

MONETARY AND FINANCIAL DEVELOPMENTS

4

ECONOMIC REPORT
2005/2006

Overview

More flexibility in monetary policy and a stronger financial and banking system...

Monetary policy continues to support economic growth in 2005, with the overnight policy rate (OPR) unchanged since its introduction in April 2004. Low interest rates and ample liquidity in the banking system helped to support the expansion in business activities and consumption. Maintaining the accommodative monetary stance, however, became more challenging, particularly in the light of significantly higher oil prices as well as the gradual tightening of monetary policies in several major and regional countries. Inflationary pressure has risen to its highest in six years due to soaring oil prices while interest rate differentials have widened *vis-à-vis* domestic interest rates. Nonetheless, inflation has been mitigated by productivity increase and capacity expansion. On the reversal of interest rate trends, particularly in the United States (US), the increase has been gradual and more importantly, their monetary policies continue to support growth. On the domestic front, Malaysia's strengthened economic fundamentals continue to accord flexibility in pursuing an accommodative monetary policy.

A significant development during the year was the removal of the seven-year old ringgit peg

against the US dollar (USD) and its replacement with a managed float, effective 21 July 2005. The depegging of the ringgit was conducted from a position of strength, particularly resilient economic growth, rising international reserves, sustained current account surplus and a healthy banking system. Furthermore, the stronger ringgit is expected to somewhat mitigate inflationary pressures that have accumulated over a series of price adjustments, including petroleum products as well as from imports. The primary objective of the exchange rate policy remains focussed on promoting stability to facilitate economic activity.

The banking system remains the main mobiliser of funds in the economy, supporting the higher financing needs from the household and business sectors. Although household financing continues to dominate bank lending since the financial crisis, growth in loans outstanding to the business sector turned positive from December 2004, affirming the recovery in private investment and entrenching the private sector as the driver of economic growth. Significantly, loans to small and medium enterprises (SMEs) rose to account for 41.8% of loans to the business sector, following several initiatives over the years to enhance SME economic contribution and resilience, especially their access to financing.

Meanwhile, financial restructuring in Malaysia has been successfully concluded, following

Danaharta's final redemption of its bonds in March this year and its scheduled cessation of operations by year-end. Measures implemented over the years to enhance the capacity and capability of domestic banking institutions, particularly through the consolidation exercise and the Financial Sector Master Plan (FSMP), have yielded positive results. The banking sector remains robust with strong capital base and record low non-performing loans (NPLs) ratio, in addition to improved efficiency and competitiveness.

The strengthened position of the financial system has enabled Malaysia to further liberalise the financial sector and foreign exchange administration rules. The threshold of foreign equity ownership has been increased from 30% to 49% for investment banks, Islamic subsidiaries and *takaful* entities to promote competition and enable greater synergies besides enhancing the integration of domestic financial entities into the global financial landscape. A key liberalisation measure to allow multilateral development banks and multilateral financial institutions to raise ringgit-denominated bonds witnessed three supranationals raising a total of RM1,660 million ringgit bonds in Malaysia, reflecting their confidence in the domestic capital market. Meanwhile, restrictions have also been lifted on foreign participation in the stockbroking, futures broking, fund management and venture capital industries.

Malaysia is also steadily evolving into an Islamic financial services hub, following the approval for three foreign players to operate Islamic banking in Malaysia and the transformation of Islamic banking windows of six domestic banks into Islamic subsidiaries. The *takaful* industry is also set to expand with the expected entry of four new players.

The bond market remains an important source of funding for the economy, with outstanding private debt securities (PDS) accounting for 37.3% of Gross Domestic Product (GDP) at end-July 2005. A significant development for the bond market was the securitisation of Government staff housing loans through the issuance of residential mortgage-backed securities. The securitisation not only introduced a new asset class for the bond market but also facilitated

more effective financial planning for the Government. Similarly, another milestone was achieved with the issuance of the world's first residential mortgage-backed securities under Islamic principles against housing loans of civil servants. The equity market was active with higher turnover and initial public offerings (IPOs), reflecting its importance as an avenue of financing. The introduction of new instruments such as Exchange Traded Funds (ETFs) and Real Estate Investment Trusts (REITs) further enhanced the depth and breadth of the domestic capital market, besides providing investors with alternative investment opportunities.

Monetary Policy

Monetary policy remains accommodative...

Monetary policy remains accommodative in 2005 for the eighth year since the 1997 Asian financial crisis to support economic activity and growth. Maintaining an easier monetary stance has, however, become more challenging amid rising inflationary pressures due to higher oil prices and widening interest rate differentials. The Consumer Price Index (CPI) crept up to 3.7% in August, the highest inflation rate since 1999. The increase in inflation was due to cost-push factors, which was however, somewhat offset by the increase in labour productivity, capacity expansion and a firmer ringgit.

Amidst ample liquidity in the financial system, interest rates remained low and stable to support economic activity and consumption. The OPR of Bank Negara Malaysia (BNM) has been maintained at 2.70% since its introduction in April 2004, reflecting the accommodative monetary stance. In contrast, there has been some tightening of monetary stance on the global front through interest rate increases to mitigate inflationary pressures from rising oil prices, as shown in *Table 4.1*. The US raised the federal funds rate to 3.75% in September this year, the eleventh consecutive increase of 25 basis points since June 2004. With the latest hike, the nominal interest rate differential has widened to 105 basis points in favour of the US. In contrast, the euro zone has kept its key interest rate unchanged

TABLE 4.1

Key Interest Rates of Selected Countries

Country	End-2004 (%)	20 Sep 2005 (%)	Change (basis points)	Effective date
Australia (cash rate target)	5.25	5.50	+25	2 Mar 2005
Euro Area (refinancing rate)	2.00	2.00	0	5 June 2003
Japan (official discount rate)	0.10	0.10	0	19 Sep 2001
UK (repo rate)	4.75	4.50	-25	4 Aug 2005
US (federal funds rate)	2.25	2.50	+25	2 Feb 2005
		2.75	+25	22 Mar 2005
		3.00	+25	3 May 2005
		3.25	+25	30 June 2005
		3.50	+25	9 Aug 2005
		3.75	+25	20 Sep 2005
Indonesia (1-month discount rate)	7.43	8.25	+82	29 June 2005
		8.44	+19	6 July 2005
		8.49	+5	13 July 2005
		8.50	+1	3 Aug 2005
		8.71	+21	10 Aug 2005
		8.75	+4	17 Aug 2005
		9.50	+75	30 Aug 2005
		10.0	+50	6 Sep 2005
Philippines (overnight call rate)	6.75	7.00	+25	7 Apr 2005
Malaysia (overnight policy rate)	2.70	2.70	0	26 Apr 2004
Thailand (14-day repurchase rate)	2.00	2.25	+25	15 Mar 2005
		2.50	+25	9 June 2005
		2.75	+25	21 July 2005
		3.25	+50	7 Sep 2005

Source: Central banks websites.

at 2.00% since June 2003, while the United Kingdom (UK) lowered its repo rate to 4.50%, the first reduction since August 2004, due to the slower growth outlook.

The seven-year fixed exchange rate regime was replaced by a managed float of the ringgit against a basket of trade-weighted currencies of Malaysia's major trading partners on 21 July 2005. The primary objective of the exchange rate policy remains focussed on promoting stability, important for the open and trade-reliant Malaysian economy. The non-internationalisation of the ringgit was, however, maintained to prevent speculative activity. The depegging of the ringgit was timely, given the nation's strong economic fundamentals and the appreciation of the ringgit

against most major and regional currencies since beginning 2005.

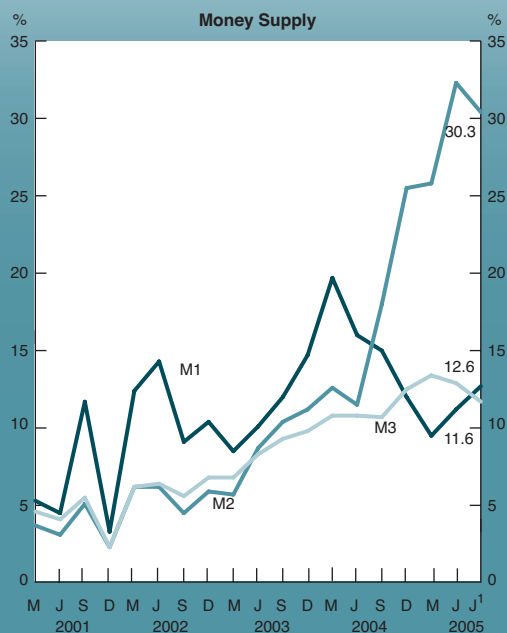
Monetary Developments

Money supply and loans expanded strongly...

Monetary aggregates expanded on the back of sustained economic activities during the first seven months of 2005. **Narrow money or M1** rose by 12.6% in July 2005 (end-2004: 11.9%), reflecting strong demand for transaction balances from households and businesses, as shown in *Chart 4.1*. **Broad money or M3** grew by 11.6% (end-2004: 12.4%), driven by continued net inflow

CHART 4.1

Monetary Aggregates (annual change)



¹ As at end-July 2005.

Source: Bank Negara Malaysia.

of external funds of RM47.6 billion and higher private sector financing of RM15.7 billion in the first seven months of 2005.

Interest rates remained low and stable amidst ample liquidity in the banking system during the first seven months of 2005. Liquidity operations of BNM helped to offset the expansionary impact of net external operations and maintained the OPR at 2.70%. The base lending rate (BLR) of commercial banks and finance companies was also unchanged at 5.98% and 6.90%, respectively at end-July 2005 (end-2004: 5.98%; 6.90%), as shown in *Table 4.2*. However, intense competition among banking institutions led to an easing of lending rates, with the average lending rate of commercial banks and finance companies declining to 5.90% and 8.75%, respectively (end-2004: 5.98%; 8.78%).

Savings deposit rates also declined between 14 and 37 basis points. Interest rates on 1 to 12-month fixed deposits, however, remained unchanged due to the prescribed minimum rates on such deposits. With inflation creeping up, the positive real rate of return to depositors has narrowed. The Merdeka Savings Bond launched

TABLE 4.2

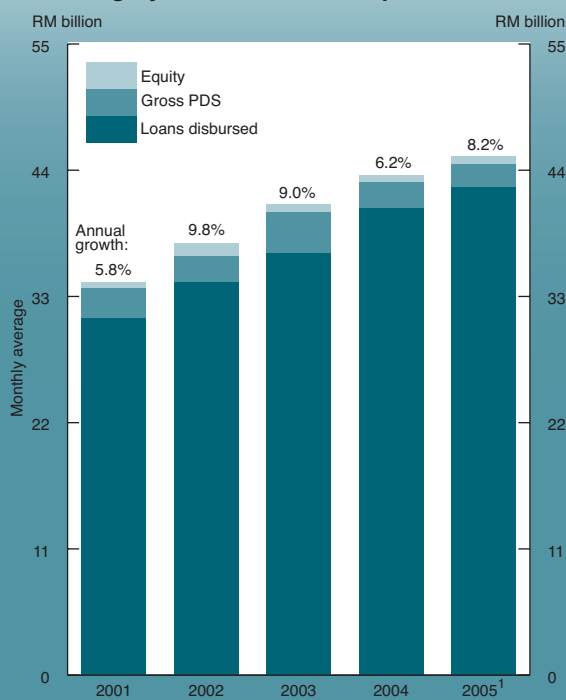
Interest Rates of Commercial Banks and Finance Companies

	End-1998 (%)	End-2004 (%)	End-July 2005 (%)	Change vs end-2004 (percentage point)
Commercial banks				
Base lending	8.04	5.98	5.98	0.00
Average lending	9.72	5.98	5.90	-0.08
Savings deposit	3.87	1.58	1.44	-0.14
1-month fixed deposit	5.82	3.00	3.00	0.00
12-month fixed deposit	5.74	3.70	3.70	0.00
Finance companies				
Base lending	9.50	6.90	6.90	0.00
Average lending	11.76	8.78	8.75	-0.03
Savings deposit	5.01	1.98	1.61	-0.37
1-month fixed deposit	6.35	3.00	3.00	0.00
12-month fixed deposit	6.57	3.70	3.70	0.00

Source: Bank Negara Malaysia.

CHART 4.2

Gross Private Sector Financing through Banking System Loans and Capital Market



¹ As at end July 2005.

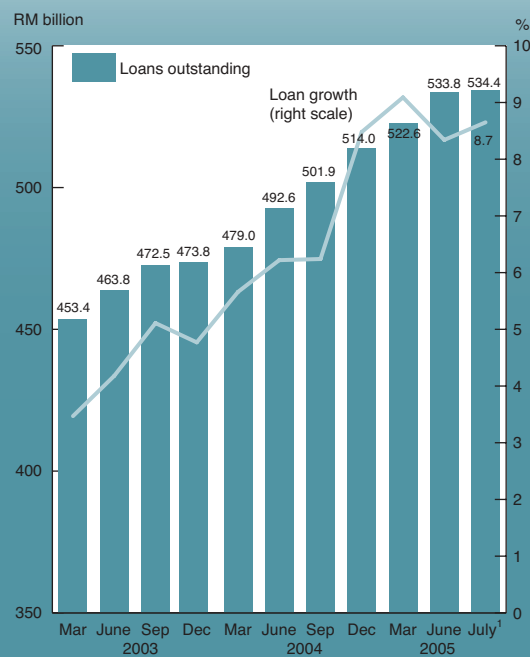
Source: Bank Negara Malaysia.

in 2004, however, provided senior citizens, retired armed forces personnel and Malaysians who have retired on medical grounds with a higher return of 5% per annum. BNM has issued Merdeka Savings Bond amounting to RM1.94 billion in 2004 and another RM1.16 billion as at end-August 2005.

Gross private sector financing through the banking system and the capital market grew by 8.2% to RM316.9 billion in the first seven months of 2005, supported by sustained demand from the business and household sectors, as shown in *Chart 4.2*. Bank lending remained resilient, with an annual growth of 8.7% in loans outstanding at end-July 2005 (end-2004: 8.5%), as shown in *Chart 4.3* and *Table 4.3*. The capital market remained an important source of financing, with total PDS raised expanding to RM14,217 million during the first seven months of 2005 (January-July 2004: RM13,385 million). Financing from

CHART 4.3

Banking System: Loans Outstanding and Growth



¹ As at end-July 2005.

Source: Bank Negara Malaysia.

the PDS market has grown significantly with total PDS outstanding at RM167,850 million and accounted for 37.3% of GDP at end-July 2005 compared to 16.5% at end 1998.

Loan applications, approvals and disbursements of the banking system expanded further by 14.5%, 7.9% and 7.9%, respectively in the first seven months of 2005 (January-July 2004: 17%; 13.7%; 12.4%), as shown in *Table 4.4*. Significantly, loans outstanding to the business sector was up by 2.6% at end-July 2005 (end-2004: 2.6%), marking eight consecutive months of positive growth rates since end-2004 in tandem with growing private investment. The bulk of loan disbursements continued to be channelled to the manufacturing sector (RM73,395 million; 24.6% of total loan disbursements) and the wholesale and retail trade, hotels and restaurants sector (RM54,221 million; 18.2% of total loan disbursements), as shown in *Chart 4.4*.

TABLE 4.3

Banking System: Direction of Lending¹

Sector	RM million			Share (%)
	December 2004	End-July 2005	Change	End-July 2005
Agriculture, hunting, forestry and fishing	10,878.8	11,192.4	313.6	2.1
Mining and quarrying	990.1	959.4	-30.7	0.2
Manufacturing	63,020.3	61,738.9	-1,281.4	11.6
Electricity, gas and water	5,195.7	4,137.2	-1,058.5	0.8
Wholesale and retail trade, hotels and restaurants	43,454.9	45,763.8	2,308.9	8.6
Broad property sector	208,460.9	219,343.1	10,882.2	41.0
Construction	30,711.1	29,687.2	-1,023.9	5.6
Residential property	132,913.6	142,209.7	9,296.1	26.6
Non-residential property	31,134.6	33,142.8	2,008.2	6.2
Real estate	13,701.6	14,303.4	601.8	2.7
Transport, storage and communication	9,915.6	9,949.7	34.1	1.9
Finance, insurance and business services	30,939.4	29,968.7	-970.7	5.6
Consumption credit	68,821.3	113,205.6	44,384.3	21.2
of which:				
Credit cards	12,838.4	15,141.3	2,302.9	2.8
Purchase of passenger cars	39,313.1	79,203.2	39,890.1	14.8
Purchase of securities	19,387.6	19,363.5	-24.1	3.6
Purchase of transport vehicles	2,493.8	3,280.4	786.6	0.6
Community, social and personal services	5,105.8	5,966.5	860.7	1.1
Others	10,114.5	9,481.2	-633.3	1.8
Total loans outstanding²	513,877.7	534,350.3	20,472.6	100.0

¹ Including Islamic banks.² Including loans sold to Cagamas.

Source: Bank Negara Malaysia.

Loans outstanding to SMEs increased by 9% to RM92,066 million at end-July 2005 (end-2004: 7.7%; RM88,301 million) and accounted for 41.8% of total loans to the business sector (end-2004: 40.3%), indicating the success of several initiatives taken over the years to enhance access to financing for SMEs as well as strengthen their capacity and competitiveness. Recent key measures include the establishment of the National SME Development Council in August 2004 as well as an increase in allocation of RM2.5 billion to the Fund for Small and Medium Industries 2 and RM850 million to the New Entrepreneurs Fund 2 in 2004. In addition, a

newly formed SME Bank is expected to start operations on 3 October 2005.

Loans outstanding to SMEs were mainly extended to the wholesale and retail trade, hotels and restaurants accounting for 26% of total outstanding loans, manufacturing (22%) and construction (13%) sectors. The five special SME funds administered by BNM totalling RM8,900 million have also been well utilised, with loans drawn down amounting to RM8,329 million from approved loans of RM10,031 million to account for a utilisation rate of 83% at end-July 2005 (end-2004: 82.6%).

TABLE 4.4

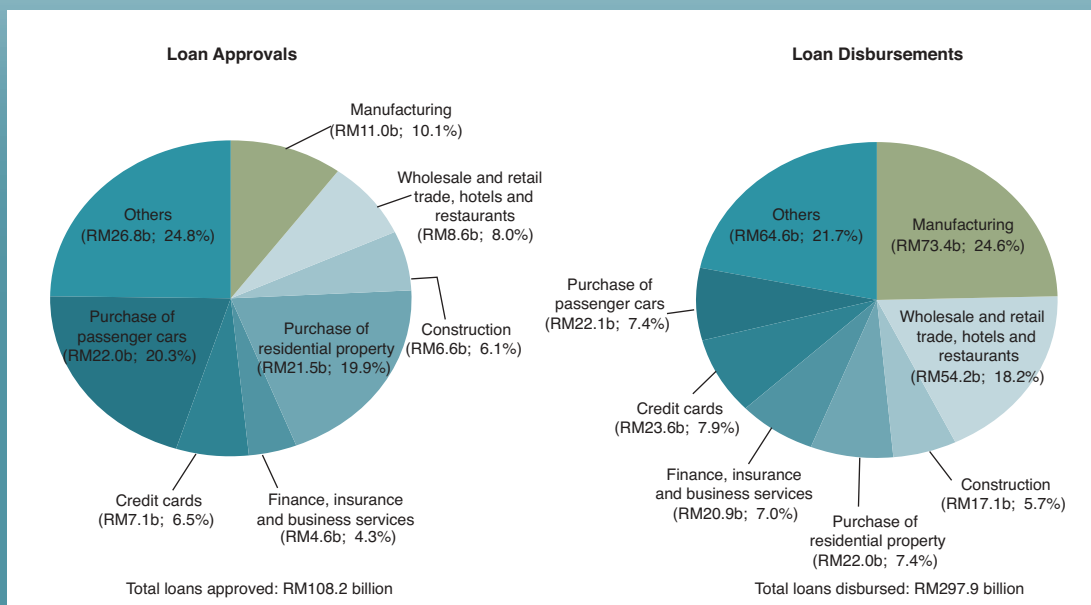
Banking System: Loan Indicators January-July

Indicator	RM million		Annual growth (%)	
	2004	2005	2004	2005
Total				
Loan applications	154,122.9	176,525.2	17.0	14.5
Loan approvals	100,231.9	108,153.3	13.7	7.9
Loan disbursements	276,002.5	297,900.4	12.4	7.9
Loan repayments	266,021.2	279,813.0	12.9	5.2
of which:				
SMEs				
Loan applications	30,173.9	35,468.4	14.3	17.5
Loan approvals	16,990.2	20,269.5	15.6	19.3
Loan disbursements	56,567.1	61,811.1	19.3	9.3
Loan repayments	n.a	n.a	n.a	n.a
Other businesses				
Loan applications	52,252.8	57,581.2	6.8	10.2
Loan approvals	31,893.9	30,506.6	2.1	-4.3
Loan disbursements	132,515.5	140,411.2	10.2	6.0
Loan repayments	n.a	n.a	n.a	n.a
Households				
Loan applications	70,350.1	80,905.1	29.2	15.0
Loan approvals	49,930.0	56,068.1	22.9	12.3
Loan disbursements	73,947.2	81,983.9	15.4	10.9
Loan repayments	61,665.6	65,800.6	18.1	6.7

Source: Bank Negara Malaysia.

CHART 4.4

Loan Approvals and Disbursements by Sector: Value and Share January-July 2005



Source: Bank Negara Malaysia.

Loans outstanding to the household sector, the driver of bank lending since the financial crisis, rose by 15.1% at end-July 2005 (end-2004: 14.4%), helped by positive consumer confidence, higher disposable income and the low interest rate environment. Loan disbursements were predominantly for credit card loans accounting for 28.9% of total household loan disbursements and the purchase of passenger cars (27.1%) and residential properties (26.9%). Credit card usage has been rising, driven by continued strong growth in private consumption and aggressive promotion in marketing of credit cards. Credit card transactions by Malaysian cardholders expanded by 17.5% to RM22,565 million in the first seven months of 2005 (January-July 2004: RM19,201 million).

The **exchange rate of the ringgit** strengthened in the first half of 2005 in tandem with the stronger US dollar. Prior to the removal of the ringgit peg on 21 July 2005, the ringgit tracked the performance of the US dollar and appreciated against the major and regional currencies, as shown in *Chart 4.5* and *Table 4.5*. The ringgit

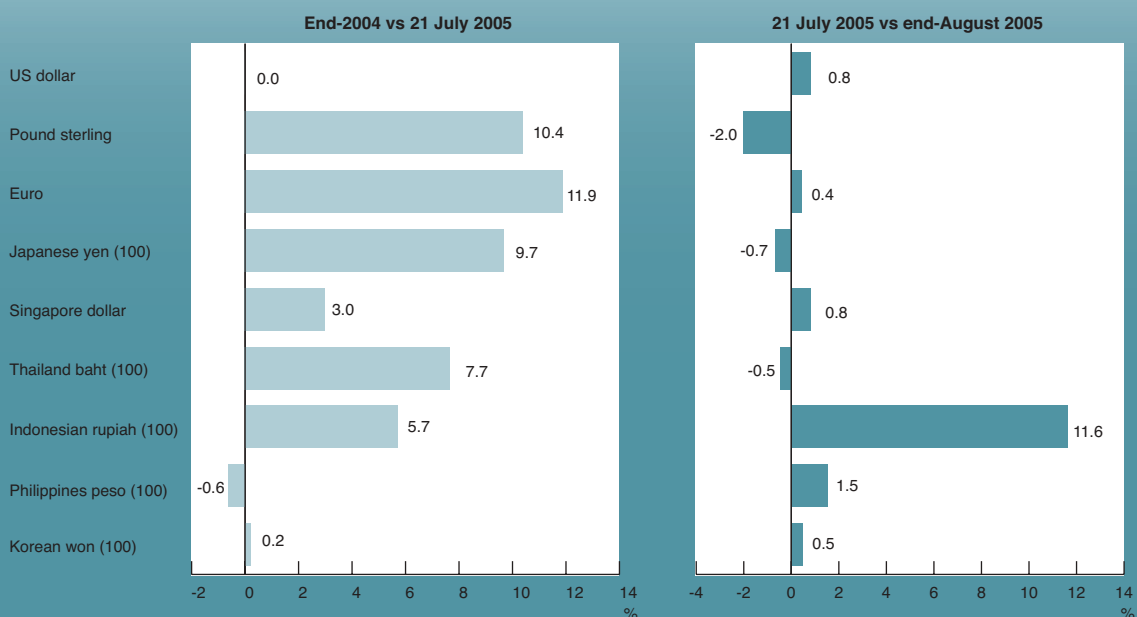
rose by a significant 11.9% against the euro, 9.7% *vis-à-vis* the yen and 10.4% against the pound. The firmer US dollar was supported by better growth of the US economy compared to the euro area and Japan as well as US interest rate increases and expectations of further hikes. The euro weakened on concerns over the future of EU integration while both the euro and pound were affected by market speculation of a reduction in the benchmark interest rates.

The ringgit also appreciated broadly between 0.2% and 7.7% against most regional currencies during the same period. The baht and rupiah weakened *vis-à-vis* the US dollar as demand for the greenback increased to pay for higher oil prices. In contrast, the Korean won firmed up against the US dollar since the fourth quarter of 2004, benefitting from strong capital inflows.

The ringgit further strengthened following the shift from a fixed exchange rate regime to a managed float of the ringgit against a currency basket, with the value of the ringgit determined by economic fundamentals effective 21 July 2005.

CHART 4.5

Performance of Ringgit against Selected Currencies (percentage change)



Source: Bank Negara Malaysia.

TABLE 4.5

Performance of Ringgit against Selected Currencies

Currency	RM per foreign currency ¹				Change (%) vs		
	2 Sep 1998	End-Dec 2004	21 Jul 2005	End-Aug 2005	2 Sep 1998	End-Dec 2004	21 Jul 2005
US dollar	3.8000	3.8000	3.8000	3.7698	0.8	0.8	0.8
Pound sterling	6.3708	7.3169	6.6270	6.7605	-5.8	8.2	-2.0
Euro ²	-	5.1729	4.6212	4.6027	-	12.4	0.4
Japanese yen (100)	2.7742	3.7026	3.3745	3.3985	-18.4	8.9	-0.7
Singapore dollar	2.1998	2.3258	2.2570	2.2395	-1.8	3.9	0.8
Thailand baht (100)	9.3713	9.7636	9.0681	9.1178	2.8	7.1	-0.5
Philippines peso (100)	8.8302	6.7706	6.8131	6.7098	31.6	0.9	1.5
Indonesian rupiah (100)	0.0354	0.0408	0.0386	0.0364	2.3	17.9	11.6
Korean won (100)	0.2827	0.3671	0.3665	0.3648	-22.5	0.6	0.5

¹ Interbank rates at 12.00 noon in Kuala Lumpur are an average of the highest buying and lowest selling quotes.

² Euro was introduced in January 1999.

Source: Bank Negara Malaysia.

Since 21 July to end-August 2005, the ringgit appreciated in the range of 0.5% and 11.6% against most major and regional currencies. The transition to the managed float has been orderly and well-managed. The increase in the value of the ringgit against other exchange rates has, however, not been large, as the ringgit had already appreciated significantly prior to the introduction of the managed float.

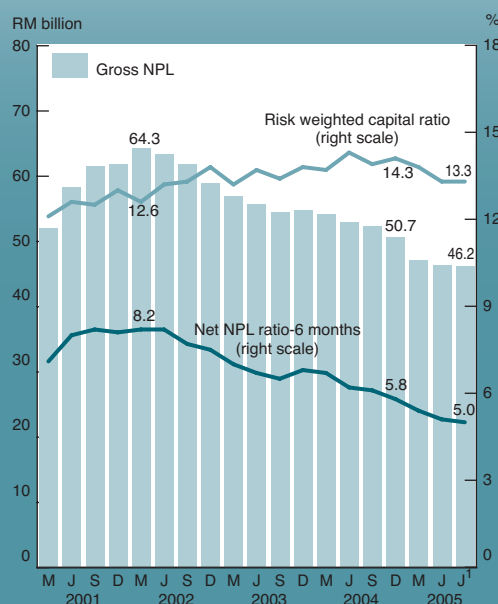
Health of the Banking System

Robust banking system, with strong capital base, higher profitability and lower NPLs...

The banking system remained robust with strong capitalisation, higher profitability and declining NPLs in the first seven months of 2005. Both the risk-weighted capital ratio and core capital ratio of the banking system remained strong at 13.3% and 10.4%, respectively at end-July 2005 (end-2004: 14.3%; 11.3%), significantly higher than the Bank for International Settlements minimum requirement of 8%. The banking system recorded pre-tax profits of RM5.8 billion during the first half of 2005, supported by favourable economic and financial market conditions.

CHART 4.6

Banking System: Gross Non-Performing Loans (NPLs), Net NPL Ratio and Risk Weighted Capital Ratio



¹ As at end-July 2005.

Source: Bank Negara Malaysia.

NPLs based on 6-months classification declined by 9% or RM4,562 million from RM50,712 million at end-2004 to RM46,150 million at end-July 2005 due to lower incidence of NPLs, higher write-offs and reclassifications of NPLs to performing status, as shown in *Chart 4.6*. Likewise, the net NPL ratio based on 6-months fell to 5% at end-July 2005 (end-2004: 5.8%), the lowest level since the financial crisis in 1997. Net NPLs based on 3-months also declined to 6.7% as at end-July (end-2004: 7.5%).

Financial Sector Restructuring

Successful conclusion of Malaysia's financial sector restructuring...

On 31 March 2005, **Danaharta** successfully redeemed its final three tranches of bonds amounting to RM795 million. Danaharta had issued 15 tranches of bonds totalling RM11,140 million to finance its acquisition of NPLs from distressed financial institutions during the financial crisis. Significantly, Danaharta had generated enough recovery from its operations to redeem the bonds. With the progress, Danaharta is on track to wind up its operations in 2005, signifying the conclusion of the financial sector restructuring exercise, which started in 1998.

Danaharta is the third institution to successfully cease operations after the closure of the Corporate Debt Restructuring Committee (CDRC) in August 2002 and Danamodal in February 2004. During its seven-year life span, Danaharta had acquired NPLs totalling RM52,440 million (loan rights acquired plus accrued interest) and achieved a recovery rate of 59%.

Progress of the Financial Sector Masterplan

FSMP ensures a stronger and more resilient domestic financial sector to face rising competition...

The implementation of the **FSMP**, a blueprint charting the strategic direction of the Malaysian

financial system, and launched in 2001 is on track and schedule. As at end-June 2005, a total of 45 recommendations has been fully completed, which accounts for almost half of the recommendations with milestones. Another 28 recommendations are being implemented on a continuous basis, where initiatives are continuously being taken to attain the desired outcomes.

The initiatives undertaken thus far have resulted in a financial sector which is stronger, more resilient and in a better position to face greater competitive pressures. The ability of domestic banking institutions and insurance companies to continue recording strong financial performance despite increasingly competitive operating environment reflects their growing strength and capability. In addition, the regulatory framework has been further enhanced to cope with the challenges of an increasingly complex financial market. Financial institutions have adopted better risk management practices in their business operations, which have also provided them greater ability and flexibility to respond to the increasing demands and expectations from customers.

A significant FSMP recommendation was implemented in 2005, which was the introduction of a deposit insurance system for Malaysia on 1 September. The deposit insurance system provides coverage of up to RM60,000 inclusive of principal and interest per depositor per bank as well as separate additional coverage for Islamic deposits, joint accounts, trust accounts, sole proprietors and partnerships. The system replaces the implicit guarantee on deposits from the Government in the event of a bank failure. The deposit insurance scheme will further strengthen consumer protection as well as encourage financial institutions to improve their risk management.

Islamic Banking

Geared for further growth with entry of foreign players and commencement of operations of Islamic subsidiaries...

The **Islamic banking industry** continued to expand albeit more moderately during the first

TABLE 4.6

Islamic Banking: Key Indicators

	RM million		Change (%)
	End-2004	End-July 2005	
Assets	94,574	102,136	8.0
Deposits	72,857	77,694	6.6
of which:			
Investment	41,993	43,123	2.7
Savings	8,432	9,005	6.8
Demand	12,887	13,652	5.9
Others	9,545	11,914	24.8
Financing	57,841	63,080	9.0
of which:			
SMEs	7,994	8,865	10.9
Large corporations	13,931	14,126	1.4
Households	34,127	38,164	11.8

Source: Bank Negara Malaysia.

seven months of 2005 with banking assets and deposits increasing by 8% and 6.6%, respectively at end-July 2005 (end-2004: 15.1%; 21.1%), as shown in *Table 4.6*. The industry sustained its market share in terms of assets and deposits accounting for 10.6% and 11.2%, respectively of the total banking system (end-2004: 10.5%; 11.2%). Islamic financing rose by 9% to RM63,080 million to constitute a higher market share of 11.8% of total financing of the banking system at end-July 2005 (end-2004: 11.3%).

Similar to conventional banking, Islamic financing was dominated by lending to households, accounting for 60.5% of total financing. Household financing was supported by strong consumer spending, particularly for the purchase of residential properties (24.9% of total outstanding Islamic loans) and consumption credit (33.2%), as shown in *Table 4.7*. Financing to SMEs

TABLE 4.7

Islamic Banking System: Direction of Lending

Sector	RM million		Change	Share (%) End-July 2005
	December 2004	End-July 2005		
Agriculture, hunting, forestry and fishing	2,328.5	2,202.1	-126.4	3.5
Mining and quarrying	76.6	134.3	57.7	0.2
Manufacturing	6,112.6	6,883.9	771.3	10.9
Electricity, gas and water	719.2	541.2	-178.0	0.9
Wholesale and retail trade, hotels and restaurants	3,070.9	3,456.8	385.9	5.5
Broad property sector	22,410.7	22,586.8	176.1	35.8
Construction	3,530.9	3,260.8	-270.1	5.2
Residential property	15,393.0	15,736.8	343.8	24.9
Non-residential property	2,580.4	2,560.0	-20.4	4.1
Real estate	906.4	1,029.2	122.8	1.6
Transport, storage and communication	1,176.5	1,208.9	32.4	1.9
Finance, insurance and business services	2,089.9	2,329.6	239.7	3.7
Consumption credit	17,490.5	20,965.6	3,475.1	33.2
of which:				
Purchase of consumer durables	43.6	40.0	-3.6	0.1
Personal use	2,448.4	3,057.6	609.2	4.8
Purchase of transport vehicles	14,998.5	17,868.0	2,869.5	28.3
Purchase of securities	877.9	908.4	30.5	1.4
Community, social and personal services	418.5	550.6	132.1	0.9
Others	1,069.5	1,312.3	242.8	2.1
Total loans outstanding	57,841.3	63,080.5	5,239.2	100.0

Source: Bank Negara Malaysia.

continued to be significant with a 10.9% growth to RM8,865 million and accounted for 14.1% of total outstanding loans at end-July 2005 (end-2004: 13.8%).

The Islamic banking industry is set to grow further following the implementation of several strategic initiatives to strengthen the development of the Islamic banking industry both on the domestic and international fronts. These initiatives include the approval of new Islamic banking licences under the Islamic Banking Act 1983 (IBA) to three leading foreign Islamic financial institutions from the Middle East. The issuance of Islamic banking licences to foreign players is part of the strategies to enhance the diversity and depth of players in the Islamic financial landscape as well as strengthen the global integration of the domestic Islamic financial system. The first foreign Islamic bank has commenced operations in August 2005.

Another important strategic measure is the transformation of the current Islamic windows into Islamic subsidiaries (IS) within the respective banking groups. To date, six domestic banking groups have been approved to establish IS, of which three have commenced operations. Meanwhile, up to 49% foreign equity is allowed in the IS. The liberalisation move is expected to increase the potential for building strategic partnerships to acquire new expertise, tap the best talents from a broad range of fields and develop new value-added activities that would stimulate greater innovation and expansion of the Islamic banking industry as well as enhance global integration of the industry.

To support the activities of syariah scholars in the areas of research and capacity building in Islamic banking and finance, a RM200 million endowment fund has been established by BNM. The endowment fund will be utilised to finance training programmes for syariah scholars worldwide, conduct research in Islamic finance and scholarships as well as organise international annual dialogues and workshops among syariah scholars.

As part of ongoing efforts to increase consumer awareness and education in Islamic banking and finance, a series of Islamic Banking and Takaful

Roadshows has also been organised. The roadshows are jointly organised by BNM, the Association of Islamic Banking Institutions Malaysia (AIBIM) and Malaysian Takaful Association (MTA). To date, three roadshows have been held, with another two to be held by end of 2005.

Development Financial Institutions

Stronger loan growth of DFIs...

Development financial institutions (DFIs) continue to complement the banking system in providing financing to certain priority areas such as infrastructure, Bumiputera entrepreneur development, agriculture, manufacturing and exports as well as SMEs. Financing activities of the DFIs grew strongly by 20% to RM45,290 million as at end-June 2005 (end-2004: 16.5%; RM37,739 million), as shown in *Table 4.8*. The surge in loan growth was mainly contributed by financing for infrastructure projects, consumption credit and purchase of residential properties.

Loans channelled to infrastructure projects recorded a growth of 26.9%, representing 27.8% of total loans outstanding by the DFIs. The increase reflected mainly loans to the transportation and communication, construction and utilities sectors by Bank Pembangunan dan Infrastruktur Malaysia Berhad (BPIMB). Higher lending for consumption credit, which rose 21.4% was attributable to stronger demand for personal loans following active promotion by Bank Rakyat and Bank Simpanan Nasional. The two banks also leveraged on the low interest rate environment to aggressively promote their housing loan products, leading to an 18% growth in financing for purchase of residential properties. Of the 14 DFIs, financing activities continued to be dominated by seven DFIs, which extended more than 85% of total loans outstanding.

Total resources of DFIs rose by 6.9% to RM96,521 million at end-June 2005 (end-2004: RM90,310 million). The increase reflected higher borrowings from the Government of RM19,098 million

TABLE 4.8

Direction of Lending by DFIs¹

Sector	RM million		Share (%)	
	End-2004	End-June 2005	End-2004	End-June 2005
Manufacturing	4,186.3	4,520.2	11.1	10.0
Agriculture	3,261.3	3,380.6	8.6	7.5
Electricity, gas and water	1,228.9	2,173.5	3.3	4.8
Broad property of which:	10,022.5	10,670.3	26.6	23.6
Construction	4,136.1	4,524.7	11.0	10.0
Residential property	4,066.4	4,795.6	10.8	10.6
Consumption credit	9,238.5	11,216.0	24.5	24.8
Transport and communications	5,315.4	6,624.5	14.1	14.6
Finance, insurance and business services	1,306.7	1,764.9	3.5	3.9
Others	3,178.9	4,939.7	8.4	10.9
Total	37,738.5	45,289.7	100.0	100.0

¹ Comprising Bank Industri & Teknologi Malaysia Berhad, Bank Pembangunan dan Infrastruktur Malaysia Berhad, Bank Simpanan Nasional, Bank Kerjasama Rakyat Malaysia Berhad, Export-Import Bank of Malaysia Berhad, Bank Pertanian Malaysia, Malaysian Industrial Development Finance Berhad, Sabah Development Bank Berhad, Borneo Development Corporation (Sabah) Sendirian Berhad, Borneo Development Corporation (Sarawak) Sendirian Berhad, Malaysian Export Credit Insurance Berhad, Credit Guarantee Corporation Malaysia Berhad, Sabah Credit Corporation and Lembaga Tabung Haji.

Source: Bank Negara Malaysia.

(end-2004: RM17,569 million), mainly to finance infrastructure projects. The increase in deposits mobilised by the deposit-taking DFIs accounted for more than 50% of total resources. The DFIs were also funded by shareholders' funds totalling more than RM10 billion or 11.5% of total resources.

In line with the objective to further develop SMEs, the SME functions of two DFIs namely, BPIMB and Bank Industri & Teknologi Malaysia Berhad (BITMB) will be merged to form the new Bank Perusahaan Kecil dan Sederhana (SME Bank). SME Bank is tasked with nurturing and developing SMEs by providing financial and non-financial services, including creating an entrepreneurial community, providing guarantees to loans granted by banking institutions, facilitating securitisation as well as providing credit ratings and business analysis on SMEs. SME Bank is expected to commence operations on 3 October 2005. Apart from establishing the SME Bank,

the Export-Import Bank of Malaysia (Exim) will be strengthened and absorb the functions of Malaysia Export Credit Insurance Berhad (MECIB) to enhance the availability of trade finance and export insurance. This initiative is expected to further encourage SMEs to venture abroad and expand their export of goods and services.

Insurance Industry

Sustained growth momentum with stronger expansion of general insurance...

The insurance industry continues to support the economy through the mobilisation of long-term savings, besides facilitating economic risk transfers. It recorded positive growth in the first half of 2005, albeit more moderately, with combined premium income for both life and general business increasing by 8.6% to RM11,546 million (January-June 2004: 21.5%; RM10,628 million), as shown in *Table 4.9*. The generation

TABLE 4.9

Life and General Insurance Business

	End-2004	End-June 2005 ¹
Life insurance business (RM million)		
New business		
Number of policies (‘000 units)	1,411	689
Sums insured	170,840.1	92,714.3
Total premiums	6,641.7	3,642.2
Business in force		
Number of policies (‘000 units)	9,724	9,953
Sums insured	593,185.9	615,164.9
Annual premiums	11,251.1	11,706.2
Premium income	15,131.0	7,844.9
Benefit payments	5,397.3	2,827.8
General insurance (RM million)		
Premium income		
Gross direct premiums	8,557.5	4,848.8
Net premiums	6,910.9	3,700.7
Reinsurance placed outside Malaysia	977.1	518.1
Retention ratio ² (%)	87.0	87.2
Number of insurance companies		
Direct		
Life	7	7
General	26	26
Composite	9	9
Reinsurance		
Life	1	1
General	5	5
Composite	1	1

¹ Preliminary data.² Net premiums to gross direct and reinsurance accepted premiums less reinsurance within Malaysia.

Source: Bank Negara Malaysia.

of premium income continued to be dominated by life insurance, which constituted about 68% of total combined premium income. The slower pace of premium income growth was attributable to the larger life premium base achieved in 2004 following exceptionally strong new demand for investment-linked and endowment products. In contrast, the general insurance sector experienced stronger growth with the stabilisation of premium rates after two consecutive years of premium rate declines in line with global rate trends.

Total benefits and claims paid by the insurance industry increased by 6.6% to RM4,674 million in the first half of 2005 (January-June 2004: 19.2%; RM4,383 million). The bulk of benefit payouts was attributable to maturity benefit payments by life insurers on endowment policies that matured during the period. Insurance fund assets expanded by 5.4% to RM91,567 million as at end-June 2005 (end-2004: RM86,852 million), with life insurance funds accounting for over 80% of total assets, as shown in *Table 4.10*. Insurance companies remained significant institutional investors in the capital market, with total investments in corporate and debt securities increasing to RM42,854 million at end-June 2005 (end-2004: RM40,380 million). In terms of asset allocation, the largest share or 46.8% of total assets (end-2004: 46.5%) continued to be concentrated in investments in corporate and debt securities, particularly longer-term bonds to match the long-term liabilities of life insurers.

New business premiums in the **life insurance** sector rose by 14.7% to RM3,642 million in the first six months of 2005 (January-June 2004: 53.7%; RM3,176 million), driven by consumer demand for attractive investment options. There was strong preference for endowment plans which grew by 71.1% to RM1,608 million (January-June 2004: 85%; RM940 million). New premiums for investment-linked business, however, fell by 31% to RM819 million due to the larger base recorded in the corresponding period of 2004 (103.3%; RM1,186 million). Despite the decline, sales of investment-linked plans contributed the second largest share or 22.5% of new life business premiums after endowment plans, which garnered 44.1%. The recent move to increase the limit for insurance companies' overseas investments

TABLE 4.10

Assets of Life and General Insurance Funds

(RM million)

	Life Insurance		General Insurance	
	End-2004	End-June 2005 ¹	End-2004	End-June 2005 ¹
Fixed assets	355.8	357.3	733.0	725.7
Loans	8,455.4	8,851.6	226.5	234.4
Government securities	12,518.7	12,310.8	2,281.1	2,519.0
Government guaranteed loans	-	-	10.1	10.0
Corporate and debt securities	34,694.6	37,159.7	5,685.1	5,693.8
Investment properties	2,969.4	3,006.9	429.7	429.1
Cash and deposits	8,899.2	9,964.0	5,837.6	6,149.9
Other assets ²	1,882.3	2,062.2	1,872.9	2,092.5
Total	69,775.4	73,712.5	17,077.0	17,854.4

¹ Preliminary data.² Includes other investments and foreign assets.

Source: Bank Negara Malaysia.

from 10% to 30% of net asset value (NAV) is expected to boost sales for investment-linked products, as insurance companies would have more flexibility to diversify investment portfolios and generate higher returns to policyholders.

New business premiums for pure protection policies, specifically credit-related term policies and medical and health insurance policies, also recorded strong growth, indicating the increasing importance of insurance as an effective tool for individuals to manage personal financial risks. The positive overall new business growth trend resulted in the market penetration level, measured in terms of the total number of policies in force to total population, increasing to 38.3% as at end-June 2005 (end-2004: 37.9%). Compared to developed countries, which have higher penetration rates, the current domestic penetration level suggests strong potential for further market expansion.

In the **general insurance** sector, premium growth rebounded strongly on the back of higher motor vehicle sales and the stabilisation of premium rates for commercial risks which had declined sharply since 2003. Gross direct premiums

expanded at an annual rate of 10% to RM4,849 million in the first half of 2005 (January-June 2004: 4.2%; RM4,409 million). Motor insurance business maintained its dominance with a 45.1% share of total premiums. Net premiums retained by insurers also increased, resulting in a higher retention ratio of 87.2% (January-June 2004: 85.7%).

Both life and general insurance continued to record profitability in the first six months of 2005. Consistent with the premium growth trends, the excess of income over outgo of the life insurance sector was lower at RM5,169 million (January-June 2004: RM5,789 million), while operating profit for the general insurance sector increased significantly to RM711 million (January-June 2004: RM504 million).

In the first half of 2005, regulatory initiatives focussed on strengthening risk management practices in the insurance industry, enhancing disclosures to consumers and promoting higher standards of professionalism among insurance intermediaries. The consolidation of the industry remains a market-driven process. As competitive pressures intensify, mergers and acquisitions

are expected to be a strategy that will be pursued by insurers to enhance capital and operating efficiencies. As at end-June 2005, the number of direct insurers has been reduced from 58 to 42, with one other merger and acquisition involving three insurers currently in progress.

Takaful

Strong performance with growing demand for investment-linked takaful plans...

The **takaful industry** recorded strong performance in the first seven months of 2005 with new business contributions of **family takaful** increasing by 33.5% to RM459 million (January-July 2004: 38.9%; RM344 million), as shown in *Table 4.11*. The new contributions were mainly generated from mortgage reducing term takaful plans in line with the growth of Islamic mortgage financing. Growth was also driven by strong consumer preference for investment-linked takaful plans with new contributions up by RM63 million (January-July 2004: RM6 million). Medical and health takaful plans further expanded with contributions increasing by 29.2%, reflecting higher demand for protection against rising healthcare cost. The number of certificates in force increased by 16.1% to 1.4 million units with market penetration level at 5.1% at end-July 2005.

The performance of **general takaful** business improved further in the first seven months of 2005, with gross contributions increasing by 21% to RM347 million (January-July 2004: 35.1%; RM286 million). The fire and motor sectors continued to dominate the general takaful business with 38.4% and 31.5% share of total gross contributions, respectively. Net claims paid by the industry increased by 46.2% to RM66 million, as a result of higher net claims in the motor sector.

During the period, assets of family and general takaful expanded further by 12.2% to RM5,642 million (end-2004: RM5,029 million). A substantial portion of takaful funds was invested in Islamic PDS and equities, accounting for 45.5% share of total assets. The market share of takaful assets improved to 6.1% of total assets of the insurance and takaful industry at end-July 2005.

TABLE 4.11

Family and General Takaful Business

	End-July 2004	Financial Year 2004	End-July 2005
Assets¹ (RM million)	4,760.6	5,028.6	5,642.8
Government Investment Issues	482.5	597.4	733.3
Investment deposits	1,585.4	1,612.9	1,641.0
Islamic PDS and equities	2,369.6	2,463.9	2,567.7
Cash and bank balances	26.9	44.6	180.5
Financing	59.9	45.4	52.0
Fixed assets	111.1	109.6	232.9
Others	125.0	154.8	235.4
Family takaful business			
New business			
Total contributions (RM million)	344.2	603.7	459.4
Sums participated (RM million)	25,474.1	36,458.1	27,657.0
Number of certificates	163,812	290,538	212,162
Business in force			
Total contributions ² (RM million)	427.4	477.2	529.3
Sums participated (RM million)	97,639.5	88,711.9	103,665.0
Number of certificates	1,214,377	1,315,195	1,410,255
General takaful business			
Gross contributions (RM million)	286.5	492.5	346.8
Net claims paid (RM million)	45.2	90.8	66.1

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

² In force contributions reported is only for annual contributions.

Source: Bank Negara Malaysia.

Several initiatives continue to be taken in the first half of 2005 to promote and strengthen the domestic takaful industry, in line with the objective for Malaysia to become an Islamic financial services hub. An additional four new takaful licenses will be issued to qualified applicants to enhance competition and accelerate the expansion of takaful business. In addition, foreign equity of up to 49% is allowed in takaful entities

to leverage on the expertise of foreign financial institutions.

Meanwhile, insurance brokers and adjusters previously licensed under the Insurance Act 1996 to conduct takaful broking and adjusting business will now be licensed under the Takaful Act 1984. This will allow BNM to better regulate and supervise takaful intermediaries, enhance consumer protection as well as mitigate the possibility of unlicensed persons from acting as takaful brokers and adjusters. An additional five new licences will also be issued to new takaful broking players to promote specialisation and spur growth of the industry. Takaful operators have also been encouraged to venture into bancatakaful arrangements as a means to enhance their market presence and penetration. Bancatakaful arrangements enable the takaful industry to utilise the extensive network of banking institutions and DFIs to market takaful products to customers.

Capital Market

Facilitating fund raising to finance stronger private sector activities...

Gross funds raised in the capital market totalled RM38,734 million, of which 52% of funds was raised by the private sector and the remaining 48% by the public sector during the first seven months of 2005, as shown in *Table 4.12*. Funds raised by the public sector moderated significantly, reflecting the Government's fiscal consolidation efforts. The bulk of funds was mainly raised through the issuance of Malaysian Government Securities (MGS) amounting to RM14,543 million (January-July 2004: RM27,764 million). Similarly, gross funds raised by the private sector through the bond and equity markets also moderated by 4.3% to RM20,195 million (January-July 2004: -42.4%; RM21,108 million), mainly attributed to the lower PDS issuance on the back of uncertainties regarding the outlook of interest rates, as well as corporates' preference towards other financing avenues. In contrast, IPO issuance was more active with the amount raised surging more than 2.5 times. After accounting for lower PDS redemptions, net funds raised by the private sector rose threefold to RM8,910 million (January-July 2004: -86.9%; RM2,940 million).

TABLE 4.12

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

	2004	2005
By public sector		
Government securities		
Malaysian Government Securities	27,763.6	14,543.1
Khazanah Bonds	0.0	833.2
Government investment issues	1,440.1	2,000.1
Merdeka Savings Bonds	1,500.0	1,162.1
New Government securities	28,203.6	18,538.5
Less redemptions	18,657.0	8,531.9
Net funds raised	9,546.6	10,006.6
By private sector		
Shares²		
Initial public offerings	1,576.6	4,227.8
Rights issues	1,005.1	552.8
Private placements	785.6	249.0
Special issues	68.0	0.0
Warrants	47.7	17.4
New share issues	3,483.0	4,798.0
Debt securities³ (gross)		
Straight bonds	943.4	1,356.4
Convertible bonds	2,470.2	2,708.7
Islamic bonds	4,452.9	3,432.0
Asset-backed bonds	1,402.5	497.3
Bonds with warrants	-	0.0
Medium term notes	4,116.0	6,222.6
Cagamas bonds	4,240.0	1,180.0
New debt securities	17,625.0	15,397.0
Less redemptions⁴	18,168.3	11,284.6
Net issues of debt securities	(543.3)	4,112.4
Net funds raised	2,939.7	8,910.4
Total net funds raised	14,283.6	18,917.0

¹ Preliminary data.

² Excludes funds raised by the exercise of Employees Share Option Scheme, Transferable Subscription Rights and Irredeemable Convertible Unsecured Loan Stocks.

³ Includes bonds issued by banking institutions since July 2000.

⁴ Includes straight bonds, bonds with warrants, convertible bonds, Islamic bonds and Cagamas bonds.

Source: Bank Negara Malaysia.

SECURITISATION OF GOVERNMENT STAFF HOUSING LOANS – A LEAP FOR THE BOND MARKET

Introduction

In line with efforts to further deepen and broaden the bond market, various measures have been implemented to facilitate securitisation, including mandating Securities Commission as the sole regulator for the issuance of bonds, the release of the Guidelines on the Offering of Asset-Backed Securities (ABS) in April 2001 and the introduction of the Prudential Standards on Asset-Backed Securitisation Transactions in April 2003 by Bank Negara Malaysia (BNM). The Government also provided several tax incentives namely, stamp duty and real property gains tax exemptions on asset securitisation transactions to further facilitate the issuance of ABS.

In Malaysia, securitisation began through the operations of Cagamas Berhad, the National Mortgage Corporation, in October 1987, with Cagamas purchasing loans and debts by raising debt securities at the secondary level. However, the debt securities were not strictly backed by cashflows from the loans and debts to be deemed as “true” securitisation.

Securitisation of Government Staff Housing Loans

The Government undertook the securitisation of Government staff housing loans (GSHL) aimed primarily at further developing the Malaysian bond market, in particular ABS as a new financial tool for raising funds in the capital market. This is in line with the key thrust of the domestic bond market development agenda to widen the range and sophistication of products to meet the increasingly diverse needs of investors and issuers.

The securitisation process involved the Government assigning by way of sales its staff housing loans on a scheduled basis over a period of time to Cagamas, the issuer, in return for cash proceeds. Cagamas will then structure a mortgaged-backed securities (MBS) issuance to fund the scheduled purchases of loans. The cashflows from the underlying loans will be utilised for the repayment of the MBS issue.

Transaction Structure

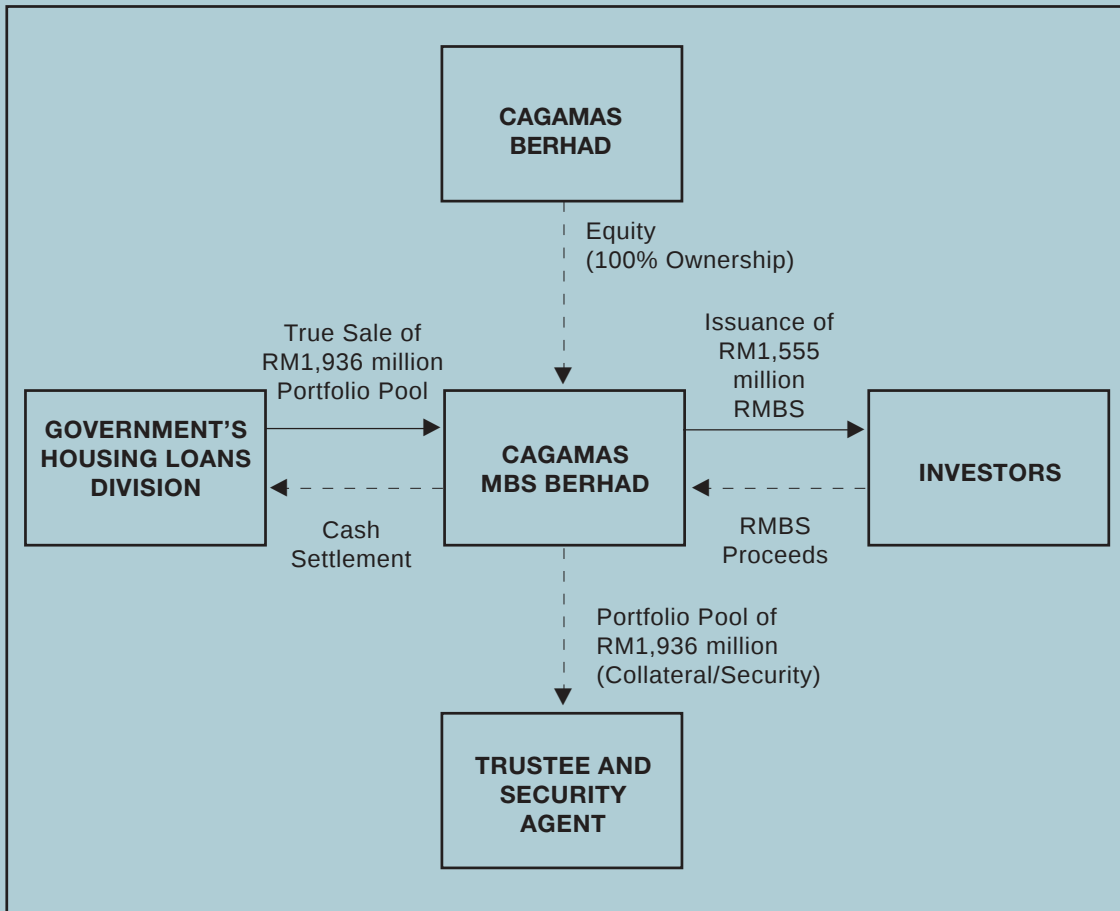
Cagamas incorporated a wholly-owned subsidiary, Cagamas MBS Berhad (CMBS), in June 2004, to undertake the securitisation of GSHL. CMBS acts as a limited-purpose entity, which will purchase GSHL progressively and issue residential mortgage-backed securities (RMBS) to raise the purchase consideration for the housing loans. The transaction structure for the securitisation of GSHL is shown in *Chart 1*.

Currently, the total housing loans amounts to some RM29.03 billion with maturities up to 25 years. Given this large size, the securitisation of GSHL will contribute significantly to:

- i. create a yield curve for RMBS with longer maturities that will serve as a benchmark for other ABS issuance;
- ii. put in place a price discovery mechanism for other ABS since RMBS bears lowest risks as it is backed by cashflows from housing loan instalments. This will enable investors to price more accurately other types of ABS;
- iii. promote a viable and active secondary market for ABS issuance; and
- iv. promote Malaysia as an issuer of Islamic ABS, given that almost half of the housing loans approved since 1994, constitute Islamic financing debts.

CHART 1

Transaction Structure



The first portfolio of GSHL was securitised on 20 October 2004, involving RM1,936 million of pensioners' housing loans and the issuance of RM1,555 million in nominal value RMBS for tenures of 3, 5, 7 and 10 years. The RMBS issue was accorded the highest rating of AAA by both Rating Agency Malaysia (RAM) and Malaysian Rating Corporation (MARC). The rating reflects the superior quality of the underlying assets, the strong counterparties as well as the credibility of the RMBS structure, where the source of repayment for the assets is the pension deductions of Government staff.

The RMBS issuance was well-received, with an over-subscription of 5.6 times. It attracted RM11.1 billion in book size, with RM2.2 billion from investors in Hong Kong and Singapore and RM8.9 billion from domestic investors. The investors included financial institutions, pension funds, asset management companies, insurance companies and corporations. The tremendous response also enabled the issue to be priced competitively at 3.7%, 4.3%, 4.95% and 5.5% for tenures of 3, 5, 7 and 10 years, respectively, as shown in *Table 1*. The success of Malaysia's inaugural RMBS reflects the confidence of the market in this new financial instrument.

TABLE 1

Composition of RMBS Issuance

Series	Tenure (Years)	Maturity Date	Amount (RM million)	Coupon Rate (%)
1	3	19 Oct 2007	580	3.70
2	5	20 Oct 2009	340	4.30
3	7	20 Oct 2011	290	4.95
4	10	20 Oct 2014	345	5.50

Islamic Residential Mortgage-Backed Securities

The Government undertook a second issuance of GSHL, which is an inaugural issuance of Islamic RMBS (IRMBS) in July 2005 of RM2.05 billion in nominal value. It was a landmark transaction for Malaysia, being the world's first rated RMBS to be issued under Islamic principles. Similar to the first conventional RMBS issued in October 2004, the IRMBS was also a huge success with an over-subscription rate of 5.4 times, reflecting the strong demand for a *syariah*-compliant instrument.

Benefits from the RMBS Issuance

The issuance of RMBS enables the Government to transform its relatively large illiquid assets into liquid and tradeable market instruments. It also provides a more efficient and cost-effective financing structure over the term of the securitisation, thus facilitating effective financial planning for the Government. To the investors, the RMBS provides a better yield pick-up compared to other financial instruments with similar rating and maturity. The RMBS also reflects high credit quality securities, as the transaction is secured by a portfolio of GSHL loans that is serviced from monthly pension/salary deductions of retired/existing Government staff.

Conclusion

The RMBS issuance is the successful introduction of an asset class that can be further developed. Going forward, it is the Government's intention that these efforts will not only facilitate the development of asset securitisation but also pave the way for further progress and stronger growth of the Malaysian bond market.

ADVANCING ASEAN AS AN ASSET CLASS

Background

In the aftermath of the 1997 Asian financial crisis, as the ASEAN region recovered and consolidated its economic and financial strengths, the ASEAN Finance Ministers launched the Roadmap for Financial and Monetary Integration in the spirit of forging a progressive and prosperous ASEAN Community by 2020. The Roadmap, initiated in 2003 to foster greater economic integration, set milestones and timelines for activities covering the areas of capital market development, liberalisation of financial services, capital account liberalisation as well as currency cooperation. Within the context of capital market development, the Roadmap lays out the goals of building capacity and establishing the required infrastructure to facilitate cross-border collaboration among the various capital markets in the region.

As a first step towards enhancing cross-border linkages among regional capital markets, member countries agreed in 2004 to conduct annual ASEAN Finance Ministers' Investor Seminars in major global capital markets. These seminars, which are collaborative investor relations initiatives, aim to raise the profile of ASEAN capital markets and promote greater dialogue with fund managers and various market participants. The dialogue sessions will enable the sharing of information on how reforms have transformed ASEAN, how regional initiatives to enhance stability in the region have progressed, and what investment opportunities the region has to offer.

As a second step, the ASEAN Finance Ministers also initiated efforts towards developing and identifying a set of investment opportunities in the region that could be promoted as an ASEAN benchmark with a view to:

- i. brand ASEAN as an asset class;
- ii. develop ASEAN as a more significant investment destination;
- iii. broaden the exposure of ASEAN companies to foreign investors;
- iv. facilitate investments into ASEAN companies; and
- v. further accelerate the broadening and deepening of the region's capital markets.

ASEAN as an Asset Class

The fundamental rationale for promoting ASEAN as an asset class is the upside potential of investment based on the prospect of sustainable and robust economic growth as a result of the region's strong competitiveness and fast-expanding economic space. It offers a market of about 550 million people that is growing at more than 2% per year, has a combined GDP of USD800 billion and is a repository of numerous natural resources and skilled labour that contributes to export industries concentrated in high growth sectors. ASEAN's USD330 billion consumer market is already larger than India's and comparable in terms of value to China's booming coastal region. Furthermore, ASEAN's 10-member grouping controls about 40% of oil and gas resources in the Asia-Pacific region, boasting a strong industrial base that has benefitted from relatively low wages in sub-sectors such as consumer electronics and semi-conductors, with scope for further economic growth in the manufacturing of biotechnology products and services sectors.

Future needs for wealth management also hold promise. In Asia, 10 years ago, the percentage of the population over 50 years of age was 15%; today, it is 18%, and progressively ageing. There is a clear trend that many are retiring, most with good health and hence longer life expectancies as well as bigger caches of retirement savings. Efforts to increase the role of domestic demand against a backdrop of high savings rates also point to rising future consumption. Furthermore, rising affluence of a relatively young, economically productive workforce provides enormous opportunities not only in terms of expenditure on high-end and lifestyle consumer products, but also on financial services and products such as consumer banking and investment advisory services, which are likely to see rising demand in the coming years. Better management of pools of funds includes cross-border financial flows, particularly within the region. Managing these funds and promoting ASEAN as an asset class would diversify portfolio risks and, in the process, augment skills of local fund managers to understand other markets.

Meanwhile, underpinning ASEAN's strong performance are the improving macroeconomic fundamentals of member countries since the 1997 financial crisis. Positive political and social changes have generally led to greater stability across the region. In addition, the corporate and financial sectors are on much firmer ground as a result of major restructuring efforts, including the tightening of regulations in parallel with requirements for high levels of disclosure as well as stronger minority shareholders' rights. Bond markets, particularly the corporate bond markets, have grown considerably in recent years while bond spreads have narrowed, reflecting improved market confidence. Likewise, ASEAN equity markets have grown in maturity and sophistication since 1997, more than doubling in market capitalisation to reach the USD600 billion mark. ASEAN now offers investors potential gains as a result of the region's economic growth rates which are expected to be in the region of 4% to 6% this year, and in 2006. Macroeconomic policies have been re-oriented to focus on increasing efficiency and productivity growth, reinforced with prudent fiscal management and a broadening of the economic base as well as reducing excessive reliance on external demand.

Southeast Asia accounts for only 1.7% of total global market capitalisation despite having approximately 10% of global population and almost 15% of global exports. Thus, if the growth rates and size of China and India serve as barometers for their future potential, ASEAN clearly holds substantial scope and promise to emerge as an asset class.

Towards an ASEAN Index

Promoting ASEAN as a viable asset class has thus far entailed the identification of a set of top-listed companies in the five major regional exchanges. The list of potential companies will be showcased as an ASEAN benchmark through the establishment of an ASEAN Index.

For the ASEAN Index to be commercially acceptable and credible, the involvement of the private sector, comprising the regional exchanges, brokers and publications as well as global index providers, was considered vital. In this context, the five ASEAN exchanges agreed to collaborate with a reputable and independent global index provider in developing the ASEAN Index to ensure its success.

Spillover Benefits

Aside from showcasing ASEAN equities as an attractive asset class, the high profile grouping of companies in the ASEAN Index must necessarily scale up the standards of governance and accountability, thereby rendering ASEAN a more attractive investment centre and accelerating the region's progression towards interlinked and integrated capital markets. This, in turn, will broaden exposure of the region's companies, facilitating investment flows into the region as well as promoting intra-regional investments.

The Index will also provide the impetus for the development of related products such as exchange traded funds (ETF), index futures, index warrants or other products based on various groupings of companies. Other sub-tracker indices, such as an ASEAN telecommunication index or plantation index, are anticipated to facilitate investment into selected growth sectors. The development of such products is expected to further develop asset management skills in the region.

Status

Two indices were constructed and developed – the ASEAN Index and ASEAN 40 Index – and subsequently launched at the Second ASEAN Finance Ministers' Investor Seminar in London on 21 September 2005. The ASEAN Index, which is a benchmark index that represents the performance of the region's markets, comprises 180 stocks from the five markets of Indonesia, Malaysia, the Philippines, Singapore and Thailand. The ASEAN 40 Index, which consists of 40 stocks from all five markets, represents the performance of the largest companies in the region's markets. The creation of this set of indices is for the trading and benchmarking of financial products such as institutional and retail funds, ETFs and derivatives contracts. Other spin-offs currently being considered include the establishment of an ASEAN Equity Mutual Fund, which could be simultaneously listed on ASEAN exchanges.

The Investor Seminar also saw the release of a supplementary booklet, "ASEAN: Opportunities Set." The booklet serves to highlight potential investment opportunities in ASEAN, including emerging companies from the BCLMV¹ countries as well as a brief profile on the economic performance and outlook for all ASEAN member countries.

Moving Forward

Discussions are ongoing to further foster closer linkages among the regional stock exchanges, including the move towards market integration, which could significantly enhance the attractiveness of ASEAN assets as a separate asset class for international investors. To ensure the success of this cooperation, ASEAN is also looking at ways to harmonise standards and expedite cross-border regulatory cooperation to facilitate investments in ASEAN listed companies, which are already assuming increasingly regional characteristics.

The integration of the capital market would, therefore, be a natural progression on the road towards an interlinked securities market by 2010, a goal that requires the further expansion of cross-border access. With this on the horizon, it is obvious that the promise of ASEAN dovetails well with the theme of this year's ASEAN Finance Ministers' Investor Seminar - "ASEAN: One Region, Unlimited Opportunities."

¹ Comprises Brunei Darussalam, Cambodia, Lao PDR, Myanmar and Vietnam.

The PDS market remained the preferred channel for companies to finance medium and long-term projects. New PDS issuance amounted to RM14,217 million (January-July 2004: RM13,385 million). The bulk of PDS proceeds was for financing new activities, accounting for 39.8% of total proceeds, as shown in *Chart 4.7*, reflecting the continued expansion in private investment activity. About 30% of new PDS were issued by companies in finance, insurance, real estate and business services, as shown in *Table 4.13*.

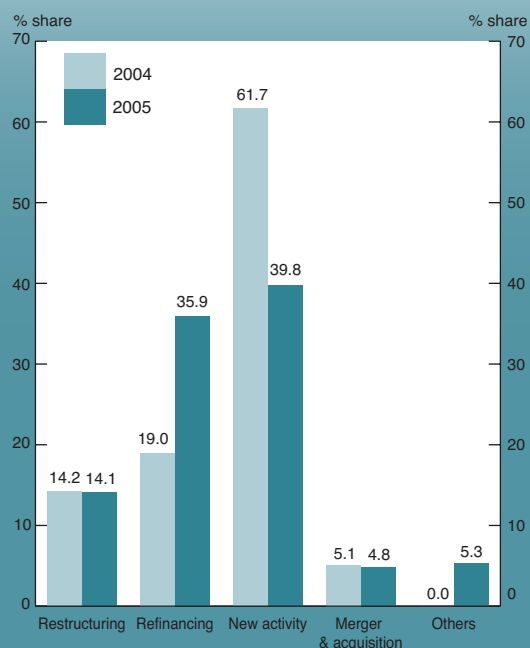
Cagamas, the National Mortgage Corporation, remained an active issuer of PDS with Cagamas outstanding bonds amounting to RM24,347 million or 12.8% of the PDS market at end-July 2005 (end-2004: RM26,752 million; 7.7%). During the first seven months of 2005, Cagamas raised 9 new PDS issues valued at RM1,180 million, accounting for 7.7% of total new issues (January-July 2004: RM4,640 million; 10 issues). The smaller issuance of Cagamas bonds led to a substantial reduction in the volume of secondary trading to RM11,627 million from RM27,412 million over the same period last year.

New issuances were largely dominated by fixed rate bonds accounting for 66.1% of total new bonds issued, followed by Cagamas *Bithaman Ajil* Securities, previously known as *Sanadat Cagamas* (33.9%). Meanwhile, the purchase of loans and debts declined by 55.5% to RM1,599 million (January-July 2004: RM3,592 million) due to less active selling of loans and debts by financial institutions, amidst flushed liquidity and the low interest rate environment in the banking system. As at end-June 2005, holdings of Cagamas bonds by banking institutions decreased to 52.6% of total holdings (end-2004: 56.8%), as shown in *Table 4.14*. Provident and pensions funds remained the largest non-banking institutional holder of Cagamas bonds with 27.9% of the total holdings.

The Government also mandated Cagamas to undertake the securitisation of the Government staff housing loans in efforts to further deepen and broaden the domestic capital market. Cagamas, through its subsidiary Cagamas MBS

CHART 4.7

New Issues of PDS by Purpose January-July



Source: Bank Negara Malaysia.

Berhad, has since launched two issues of RMBS. The first portfolio involved RM1,555 million RMBS issued in October 2004 while the second issuance in July 2005 comprised RMBS based on Islamic principles totalling RM2,050 million.

During the first seven months of 2005, the number of ratings completed by both **Rating Agency Malaysia (RAM)** and **Malaysian Rating Corporation (MARC)** increased to 112 issues, valued at RM33,451 million (January-July 2004: 94 issues; RM27,010 million). The number of ratings on Islamic PDS rose significantly to 63 issues valued at RM17,562 million (January-July 2004: 35 issues; RM9,942 million), reflecting significant interest in Islamic papers. Similarly, credit ratings on asset-backed securities (ABS) increased to 27 issues valued at RM5,637 million (January-July 2004: 20 issues; RM3,315 million),

TABLE 4.13

**New Issues of PDS by Sector¹
January-July**

Sector	2004		2005 ²	
	RM million	Share (%)	RM million	Share (%)
Agriculture	0	0	155.5	1.1
Manufacturing	1,291.7	9.7	1,127.1	7.9
Electricity, gas and water	4,484.0	33.5	3,533.0	24.9
Wholesale & retail trade, hotels and restaurants	20.0	0.1	122.0	0.9
Construction	4,207.6	31.4	2,211.6	15.6
Transport, storage and communication	556.0	4.2	1,698.3	11.9
Finance, insurance, real estate and business services	2,790.6	20.8	4,242.8	29.8
Government and others	35.0	0.3	1,126.7	7.9
Total	13,385.0	100.0	14,217.0	100.0

¹ Excluding Cagamas bonds.² Preliminary.

Source: Bank Negara Malaysia.

indicating the growing ABS market following Government's initiatives to increase the depth and breadth of the domestic capital market. Ratings completed were predominantly on PDS with tenure of more than 5 years, accounting for 71% of the total number of proposed PDS issues. The bulk of PDS rated was in the single-A category from various sectors, including infrastructure and utilities, financial services as well as trading and manufacturing.

Bursa Malaysia

Strong performance on the back of investor confidence...

Bursa Malaysia, which staged a rally in the fourth quarter of 2004, extended its favourable performance into 2005 with the benchmark Kuala Lumpur Composite Index (KLCI) breaching a four and half-year high at 937 points in January. The market, however, retraced some of its gains in line with other regional markets as investors were affected by high oil prices and slower global economic growth. The market was also affected by the heavy sell-down of second and third liner stocks in May following the withdrawal of share financing by some banks. As a result, the second board index plunged to its lowest level in nearly seven years at 81.75 points while the MESDAQ market index fell to 84.3 points, a two-year low. However, market sentiment improved following the Government's swift action to restore market integrity and confidence as well as continued assurance by local banks to maintain and expand shares financing facility. Investors also responded positively towards the Government's decision to lift the ringgit peg with the KLCI surging to a five year high to close at 952.59 points on 3 August, with market capitalisation of RM738.9 billion. The upward trend, however, could not be sustained, as concerns over the impact of record high oil prices on economic growth led to more cautious sentiments in global and regional stock markets. The KLCI closed at 921.99 points on 16 September 2005 with a gain of 1.6% (end-2004: 907.43 points), as shown in *Chart 4.8*.

TABLE 4.14

Distribution of Cagamas Bonds

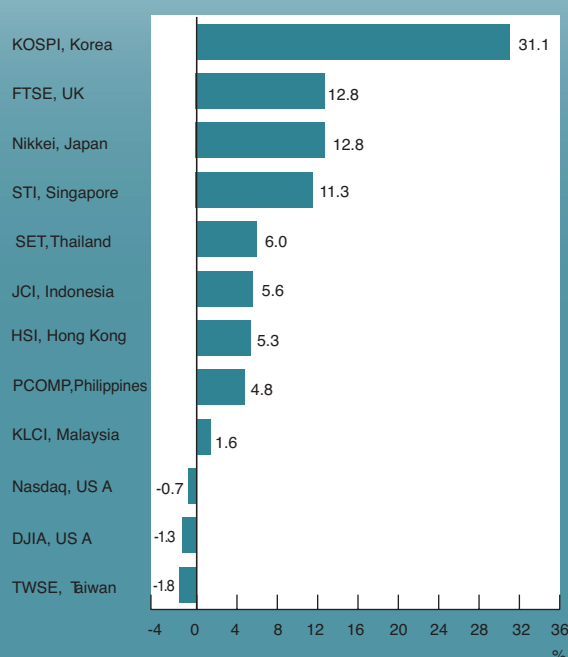
Holder	End-2004		End-June 2005	
	RM million	Share (%)	RM million	Share (%)
Banking institutions	15,207	56.8	13,540	52.6
Insurance companies	1,189	4.5	3,027	11.7
Provident and pension funds	7,129	26.6	7,184	27.9
Other investors	3,227	12.1	2,005	7.8
Total	26,752	100.0	25,757	100.0

Source: Cagamas.

CHART 4.8

Performance of Selected Stock Market Indices

End - 2004 vs 16 September 2005



Source: Bank Negara Malaysia.

Trading on Bursa Malaysia was higher at 74,817 million units in the first eight months of 2005 (January-August 2004: 72,323 million units), as shown in *Table 4.15* and *Chart 4.9*. The market attracted higher foreign participation, accounting for 34.5% of trading activity during the period. Foreign funds were encouraged by several positive developments including the resilience of the Malaysian economy, the ongoing reform of government-linked companies (GLCs) and further liberalisation in financial services. On a sectoral basis, the plantation sector was the top-performing sector with an increase of 6.4% in the plantation index on account of favourable earnings of plantation companies, as shown in *Table 4.16*. The MESDAQ Market Index declined by about 26%, underpinned by the down-cycle of the technology sector, particularly in the semiconductor segment.

The equity market remained an important avenue for the private sector to raise funds. A total of 58 IPOs was issued during the period, with the majority being oversubscribed, indicating strong

TABLE 4.15

Bursa Malaysia: Selected Indicators
January-August

	2004	2005
Price indices¹		
Composite	828.0	913.6
Emas	196.9	208.2
Second Board	109.2	88.4
MESDAQ Market	115.5	90.5
Total turnover²		
Volume (million units)	72,322.7	74,817.0
Value (RM million)	147,797.6	127,021.6
Average daily turnover²		
Volume (million units)	441.0	456.2
Value (RM million)	901.2	774.5
Market capitalisation ¹ (RM million)	654,260.3	704,361.7
Market capitalisation ¹ /GDP (%)	145.5	144.5
Total no. of companies listed¹	944	1,003
Main Board	614	639
Second Board	280	272
MESDAQ Market	50	92
Market liquidity¹		
Turnover value/market capitalisation (%)	22.6	18.0
Turnover volume/no. of listed securities (%)	25.5	23.4
Market concentration¹		
10 most highly capitalised stocks/market capitalisation (%)	34.2	36.4
Average paid-up capital of stockbroking firms ¹ (RM million)	174.7	170.6

¹ End period.² Based on market transactions during period.

Source: Bursa Malaysia.

investor interest in new listings. A large number of smaller firms raised funds in the equity market, with 31 on the MESDAQ market and 16 on the Second Board, against 11 companies on the Main Board. Funds raised rose more than twofold to RM4,228 million (January-July 2004: RM1,577 million). With 1,003 companies listed at end-August 2005, Bursa Malaysia ranked third in East Asia (excluding Japan) in terms of listings on a stock exchange.

TABLE 4.17

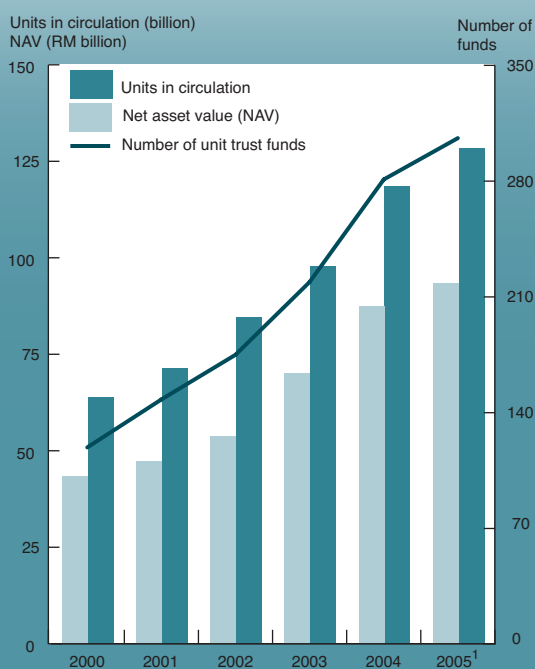
Unit Trust Industry: Selected Indicators

	End-2004			End-July 2005		
	Government supported Funds	Private Funds	Total	Government supported Funds	Private Funds	Total
Number of unit trust management companies	10	26	36	10	26	36
Number of unit trust funds ¹	35	238	273	35	271	306
Conventional	29	179	208	29	205	234
Islamic	6	59	65	6	66	72
Units in circulation (million)	53,716	64,911	118,627	55,082	73,427	128,509
Number of accounts (million)	8.745	1.680	10.425	8.839	1.777	10.616
Net asset value (NAV) (RM million)	50,090	37,295	87,385	52,059	41,240	93,299
Conventional	49,651	30,974	80,625	51,642	34,036	85,678
Islamic	439	6,321	6,760	417	7,204	7,621
NAV/Bursa Malaysia market value (%)	6.94	5.17	12.11	7.18	5.69	12.87

¹ Refers to funds already launched.

Source: Securities Commission.

CHART 4.10

Unit Trust Industry: NAV, Units in Circulation and Number of Funds

¹ As at end-July 2005.

Source: Securities Commission.

to further grow, given that the penetration level as measured by the ratio of NAV to market capitalisation of the stock exchange remains low at 12.9% at end-July 2005. The liberalisation to allow unit trust companies to invest 10% of the NAV overseas in April 2004 and enhanced to 30% in April 2005 has enabled Malaysian investors to further diversify their portfolio investment. As at end-July 2005, 34 funds amounting to RM207 million have been launched to invest in overseas markets.

A positive development in the fund management industry is the introduction of REITs, which use a professional management team to buy, develop, manage and sell real estate assets by offering common shares to the public. The advent of REITs augurs well for capital market development in Malaysia by providing investors with an alternative investment opportunity besides unlocking the value of properties. The Government has also provided attractive tax treatment for REITs in Budget 2005, including tax exemption on income distributed to unit holders and tax credit for accumulated income that has been taxed and subsequently distributed. As at end-August 2005, 4 REITs have been listed on Bursa Malaysia.

Derivatives Market

Lower turnover of KLCI and CPO futures...

The performance of products traded on **Bursa Malaysia Derivatives** was generally more subdued in the first eight months of 2005 with trading volume declining by 7.1% to 1,652,821 contracts (January-August 2004: 42.6%; 1,778,446 contracts). Crude palm oil (CPO) futures maintained its dominance as the most actively traded product accounting for about half of the total volume transacted. Reflecting the developments in the physical palm oil markets, total turnover of CPO futures was, however, lower with volume traded declining by 12.2% to 794,600 contracts (January-August 2004: -0.4%; 905,183 contracts). Average CPO futures prices declined by 21.1% to RM1,388 per tonne in the first eight months of 2005 (January-August 2004: RM1,759 per tonne), due to increased CPO production and lower soyoil prices in the world market.

Similarly, the performance of KLCI futures was also weaker with total turnover down by 2.3% to 735,993 contracts (January-August 2004: 409%; 753,174 contracts). The slower performance of KLCI futures was attributed to lower investor participation in the futures market in the first half of 2005, following lack of volatility in the benchmark KLCI during the period. The market, however, rebounded in July and August due to renewed investor interest in the equity market. Financial futures performed better, with the 3-month Kuala Lumpur Interbank Offered Rate (KLIBOR) futures registering an increase of 9.4% to 108,751 contracts (January-August 2004: 19.2% 99,434 contracts), due to flushed liquidity in the interbank cash market as well as market anticipation of a domestic interest rate hike in the second half of 2005. Total turnover of MGS futures, however, declined by 33.4% due to limited MGS issuance in the underlying market.

Progress of the Capital Market Masterplan

Significant progress with more than 60% of CMP recommendations completed...

The **Capital Market Masterplan (CMP)** launched in 2001, entered its second phase of

implementation in 2004. In Phase II of the CMP (2004-2005), efforts will be geared towards further strengthening key sectors in the capital market, promoting market efficiency through the usage of technology in market processes and further liberalising market access. As at end-July 2005, 63% of the 152 CMP recommendations have been fully implemented while the remaining recommendations are still in progress.

In efforts to further strengthen domestic intermediaries, branching restrictions and capital framework have been further relaxed enabling stockbroking companies to offer the full range of corporate advisory services. Meanwhile, the domestic investment management industry has bright prospects with the recently relaxed investment rules allowing investment companies to invest abroad up to 30% of NAV of resident funds as well as the increase in the amount of EPF funds outsourced to local fund management to RM6 billion over the next three years. Investment restrictions for the takaful industry have also been liberalised to facilitate greater mobilisation of takaful funds into the Islamic capital market.

To further enhance the position of Malaysia's capital market in the global financial landscape, the Government has permitted greater foreign participation in the stockbroking, futures broking, fund management and venture capital industries. As at 23 September, two foreign stockbroking companies have commenced operations, while the other three are expected to do so by year end. Meanwhile, one foreign fund management company has also started its operations in the domestic market. As for the futures broking industry, three foreign futures brokers have obtained approval to become trading participants of Bursa Malaysia Derivatives. In addition, multilateral development banks and multilateral financial institutions are now allowed to raise ringgit bonds in the domestic capital market. To date, three supranationals have raised ringgit bonds totalling RM1,660 million (Asian Development Bank, RM400 million; International Finance Corporation, RM500 million; and the World Bank, RM760 million). The issuance augurs well for the growth and development of Malaysia's bond market as well as reflects the confidence of international organisations in the domestic capital market. Meanwhile, efforts to internationalise the Islamic capital market were

Key Capital Market Measures

Continuous improvement efforts through capacity building, increasing performance standards and enhancing efficiency...

Capital market measures introduced in the first seven months of 2005 were aimed at further strengthening the capital market and the intermediation process as well as enhancing capacity building. The key measures include the following:

Restructuring of the Stock Exchange

- On 18 March 2005, Bursa Malaysia was listed on the Main Board. The listing completed the restructuring process of the stock exchange, which involved consolidation, demutualisation and listing of the exchange. The restructuring exercise is aimed at promoting capital market efficiency and enhancing competitiveness.

Enhancing Capacity Building

- The Capital Market Development Fund (CMDf) was established in November 2004 for the purpose of development and promotion of the Malaysian capital market. The CMDf was allocated 30% of the value of the exchange upon demutualisation. Among the aims of the CMDf are to assist in capacity building of skills, knowledge, research and education to enhance the standards of expertise and professionalism. In January 2005, the first project of the CMDf, the CMDf-Bursa Research Scheme (CBRS), was launched to widen coverage and raise the profile of domestic companies. Currently, the scheme has 100 participating companies covered by ten research houses. The CBRS reports are expected to spur greater interest among investors as well as broaden the daily trading base across a spectrum of counters.

Improving the Quality of Public Listed Companies

- On 1 January, Guidance Notes relating to Policies and Guidelines on the Issue/Offer of Securities were released to facilitate the injection of assets into distressed listed companies. Among others, the guidance notes also liberalises the requirements in relation to acquisitions of foreign assets by Malaysian companies.

Strengthening Bond Market

- On 28 March, the National Bond Market Committee (NBMC) removed restrictions on the utilisation of proceeds from bond issues, other than those relating to foreign exchange requirements in BNM's Exchange Control Guidelines on PDS for Lead Arrangers. The lifting of restrictions will encourage more issuance of bonds to finance property development projects.
- On 31 March, Securities Commission (SC) and BNM issued an Information Note to facilitate the issuance of ringgit-denominated bonds in Malaysia by multilateral development banks or multilateral financial institutions.
- On 6 April, SC issued a Practice Note on the Guidelines on the Offering of PDS to facilitate the issuance of negotiable instruments of deposit with tenure of more than five years by licenced institutions or Islamic banks.

Facilitating Introduction of New Products

- On 3 January, the Guidelines on Real Estate Investment Trusts (REITs) were released in efforts to accelerate its growth and establish a vibrant and competitive REIT industry in Malaysia. The guidelines supercede the earlier Guidelines on Property Trust Funds issued on 13 November 2003.
- On 28 June, the Guidelines on Exchange Traded Funds (ETFs) were released to facilitate the introduction of ETFs as a new investment instrument. Apart from expanding the product range in the capital market, ETFs are expected to enhance liquidity in the equity market.

Enhancing Capacity and Capability

- On 1 July, BNM and SC issued the Guidelines on Investment Banks. The guidelines outline the salient features of the framework on investment banks including process and procedures for its establishment, scope of activities that can be conducted and the co-regulatory and supervisory framework by BNM and SC. The establishment of investment banks involves the integration and rationalisation of merchant banks, stockbroking companies and discount houses within a banking group. Entities involved in the rationalisation exercise are given one year from 1 July 2005 to transform into investment banks. Foreign equity for investment banks is also increased to 49% from 30% previously to strengthen global linkages. The creation of investment banks is to enhance the capacity and capability of domestic capital market players in competing in an increasingly liberalised and globalised environment.

Strengthening Market Intermediaries

- On 17 February, SC amended the securities regulations to facilitate the launch of the Electronic Licensing Application System (ELA). The ELA allows applications and renewals of capital market intermediary licences to be made via the Internet.
- On 15 March, the Guidelines on Compliance Function for Fund Managers were issued for fund managers to further strengthen the level of investor protection and promote market integrity. The guidelines require fund managers, among others, to comply with the Anti-Money Laundering Act 2001 and adhere to best practices for trading and portfolio management. The introduction of these guidelines will assist fund managers to strengthen internal controls and increase overall standards of ethical and prudential conduct in the investment management industry. All fund managers are given a grace period of one year to comply with the guidelines.
- On 25 March, the SC announced further relaxations for stockbroking companies that have merged with at least one other stockbroking company and have shareholders funds of at least RM100 million. These stockbroking companies will be allowed to undertake the full range of corporate advisory services, operate futures broking activities within the stockbroking entity and have unrestricted branching from 2006.
- On 28 April, the Guidelines on E-Contract Notes were issued to provide stockbrokers with guidelines on minimum safeguards that must be put in place before offering their clients the option of receiving contract notes electronically.
- On 29 June, the Guiding Principles for Outsourcing of Backoffice Functions for Capital Market Intermediaries were issued to facilitate market intermediaries to achieve greater efficiency, reduce administrative burden and to operate in cost effective manner by allowing the outsourcing of backoffice functions by intermediaries to external service providers, which functions are otherwise undertaken by the internal staff of the market intermediaries.

- On 29 June, the Guidelines on Performance of Supervision Functions at Group Level for Capital Market Intermediaries were issued. The guidelines permit the supervisory functions currently performed at the market intermediary level to be carried out at the group level, subject to certain requirements.
- On 18 July, BNM issued the Guidelines on Access to Interbank Market by Universal Brokers, which allows universal brokers to participate in the interbank money market, subject to prudential requirements that must be complied with.

Promoting Venture Capital Industry

- On 14 April, the revised Guidelines for Annual Certification for Tax Incentives for the Venture Capital Industry were released, which became effective from assessment year 2003. The revised guidelines aimed at assisting the venture capital industry in their application to the SC for annual certification in order to enjoy the tax incentives provided for the sector, namely tax exemption for venture capital companies and tax deduction for any company or individual that has provided venture capital funding subject to certain criteria.

Enhancing Investor Protection

- On 28 February, SC released the Plain Language Guide for Prospectus to encourage the use of simple English in prospectus to enable investors to grasp vital information and make informed investment decisions.

Liberalising Market Access

- On 29 April, revisions were made to the Guidelines for Dealers and Dealer's representatives and the Guidelines for Fund Managers and Fund Manager's Representatives under the Securities Industry Act 1983. The revisions are to facilitate the licensing of fully foreign-owned stockbroking and fund management companies permitted to establish operations in Malaysia, following the liberalisation measures announced in Budget 2005 to allow up to five foreign stockbroking companies and five foreign fund managers to operate in Malaysia.

Facilitating Listing Process

- Effective 1 January, SC will approve all applications for listing and corporate proposals on the MESDAQ market while Bursa Malaysia will continue approving admission to the Official List and quotation for trading of securities on the MESDAQ market.
- On 14 February, amendments were made to the listing requirements and MESDAQ Market listing requirements to facilitate the transfer of Second Board and MESDAQ listed companies to the Main Board.
- On 28 June, a Practice Note was issued to clarify the requirements of the Prospectus Guidelines on Public Offerings relating to the listing of companies with foreign-based operations/subsidiaries/associated companies or companies involved in acquisition of foreign securities and assets.

further enhanced with the signing of two memorandums of understanding (MOUs) by the Labuan Financial Exchange (LFX) with the International Islamic Financial Market (IIFIM) and the Bahrain Stock Exchange (BSE). The MOUs will enhance the position of LFX as an international financial exchange that could bridge the requirements between Europe, Middle East and Asia in Islamic financial instruments.

Outlook for 2006

Monetary policy to continue to support growth, aided by a more competitive and efficient financial market...

Monetary policy in Malaysia in 2006 will take into consideration both global and domestic developments, and will continue to focus on ensuring that monetary conditions remain optimal for sustainable economic growth with price stability. The fundamental factors that supported the Malaysian economy in 2005 are expected to remain in 2006. Private consumption and investment will continue to drive economic activity. As for inflation, the Government will continue to monitor conditions to avert any potential build-up in domestic inflation, while maximising the growth potential of the economy. Malaysia's strong economic fundamentals, efficient financial market and a strong record of policy prudence provide a strong base for monetary policy to be implemented effectively.

The stronger and more resilient banking system is well-poised to meet the growing financing needs of the economy as well as cope with rising competition. Following efforts in realigning the activities and institutional structure of the DFIs, particularly the establishment of Bank SME, DFIs now have greater focus in providing financial and non-financial support to identified strategic

sectors of the economy, especially SMEs. Growth of the insurance industry is expected to continue to be spurred by the strong demand for investment-linked and endowment insurance products.

Islamic financial services in Malaysia are set to further expand with the transformation of Islamic windows of domestic banks into Islamic subsidiaries as well as the entry of foreign players. The presence of foreign Islamic financial institutions as well as higher foreign equity in domestic Islamic subsidiaries is expected to further spur competition and accelerate the global integration of the Malaysian Islamic banking system. Meanwhile, some Malaysian financial institutions are gearing to be important financial players through their presence in regional markets as well as plans to expand to other growth areas, such as the Middle East.

The capital market will continue to remain an important source of financing for the economy. With successful completion of financial restructuring in Malaysia, PDS issuance is expected to be largely used for business expansion and new activity in tandem with the rebound in private investment. The issuance of ABS is set to grow, supported by the securitisation of Government staff housing loans. Other ongoing initiatives will further drive the development of Malaysia's capital market, such as the proposed Bursa Malaysia-Singapore Exchange tie-up, a common trading platform for equities and derivatives and an electronic exchange for trading in bonds, as well as the creation of a regional index series involving five Asean stock exchanges, including Bursa Malaysia. Meanwhile, regional economic and financial cooperation under the Asean Bond Markets Initiative (ABMI) is set to further accelerate with efforts in exploring securitisation and cross-border bond issuance.