex financing instruments are being tested, introduced and applied such as bond issue, derivatives, setting up of special purpose vehicle (SPV), asset-back

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<sup>1</sup> Lovelock,1981;Shostack,1977;Bowen and Schneider,1988