

Developments in the Financial System

Overview

Monetary policy in 2001 continues to give priority to financial and price stability in facilitating economic growth. At the same time, the monetary stance remains pragmatic and flexible to adjust to the changes, challenges and risks in the economic and financial environment arising from increasing globalisation. Given the adverse external developments, an accommodative monetary policy is necessary to complement the fiscal stimulus in sustaining economic growth.

On the exchange rate front, the ringgit peg remains consistent with macroeconomic fundamentals to continue to provide a stable and predictable environment to support economic growth. The accommodative monetary policy also seeks to strike a balance in promoting investment through low interest rates while maintaining positive real rates of return on savings. Despite the slowing down in economic activities, the banking system continues to remain strong with loan growth augmented by increased financing through the private debt securities (PDS) market. There has been further progress in financial and corporate restructuring, with recent initiatives announced to further intensify restructuring efforts.

Islamic banking continues to make significant progress with measures taken towards promoting Malaysia as a regional Islamic banking and insurance centre. Similarly, the development financial institutions complement the banking system in terms of increased loan performance to priority sectors as well as extending financing under several funds. Total resources of provident and pension funds continued to increase, despite higher withdrawals made by contributors. The

insurance industry, comprising conventional and Islamic insurance also expanded and contributed to the strong growth of the services sector.

The capital market remained active, despite the decline in net funds raised on account of higher redemptions. The Kuala Lumpur Stock Exchange, despite the downtrend due to the adverse external environment, continued to outperform other selected regional stock markets. The unit trust industry expanded with new funds launched while the derivatives market was active in terms of trading in the 3-month Kuala Lumpur Interbank Offered Rate and crude palm oil futures. Meanwhile, several measures were taken to further enhance on-going efforts to promote the efficiency, resilience and competitiveness of the capital market as well as in improving corporate governance and shareholder protection.

Monetary Policy

Monetary policy remains accommodative in 2001 to support domestic economic activities to mitigate the effects of the global economic slowdown on Malaysia. The nation's strong fundamentals, including the low inflationary environment and strengthened banking system, together with the global easing of interest rates have accorded greater flexibility for the accommodative domestic monetary policy. Bank Negara Malaysia (BNM) continued to ensure that sufficient liquidity was available in the banking system. Special funds for vital sectors and the small- and medium-scale enterprises (SMEs) were promoted through expanding the size and scope of these funds as well as lowering their lending rates. Meanwhile, the pegged exchange rate regime continues to

provide an environment of stability and predictability to support economic activities as well as banking and corporate restructuring, thus helping to support economic growth.

The recent event in the US has increased the short-term risks that are biased towards a global economic downturn in 2001 and slow recovery in 2002. Despite the strong economic fundamentals of subdued inflationary conditions and strong external balance, being an open trade-oriented economy, Malaysia is not insulated from these external developments. Against this backdrop, BNM reduced the 3-month intervention rate by 50 basis points to 5% on 20 September, marking its first cut in more than two years. The reduction serves to support domestic consumer and business activities, thereby alleviating the adverse impact of external developments. Effectively, the ceiling base lending rates (BLRs) of commercial banks and finance companies declined to a new historical low of 6.42% and 7.46%, respectively (from 6.83% and 7.98%). These reductions will benefit all sectors including the banking institutions, by reducing the borrowing cost and debt service burden of corporate and individual borrowers, while containing the likelihood of loans turning non-performing. On the other hand, the decline in fixed deposit rates of commercial banks and finance companies have been smaller in the range of 10 to 25 basis points for the 1-month to 12-month maturities.

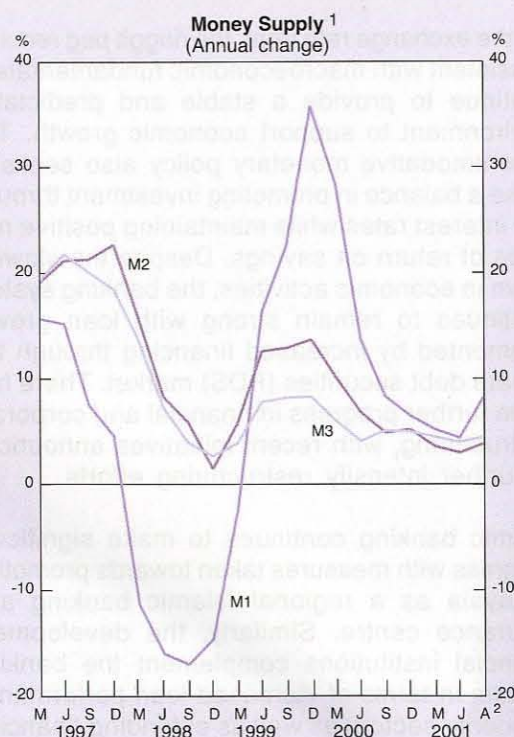
Monetary Developments

The performance of the monetary aggregates in the first eight months was in line with real sector activities, and reflected the policy of ensuring sufficient liquidity to finance real output expansion while maintaining price stability. **Narrow money, M1**, comprising currency in circulation and demand deposits expanded at a faster rate of 8.4% as at end-August (end-2000: 6.5%). Following a moderation (-RM6,171 million) in the first half of the year, M1 recovered to register a significant expansion of RM3,194 million in July-August, partly reflecting the better performance in the stock market. Meanwhile, **M2**, comprising M1 and narrow quasi-money, registered an increase of 3.9% as at end-August (end-2000: 5.2%). The moderate growth in narrow quasi-money

was partly attributable to the shift in deposits to banking institutions other than commercial banks.

The **broad monetary aggregate, M3**, continues to increase on an annual basis, rising by 4.5% as at end-August (end-2000: 5%). Underpinned by higher savings, foreign currency deposits, repurchase agreements (repos) and negotiable instruments of deposit (NIDs), M3 expanded by RM3,209 million in the first eight months. In terms of determinants, the expansion in M3 mainly reflected higher claims on the private sector (RM11,751 million; January-August 2000: RM12,706 million), which was the result of a significant increase in bank lending activities (RM13,565 million; January-August 2000: RM5,868 million), supported by an environment of low interest rates and ample liquidity. The increase in bank loans was slightly offset by a reduction in holdings of securities (-RM1,825 million; January-August 2000: RM5,074 million). Net external assets also contributed to the

CHART 8.1
Monetary Trends



expansion in M3, rising by RM6,731 million and reflecting to a large extent continued inflows from trade and foreign direct investment.

Meanwhile, Government operations exerted a contractionary impact on money supply (-RM3,600 million; January-August 2000: RM1,755 million), largely due to the increase in placement of Government deposits with BNM. This largely reflected the receipts from two reopenings of Malaysian Government Securities (MGS) issues of RM5,000 million each in March and June, respectively as well as the proceeds from the USD1,000 million 10-year Notes issued by the Federal Government at the end of June. There was also a reduction in banking institutions' holdings of MGS on account of several redemption exercises in the first eight months. Government operations are, however, likely to exert an expansionary impact on money supply in the remaining months of the year, as the Government implements the fiscal stimulus programme.

Total deposits, including repos mobilised by the banking system (including Islamic banks), increased by RM2,807 million or 0.6% in the first eight months (January-August 2000: RM1,243 million or 0.3%), as shown in *Table 8.1*. The increase in deposits reflected mainly higher placements by individuals and statutory authorities, which more than offset the net withdrawals by business enterprises and the government sector. Fixed deposits continue to dominate deposits of the banking systems, accounting for a 58.4% share. On an annual basis, total deposits of the banking system increased by 3.5% at end-August 2001. Commercial banks continue to account for the largest share of total deposits at 76.6%, as shown in *Table 8.2*.

Lending activities remained robust in the first eight months. The banking system, in particular, had expanded their financing activities through new loans as well as PDS financing, amid ample

TABLE 8.1

Banking System: Deposits
(including Islamic Banks)

	Change During Period				End-August 2001	
	2000 January-August		2001 January-August			
	RM million	(%)	RM million	(%)	RM million	Share (%)
Demand deposits	-138.0	-0.3	-2,416.0	-4.6	52,211.2	11.0
Saving deposits	3,381.0	7.6	1,671.1	3.7	45,158.3	9.5
Fixed deposits	-4,156.3	-1.5	-7,828.6	-2.8	276,590.1	58.4
NIDs ¹	-5,702.0	-25.0	2,119.3	9.5	22,296.7	4.7
Repos	-922.1	-5.3	103.5	0.6	18,343.0	3.9
Others ²	8,780.5	15.3	9,158.1	15.6	58,612.5	12.4
Total	1,243.1	0.3	2,807.4	0.6	473,211.8	100.0

¹ Negotiable instruments of deposit.

² Includes New Investment Fund and special deposits.

Source: Bank Negara Malaysia.

TABLE 8.2

Deposits by Banking Institutions
(including Islamic Banks)
(end-August)

	RM Million		Share (%)
	2000	2001	
Commercial banks	347,256.8	362,692.5	76.6
Finance companies	84,848.8	84,057.1	17.8
Merchant banks	24,949.7	26,462.2	5.6
Total	457,055.3	473,211.8	100.0

Source: Bank Negara Malaysia.

liquidity. Overall banking system loans together with PDS issued by the private sector, increased strongly by RM22,662 million during the period. On an annual basis, it increased by 8% at end-August 2001 as shown in *Table 8.3*.

On the whole, the low interest rates have been an important contributing factor in stimulating demand for loans. Loan approvals and disbursements were relatively strong in the first eight months. **Loan approvals** remained high during the period, amounting to RM85,967 million (January-August 2000: RM88,877 million). Loans were granted mainly for the purchase of residential property and passenger cars (RM18,231 million and 13,154 million, respectively) as well as manufacturing and construction activities (RM10,502 million and RM6,998 million, respectively). During the same period, **loan disbursements** increased substantially to RM247,144 million (January-August 2000: RM229,932 million). Loans were disbursed to a wide range of activities, including manufacturing, wholesale and retail trade, financial, insurance and business services, for the purchase of residential property and passenger cars as well as for construction. The substantial loan disbursements particularly to the household sector, specifically housing and hire-purchase loans, suggest sustained growth in domestic economic activities. Meanwhile, **loan repayments**

were also higher, amounting to RM238,497 million (January-August 2000: RM225,309 million), which had to some extent moderated the increase in loans outstanding, particularly in the manufacturing and wholesale and retail trade sectors.

Notwithstanding the higher repayments, total loans outstanding expanded by RM14,372 million (January-August 2000: RM13,037 million). Outstanding loan growth was 5.6% as at end-August 2001 (end-August 2000: 3.6%), still below the target of 8%. Both commercial banks and finance companies recorded annual loan growth of 6.1% and 7%, respectively as at end-August.

On the whole, banking system loans were broad-based in the first eight months of 2001. The strong loan performance was driven mainly by robust demand for consumer loans, in particular housing and hire-purchase loans amid the low interest rate environment. In addition, many other sectors also recorded improved performance, particularly the finance, insurance and business services, transport, storage and communications sector as well as construction activities, as shown in *Table 8.4*.

Several measures have been introduced in recent years to further improve the accessibility to credit, particularly to the SMEs. These include improving the loan approval process in banking institutions,

TABLE 8.3

**Financing Through Banking System
Loans and Private Debt Securities**
(end-August)

	2000		2001	
	RM million	Annual growth (%)	RM million	Annual growth (%)
Loans outstanding	443,504.7	3.6	468,391.2	5.6
PDS outstanding	91,381.4	93.9	109,128.6	19.4
Total	534,886.1	12.6	577,519.8	8.0

Source: Bank Negara Malaysia.

TABLE 8.4
Banking System: Direction of Lending¹
 (including Islamic Banks)

Sector	Change During Period				End-August 2001	
	2000 January-August		2001 January- August			
	RM million	(%)	RM million	(%)	RM million	Share (%)
Agriculture	606.2	6.0	37.5	0.3	11,995.3	2.6
Mining and quarrying	55.0	3.2	-96.1	-5.9	1,632.3	0.3
Manufacturing	2,609.3	3.8	1,864.6	2.7	70,226.8	15.0
Wholesale, retail, restaurants & hotels	1,369.2	3.6	138.3	0.4	38,197.8	8.2
Broad property sector	5,997.1	3.7	9,358.5	5.4	172,602.9	36.9
Transport, storage & communications	-1,279.4	-8.9	826.0	5.6	14,757.2	3.2
Finance, insurance and business services	-1,180.4	-3.6	1,082.8	3.0	35,537.4	7.6
Consumption credit	5,605.7	9.8	5,458.2	8.4	65,182.8	13.9
Purchase of securities	-646.7	-2.0	-2,426.1	-7.8	31,189.6	6.7
Others	-98.8	-0.4	-1,871.4	-6.9	27,069.1	5.6
Total	13,037.2	2.9	14,372.3	3.1	468,391.2	100.0

¹ Including loans sold to Cagamas and Danaharta.

Source: Bank Negara Malaysia.

enhancing the role of Credit Guarantee Corporation (CGC), promoting alternative sources of financing including PDS and venture capital, setting up dedicated units to monitor loan complaints and to manage problem loans (in banking institutions) as well as providing assistance to Bumiputera entrepreneurs.

In addition, in March 2001, the special funds, namely the Fund for Food, New Entrepreneurs Fund and the Fund for Small and Medium Industries 2 were enhanced by raising the levels, expanding the scope as well as lowering the lending rates. The most significant measure has been the increase in the paid-up capital of CGC by RM1,000 million to RM1,600 million as at end-2000. CGC will now play a greater role in increasing access to financing by SMEs. In order

to enhance its effectiveness as the sole agency, which provides guarantee cover in Malaysia, CGC has introduced the Direct Access Guarantee Scheme (DAGS) in 2000. Under DAGS, all loan applications, which need guarantee cover, would be submitted first to CGC and then forwarded to banking institutions once guarantee cover has been secured. The branch network of CGC has also been expanded to facilitate access to guarantee cover and financing from banking institutions. As part of the efforts to make CGC a one-stop centre for SMEs, CGC was also appointed to manage the Fund for Small and Medium Industries 2 in 2000 and the New Entrepreneurs Fund in July 2001. CGC launched a web service portal to assist SMEs in applying for loans through the Internet in July 2001.

Reflecting the accommodative monetary policy stance and ample liquidity situation, **interest rates** remained low and stable to stimulate domestic economic activities to mitigate the effects of the weak external demand. Up until 20 September 2001, the 3-month BNM intervention rate was kept unchanged at its August 1999 rate of 5.5%, thus allowing the BLRs of commercial banks and finance companies to remain at historical lows. The ample liquidity situation and increased competition among banking institutions also led to a downward trend in the average lending rates (ALRs) of commercial banks and finance companies, declining by 31 and 54 basis points to 7.14% and 10.60%, respectively as at end-August 2001, as shown in *Table 8.5*. Savings deposits rates of commercial banks and finance companies were at 2.60% and 3.12%, respectively, lower than their levels at the beginning of the year. Fixed deposit rates, however, remained relatively stable.

On 20 September, in a move to stimulate domestic consumer and business activities, BNM reduced its 3-month intervention rate by 50 basis points to 5%, aimed at addressing the short-term risks that were leaning towards weaker domestic economic growth and to counter further adverse impact from external developments. Accordingly, the ceiling BLRs of commercial banks and finance

companies declined to 6.42% and 7.46%, respectively (from 6.83% and 7.98%). At the same time, BNM ensured that its liquidity operations would support interbank rates at the current low levels in order to minimise the impact of lower intervention rate on deposit rates. As at 28 September, most commercial banks and finance companies had lowered their quoted 1-month to 12-month fixed deposit rates by 10-25 basis points. In comparison, their BLRs had fallen by 40 basis points and 50 basis points, respectively.

Performance of The Banking System

The risk-weighted capital ratio (RWCR) of the banking system increased from 12.4% as at end-December 2000 to 12.6% as at end-August 2001, exceeding the Basle minimum ratio of 8%, as shown in *Chart 8.2*. The improvement follows the completion of the capital raising exercises by several banking institutions and the strong profitability recorded during the first half of 2001. Preliminary unaudited profits before tax of the banking system amounted to RM4,000 million during this period. The core capital ratio of the banking system also rose from 10.5% at end-December 2000 to 10.6% as at end-August 2001.

The NPL ratio of the banking system, based on a 6-month classification, rose to 8.3% as at end-August 2001 from 6.3% at end-2000. The increase in NPLs was largely attributable to the reclassification of loans previously given indulgence by BNM to accelerate the restructuring process and to some extent as a result of the economic slowdown. The amount of loans, which were previously granted indulgence, that was reclassified as NPLs during the first half of 2001 amounted to RM4,322 million or 1% of total loans.

Based on the current level of capitalisation and profitability, the banking system is in a position to withstand the adverse effects of a more prolonged economic slowdown. The stress test conducted by BNM, which incorporates potential loan losses, has also indicated that the banking system has sufficient capital to absorb any potential losses that could result should growth slow down further.

TABLE 8.5

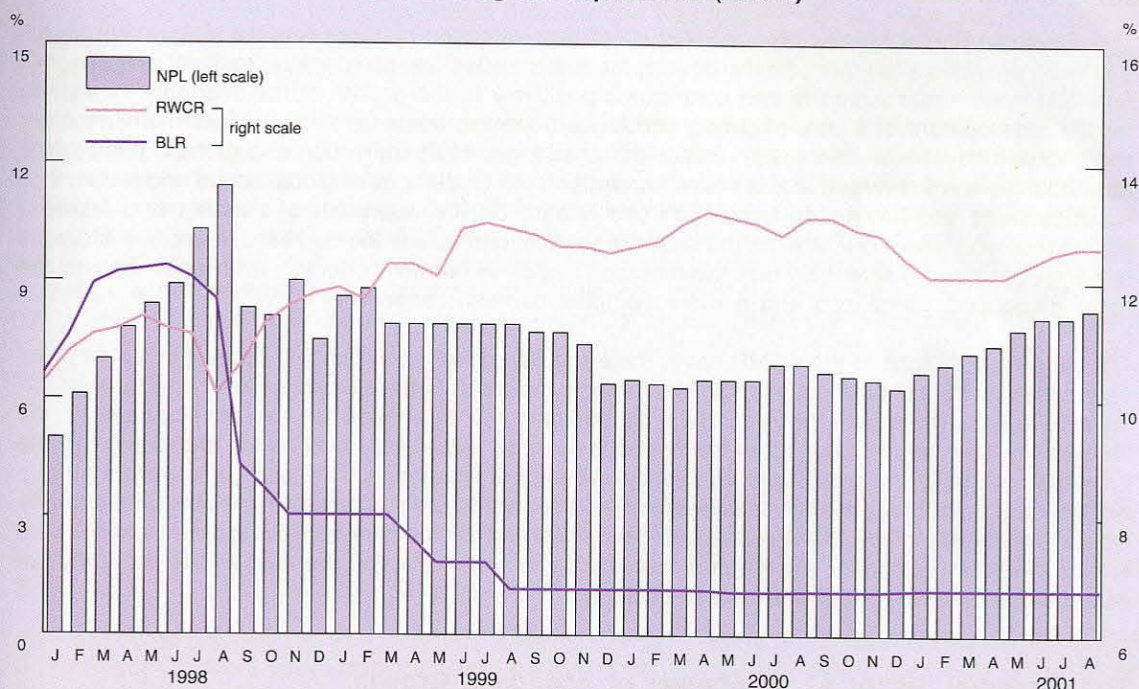
Interest Rates of Banking Institutions (%)

	End-2000	End-August 2001	Difference
Commercial Banks			
Base lending	6.78	6.79	0.01
Average lending	7.45	7.14	-0.31
Savings deposit	2.72	2.60	-0.12
3-month fixed deposit	3.47	3.44	-0.03
Finance Companies			
Base lending	7.95	7.95	0.00
Average lending	11.14	10.60	-0.54
Savings deposit	3.44	3.12	-0.32
3-month fixed deposit	3.52	3.47	-0.05

Source: Bank Negara Malaysia.

CHART 8.2

Commercial Banks' Base Lending Rate (BLR), Banking System's NPL Ratio and Risk Weighted Capital Ratio (RWCR)



Developments in the Banking System

The **Financial Sector Masterplan (FSMP)** was released by BNM in March 2001, providing a blueprint for the development of an effective, competitive, resilient and dynamic financial system that supports and contributes positively to the growth of the economy as well as the development of a core of strong and forward-looking domestic institutions that are more technology driven and ready to face the challenges of liberalisation and globalisation. The FSMP envisages three phases of implementation, subject to achieving certain milestones and safeguards. Phase I, covering the first three years, is focussed on building the capacity of domestic institutions. Phase II, covering the next three to four years, is aimed at increasing domestic competition while Phase III sets the pace for integration with the international market and the possibility of introducing new foreign competition after seven years.

Financial and Corporate Sector Restructuring

There has been significant progress in financial sector reform. The merger programme for the banking sector has been successfully completed with 52 out of 54 banking institutions consolidated into 10 banking groups and 98% of the total assets of the domestic banking sector rationalised and consolidated.

Danaharta, Danamodal and the Corporate Debt Restructuring Committee (CDRC) continue to achieve further progress in financial and corporate restructuring. As at end-June 2001, the NPL portfolio of **Danaharta** amounted to RM48,027 million, accounting for approximately 39.7% of total NPLs of the banking system. Total purchase price for acquiring the NPLs was RM9,015 million, comprising RM800 million in cash and Government-guaranteed bonds valued at RM8,215 million. The restructuring cost of the

THE FINANCIAL SECTOR MASTER PLAN

The Financial Sector Master Plan (FSMP) which was released by Bank Negara Malaysia in March this year, provides a blueprint for the development of an effective, competitive, resilient and dynamic financial system that supports and contributes positively to the growth of the economy as well as for the development of a core of strong and forward-looking domestic financial institutions that are more technology driven and ready to face the challenges of liberalisation and globalisation. While opportunities have emerged in this new environment, the challenges of globalisation and technology advancements are having an unprecedented impact on the approach of banking and financial businesses. It is, therefore, vital for the financial system, particularly the domestic financial institutions to be resilient and efficient so that the financial sector will remain effective and responsive in the more globalised, liberalised and a more complex domestic economy.

The recommendations in the FSMP have, therefore, focussed on enhancing domestic capacity and capability prior to the introduction of an increasingly more competitive environment and subsequently towards greater international integration. In outlining the strategies for the development of the financial system, an assessment of the financial services required as well as the implications of the forces of change in the global and domestic environment was made. The focus is to build a strong, resilient and responsive financial sector that is able to face future challenges in the new environment. Consideration was made to achieve a well-diversified and competitive financial system which is vital for the long-term economic growth development so as to ensure that the risks in the economy are well distributed among the various sub-sectors.

The Financial Sector as an Enabler of Economic Growth

The financial sector will continue to be an important enabler of economic performance. The development of the financial sector has thus far been evolving with the changing profile of the domestic economy. The growth of international trade and cross border activities has resulted in the increase of the provision of trade financing facilities as well as international banking. Similarly, to meet the demand of identified priority sectors, development financial institutions were established. The need for long-term funds from domestic sources by large corporates that are cost efficient and effective has led to the development of the domestic capital market.

Given the gradual process of economic transformation and the economic opportunities that have yet to unfold, going forward, the long-term objectives for the domestic financial sector as outlined in the FSMP have taken into account the needs envisioned for the economy. The FSMP highlights that the objectives for the financial sector for an emerging economy such as Malaysia is, therefore, not necessarily similar to those systems that aim to develop as an international financial centre where rapid deregulation and liberalisation are key parts of the process. In an emerging economy, the financial system has a pivotal role in facilitating the growth process and is, therefore, not developed independently of the requirements of the real sector. Consideration has also been given to both the objectives of efficiency and stability and that of the social agenda. The importance of the new areas to growth and the other alternative modes of financing are also discussed in the FSMP. Financial institutions need to be proactive in providing services to new industries and businesses, thus supporting a more diversified economic structure.

Approach to Implementation

The change program as outlined in the FSMP involves 119 recommendations to be implemented over the next 10 years. The implementation will be done in three phases as certain milestones are

achieved in each stage. The first phase of implementation of the FSMP places emphasis on capacity building. This includes the implementation of measures to enhance the capability of financial institutions to compete and become more efficient and effective as well as measures to promote stability. As part of this process, the regulatory and institutional infrastructure is planned to be further enhanced and a more efficient consumer protection framework to be instituted.

The second phase of development involves the gradual deregulation of the domestic financial market, with the objective of bringing about greater competition among the financial institutions. The ability of domestic financial institutions to compete meaningfully under a more liberalised environment during the second phase would allow for further market liberalisation. This is to ensure the liberalisation measures do not bring about destabilising implications on the financial system and economy as a whole. Further liberalisation measures, including the possibility of introducing new foreign competition would be undertaken during the third phase of development of the financial sector. As outlined in the FSMP, this needs to be properly sequenced to ensure that they bring about the desired improvement and offer new opportunities and benefits for the domestic financial system while preserving the overall financial stability.

Banking Sector

While the financial sector will become increasingly more diversified, the banking sector will continue to be the most important source of financing for the domestic economy. The development of the banking system, particularly the domestic banking institutions is, therefore, vital to facilitate and support the economic growth and transformation process.

The landscape of the Malaysian banking sector can be expected to evolve and change significantly. It is envisaged that a set of core domestic banking institutions will emerge, out of the competitive process, to become leaders in the financial sector that is able to compete meaningfully with the foreign players. The role played by foreign banking institutions will be assessed in terms of their contribution to the development of the financial industry as well as to the overall economic growth and stability. As highlighted in the FSMP, the introduction of new types of foreign competition, particularly during the advanced stage of development of the financial system, will also be considered with a view to ensure that the domestic financial system continues to be effective, vibrant and responsive to the requirements of the economy.

The regulatory environment will also influence the future landscape of the banking sector. Changes in regulatory philosophies and approaches that are planned, aim to provide a conducive environment for growth and expansion of banking institutions.

On the consumer front, the FSMP highlights the need for consumers to take charge of their own finances to engender a competitive environment. In order to achieve this, a proactive education programme is planned to enable consumers to make well-informed financial decisions. Transparency will need to be enhanced, both at the product and institutional levels to promote consumer awareness of banking and financial products. Similarly, the greater flexibility in product pricing would lead to competitive and differentiated strategies among banking institutions that will eventually benefit customers in the form of lower costs, better quality products and services.

Insurance Sector

The recommendations in the FSMP aim to build a more efficient, effective and stable insurance sector that will support both the needs of the real economy and the socio-economic objectives of the country. This entails an insurance industry that:

- i. is an effective mobiliser of long-term savings to support economic growth;
- ii. is financially resilient to market volatility and competitive pressures;

- iii. adopts international best business and management practices;
- iv. is at the cutting edge of innovation with a broad range of products for consumers at competitive prices;
- v. conducts business through a broad range of distribution channels for the convenience of consumers;
- vi. displays high professional ethics and standards; and
- vii. is more productive and cost-efficient.

To this end, the FSMP sets out a programme of change that will build the capabilities of domestic insurers to compete more effectively for a share of the growing insurance market without compromising international commitments to liberalisation of the insurance sector, while ensuring that Malaysian consumers have access to the best products and services available to meet their requirements. This will be achieved through a series of measures designed to enhance the capabilities and competitiveness of domestic insurers, promote consolidation and the adoption of best practices and stimulate innovation through progressive liberalisation.

Islamic Banking and Takaful

Taking cognisance of the encouraging progress of the Islamic banking and takaful industry since its inception, the recommendations in the FSMP aims to strategically position the industry to enter its next stage of development and enhance its significance in the financial landscape of Malaysia. Given Malaysia's pioneering efforts in promoting Islamic banking and takaful and the establishment of the financial infrastructure to support Islamic financial operations, Malaysia is strategically positioned to establish a niche in Islamic banking and takaful at the domestic, regional as well as the international markets.

As highlighted in the FSMP, the objective of Islamic and takaful is to create an efficient, progressive and comprehensive Islamic financial system that contributes significantly to the effectiveness and efficiency of the Malaysian financial sector while meeting the economic requirements of the country.

It is envisioned that the Islamic banking and takaful industry landscape in 2010 would evolve in parallel with conventional banking and insurance to achieve the following:

- i. epitomise Malaysia as a regional Islamic financial centre;
- ii. constitute 20% market share within the banking system and insurance industry;
- iii. represented by a number of strong and highly capitalised Islamic banking institutions and takaful operators providing a comprehensive and complete range of Islamic financial products and services; and
- iv. underpinned by a comprehensive and conducive Syariah, legal and regulatory framework.

To achieve this vision and objective, specific recommendations and strategies outlined in the FSMP have been formulated to focus on three main areas: institutional capacity enhancement; financial infrastructure development; and regulatory framework development. Institutional capacity enhancement involves measures to prepare the Islamic banking and takaful industry players to be among the best managed institutions, capable of capitalising on the unique features of Islamic banking and takaful to achieve significant competitive edge.

The implementation of the recommendations as envisaged in the FSMP will be undertaken under three phases. Under Phase I, the focus will be to prepare a viable platform for the sound expansion of Islamic banking and takaful. Under Phase II, new licenses will be issued to qualified domestic industry players to stimulate increased competition. In addition, the infrastructure of the Islamic banking and takaful will be further upgraded. Phase III will involve the issuance of Islamic banking license to qualified foreign Islamic banking players whilst ensuring the development of a comprehensive and effective infrastructure to support financial operations in a more liberalised environment.

Development Financial Institutions

The availability of strong and dynamic development financial institutions would ensure that the socio-economic objectives of Malaysia are met in the most effective and efficient manner. To effectively complement the banking sector, it is the objective of the FSMP that the development financial institutions be strengthened through better defined roles, more effective regulatory and supervisory framework, improvements in processes and procedures as well as greater application of technology.

Venture Capital Industry

In moving towards a more diversified financial sector, the development of alternative modes of financing is emphasised. More specifically, the aim is to develop a dynamic venture capital industry as well as encourage the development of new type of institutions that will cater for the needs of new areas such as the financial guarantee insurance.

Labuan International Offshore Financial Centre

For the offshore industry, the Labuan International Offshore Financial Centre (IOFC) would be developed to be a centre that not only thrives on the offshore financial services, but also one, which is developed holistically to support the development of the island.

banking sector has been lower at RM18,100 million than the anticipated RM31,000 million.

Danaharta is currently focusing on managing its NPL portfolio, employing various resolution methods, such as loan restructuring, rescheduling and schemes of arrangement for viable loans as well as foreclosures and appointment of special administrators for non-viable loans. Up to end-June 2001, Danaharta has initiated recovery action on 81% of NPLs under its portfolio. The expected recovery from NPLs is RM23,210 million (net of default), representing a recovery rate of 57%.

Danamodal has injected RM7,590 million capital into 10 banking institutions since its establishment

in August 1998. To date, seven banking institutions have made full repayment while two made partial repayment, amounting to RM3,850 million. The outstanding recapitalisation in the remaining three banking institutions stood at RM3,740 million as at end-July 2001 (end-2000: RM4,440 million), and is expected to be further reduced with the recent sale and purchase agreement concluded for one of the three banking institutions.

CDRC received 62 eligible cases with debts valued at RM56,383 million as at end-August 2001. CDRC has successfully completed the restructuring of 35 cases with debts worth RM27,379 million, including five cases which were resolved by Danaharta. There were 27

cases with outstanding debts of RM29,004 million as at end-August, including the restructuring of seven previously completed cases, which are currently being revised due to changes in market conditions and six cases being restructured by Danaharta with debts totalling RM1,573 million.

The debt restructuring process by CDRC is expected to be accelerated with the new set-up and rules put in place recently. Among others, CDRC has widened its steering committee's membership to include representatives from Danaharta and the Federation of Public Listed Companies. There are also significant changes in the framework and approach used to speed up the restructuring process such as establishing a timeline for restructuring. More importantly, the revised framework also emphasises the need for borrowers to undertake operational restructuring alongside debt restructuring. The final initiative would be in the area of disclosure and reporting to keep the market abreast of its restructuring efforts. CDRC expects to receive less applications in future as it will only accept cases from a borrower with a minimum debt amount of RM100 million and with an exposure to at least five creditor banks as opposed to a minimum amount of RM50 million and two creditor banks previously.

Islamic Banking

Islamic banking offers an important alternative to conventional banking in the financial system. Islamic banking continues to expand in 2001, reflecting increased acceptance among the public. The market share of Islamic banking assets in the banking system rose to 7.3% at end-July 2001 (end-2000: 6.9%) while Islamic banking deposits and financing constituted 8.3% and 6.2%, respectively (end-2000: 7.4% and 5.3%). As at end-July 2001, the Islamic banking system comprises two Islamic banks, namely Bank Islam Malaysia Berhad and Bank Muamalat Malaysia Berhad as well as 35 other financial institutions (14 commercial banks, nine finance companies, five merchant banks and seven discount houses) offering Islamic banking services under the Islamic Banking Scheme (IBS).

Total assets of the Islamic banking system continued to expand, increasing by 3.2% during the first seven months of 2001, in tandem with the 10% increase in deposits, as shown in *Table 8.6*. Similarly, financing extended by the Islamic banking system also rose by 20.3%. A major proportion of the financing continued to be channelled to the residential property sector, accounting for a 21.3% share, followed by the transportation sector with 19.4% and the manufacturing sector with 11.7%. Trading in the Islamic interbank money market, however, moderated to a monthly average of RM22,700 million in the first seven months of 2001 (2000: monthly average of RM25,152 million).

Several measures continue to be undertaken to further develop the Islamic banking system, such as:

- i. strengthening the Islamic banking system to enable it to capture at least 20% market share of the overall banking system and insurance industry by 2010 as outlined in the FSMP;
- ii. developing an International Islamic Financial Market (IIFM). Towards this end, the Labuan Offshore Financial Services Authority (LOFSA) together with the Islamic Development Bank (IDB) and the other Islamic central banks of Bahrain, Sudan

TABLE 8.6
Islamic Banking: Key Indicators

	RM million		Change (%)
	2000	End-July 2001	
Assets	47,069	48,589	3.2
Deposits	35,923	39,523	10.0
Investment	24,464	30,006	22.7
Savings	3,327	3,695	11.1
Current	6,564	6,045	-7.9
Financing	20,891	25,141	20.3
Manufacturing	2,044	2,947	44.2
Residential property	3,974	5,355	34.8
Transport	788	4,879	519.2

Source: Bank Negara Malaysia.

and Indonesia have signed a memorandum of understanding to develop IIFM. The establishment of IIFM is anticipated to further promote Labuan as a regional offshore financial centre in Islamic banking;

- iii. establishing an Islamic Financial Services Organisation (IFSO), which is currently being pursued by several Islamic central banks. IFSO would be entrusted with formulating and issuing regulatory and prudential standards for Islamic financial institutions around the world. Malaysia has offered to host the IFSO; and
- iv. introducing three new products, namely the Islamic floating rate financing, the revised Islamic negotiable instruments and Islamic leasing under the *Al-Ijarah Thumma Al-Bai'* concept.

Development Financial Institutions

Development financial institutions (DFIs) were established primarily to promote the development of the strategic sectors of the economy, particularly the agriculture, manufacturing and infrastructure sectors as well as promote exports, especially of capital goods. Total resources of the eight DFIs increased moderately by 7% to RM25,914 million as at end-June 2001 (end-June 2000: RM 24,229 million). The increase was mainly due to higher borrowings and deposits obtained from Government and related corporations, which rose by 37.9% to RM16,498 million, accounting for 63.7% of the total resources. Higher borrowings were mainly by Bank Pembangunan and Infrastruktur Malaysia Berhad (BPIMB) due to the need to finance privatised infrastructure projects. Capital funds of DFIs, however, increased marginally to RM2,965 million as at end-June 2001.

Loans extended by DFIs increased by 23.4% to RM13,940 million as at end-June 2001, as shown in *Table 8.7*. Loans extended to the transport and storage sector constituted a significant share at 26.1%, in consonance with the expansion of the services sector in the economy. Loans to the agriculture and manufacturing sectors increased moderately, but their share to total loans declined marginally to account for 15.7% and 25.4%, respectively.

TABLE 8.7
**Direction of Lending by Development
Financial Institutions**
(end-June)

Sector	RM million		Share (%)	
	2000	2001 ^P	2000	2001
Agriculture	1,972	2,185	17.5	15.7
Manufacturing	3,078	3,540	27.2	25.4
Services	3,126	4,563	27.7	32.7
Transport and storage	2,226	3,634	19.7	26.1
Real estate & construction	2,480	2,925	22.0	21.0
Others	637	727	5.6	5.2
Total	11,293	13,940	100.0	100.0

^P Preliminary.

Source: Bank Pertanian Malaysia, Bank Pembangunan dan Infrastruktur Malaysia Berhad, Malaysian Industrial Development Finance Berhad, Bank Industri & Teknologi Malaysia Berhad, Export-Import Bank of Malaysia, Sabah Development Bank, Borneo Development Corporation (Sabah) Sdn. Bhd and Borneo Development Corporation (Sarawak) Sdn. Bhd.

DFIs and other participating financial institutions continue to provide financing under several specialised assistance schemes, which are aimed to primarily assist SMEs and entrepreneurs. Loans extended under the funds by BNM increased marginally to RM9,521 million as at end-August 2001 (end-2000: RM9,165 million). Several major changes in the size of the specialised assistance schemes as well as the eligibility criteria were announced on 27 March 2001 as part of the fiscal stimulus and pre-emptive measures to counter the impact of a US economic slowdown, and aimed at promoting the financing of SMEs. The details are as follows:

- i. the Fund for Food (3F) was increased by RM300 million to RM1,300 million;
- ii. the New Entrepreneurs Fund (NEF) was raised by RM250 million to RM1,500 million;

- iii. the Small and Medium Industry 2 (SMI 2) Fund was doubled to RM400 million with the eligibility criteria expanded to include the non-export sector;
- iv. a new Entrepreneur Rehabilitation and Development Fund (ERDF) of RM500 million was set up, incorporating rehabilitation measures such as advisory services, new contracts and financial support; and
- v. the lending rate to borrowers for 3F was lowered from 4% to 3.75% while rates for the NEF and SMI 2 Fund were reduced from 6% to 5.5% and 6.5% to 5.5%, respectively.

The additional allocation of RM250 million for the NEF was placed with the CGC for its administration. The additional allocation has been renamed as the New Entrepreneurs Fund 2 (NEF 2) with effect from 15 July 2001. To ensure that the SMEs would have a wider choice in seeking financing from the financial institutions under the NEF 2, the funds are channelled to them through commercial banks, Islamic banks and finance companies as well as through Bank Industri and Teknologi Malaysia Berhad, BPIMB and Malaysian Industrial Finance Berhad.

Other Financial Institutions

Discount Houses

Discount houses play an important role in the financial system, including the growth and development of banking activities based on Islamic principles. Total resources of discount houses continued to expand, increasing by 44.3% to RM12,910 million as at end-August 2001. Following the expansion in total resources, total investments of discount houses rose 11.9% to RM19,424 million (end-August 2000: RM17,357 million). A major proportion of the resources of discount houses continued to be invested in bankers' acceptances (BAs), amounting to RM5,152 million or a 26.5% share (end-August 2000: RM3,638 million). BAs remained attractive as they were short-term and tradable. As at end-August 2001, seven discount houses were in operation.

National Savings Bank

The **National Savings Bank (BSN)** continues to play an important role in promoting and mobilising savings, especially among the middle and lower income groups. Total resources of BSN increased 17.2% to RM11,312 million at end-June 2001 (end-June 2000: RM9,655 million), largely attributable to a 25% increase in deposits, as shown in *Table 8.8*. Fixed deposits remained the most popular deposit scheme, accounting for a 46.3% share, followed by GIRO deposits with a 27.2% share. Loans extended by BSN rose 20% to RM2,356 million, with the bulk of it extended to individuals, accounting for 55.5% of total loans.

TABLE 8.8

National Savings Bank (as at end-June)

	2000	2001 ^P
Deposits¹ (RM million)	9,194.16	11,488.30
Savings	1,353.51	1,281.52
Fixed	4,038.05	5,317.81
Save-as-you-earn	14.67	15.80
GIRO	2,855.06	3,126.31
Premium Savings Certificates	571.51	656.41
Sistem Perbankan Islam	193.36	194.45
CHESS	168.00	896.00
Gross loans (RM million)	1,962.93	2,356.28
Individuals	817.92	1,307.86
Corporate	199.00	182.88
Credit cards	40.37	47.43
Hire-purchase	905.64	818.11
Number of BSN branches	437	434
Number of post offices with BSN facilities	506	482
Number of depositors ('000)	8,435	8,383

¹ Includes interest credited.

^P Preliminary.

Source: National Savings Bank.

Provident and Pension Funds

Provident and pension funds (PPFs) continue to play an important role in the economy in terms of mobilising and channelling funds to finance public and private sector projects. Total resources of the nine PPFs, comprising the Employees Provident Fund (EPF), the Social Security Organisation (SOCSO), the Armed Forces Fund, the Pensions Trust Fund and five other private PPFs continued to expand. The increase in resources was 7.6%, mainly due to a 4.8% growth in accumulated contributions, as shown in *Table 8.9*. EPF continued to account for the major proportion of resources with a 83.8% share.

TABLE 8.9

Provident and Pension Funds: Selected Indicators

	RM million	
	2000	2001 ^P
As at end June		
Number of contributors ('000)	30,182	30,014
of which: EPF	9,731	10,101
SOCSO	4,643	5,185
Accumulated contributions	189,996	199,204
Total resources	206,440	222,052
of which: EPF	176,900	186,065
SOCSO	8,722	9,552
Investments in MGS	68,045	78,987
During the period		
Gross contributions	9,206	10,154
Withdrawals	4,542	14,452
Net contributions	4,660	(4,304)
Investment income	9,933	9,556

^P Preliminary.

Source: Employees Provident Fund, Social Security Organisation, Pensions Trust Fund, Armed Forces Fund and five other private provident and pension funds (Malaysian Estates Staff Provident Fund, MAS Malaysia Provident Fund, SESCO Employees Provident Fund, Petronas Retirement Benefit Scheme and Jenderata-Bernam Provident Fund).

During the period, net contributions of PPFs remained in negative territory, reflecting higher withdrawals of 218.2%, largely made by EPF contributors under the four new withdrawal schemes for the purchase of computers, education, government pensionable employees and the annuity scheme. Gross contributions of PPFs, however, continued to grow by 10.3% in tandem with the increase in the number of contributors. Investment income of PPFs, however, declined by 3.8%. The PPFs continued to invest substantially in MGS, which increased by 16.1% to constitute 35.7% of total investments. Investments in corporate securities and bonds also rose by 18.7% to RM72,261 million, accounting for a 32.6% share (end-June 2000: RM60,892 million and a 29.4% share).

Insurance Industry

The **insurance industry** is an integral part of the financial system and continues to evolve in an increasingly dynamic business environment. The industry, comprising life insurance and general insurance, continues to grow, in tandem with the expansion in the services sector. New business premiums of **life insurance** increased by 185% to RM3,463 million (January-June 2000: RM1,215 million) while new sums insured grew by 10% to RM66,150 million (January-June 2000: RM60,156 million), largely due to the introduction of the annuity scheme, as shown in *Table 8.10*. New business premiums for the annuity business amounted to RM2,164 million in the first five months of 2001 before its suspension in May, compared to RM1.4 million in the third quarter of 2000 when it was first launched. Total assets of life insurance funds grew by 21.9% to RM41,457 million (end-June 2000: RM34,002 million) with the bulk of it invested in corporate and debt securities with a 47.5% share, followed by cash and deposits with 15.8%.

Gross direct premiums of **general insurance** grew moderately by 9.3% to RM3,207 million in the first half (January-June 2000: RM2,933 million), as shown in *Table 8.11*. Motor insurance increased by 13% and continued to account for the largest share at 45.7% of total gross direct premiums. Total assets of general insurance funds increased moderately by 4.7% in tandem

TABLE 8.10

Life and General Insurance Business

	End 2000	End-June ^P 2001
Life Insurance (RM million)		
New business		
Number of policies ('000 units)	1,174.2	672.7
Sums insured	116,816.6	66,149.7
Total premiums	2,942.3	3,462.5
Business in force		
Number of policies ('000 units)	7,234.9	7,597.0
Sums insured	399,662.8	412,049.2
Annual premiums	7,364.7	7,682.9
Premium income	8,870.3	6,693.8
Assets (RM million)	36,777.3	41,456.9
of which: <i>Corporate and debt securities</i>	16,673.3	19,672.6
<i>Cash and deposits</i>	5,543.4	6,542.7
General Insurance (RM million)		
Premium income		
Gross direct premiums	5,928.6	3,206.5
Net premiums	5,057.9	2,572.9
Reinsurance placed outside Malaysia	585.4	344.7
Retention ratio (%) ¹	89.6	88.2
Assets (RM million)	13,793.7	14,442.4
of which: <i>Corporate and debt securities</i>	4,021.5	4,404.4
<i>Cash and deposits</i>	5,160.2	5,426.4

¹ Net premiums over gross direct and reinsurance accepted premiums less reinsurances within Malaysia.

^P Preliminary.

Source: Bank Negara Malaysia.

with the slower growth rate of gross direct premiums. Investments of general insurance funds continued to be dominated by holdings in cash and deposits, accounting for a 37.6% share, followed by corporate and debt securities with 30.5%.

Islamic Insurance

Islamic insurance offers an alternative to conventional insurance. The Malaysian takaful industry consists of two takaful operators, namely Syarikat Takaful Malaysia Berhad and Takaful Nasional Sdn. Berhad. The takaful industry continues to sustain its growth momentum with the main business indicators recording higher double-digit growth. New family takaful business increased sharply by 370.9% to RM1,316 million, which was mainly attributable to the annuity scheme for EPF contributors, as shown in *Table 8.12*. Similarly, general takaful business also expanded by 28.7% in terms of gross contributions. Combined assets of takaful funds and shareholders' funds increased significantly by 66.8% to RM2,189 million at end-June 2001. The bulk of takaful assets was held in cash and deposits with a 29.5% share, followed by investment in corporate securities with 16.5%.

Capital Market

The unveiling of the **Capital Market Master Plan (CMP)** in February 2001 has further highlighted the Government's aspiration to propel the capital market towards greater resilience, efficiency and competitiveness. The CMP aims at equipping and positioning the capital market to support national economic growth needs as well as strategically gearing it towards gradual liberalisation in meeting the challenges of increasing globalisation. To date, more than 20% of its recommendations has already been implemented.

Funds Raised in the Capital Market

Total net funds raised by the public and private sectors through the capital market in the first eight months declined by 35.2% to

TABLE 8.11
**General Insurance
Premium Growth and Distribution**
(January-June)

Sector	2000		2001		Growth (%)
	RM million	Share (%)	RM million	Share (%)	
Motor	1,298.0	44.2	1,466.7	45.7	13.0
Marine, aviation and transit	233.4	8.0	278.0	8.7	19.1
Fire	695.7	23.7	696.7	21.7	0.1
Miscellaneous	705.8	24.1	765.1	23.9	8.4
Gross direct premiums	2,932.9	100.0	3,206.5	100.0	9.3

Source: Bank Negara Malaysia.

RM15,394 million, reflecting slower economic activities, as shown in *Table 8.13*. The private sector accounted for RM11,357 million or 73.8% of net funds raised, with the balance of RM4,037 million raised by the public sector.

During the period, issuance of MGS increased by 16.2%, amounting to RM11,257 million to account for 82.5% of gross funds raised by the public sector. The increase reflected the Government's higher financing needs and commitment to establish a benchmark yield for the bond market through regular issues of MGS. Funds raised through the issuance of Khazanah bonds, however, declined to RM583 million. A higher redemption of RM9,609 million was recorded, comprising largely of MGS valued at RM6,600 million.

Gross funds raised in the PDS market were higher, amounting to RM19,900 million, as the low interest rate environment encouraged corporates to lock in the cost of financing. Net funds raised in the PDS market, however, shrank 39.3% to RM6,814 million on account of higher redemption of RM13,086 million. Islamic bonds dominated the PDS market, accounting for a 37.1% share, reflecting the strong demand for Islamic debt securities among market participants, followed by straight bonds and Cagamas bonds,

accounting for 26.4% and 24.3%, respectively of total PDS.

Despite the weak market sentiments, the equity market remained an important source of financing. Funds raised through equity issues, increased marginally by 0.8% to RM4,543 million. A major proportion of the funds raised in the equity market was through private placement and restricted offer-for-sale, amounting to RM1,653 million to account for a 36.4% share.

Rating Agencies

The two credit rating agencies continue to play an integral role in the development of the bond market. The number of ratings completed by both **Rating Agency Malaysia (RAM)** and **Malaysian Rating Corporation (MARC)** declined to 53 ratings valued at RM14,053 million in the first eight months (January-August 2000: 60 ratings valued at RM23,520 million), consistent with the slowing down of economic activities. Of the 53 rating exercises, RAM completed 35 ratings valued at RM9,773 million with the balance of 18 ratings worth RM4,280 million completed by MARC. Despite the slower economic activities, a significant proportion of the rated PDS issues was in the A-rated and above categories, reflecting improving corporate credit risk profile. The

TABLE 8.12

Family and General Takaful Business

	Financial Year 2000	Financial Year 2001 ^P
Assets ¹ (RM million)	1,312.3	2,188.6
Malaysian Investment Certificates	142.3	355.5
Investment in Bank Islam Malaysia	126.3	45.8
Corporate securities	228.2	360.6
Cash and deposits	294.4	644.7
Financing	91.8	255.0
Fixed assets	133.5	130.8
Others	295.8	396.2
Family Takaful Business		
New business		
Total contribution (RM million)	279.5	1,316.1
Sums participated (RM million)	12,067.5	17,711.7
Number of certificates	163,492	221,028
Business in force		
Total contribution (RM million)	596.7	1,771.5
Sums participated (RM million)	25,568.2	39,672.0
Number of certificates	439,822	649,082
General Takaful Business		
Gross contributions (RM million)	177.0	227.8
Net claims paid (RM million)	31.0	57.7

¹ Assets of family takaful funds, general takaful funds and shareholders' funds.

^P Preliminary.

Source: Syarikat Takaful Malaysia Bhd. and Takaful Nasional Sdn. Bhd.

TABLE 8.13

**Funds Raised in the Capital Market
(January-August)
(RM million)**

	2000	2001 ^P
By Public Sector		
Debt securities		
Malaysian Government Securities	9,690.7	11,256.7
Khazanah bonds	680.3	583.3
Government Investment Issues	0	1,805.5
Malaysia Savings Bonds	0	0
New Government debt securities	10,371.0	13,645.5
Less: Redemptions		
Malaysian Government Securities	2,350.0	6,600.0
Government Investment Issues	0	2,000.0
Malaysia Savings Bonds	14.3	8.7
Khazanah bonds	0	1,000.0
Net funds raised	8,006.8	4,036.8
By Private Sector		
Shares ¹		
Public issues	742.3	1,565.6
Rights issues	2,791.2	883.6
Private placements/ Restricted offer-for-sale	803.7	1,653.2
Special issues	97.9	32.9
Warrants	70.5	408.0
New share issues	4,505.6	4,543.3
Debt Securities ² (gross)		
Straight bonds	4,986.2	5,249.0
Convertible bonds	1,711.7	1,256.0
Islamic bonds	4,715.0	7,386.8
Bond with warrants	0	912.8
Cagamas bonds	6,591.0	4,840.0
Asset-Backed bonds	0	255.0
New debt securities	18,003.9	19,899.6
Less: Redemptions		
Private Debt Securities ³	4,223.9	8,120.9
Cagamas bonds	2,550.0	4,965.0
Net issues of debt securities	11,230.0	6,813.7
Net funds raised	15,735.6	11,357.0
Total net funds raised	23,742.4	15,393.8

¹ Excludes funds raised by the exercise of Employees Share Option Scheme, Transferable Subscription Rights, Warrants and Irredeemable Convertible Unsecured Loan Stocks.

² Excludes bonds issued by banking institutions.

³ Includes straight bonds, bonds with warrants, convertible bonds and Islamic bonds.

^P Preliminary.

Source: Bank Negara Malaysia.

domestic rating agencies continued to undertake efforts to further develop and strengthen the industry. In particular, the strategic alliance established by MARC with Fitch, one of the only three internationally recognised rating agencies, is expected to further enhance the rating of corporates and PDS issues, especially asset-backed securities.

Cagamas

Cagamas, the national mortgage corporation continues to remain an important player in the development of the corporate bond market. Cagamas raised a total of 34 issues valued at RM13,030 million during the first eight months (January-August 2000: RM18,448 million from 39 issues), comprising RM8,190 million notes and RM4,840 million bonds. Housing loans purchased by Cagamas, however, declined by 57% to RM2,352 million during the period (January-August 2000: RM5,477 million), reflecting the excess liquidity situation in the banking system and the low interest rate environment which poses a disincentive effect on the financial institutions to securitise their housing loans to Cagamas. Hire-purchase financing and leasing, however, increased significantly by 30.8% to RM3,465 million (January-August 2000: RM2,650 million). This was mainly attributable to the hedging needs of financial institutions involved in hire-purchase financing and leasing.

Kuala Lumpur Stock Exchange

In line with other regional bourses, the **Kuala Lumpur Stock Exchange (KLSE)** commenced the year 2001 on a bearish undertone as a result of weak global economic conditions and market volatility. Nevertheless, the benchmark Kuala Lumpur Composite Index (KLCI) breached the 700-point level in a pre-Chinese New Year rally and continued to rise to close at 727.73 points, an increase of 7.1% at end-January (end-December 2000: 679.64 points).

The uptrend, however, could not be sustained and the KLCI plunged below the 600 point-level to close at 584.50 points in April. Market sentiments improved in July, mainly due to some developments in corporate mergers and acquisitions as well as the Government's firmer stand on corporate restructuring. The KLCI rose steadily to close at 659.40 points in July and ended higher at 687.16 points in August. The KLCI was poised to continue its upward trend, breaching the 700-point level in intra-day trading on 10 September and ending at 690.54 points on 11 September. Nevertheless, following the recent attack on the US, the KLCI along with

TABLE 8.14

Kuala Lumpur Stock Exchange: Selected Indicators

	January- September		Change (%)
	2000	2001	
Price indices¹			
Composite	713.51	615.34	-13.8
Emas	174.94	145.84	-16.6
Second Board	172.31	109.61	-36.4
Total turnover²			
Volume (million units)	60,799	33,081	-45.6
Value (RM million)	201,134	59,359	-70.5
Average daily turnover²			
Volume (million units)	330	180	-45.6
Value (RM million)	1,093	323	-70.5
Market capitalisation ¹ (RM million)	488,815	411,347	-15.8
Market capitalisation ¹ / GDP (%)	143.5	119.1	-17.0
Total no. of companies listed¹			
Main Board	487	515	5.7
Second Board	301	292	-3.0
Market liquidity¹			
Turnover value/Market capitalisation (%)	41.2	14.4	-65.0
Turnover volume/No. of listed securities (%)	32.3	16.8	-48.0
Market concentration¹			
10 most highly capitalised stocks/Market capitalisation (%)	34.5	36.8	6.7
Average paid-up capital of stockbroking firms ¹ (RM million)	126	141	12.6

¹ As at end of period.

² Market transactions only.

Source: Kuala Lumpur Stock Exchange.

other major and regional bourses, fell to close lower at 615.34 points at end-September.

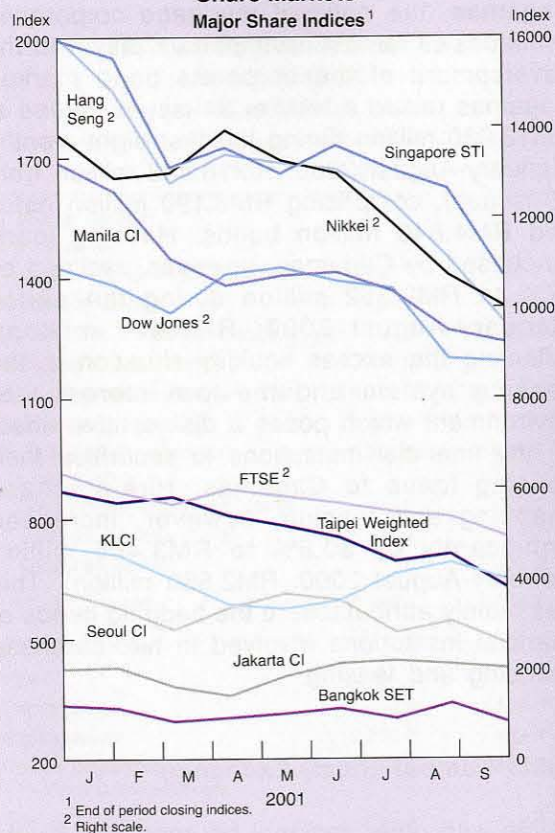
Despite the decline, the KLCI continued to outperform other selected regional stock markets. During the period end-2000 to end-September 2001, the KLCI decreased by 9.5%. In contrast, the Hang Seng Index declined by 34.1%, the Singapore Straits Times (STI) Index 31.5% and the Nikkei Index 29.1%, while the Philippines Composite Index, the Taipei Weighted Index, Jakarta Composite Index and Korean Composite Index shed 24.6%, 23.3%, 5.7% and 4.9%, respectively, as shown in *Chart 8.3*. The level of KLCI at 615.34 points is, however, significantly higher by 134.2% than its low of 262.70 points on 2 September 1998. In terms of market capitalisation, KLSE ranked seventh among markets in the Asia-Pacific region as at end-August 2001, just behind Singapore and ahead of other ASEAN countries.

Total volume transacted on the KLSE, however, declined by 45.6% to 33,081 million units while average daily turnover registered 180 million units in the first nine months, as shown in *Table 8.14*. In terms of sectoral performance, the trading/services sector continued to account for a significant proportion of total trading volume with 25%, followed by the loans/transferable subscription rights/warrants sector with 23.7% and the financial sector with 16.9%. During the period, 14 new companies were listed with a combined nominal capital of RM323 million, of which six companies were listed on the Main Board and eight on the Second Board.

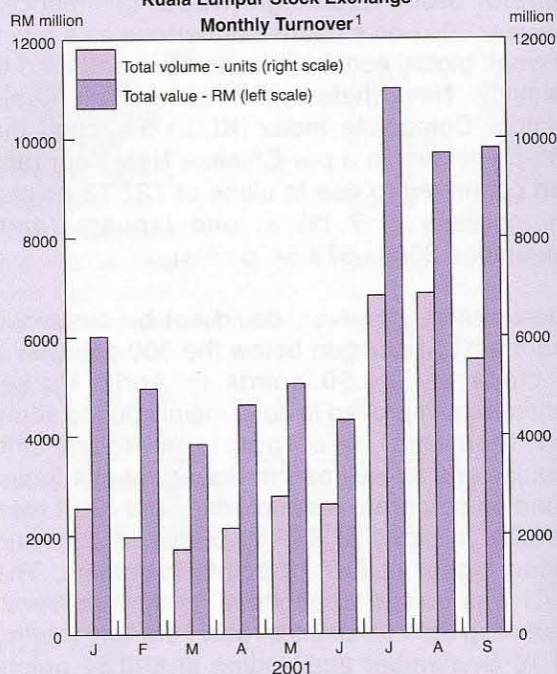
Malaysian Exchange of Securities Dealing and Automated Quotation

The performance of the **Malaysian Exchange of Securities Dealing and Automated Quotation (MESDAQ)** Composite Index (MCI) began the year on weak market sentiment to close at 86.76 points at end-January 2001 (end-2000: 93.10 points). The MCI trended downward further to close at 77.35 points at end-September 2001, as shown in *Chart 8.4*, reflective of the generally weaker performance of global technology stocks. Market capitalisation, however, increased by 19.8% to RM157 million (end-January 2001: RM131 million). Several measures continue to

CHART 8.3
Share Markets
Major Share Indices¹



Kuala Lumpur Stock Exchange
Monthly Turnover¹



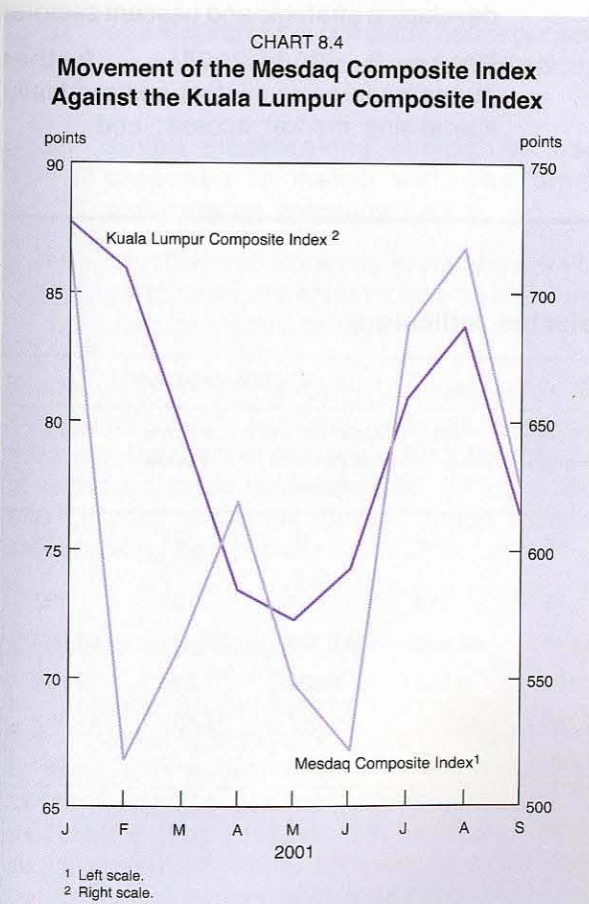
be undertaken by MESDAQ to promote the exchange as an avenue for capital raising, including allowing the listing of technology incubators and MSC-status companies seeking listing on MESDAQ to dual list on NASDAQ. MESDAQ has further liberalised the market to allow applicants to utilise more than 50% of the funds raised in the initial public offering outside Malaysia, subject to certain conditions (previously 70% of funds raised must be utilised in Malaysia). MESDAQ and KLSE are also in active discussions to set up a common trading platform for shares traded on both exchanges, in line with the recommendation of the CMP for a single Malaysian exchange by 2002.

Unit Trust Industry

The **unit trust industry** continues to provide investors with a diversified investment management tool to reduce the price volatility of their equity investments. Recognising the importance of the industry, development efforts

are geared towards enhancing liquidity in the domestic market, ensuring a more facilitative regulatory framework as well as developing a large pool of highly skilled professionals to foster greater innovation and competitiveness. The CMP has also made several recommendations to further develop the industry, including the liberalisation of the 30% restriction on foreign ownership from 2003, subject to market readiness assessment by the Securities Commission (SC).

During the first seven months of 2001, 14 new funds were launched (2000: 18 funds), bringing the total number of unit trust funds to 133, comprising 102 private funds and 31 government-supported funds, as shown in *Table 8.15*. Units in circulation rose 6.5% to 68,005 million units at end-July 2001. Despite the dampened equity market, the net asset value (NAV) of the unit trust industry increased 2.5% to RM44,402 million. Similarly, the ratio of the NAV of unit trust industry to the KLSE market capitalisation, rose marginally to 9.8% due to the lower market capitalisation. The NAV ratio is relatively small compared to a penetration rate of about 40% in developed countries, indicating scope for greater promotion of the unit trust industry.



Malaysia Derivatives Exchange

The **Malaysia Derivatives Exchange (MDEX)**, launched in June 2001 was formerly known as the Kuala Lumpur Options and Financial Futures Exchange (KLOFFE). MDEX is an integrated derivatives exchange as a result of the merger between KLOFFE with the Commodities and Monetary Exchange of Malaysia (COMMEX), in line with the recommendation of the CMP to establish a single exchange offering a wider range of products to investors.

During the first nine months of 2001, trading volume of the **Kuala Lumpur Stock Exchange Composite Index Futures (KLSE CI Futures)** declined by 20.6% to 227,384 contracts (January-September 2000: 286,294 contracts), largely due to the generally weak market sentiment. Similarly, trading activities in the newly launched **Kuala Lumpur Stock Exchange Composite Index Options (KLSE CI Options)** were generally weak. Various measures will be undertaken in the near future to encourage more participants into the options market, including

programmes to increase public awareness and the introduction of a market maker scheme.

The performance of the 3-month **Kuala Lumpur Interbank Offered Rate (KLIBOR)** and **Crude Palm Oil (CPO)** futures was more encouraging. Turnover of the 3-month KLIBOR futures contracts surged 21.8% to 43,144 contracts during the first nine months (January-September 2000: 35,433 contracts). The higher trading activity reflected the ample liquidity situation in the interbank cash market as well as increased interest in the local bond and interest rate swap (IRS) markets. Trading in CPO futures increased sharply by 53.1% to 347,392 contracts (January-September 2000: 226,910 contracts), following the reduction of excess stock and increased CPO exports. Subsequently, the average price of CPO futures increased significantly by 44.4% to RM1,028 per tonne in September compared to RM712 per tonne in January 2001.

Key Capital Market Measures

SC and KLSE introduced several regulatory and legislative measures during the first eight months, aimed at further enhancing on-going efforts to

promote efficiency, transparency, resilience and competitiveness of the capital market. At the same time, additional measures were introduced to improve corporate governance and minority shareholder protection. The key measures were as follows:

Capital Market Master Plan

SC launched the CMP on 22 February. The CMP seeks to ensure that the capital market is well positioned to play its part in supporting national economic growth needs and aspirations, meeting the challenges of regional competition and increasing globalisation, as well as tapping value-added opportunities within areas of comparative and competitive advantage. The implementation of the CMP will be done in three phases:

- i. Phase 1 (2001-2003) – further strengthening domestic capacity and developing strategic and nascent sectors;
- ii. Phase 2 (2004-2005) – further strengthening key sectors and gradually liberalising market access; and

TABLE 8.15

Unit Trust Industry: Selected Indicators

	2000 ¹			2001 (end-July)		
	Government Supported Funds	Private Funds	Total	Government Supported Funds	Private Funds	Total
Number of unit trust management companies	10	24	34	10	24	34
Number of unit trust funds ²	30	89	119	31	102	133
Units in circulation (million)	40,201	23,645	63,846	41,323	26,682	68,005
Number of accounts (million)	8.429	1.153	9.582	8.538	1.234	9.722
Net asset value (NAV) (RM million)	30,544	12,755	43,299	29,867	14,535	44,402
NAV/KLSE market value (%)	6.87	2.87	9.74	6.61	3.22	9.83

¹ End of period.

² Refers to funds already launched.

Source: Securities Commission.

- iii. Phase 3 (2006-2010) – further expanding and strengthening market processes and infrastructure towards becoming a fully-developed capital market and enhancing international positioning in areas of comparative and competitive advantage.

Consolidation of the Stockbroking Industry

Efforts continue to be undertaken in consolidating the stockbroking industry. The consolidation exercise is aimed at further strengthening the domestic capital market and making it more efficient, cost-effective and resilient to face the challenges of globalisation and liberalisation. As at end-August 2001, the progress of the consolidation exercise was as follows:

- i. seven stockbroking companies had entered into firm agreements to acquire or merge with three other stockbroking companies;
- ii. one stockbroking company had proposed to merge with two other stockbroking companies;
- iii. seven stockbroking companies had proposed to merge with one other stockbroking company each;
- iv. 21 other stockbroking companies have yet to make any announcements or submit their proposals to SC.

There were 53 stockbroking companies as at end-August 2001. Following the consolidation exercise, the number of stockbroking companies is expected to be reduced to 36. To date, SC has granted Universal Broker status to four stockbroking companies.

Corporate Bond Market

In February, SC introduced a practice note on the offering of foreign currency denominated PDS by Malaysian public companies, exclusively to persons outside Malaysia. Among others, it stipulates that investor protection-related requirements on rating, underwriting, minimum denomination and mode of issue need not apply

to issues that are made to investors outside Malaysia. It is presumed that these investors will be protected by the rules in their respective home jurisdictions.

In April, SC released the Guidelines on the Offering of Asset-backed Debt Securities as part of continuous efforts towards developing the corporate bond market. Applying a disclosure-based approach, the guidelines provide clear and transparent criteria governing various aspects and parties involved in securitisation transactions, such as on originators, special purpose vehicles, assets and true sale criteria.

Equity Market

In January, KLSE introduced the new Listing Requirements to further enhance efficiency in capital market activities, corporate governance and transparency as well as strengthen investor protection and promote investor confidence. Several new practice notes were issued to assist public listed companies in their compliance with the new Listing Requirements.

In efforts to ensure that the equity market continues to remain competitive, transaction costs were further liberalised. These included the reduction of the SC levy, the Securities Clearing Automated Network Services (SCANS) and the System on Computerised Order Routing and Execution (SCORE) fees. Similarly, the KLSE levied System Maintenance Fee on stockbroking companies was also reduced and the monthly subscription payable by stockbroking companies in respect of dealer's representatives abolished effective 1 July.

SC is currently in the final stages of approving revised rules on the opening and use of omnibus clearing accounts maintained by local brokers for foreign intermediaries for the purpose of price averaging. With the revisions, all foreign intermediaries will be able to open and use omnibus clearing accounts on submission of a declaration and a minimum amount of information to the local broker. Previously, foreign fund managers were required to provide a wide range of information as well as obtain explicit approval from KLSE.

THE CAPITAL MARKET MASTER PLAN : A PROGRESS UPDATE

Introduction

The Capital Market Master Plan (CMP) was launched by the Securities Commission (SC) on 22 February 2001. The CMP is aimed at ensuring that the domestic capital market is well-positioned to play its part in supporting national economic growth needs and aspirations, meeting the challenges of regional competition and increasing globalisation as well as tapping value-added opportunities within areas of comparative and competitive advantage.

The CMP comprises six key objectives that are linked to 24 strategic initiatives and 152 recommendations in areas such as market institutions, the equity, bond and derivatives markets, Islamic capital market, stockbroking industry, investment management, corporate governance, regulatory framework, technology and e-commerce as well as education and training. The key objectives of the CMP are aimed at: seeking to be the preferred fund-raising centre for Malaysian companies; promoting an effective investment management industry and a more conducive environment for investors; enhancing the competitive position and efficiency of market institutions; developing a strong and competitive environment for intermediation services; ensuring a stronger and more facilitative regulatory regime; and establishing Malaysia as an international Islamic capital market centre.

Progress

As at mid-September 2001, the implementation of more than 20% of the recommendations of the CMP has already been completely or partially completed. The implementation of nine recommendations has been fully completed while another 27 have made significant progress through a variety of measures undertaken. Work is continuing on the other recommendations, especially those due for completion in Phase 1 (2001-2003), including recommendations aimed at promoting liquidity within the domestic market, enhancing fund-raising means and processes, strengthening market institutional structures, developing the competitiveness of service providers as well as promoting corporate governance and shareholder value. The key implementation initiatives that have been undertaken are discussed below:

■ Developing the Domestic Corporate Bond Market

On 1 July 2000, the SC became the approving and registering authority for prospectuses in respect of all securities other than securities issued by unlisted recreational clubs, following the amendments to the Securities Commission (Amendment) Act 2000. The main thrust of the amendments is to streamline the regulatory structure for all fund raising activities. Various guidelines and regulations have since been introduced, aimed at establishing an efficient and facilitative issuance process for corporate bonds, including: the Guidelines on the Offering of Private Debt Securities; Guidelines on Prospectus Content for Debentures; Securities Commission (Shelf Registration Scheme for Debentures) Regulations 2000; Guidelines on Minimum Content Requirement for Trust Deeds; and the more recent Guidelines on the Offering of Asset-Backed Debt Securities.

■ Developing the Investment Management Industry

A key area identified in the CMP is the development of a vibrant and competitive investment management industry to meet increasing demands for greater efficiency, diversity and cost-effectiveness in the management of investor funds. Towards this end, efforts are currently directed at laying the groundwork to ensure the timely and successful implementation of recommendations pertaining to it. Some measures had already been announced prior to the launch of the CMP, such as the incorporation of greater flexibility in the application of the Guidelines on the Establishment of Foreign Fund Management Companies to encourage greater foreign participation in the industry. The SC has also issued a Consultation Paper on Additional Requirements for Islamic Unit Trust Funds in August, to facilitate the development of a wider range of Islamic collective schemes and to enhance the integrity and credibility of Islamic unit trust funds.

■ Establishing a Single Malaysian Exchange

An important initiative of the CMP is the establishment of a single Malaysian exchange through the consolidation of all existing exchanges. Among other things, this would allow domestic exchanges to better align their respective business development strategies as well as facilitate efforts at enhancing their overall competitiveness and strategic positioning, consistent with developments in other markets. The merging of the KLOFFE and COMDEX in June to form the Malaysia Derivatives Exchange Berhad (MDEX) marked an important step towards the creation of a single Malaysian exchange. In addition, the Kuala Lumpur Stock Exchange (KLSE) and MESDAQ have entered into a memorandum of understanding on the merger of the two exchanges, with the merger process expected to be completed by year end. Work is also on-going to identify and implement the necessary measures for the smooth transformation of the single exchange from a mutual structure to a demutualised entity and to list the exchange on the stock market.

■ Consolidating the Stockbroking Industry

Current efforts under the stockbroking industry consolidation programme include the approval of four Universal Brokers as well as the deregulation of restrictions on the scope of activity and branching for these companies. Based on the announcements made by the stockbroking companies and the proposals received by the SC to date, the number of stockbroking companies will be reduced to 36 from 53.

The policy for the consolidation of the stockbroking industry was introduced in tandem with the liberalisation of stockbroking commission rates to enhance the competitiveness of the industry. Stage 1 of the initiative to liberalise commission rates took effect from 1 September 2000. In view of current market sentiments and prolonged low volumes in the marketplace, the SC has, however, agreed to defer the implementation of Stage 2 for a year to minimise adjustment costs. The commission rates for all trades will be fully negotiable, subject to a cap of 0.70%, effective 1 July 2002.

■ Enhancing the Fund-Raising Process

The implementation of the first two phases of the transition to a full disclosure-based regulatory (DBR) framework for equity issuance has been completed. The final move towards instituting a full DBR regime is premised in part on the findings of a market readiness study. The findings

of the study will soon be presented and made known to the relevant industry groups for further discussions and deliberations before the adoption of a full DBR structure. The adoption of a full DBR framework would entail the SC evaluating the issue, offer and listing of securities primarily from the perspective of information disclosure, instead of the merits of an investment.

In May, consistent with the move towards full DBR, the SC introduced several flexibilities to facilitate the issue, offer and listing of securities by Malaysian companies. In September, the SC introduced further flexibilities to complement these measures in cognisance that companies seeking to list *via* initial public offerings (IPOs), raise funds and restructure during the first half of this year had faced difficulties arising from capital market conditions. By allowing companies more options in structuring their corporate proposals and responding to changing market conditions, it is expected that the overall efficiency of the fund-raising process will be enhanced, consistent with the objective for the Malaysian capital market to be the preferred fund-raising centre for domestic companies.

■ Developing the Venture Capital Industry

A strategic initiative in the CMP is to facilitate the development of the venture capital industry to effectively meet the financing needs of emerging high-growth companies in value-added industries through the provision of risk capital. Towards this end, several of MESDAQ's listing rules have been liberalised, including reducing the requirement that 70 per cent of the listing proceeds be used in Malaysia, so as to facilitate the access of venture capital companies to the capital market. In line with the tax incentives announced in Budget 2000 to spur the growth of the venture capital industry, the SC released the "Guidelines for the Annual Certification for Tax Incentives for the Venture Capital Industry" in August to facilitate the administration of the tax incentives.

The SC has also approved the admission of technology incubators on MESDAQ. Technology incubators provide funding to early-stage companies, that is, unlisted companies with little operating history. The listing of technology incubators on MESDAQ will not only facilitate the expansion of the total amount of venture capital funds available to start-up companies, but also provide a means for retail investors to participate in start-up companies at a relatively lower risk, given that the investments will be professionally evaluated and managed by the incubator.

Conclusion

The increasing integration of financial markets worldwide necessitates that the domestic capital market continues to enhance its efficiency, resilience and competitiveness in facing the global challenges. Given the dynamism of the financial market as well as the need to reduce the over-dependence of financing on the banking sector, it is important to ensure that Malaysian companies continue to have access from an efficient and effective capital market, thus supporting economic growth. In this regard, the formulation of the CMP is timely and appropriate in addressing the challenges faced by the capital market as well as charting the strategic positioning and future direction over the next ten years. Meanwhile, the implementation of the recommendations will be sequenced in moving towards gradual liberalisation and assessed against the market's capacity and readiness.

KLSE and MESDAQ signed a memorandum of understanding on 27 June to commence efforts for MESDAQ to join the KLSE group to form a single Malaysian exchange. This is in line with the recommendation of the CMP to establish a single Malaysian exchange through the consolidation of all existing exchanges by 2002.

Further amendments were made to the Securities Commission Act in July, aimed at establishing an efficient regulatory regime for capital raising in Malaysia, in line with the CMP's objective to develop the capital market as the preferred fund-raising centre for domestic companies. In addition, SC has also introduced further flexibilities in September, to facilitate listings, raising and restructuring by companies on KLSE. These flexibilities would allow companies sourcing funds from KLSE to have more options in structuring their corporate proposals and respond more effectively to the changing market conditions.

Derivatives Market

The Malaysian Derivatives Exchange (MDEX) was launched on 11 June. MDEX is an integrated derivatives exchange as a result of the merger between KLOFFE with COMMEX. The integrated exchange would achieve economies of scale, offer a wider range of products to investors and enhance cost efficiency.

Disclosure-Based Regulation

SC's shift from merit-based regulation (MBR) to disclosure-based regulation (DBR) began in 1996 under a three-phased process. DBR is a market-based approach to regulation which focuses on the quality of information disclosed by issuers when they issue, offer or list securities so as to enable investors to make informed investment decisions. Under DBR, the securities regulator

does not assess the merits and suitability of an offering, as opposed to an MBR. In April, SC embarked on a study to assess market readiness for the implementation of full DBR. The study which is now in its final stages of completion will provide critical input for SC to determine if market participants are ready to move to full DBR.

On 1 August, amendments were effected to the Securities Industry (Reporting of Substantial Shareholding) Regulations 1998. The amendments define a substantial shareholder as a person having an interest in not less than 5% of the nominal amount of the voting shares in a company (previously, less than 2%). In addition, the requirement for disclosures of substantial shareholding by bare trustees has been removed. The amendments are also in line with the recent amendments to the Companies Act 1965 relating to substantial shareholding reporting.

Corporate Governance and Minority Shareholder Protection

The new KLSE Listing Requirements released on 22 January continued to address the issue of corporate governance. In particular, the requirements on the reporting of extent of compliance with the Code of Corporate Governance, disclosure by directors on the state of internal controls, independence of the board of directors as well as mandatory accreditation were emphasised. Directors of public listed companies are required to be accredited with the Research Institute of Investment Analysts Malaysia (RIIAM) under its Mandatory Accreditation Programme. Meanwhile, a Minority Shareholders Watchdog Group, comprising EPF, Lembaga Tabung Angkatan Tentera, Lembaga Tabung Haji, SOCSO and Permodalan Nasional Berhad, has been set up, aimed at encouraging proactive shareholder participation in public listed companies. The Watchdog Group is expected to be fully operational in the near future.