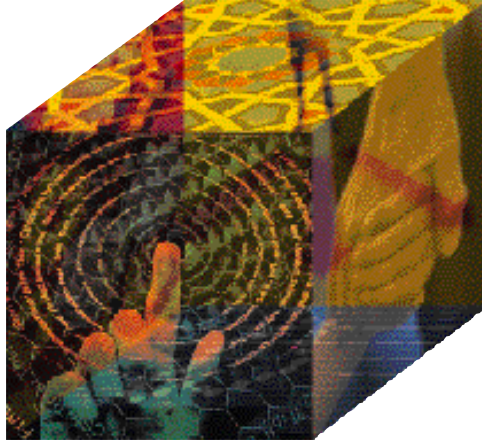


financial sector **stability**

SEKTOR KEWANGAN

KESTABILAN

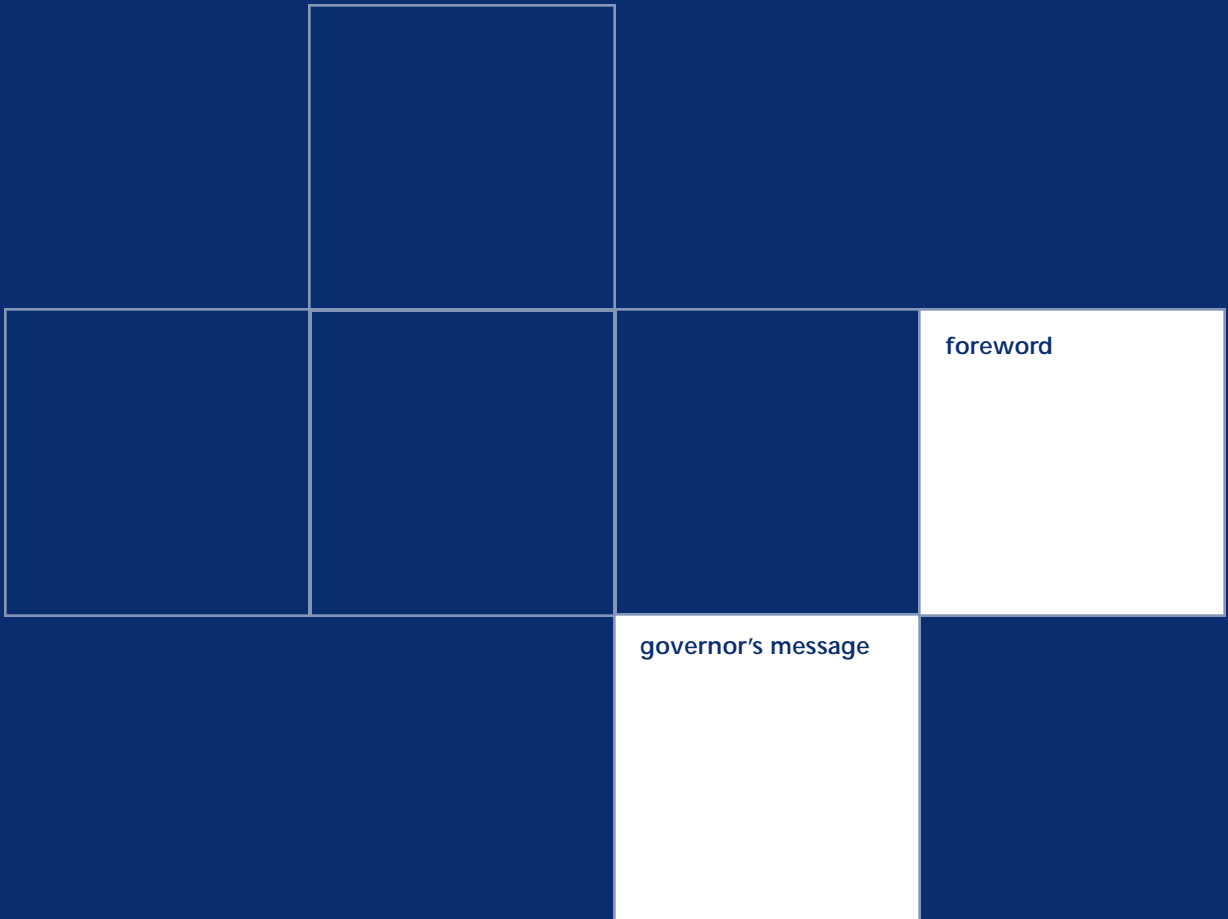


the masterplan: building a secure future
pelan induk ke arah masa depan yang lebih terjamin

contents

| | | | |
|----------------------|------------|-----|---|
| 4 foreword | chapter 1 | 10 | executive summary |
| 5 governor's message | chapter 2 | 15 | vision and objectives of the financial sector |
| | stability | 26 | towards stability in the financial sector |
| | chapter 3 | 32 | banking sector |
| | chapter 4 | 62 | insurance sector |
| | chapter 5 | 77 | islamic banking and takaful |
| | chapter 6 | 87 | development financial institutions |
| | chapter 7 | 96 | alternative modes of financing |
| | chapter 8 | 111 | labuan IOFC |
| | appendices | 121 | summary of recommendations |
| | | 126 | glossary |





foreword

governor's message



Foreword from the Minister of Finance and Minister of Special Functions

The Financial Sector Masterplan is being launched after several decades of high growth, and comes at a time when Malaysia is at a threshold of a new stage in development. It charts the future direction for the financial system over the next 10 years and outlines the strategies to achieve a diversified, effective, efficient and resilient financial system.

The Masterplan is about determining the direction and defining the financial structure that is most appropriate to our requirements as our economy moves to its next stage of development.

The Financial Sector Masterplan has identified the key elements and building blocks necessary to form the foundation on which future development can be built. In moving forward, a meaningful change in the financial sector cannot be achieved overnight.

Therefore, it requires a unified effort of all the stakeholders – the financial players, consumers, regulators and the Government to take the necessary steps towards meeting the objectives of the Financial Sector Masterplan. The Government will continue to support the process.

I am confident that with this concerted approach between the Government and the private sector focussing towards a common objective, the vision envisaged by the Financial Sector Masterplan will be realised for the ultimate benefit of the nation.

Daim Zainuddin
1 March 2001



Message from the Governor

The financial system has over several decades been instrumental in facilitating the economic success of Malaysia. As Malaysia advances into the new millennium, the transition to the new economy – into a more globalised, a more digitised and knowledge-based economy – will require the financial system to evolve accordingly to support this transformation and growth process. The financial system is also operating in an era of rapid change, in an environment that is being shaped by advances in technology, by trends towards greater market orientation and globalisation. In response to the challenges in this new environment, achieving a more efficient, competitive and resilient financial system will be vital for securing our prospects for sustainable growth and development.

Over the years, the strength and resilience of the financial sector, has from time to time, been severely tested, in the face of periods of economic difficulties. In the recent Asian financial crisis, we have seen the stability of the financial system challenged. With the prompt corrective measures that were taken, financial stability was restored and Malaysia has emerged stronger from the crisis. The opportunity is now taken to focus on the medium and longer

term agenda to build a financial sector that is responsive to the changing economic requirements and a financial system that is strong and resilient in facing the future challenges in this new environment. It is within the context of these objectives that the Financial Sector Master Plan (FSMP) was formulated to outline the strategies for the development of the financial sector.

The objective is to evolve a competitive, resilient and dynamic financial system, with best practices, that is able to meet the increasingly more sophisticated demands of consumers and businesses, able to adapt and adjust to the technological advances, able to face the challenges from globalisation and liberalisation and able to withstand the economic cycle, thereby contributing to overall economic growth and stability. In achieving the end game of creating an effective, efficient and stable financial sector, the respective building blocks of the various parts of the financial sector need to be put in place to form the solid foundation on which further progress can be built. The recommendations therefore are focused on enhancing domestic capacity and capability before proceeding with the introduction of an increasingly more competitive environment and subsequently towards greater international integration.

This plan has been prepared by Bank Negara Malaysia (BNM) with inputs received from the industry, independent consultants, Government agencies and private corporations. The plan benefited from the consultative process that was adopted. While the strategic direction has been outlined in the plan, the implementation of the recommendations will be managed with flexibility to achieve the desired objectives. The approach for the implementation of the recommendations outlined in the plan will be undertaken in an iterative process taking into account the potential for changes that may occur in both the domestic and external environment and the changes in technology that may emerge. The opportunity is taken here to record gratitude to the Minister of Finance Tun Daim Zainuddin for his full and continued support given to BNM in preparation of the plan.

In moving forward, the implementation of the FSMP will be the result of the combined efforts of all the relevant parties in the financial sector – the industry, the regulators, the market participants and the Government. While the FSMP is motivated by the need to achieve the desired objectives, it will also be tempered with the realities of the environment. The Government has and will continue to provide the supporting infrastructure and to implement policies for a positive economic and financial environment. I am confident that with the orientation towards collective responsibility and perseverance, the vision envisaged by the FSMP will be achieved.



Project Approach

The Financial Sector Masterplan (FSMP) was developed by Bank Negara Malaysia (BNM) through a joint team involving a number of departments in BNM. An internal steering committee chaired by Dr. Zeti Akhtar Aziz (then Deputy Governor) and comprising the Assistant Governors and Directors of the relevant departments was set up to oversee the work of the team.

To facilitate consultations with the financial industry on specific issues, an Industry Advisory Group was set up comprising Chief Executive Officers and Managing Directors of selected institutions. A number of consultations and discussions were also held with relevant ministries and Government agencies, industry players and other key stakeholders on the specific recommendations in the FSMP. The approach was to determine the most viable options in achieving the strategic direction and objectives with an emphasis on an iterative, consultative and collaborative process. The process was pursued through a series of workshops/meetings/interviews with industry players on related issues. This involved analysing industry trends through external and internal interviews, cross country comparison of alternative financial structures and liberalisation paths, identifying the critical gaps in the financial system, defining key success factors in financial market development and formulating alternative end games for the Malaysian financial system.

Acknowledgements

BNM wishes to thank all parties involved in the development of the FSMP. Inputs from the National Economic Action Council, Government ministries and other regulatory agencies, namely, the Labuan Offshore Financial Services Authority and the Securities Commission have been useful in the formulation of the FSMP. The FSMP also benefited from discussions with Chief Executive Officers and Managing Directors of financial institutions, management of selected domestic and foreign financial institutions, and the following agencies and organisations:

| | |
|---|---|
| Association of Banks in Malaysia | Islamic Banking and Finance Committee (of MAPEN II) |
| Association of Discount Houses in Malaysia | Labuan Development Authority |
| Association of Finance Companies of Malaysia | Labuan International Insurance Association |
| Association of Islamic Banking Institutions Malaysia | Life Insurance Association of Malaysia |
| Association of Labuan Trust Companies | Malaysian Airline System Berhad |
| Association of Merchant Banks in Malaysia | Malaysian Institute of Bond Dealers |
| Association of Money Brokers Malaysia | MIMOS Berhad |
| Association of Offshore Banks | Multimedia Development Corporation Sdn Bhd |
| Cagamas Berhad | National Association of Malaysia Life Insurance Agents |
| Credit Guarantee Corporation Malaysia Berhad | Petroleum Nasional Berhad |
| Federation of Malaysian Manufacturers | Telekom Malaysia Berhad |
| General Insurance Association of Malaysia | Tenaga Nasional Berhad |
| Institute of Bankers Malaysia | The Malaysian Insurance Institute |

chapter one
executive summary

Introduction

Changing economic and business environment as well as rapid technological advances over the last decade have had significant impact on the development of the financial system, domestically and globally.

Global forces at work and advances in technology have redefined the rules of the game and transformed the operational environment within which financial institutions operate. Indeed, the ability to reap the benefits arising from greater competition depends largely on the capability and capacity of financial institutions to adapt swiftly and to embrace the changes.

Similarly, the rapid pace of economic development and transformation that creates new demands as well as opportunities for businesses have called for a more effective and efficient provision of financial services. In moving ahead, a well-defined strategy will need to be formulated for the financial sector if it were to prosper in the new environment and play a meaningful role in the nation's future economic development.

Vision and Objectives of the Financial Sector

The objective of the FSMP is therefore 'to develop a more resilient, competitive and dynamic financial system with best practices, that supports and contributes positively to the growth of the economy throughout the economic cycle, and has a core of strong and forward looking domestic financial institutions that are more technology driven and ready to face the challenges of liberalisation and globalisation'. The development of domestic institutions that form the core of an efficient, effective and stable financial sector is an important part of this process.

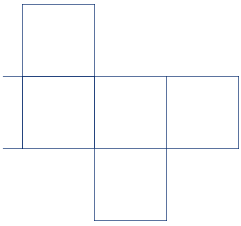
- It is envisaged that Malaysia's real economy will continue to expand significantly during the decade, becoming more internationally integrated and more dynamic (with more high-tech services, with greater reliance on small and medium-sized industries [SMIs] and with increasingly rapid rate of innovation), and with more differentiated and demanding consumers.
- To serve this dynamic economy efficiently and effectively, and to ensure that domestic institutions will have a leading role within it, the financial sector, particularly its domestic institutions will need to be more focused, efficient and innovative.
- The regulatory framework within which the financial industry operates will be based on a supervised market approach. The regulations will allow product innovations and market activism, while being strongly supervised by standards and prudential requirements.
- The financial landscape at the end of the 10-year period will consist of a more diversified range of 'brick and mortar' financial service

providers, from large one-stop financial centres to niche providers, of specialist services - competing with 'virtual' providers across most product areas. In addition, the capital market will have a relatively more important role in the allocation of resources and risks.

Key Challenges that Need to be Addressed

As changes in the global financial industry continue to evolve and accelerate in the new millennium, the Malaysian financial system, particularly domestic banking institutions and insurance companies will face mounting pressure to become more efficient and competitive, innovative, technology-driven, and strategically more focused. The financial infrastructure will have to be developed accordingly to facilitate and support this development. In so doing, the industry will face the following key challenges:

- The need for domestic institutions to improve their efficiency and effectiveness to be at par with the best international players; and
- The need to ensure that performance gaps do not widen, as technology continues to drive global trends in financial services. In order to compete in the new environment, financial institutions in leading markets are leveraging on new technology, as well as:



- Becoming increasingly global and specialised;
 - Using new organisation structures and more aggressive compensation models;
 - Relying much more on alliances and third party relationships; and
 - Investing more in technology.
- Meet the socioeconomic objectives of Malaysia that will result in the least possible distortion and to minimise the burden on the institutions; and
 - Promote a more market driven consumer protection infrastructure.

Recommendations to Achieve Objectives

In order to bring in greater innovation, flexibility and dynamism into the Malaysian financial system, the FSMP has made a number of recommendations to be implemented over the plan period. Measures to identify and remove impediments to progress will be implemented, beginning with improvements in infrastructure and increasing the intensity of domestic competition, so as to allow best institutions to flourish.

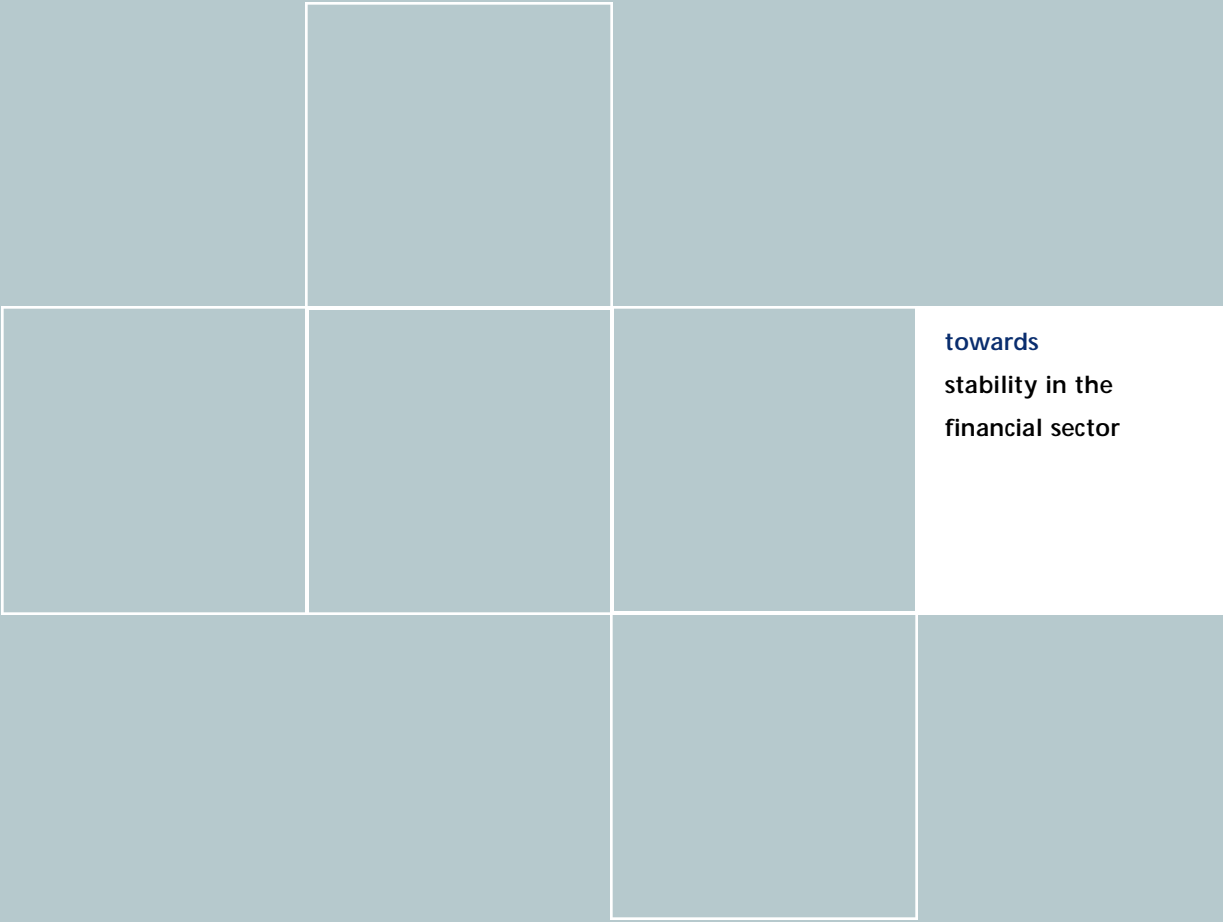
Given the important roles played by domestic financial institutions in ensuring the stability of the financial system and supporting the economy, steps will need to be taken to:

- Develop the best domestic institutions by:
 - Building the capabilities of domestic institutions; and
 - Increasing the incentives for domestic institutions to drive performance.
- Maintain stability of the financial system through an efficient infrastructure, more resilient institutions as well as strong prudential regulations and supervision;

Approach to Implementation

The change programme will be implemented over the next 8-10 years in three phases, subject to achieving specified milestones and safeguards. The first phase is on building the domestic capacity, the second phase in which domestic competition increases and the third phase in which the pace for the integration with the international market is increased.

While measures to increase domestic capacity would be implemented during the first phase, these measures will continue to be strengthened during the second and third phases to ensure orderly adjustment to a more competitive and increasingly deregulated and liberalised market. The order in which specific recommendations are made in this FSMP will not necessarily indicate the sequence of implementation. Implementation of the recommendations will be done in a practical manner such that the desired outcomes are achieved without any destabilising impacts to the financial sector.



towards
stability in the
financial sector

Building a stable and diversified financial system for the future

stability

While the financial sector will become more diversified, the banking sector will continue to be an important source of financing for the domestic



economy in the future. The development of the banking system, particularly the domestic banking institutions is therefore vital to facilitate and support the economic growth and transformation process.

BANKING SECTOR

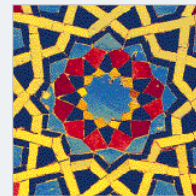
Significant changes must be made to raise performance standards in the Malaysian insurance industry in tandem with the global advances in



order to narrow the gap between the standards and performance of Malaysian insurers with the established international best practices and performance standards.

INSURANCE SECTOR

It is now timely to formulate specific strategies to develop further Islamic banking and takaful. Moving forward, these strategies will also contribute to strengthening Malaysia as a



regional Islamic financial centre.

ISLAMIC BANKING AND TAKAFUKL

It is envisaged that in the coming decade, DFIs would continue to progress and assume a significant role in addressing the development strategies of the nation by



DEVELOPMENT FINANCIAL INSTITUTIONS

complementing the established private financial institutions to meet the requirements of the changing economy.

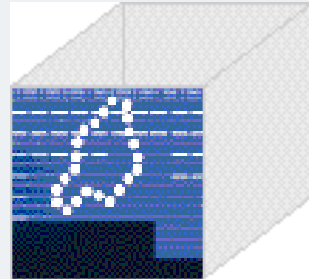
As the economy transforms into one in which service and productivity will drive growth, different sources of financing are required to meet the substantial financing



ALTERNATIVE MODES OF FINANCING

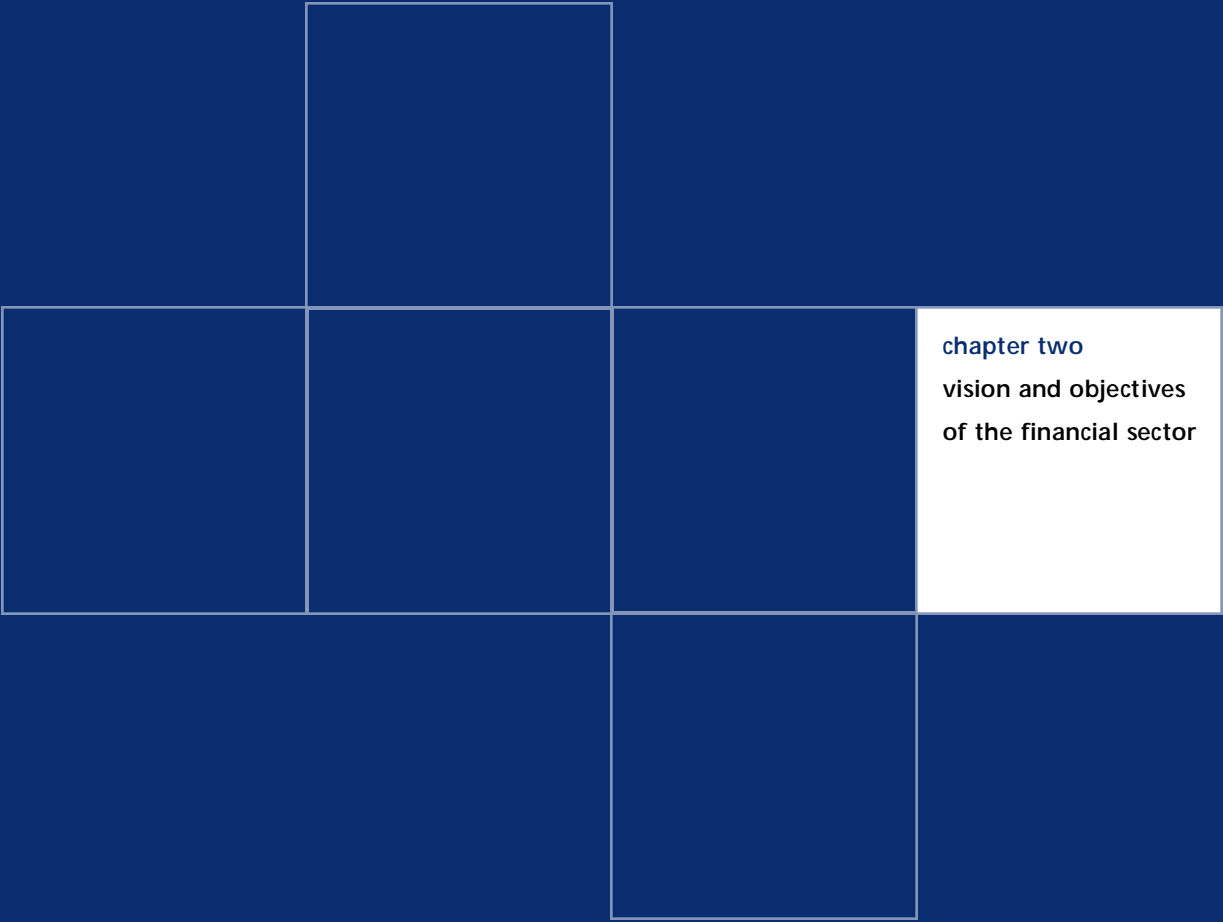
requirements of new activities and industries.

The IOFC in the future is not only a centre that thrives on the offshore financial services, but also one, which is developed holistically to support the development of



LABUAN IOFC •

the island, and plays an effective complementary role to domestic financial market.



chapter two
vision and objectives
of the financial sector

Introduction

The Malaysian economy has recorded strong growth that has been sustained over several decades. During this period, growth has averaged 7% and inflation has remained low in the region of 2%-3%. This growth process has also been accompanied by changes in the economic structure as the economy has become increasingly more diversified. The financial sector has had a pivotal role in facilitating and supporting this process. The financial system that has experienced phases of dynamic growth also evolved to become more diversified. During the recent financial crisis in 1997-1998, we have seen the stability of the financial system seriously challenged. Prompt measures were taken. Institutional arrangements to deal with the emerging problems were put in place and appropriate policies implemented to mitigate the impact of the crisis and to maintain financial stability.

The Malaysian response to the Asian financial crisis has produced results earlier and better than initially expected. With stability restored, and the growth process resumed, the opportunity is now taken to be forward looking, to build the necessary foundation so that the financial sector continues to play its important role in the economy and continues to be strong and resilient in facing the future challenges.

Efforts to strengthen and develop the financial system require an assessment of the financial services required as Malaysia moves towards the new economy as well as an assessment of the implications of the forces of change in the global and domestic environment. The future landscape of the Malaysian financial system will be developed against the backdrop of an increasingly global and integrated economic environment and financial markets. The purpose of the FSMP is to set out the plan to chart future direction of the financial system over the next 10 years that will ensure its continued effectiveness, competitiveness and resilience.

Vision and Objectives

A well-diversified and competitive financial system is vital for the long-term economic growth and development to ensure that risks in the economy are well distributed among the various sub-sectors. In the new millennium, the future of the financial system lies in its ability to create a dynamic set of financial players, which are able to provide the support to the domestic economy, and more importantly, that are increasingly more efficient, competitive, sound and stable that would facilitate the economic transformation process. The objective of the FSMP is therefore 'to develop a more resilient, competitive and dynamic financial system with best practices, that supports and contributes positively to the growth of the economy through the economic cycle, and has a core of strong and forward looking domestic financial institutions that are more technology driven and ready to face the challenges of liberalisation and globalisation'. While opportunities have emerged in this new environment, threats of the global marketplace are becoming more intensive, as global players and technology advancements are having an unprecedented impact on the approach of banking and financial businesses. Against this background, it is vital for the financial system, particularly the domestic financial institutions to be resilient and efficient if Malaysia is to ensure that its financial sector remains effective and responsive in the face of a more globalised, liberalised and a more complex domestic economy.

In the new environment, the ability of the financial institutions to deliver products and services in the

most efficient and effective manner will be the key to determining performance and relevance. The soundness of individual institutions will be a key factor in order to maintain the stability of the overall financial system. In the banking sector, despite the achievements of the domestic banking system that has been secured thus far, the Malaysian banking institutions need to strive to enhance their capacity and capability so that they will be at par with global players in terms of efficiency, effectiveness and financial soundness. Against the backdrop of socioeconomic objectives of the country, the vision is for the development of a well-diversified financial sector that is defined based on five main characteristics, namely:

Efficiency

The range of financial products and services should be offered at the lowest cost to both institutional and individual consumers, namely, borrowers, investors, depositors and risk managers. In this regard, improvement in productivity and higher returns on assets for the financial institutions will need to be realised through greater penetration of efficient and low cost delivery channels, access to scale advantages in processing, procurement and other back-office functions, and leveraging on world-class skills. This operational efficiency can be achieved through greater investment in technology and skill enhancements.

Effectiveness

The availability of a broad range of products and services is essential to meet the needs of customers that can be expected to be increasingly more demanding and sophisticated. The degree of

innovation of the financial institutions will determine the range of products and delivery channels offered. While Malaysian institutions do offer basic banking and insurance products, there is significant room for advancement in meeting the new requirements of the new economy, in particular, highly differentiated financial products which are tailored to meet specific demands of the consumers and the corporate sector. In an increasingly competitive market, innovation and improved services will be introduced through the existence of innovative players and a more conducive operational environment.

Stability

A safe, sound and stable financial system that is able to withstand sudden adverse economic and financial shocks that emanate from within and outside the system without significantly disrupting the intermediary function and the functioning of the economy. To have a stable system, there must be efficient, effective and robust financial institutions, strong prudential regulations and supervision, and efficient and reliable infrastructure.

Robust financial institutions that would have strong risk management capabilities and credit skills as well as sound corporate governance. Improvements in credit skills and risk management among financial institutions would be demonstrated among others by the greater use of financial models and application of risk management framework that is more comprehensive. Corporate governance could be enhanced through improving the quality and accountability of the board of directors and management of financial institutions.

Prudential regulations

While the foundation of a strong financial system is the implementation of effective prudential

regulations and supervision, this needs to be balanced with the need to provide an environment which is conducive to the development of an efficient and innovative financial system.

Infrastructure

The availability of strong infrastructure is crucial to ensure overall stability of the financial system, with a core of strong domestic institutions and an efficient and stable payments system forming the backbone of the financial system. This is to ensure domestic institutions will continue to have a prominent role in the financial system. This will be achieved through institutional development and capacity building, increasing the competitive environment, the continuous improvement in the existing payments and financial markets infrastructure, and instituting a more market-driven consumer protection framework (including deposit protection).

Against the above objectives, the FSMP outlines the strategies for the Malaysian financial sector to progressively develop to achieve the objectives in meeting the requirements of the real economy and to adapting and adjusting to the forces of change in the domestic and international environment. Of importance, the FSMP seeks to identify strategies to generate flexibility, adaptability and innovation to ensure the financial sector continues to play an effective role in a more dynamic and competitive economic and financial environment.

The Financial Sector Landscape in 2010

While it may not be possible to project accurately how Malaysia's financial sector will be structured in 10 years time, taking into account the forces at work

and how the challenges facing the industry are being met, the future financial landscape can be expected to be characterised by the following:

- An increasingly more diversified financial sector meeting the requirements of a more diversified economic structure;
- The competitive environment in the banking sector is likely to result in institutions with differentiated strategies based on their strengths and market niches. This implies that:
 - Fewer large, broad based institutions will thrive, exploiting their privileged relationships with retail customers and mid-market corporates to provide a full range of financial services to market segments that value banking relationships and/or convenience.
 - The successful institutions will be those who continue to leverage on the advancements made in technology, in reengineering work processes and delivery modes, and offering state-of-the-art products and services that serve as complete financial solution for varying types of consumers.
 - Employing and retaining highly skilled workers and the reskilling of existing work forces and promoting a culture of continuous learning will be continuously pursued as human factor becomes a defining characteristic of a successful banking institution.
- Specialist providers will emerge:
 - Some competing to provide specialised products such as mortgages and credit cards on the basis of lower costs or better marketing. These players are likely to be regional or global in scale;
 - Some competing only in particular segments of the business system, while outsourcing all other functions (such as mortgage originators, credit card processors or custodial service providers); and
 - Some dominating certain customer niches, such as the SMIs or high net worth individuals, by providing specifically tailored services beyond traditional banking offerings to satisfy the needs of customers they understand better than a more generalist competitor.
- New service providers will emerge with the advent of new technologies and increased popularity of the internet. This may include telecommunications and other utility companies providing bill payment services, and supermarkets and other retailers providing basic lending services.
- The insurance industry will be more dynamic and increase in size:
 - The new economy will exert pressure on the industry to become more competitive with

increasing demands for general insurance protection in various sectors. Increasing wealth amongst the population will increase the demand for life insurance products, and institutions will be differentiated by their ability to introduce insurance products that serve the needs of the nation.

- Competition will be greater among the domestic and foreign insurance companies, bringing down costs and premium, and sizeable increase in business volume.
- The professionalism of the industry, particularly the agents and the financial advisors, will be enhanced through competition as a result of increasingly complex demands of the consumers and the need to continue to conform with the industry rules and regulations derived from international best practices.
- Consolidation of the insurance sector will be inevitable as size and scale would be a key factor to adequately insure the risks within the domestic economy.
- Islamic banking and takaful industry will be more significant, larger and sizeable. New players will join the industry and market operational framework will be increasingly more global;
- Development financial institutions will be strengthened through formulation of common rules and regulations, as well as having strategic business focus and employment of prudent principles;
- The payments infrastructure will be redefined as a result of significant innovation in technologies. An efficient and stable payments system will be developed through the adoption of a flexible, proactive and effective regulatory framework;
- Capital market and technology will disintermediate banks, brokers and traditional exchanges:
 - Banks will provide their traditional customers with access to market-based savings products as well as capital market instruments instead of just deposits and bank loans.
 - Investors and issuers will increasingly lend funds, raise funds and trade directly in the market, relying on financial advice from financial institutions, rather than on their executional capabilities.
 - Specialised domestic institutions, with a deeper understanding of domestic market segment needs and/or privileged relationships with local customers, are expected to develop profitable niches. Successful fund managers, local or global, are expected to set new benchmarks for the performance of existing domestic institutional investors and contributing to the development of the venture capital industry.
- Labuan International Offshore Financial Centre (IOFC) will thrive on Islamic finance and insurance activities, and business generated through the Labuan International Financial Exchange, such as trading of financial and non-financial products, in addition to the traditional and other peripheral activities. Policy convergence with the onshore regulations is expected as offshore institutions are continuously encroaching into the domestic businesses, providing greater competition and innovation in the financial system; and
- Regulators, which include BNM, Labuan Offshore Financial Services Authority (LOFSA) and the Securities Commission (SC), will work closely to keep abreast with the convergence (blurring of

boundaries) between the financial service providers. The focus will now be more on preserving system stability and market integrity through a coordinated supervision given that the pace of innovation will be far too rapid for more interventionist approach.

The Economy in 2010 and the Role of Financial Institutions

The financing needs for the real economy over the next 10 years can be expected to increase significantly and become increasingly complex and diversified. Public and private investments are expected to grow by 5.4% and 17.5% a year respectively during this decade. In the period from 2001 to 2010, the combined total of both public and private investments is expected to amount to RM2,231 billion compared with RM790.9 billion in 1991-2000. The structure of the economy is also expected to change significantly to become increasingly diversified, with greater emphasis on small and medium-sized businesses in the technology and services sectors, and continued growth of skilled knowledge workers as a percentage of total population. While banking institutions will continue to be the backbone of the financial system, insurance and other specialised institutions and the capital market will increase in importance. New growth areas, the increased importance of SMIs and the need to be innovative in product offering as the more sophisticated and technologically literate population will demand a wider range of specialised products and services.

More domestic corporates will be expanding regionally and globally, and will require capital investment in technology to increase their productivity as labour costs rise. To do so, there will be the need for increased access to long-term fixed

rate financing and more sophisticated risk management advisory services and products from domestic banking institutions, insurance companies and offshore financial institutions.

To underpin this, Malaysia will continue to invest significantly in developing and upgrading the infrastructure, to be developed in part by the private sector. Therefore, continuing efficient mobilisation of domestic savings and foreign investment will remain important. Infrastructure companies and Government will have to tap domestic and international capital markets, and local institutions will have to build the placement capacity – through alliances and technology – to serve these needs.

Finally, as in all developed and developing economies, there will remain segments of the population requiring special attention to ensure access to basic financial services, and segments of the economy requiring special support. The financial system will continue to have a role in the socioeconomic development of Malaysia. The financial system as a whole will consist of a set of robust and efficient financial institutions, whereby financing needs will be met at appropriate costs and structures, through capital or debt obligations. Similarly, the development financial institutions will continue to be relied upon as providers of funds. New growth industry will be supported by venture initiatives – capital generated by business angels or Government-sponsored venture funds.

The challenges facing the financial sector are broad and seamless, requiring efforts to be addressed on all fronts. The FSMP will deal with the broad spectrum of these issues. The recommendations in the report would focus especially in building the capabilities of domestic financial institutions, maintenance of financial stability, providing the framework for

consumer protection and improving the financial landscape consisting of banking institutions, insurance companies, Islamic financial institutions, venture capitalists, offshore financial institutions and specialised financial institutions.

The Financial Sector as an Enabler of Economic Growth

The financial sector will continue to be an important determinant of economic performance and thereby the quality of life of the people. In response to changes in the global and domestic economic environment over several decades, the Malaysian economy has experienced waves of economic transformation from primary product producer to a significant manufacturing base and to now an even more diversified economic structure in which greater importance will be accorded to the development of the services sectors, including the financial services sector, agriculture and the technology and knowledge-based activities.

Financial sector has thus far been evolving with the changing profile of the domestic economy. The growth of international trade and cross border activities has resulted in the increase of the provision of trade financing facilities as well as international banking. Similarly, the need to invest in the massive physical infrastructure and other identified priority sectors had led to the setting up of development financial institutions to cater for this purpose. The need for lower cost of funds in the long term from domestic sources by large corporates has aided the development of the domestic capital market.

Given the gradual process of economic transformation and the economic opportunities that have yet to unfold, the long-term objectives for the domestic financial sector will continue to take into account the needs and vision of the economy. The objectives for the financial sector for an emerging economy such as Malaysia is therefore not necessarily similar to those systems that aim to develop as an international financial centre where rapid deregulation and liberalisation is a key part of the process, relatively independent of developments in the real sector. In an emerging economy, the financial system has a pivotal role in facilitating the growth process. Careful consideration therefore has to be given to both the objectives of efficiency and stability and that of the social agenda.

To become an efficient and effective enabler of growth, the financing capability of the financial sector will need to recognise the importance of the new areas to growth and the other alternative modes of financing, suitable for the risk of the specific economic sub-sectors. Financial institutions will therefore need to be prepared and proactive in providing services to such new industries and businesses, recognising the need for diversified economic structure and a balanced growth, with the objective being to achieve sustainable growth and development, as well as overall prosperity.

Adapting and Responding to Forces at Work

Going forward, global forces at work and the advances in technology is likely to have a significant

impact on the financial system and can be expected to potentially create significant performance gaps between Malaysian institutions and the world best practices. The rapid technological change is constantly improving efficiency and effectiveness in the global financial services industry. The ramifications of technological advances will extend beyond the technology itself. Financial institutions will need to recognise the forces of change and be positioned to adapt to the new forces at work in the financial industry. These include the following:

A. Greater competition driven by deregulation, consolidation, new entrants and greater price transparency

The global trend, including in Asia, deregulation, consolidation, the entry of non-traditional players and the emergence of virtual marketplaces are intensifying competition. In some Asian economies, foreign ownership limits have been raised significantly with most no longer having foreign ownership limits, deregulating price controls, issuing new licences or allowing universal banking. The issue of the move to higher market orientation and the pace of liberalisation and greater international integration will be addressed in this FSMP.

B. Growing capital market will increasingly result in disintermediation

As the domestic capital market deepens, there will also be a shift from bank lending to the capital market. Large domestic corporates will also seek to list their shares on foreign stock exchanges in order to have access to global equity market. With increasingly open economies, companies will be faced with increased competitive pressure for both their outputs and inputs (such as human talent). As such, to be competitive, firms will need to tap the lowest cost and most stable funds.

C. Financial institutions are becoming increasingly global and specialised

The new competitive environment is driven by the revolution in communication technology, which has become an important means to drive competitive advantage through access to economies of scale and more global outlook. This process is also driven by increasing demand among high-end customers for international standard investment options and financial solutions.

D. Financial institutions are using new organisational structures and more aggressive compensation models, and relying much more on alliances and third party relationships

In an ever-growing, fast-changing business, the value of good ideas is correspondingly multiplied, and the value of top talent increases accordingly. The best talent, and the technology and strategy that come with it, are increasingly unaffordable and have to be accessed externally. As a result, the use of new compensation structure as well as outsourcing and alliances by financial institutions are becoming widespread.

E. Financial institutions are investing more in technology

Investment in technology is soaring in order to improve key capabilities such as marketing (achieve better results through data mining), credit risk management (control risks better), pricing (price products based on segmentation and credit history) and delivery channels (develop phone, internet and electronic banking). This is happening not only in the U.S. and Europe, but also in Asia.

Future Technological Developments - Facing the Uncertainty

Modern technology will continue to be a key driver that shape future development and competition in financial services in the new millennium. Information and communication technology (ICT) is affecting every aspect of banking in unprecedented ways. It is facilitating radical change in the operations and structure of financial markets, in roles and relationship among service providers, intermediaries and investors, as well as regulators.

In the light of fast ICT development, speed, reliability and the availability of multiple delivery channels have become important prerequisite in order to remain relevant. Traditional brick and mortar financial institutions are already confronted with new types of players, such as 'aggregators' that threaten to take away their businesses through the introduction of more innovative solutions, and more efficient delivery channels. In facing these challenges, a natural response of traditional players would be to invest in developing an ICT platform that would be robust enough to allow internal efficiency to be achieved and at the same time enable the financial institutions to reach larger pool of customers.

Another distinct characteristic of modern technology is the degree to which it empowers consumers to make their choices. Through one-stop financial portals, consumers are connected online to multiple providers. The ability of consumers to control their own transactions and their ability to access huge amounts of financial information will allow and encourage direct participation of retail investors into the market.

In the light of the changing role of consumers and the financial freedom made available by market

liberalisation, the function of managing consumer relationships becomes more daunting. Financial institutions will have to learn to rely less on consumer loyalty, but more on its own creativity and competitiveness. A key ingredient to remain competitive is to maintain close relationship with customers. Databases that contain consumer information that could be easily dissected are powerful tools that allow financial institutions understand their customers better and become more proactive in reaching out to them.

Product developments have also been assisted by modern technology. Sophisticated products using derivatives such as hedging tools have enabled banking institutions to implement better risk management. Insurance companies can leverage on sophisticated actuarial models for risk assessment. Similarly, the bundling of products from different providers has increased emphasis on product specific branding and reduced the significance of institutional branding. The strength of technology indeed lies in its capability to enable financial institutions to structure innovative products in the most efficient ways. The ultimate challenge to financial institutions in the future is to identify and optimise on these capabilities.

Technological development can be so dynamic, even in a short time frame, that future directions become highly unpredictable. As financial markets become more electronic-based and interconnected, the nature of business transactions conducted through these markets becomes increasingly blurred and complex. Electronic communication networks are also disintermediating traditional players. In such an environment, the effectiveness of the implementation and enforcement of traditional rules and regulations would be questioned. The lack of

physical location, the different legal jurisdiction for different business functions, limited ability to restrict access to markets, and over-dependence on technology, are among the myriad of issues that have to be addressed by regulators.

Managing the implications of technology on systemic stability and encouraging innovation and efficiency will involve a careful balance. In responding to these challenges, BNM will adopt a proactive approach and seek to ensure that the regulatory framework will cater for the development of a financial system that can support the new economy driven by modern technology. While some of these issues can be addressed at the domestic level, it is recognised that there needs to be discussion and coordination at regional as well as international level. A coordinated and proactive approach is necessary to ensure that the potential destabilisation and disruptive consequences of an uncertain future and disruptive consequences can be minimised.

Promoting Shareholders' and Consumers' Activism

Shareholders' and consumers' activism is an important element that would drive performance in banking institutions and the desired efficiency and effectiveness in a market driven environment. Over the longer term, more avenues for activism, such as for minority shareholders will be identified to ensure that shareholders continue to exert pressure for performance. Shareholders' activism will also be improved if shareholders better understand their banking institutions' performance and strategic

issues. As for consumer protection, an active consumerism is healthy in creating a dynamic and responsive banking system. Consumers shall be given the opportunity to play an effective role in determining the quality of banking products and services they are getting. This shall be done through improvement in transparency of product offerings as well as the financial performance of banking institutions to generate better-informed consumers. The regulatory framework would be enhanced to provide necessary infrastructure for better consumer protection, while at the same time, consumer education will be focused towards promoting greater awareness on consumers' rights with regard to banking products and services.

Public Policy in the New Environment

In achieving the long-term objectives of developing a more efficient, effective and stable financial system, policy implementation will need to be formulated within the broad public policy objectives, that cuts across all economic sub-sectors. Policy decision-making will involve the need to maintain certain key policies while priorities would need to be attached to others depending on prevailing circumstances. While the objectives of most public policies will provide the strategic focus, the approaches perhaps require flexibility. The responsibility of meeting the socioeconomic objectives, needs to be achieved in the most efficient and effective manner.

Regulatory control

An important element in achieving an efficient and innovative market is for BNM to move from the traditional 'regulator knows best' approach to a 'supervised market approach'. As BNM moves towards a supervised market approach, it will be

essential for banking institutions to understand the regulatory philosophy of 'what is not forbidden is allowed'. There will be a move away from 'micro-managing'. Efforts will be directed to ensure that changes in regulatory directions and approaches are well communicated and understood by the industry as well as the consumers. This will create an environment for innovation and creativity to be further encouraged. Market forces, rather than regulations, will play an increasingly important role in determining the future landscape of domestic competition. In order to achieve this, BNM will focus on greater supervision of market integrity with minimal regulation imposed on business decisions.

Priority sector financing

The availability of financing to specific priority sectors such as the SMEs continues to remain vital to ensure that these sectors grow providing an economic structure that has greater agility. As the banking sector continues to become the main source of financing in the economy, their roles in financing the priority sector will remain significant. While policy will continue to focus on ensuring access to such activities, there would be a move from imposing lending targets on banking institutions to a new framework that would increase the effectiveness and efficiency in providing access to these sectors. Such framework will involve the Credit Guarantee Corporation and securitisation agencies. At the same time, the role of the development financial institutions will be enhanced in these areas. An active venture capital industry will also mobilise funding to ensure adequate financing to the specialised sectors.

chapter three
banking sector

Background

The banking sector comprises licensed institutions namely commercial banks, finance companies, merchant banks, discount houses and money brokers which are licensed under the Banking and Financial Institutions Act 1989 (BAFIA) and supervised by BNM.

The banking sector plays an important role as financial intermediary and is a primary source of financing for the domestic economy, accounting for about 70% of the total assets of the financial system as at end-1999.

As at end-2000, there were 31 commercial banks (of which 14 are fully foreign-owned), 19 finance companies, 12 merchant banks and 7 discount houses. Upon completion of the merger programme among domestic banking institutions, the number of domestic banking institutions will be significantly reduced to 10 domestic banking groups consisting of 10 commercial banks, 10 finance companies and 9 merchant banks.

Currently, the domestic banking institutions (excluding the discount houses) control about 75% of banking sector's market share, in terms of total assets and total deposits. Despite the dominance of domestic banking institutions, the 14 fully foreign-owned banking institutions have made a strong presence in the domestic banking sector. The foreign banking institutions as a group has generally been ahead of domestic players in terms of financial performance as reflected by the higher return on equity and return on asset, operational efficiency and product innovation in the domestic market. The incumbent foreign banking institutions have generally operated based on a target market, focused on high value corporate clients as against the mass consumer and corporate customers by the domestic banking institutions. Other factors contributing to the better performance of the incumbent foreign banking institutions include their global network, access to talents and experience in various markets as well as their superior level of information technology. There are therefore significant gaps between foreign and domestic banking institutions, which need to be narrowed to achieve the orderly development of a viable and effective domestic banking sector.

to lower margins as the best product offers attract a wider range of better-informed customers.

The landscape of the Malaysian banking sector can be expected to evolve and change significantly. Players with strong value proposition will survive and expand while others will eventually exit the market. The aim is for a set of core domestic banking institutions to emerge, out of the competitive process, to become leaders in the financial sector that is able to compete meaningfully with the foreign players.

The presence of foreign banking institutions in Malaysia is currently high, controlling about 25% of banking sector's market share in terms of total assets and total deposits as at end-2000. Moving forward, incumbent foreign banking institutions will be able to operate on a more level playing field with domestic banking institutions as the domestic market is increasingly deregulated. The role played by foreign banking institutions will be assessed in terms of their contribution to the development of the financial industry as well as to the overall economic growth and stability. The introduction of new types of foreign competition, particularly during the advanced stage of development of the financial system, will also be considered with a view to ensuring that the domestic financial system continues to be effective, vibrant and responsive to the requirements of the economy.

Over time, it is expected that the domestic banking groups, through a process of mergers, acquisitions, asset swaps and alliances, will evolve into more

differentiated competitors, spurred by increasingly more demanding customers and shareholders. Banking institutions will be competing on cost, to be global and to dominate in certain product segments in Malaysia at the expense of generalist institutions. The key to this is the build-up of capital size and business scale as well as the investment in the requisite ICT infrastructure and human talents.

It is envisaged that the trend towards building meaningful size will be complemented by greater specialisation. Financial institutions are specialising more and more in specific product markets or specific functions along the business chain of traditional services. These institutions develop scale and skills in the particular functions necessary to dominate in the area of focus, reduce costs and increase service quality. As they succeed in one market, these 'specialised institutions' develop other skills and scale necessary to enter new markets and become globally competitive based on strategic approaches by focusing on specific product markets or specific functions along the business chain.

While increasing size is important, this takes time and requires significant resources. Domestic banking institutions are therefore expected to consider the alternative means by which to leapfrog and acquire new skills and experience. Outsourcing and strategic alliances can assist this process. Global trend indicates this has been widespread, and is fast increasing. Banking institutions are increasingly outsourcing and entering into strategic alliances to access the skills they do not possess internally. External access to

technology, which entails high costs, ensures banking institutions access to the latest technology and will reduce replacement costs. The most significant example in the area of outsourcing is the growth of virtual banks that outsource nearly all their functions.

ICT will continue to be a key driver in banking in the future. Successful banking institutions will be the ones that are able to leverage most from the ICT revolution. Greater recognition of ICT as a driver of change among domestic banking institutions will see the rise in investment in ICT. One of the key areas of new technology investment is the development of alternative delivery channels, notably the internet. Internet financial services are already widespread in North America. Hong Kong is leading in Asia (excluding Japan) where internet financial service providers are developing strong value propositions with high participation from banking players, both in the context of wired and wireless internet banking.

Successful banking institutions in the future will be increasingly dependent on intangible assets such as talent. As competition intensifies, the need for domestic banking institutions to attract and retain the best skills and talents will become more urgent. Domestic banking institutions would therefore be expected to strengthen their human resource management.

The regulatory environment will also influence the future landscape of the banking sector. Changes in regulatory philosophies and approaches to be undertaken aim to provide conducive environment for growth and expansion of banking institutions.

The key to this is the ability of individual banking institutions to adapt swiftly as well as respond and adjust to new rules.

On the consumer front, a change in mindset will have to be evolved over time. Consumers must take charge of their own finances to engender a competitive environment and lower the cost of capital. In order to achieve this, a proactive education programme has to be implemented for the consumers to be able to make informed financial decisions. Transparency will need to be enhanced, both at the product and institutional levels to promote consumers' awareness of banking and financial products. Similarly, greater flexibility in product pricing that would lead to competitive and differentiated strategies among banking institutions will, eventually benefit genuine customers, in the form of lower costs. The ability of consumers to influence the market to react positively is an important enabler for deregulation within the domestic financial sector.

Recommendations

A **change programme** would be implemented over the next 8-10 years with the objectives of improving efficiency, innovation, flexibility, resilience and dynamism in the banking system. The programme will focus primarily on building the capabilities of domestic banking institutions and increasing the incentive to improve performance. The programme will contain recommendations to be implemented over the period to develop domestic financial infrastructure, strengthen domestic banking institutions, promote financial stability, and meet

the social objectives of Malaysia in an efficient and effective manner which will cause least distortion or disruption to the financial sector. The implementation of the recommendations will observe the following approach and safeguards:

PHASE I

The main objective in the transition is to develop a core set of strong domestic banking institutions. Therefore, initial steps shall focus on measures that seek to strengthen the capability and capacity of domestic banking institutions, create an environment where the best domestic banking institutions emerge, and building and enhancing the financial infrastructure. All the 'building blocks' for creating stronger domestic banking institutions will be implemented early within the first two to four years, along with steps to create the necessary infrastructure for a more market-based consumer protection framework, which is a vital element before moving to the next phase of development. As the consumer protection infrastructure is in place, the framework to foster further competition will be introduced. The result should be the emergence of domestic players that are stronger, more efficient and innovative and increasingly more competitive and resilient.

PHASE II

Following the initial phase in which domestic banking institutions have built greater capacity and capability to compete, the playing field for incumbent foreign players will increasingly be leveled. This will begin with the removal of some of the restrictions on incumbent foreign players to add

further competition to the industry, as well as providing wider choices for the consumers. These steps will be implemented gradually depending on the overall ability of the financial system to absorb these changes.

PHASE III

Consider introducing new foreign competition in the third phase of development. Given the intensifying degree of global competition and greater assimilation into the global arena, the banking sector needs to be prepared for greater liberalisation. Introducing new foreign competition would therefore be considered. In addition, there will be expansion of domestic banking institutions to foreign markets. At the same time, the potential 'threat' from new and aggressive non-financial players would also serve as an incentive against complacency and for incumbent players to remain competitive.

I. Enhancing Domestic Capacity

The emphasis here is to develop a core of strong domestic banking institutions that is able to provide the broad range of high quality products and services to the economy and that is efficient and cost-effective; and that has a significant share of domestic banking assets and profits. Broadly, this objective is to be achieved in two steps, that is, building the capabilities of domestic banking institutions through several proactive measures and implementing deregulation measures to increase competition and facilitate the emergence of leaders.

The specific recommendations for building the capabilities of domestic banking institutions are summarised as follows:

- The development of industry-wide benchmarks to drive performance improvement, investment in technology and shareholder understanding of banking institutions;
- Introduce a proactive set of capacity-building measures and solving problems identified based on information generated by the benchmarking process. A series of institutionally sponsored programme of senior management seminars and industry-wide training exercise will also be conducted;
- Enhance credit skills of the banking institutions by introducing proactive credit skill-building measures and monitoring the accreditation programme that will be required for officers involved in credit processing and decisions;
- Strengthen skills in all areas and thereby enhancing the ability of domestic banking institutions to mobilise, attract and retain the highly skilled manpower from Malaysia and overseas;
- Introduce measures to further strengthen corporate governance;
- Encourage the maximisation of economies of scale in cost, revenue and customer relationship through rationalisation and strategic alliances between financial and non-financial institutions;
- Streamline regulation of discount houses and merchant banks to level the playing field;
- Encourage and facilitate mergers between merchant banks and stockbroking companies or discount houses of the same group to create full-fledged investment banks;
- Encourage greater shareholders' activism and promote long-term support for the growth of the banking industry through institutionalised and dispersed ownership of banking institutions and bank holding companies;
- Allow and encourage outsourcing of non-core business activities;
- Encourage the development of alternative delivery channels such as internet banking;
- New licenses will be issued to banking groups with attractive value proposition such as virtual banking;
- Encourage innovation among banking institutions in product offerings whereby the regulatory philosophy of 'what is not forbidden is allowed' will be adopted;
- Remove restrictions on pricing when the necessary infrastructure for consumer protection framework is well in place and there is a conducive environment for competition;
- Enhance market discipline among banking institutions through requirement of independent ratings;

- Encourage competition and participation of banking institutions in the areas currently served by fringe institutions;
- Facilitate the development of a conducive tax regime that encourages prudence and innovation; and
- Facilitate greater coordination and research and development within the financial sector through the merging of existing associations of commercial banks, merchant banks and finance companies into one single association.

Recommendation 3.1:

Develop industry-wide benchmarks to drive performance improvement in domestic banking institutions

Increased domestic competition through deregulation will be a key driver of strategic and operational performance improvement in the domestic banking institutions. An industry-wide benchmarking programme provides a powerful tool for greater strategic focusing, for guiding domestic banking institutions to measure their own performance in ways that will highlight both operational and strategic opportunities and for the implementation of skill building measures.

Benchmarking can be used to drive the banking institutions to understand where and how to compete, and therefore stimulate the desired strategy formulation required to build strong domestic banking institutions. It can also highlight specific areas of operational weaknesses that

individual banking institutions need to address, by having the right skills and business targets. The information would also enlighten shareholders on the state of their banking institutions.

To achieve these objectives, the benchmarking process will involve the collection of a broad range of data, which would include:

- **Financial and operating statistics** to be collected based on customer segment and product group and aims at driving banking institutions to understand their relative performance as well as the drivers of performance. This will help banking institutions understand their risk-adjusted returns on capital by product and customer segment, which is a necessary precondition to understanding their competitive strategies;
- **Customer needs analysis and satisfaction surveys** should form part of the process. It is important for banking institutions to do systematic market research to drive customer segment strategies, particularly in retail and small business banking; and
- **Risk management processes** which should be benchmarked against best practice templates.

A working group comprising BNM and the banking industry has been established to identify the relevant indicators and approaches that are appropriate for this process.

Recommendation 3.2:

Improve awareness of best practices and conduct focused training

Resulting from the benchmarking programme, banking institutions should undertake proactive measures to address the gaps that have been identified. Efforts will be taken by BNM, Institut Bank-Bank Malaysia (IBBM) as well as the banking institutions themselves to conduct programmes for senior management. Industry-wide training programmes, including periodic discussion groups would be organised to facilitate this process. While seminars and training programmes are long-term measures to build capabilities, the immediate objective of training programmes is to raise awareness of best practices and should be targeted at those areas necessary to improve the institutions. The immediate core areas that need to be addressed are:

- Credit risk management;
- Consumer marketing (including sales force management);
- Performance management;
- Risk-adjusted profitability analysis and pricing;
- Procurement of operational support system (such as ICT, risk management system and physical branch network); and
- Electronic commerce and banking.

Recommendation 3.3:

Enhance credit skills and monitor the requirement for accreditation of credit officers and managers

Strengthening credit skills require proactive focus in the short term. It has been identified as requiring improvement due to the following observations:

- Few domestic banking institutions use credit scoring for retail and small business lending, leading to over-reliance on collateralised lending, high costs, wide margins and customer dissatisfaction;
- Few banking institutions separate credit assessment from credit origination, leading to an inherent conflict in objectives;
- Few banking institutions conduct explicit customer risk-rating exercises, or price their lending products to cover explicitly estimated expected losses, and even fewer manage and price credit risk based on incremental additions to the risk of their total portfolio; and
- Few banking institutions monitor customer accounts across products, one of the key elements of an effective early warning system, apart from being an effective marketing tool.

In this regard, the necessary structures as well as industry seminars and training programmes to raise awareness of best practices in credit risk management and credit processes would continue to be developed and organised. Minimum standards on credit risk management will also be issued by BNM so as to further improve the credit culture. In addition, the accreditation requirement as required by BNM would need to be closely monitored to ensure its effectiveness.

Recommendation 3.4:

Remove restrictions on salaries and staff mobility in banking industry

People are the most important asset for the development of an efficient and effective banking industry. Successful financial banking institutions all over the world are those that are able to attract the best talent and reward this talent accordingly. In the

case of domestic banking institutions, senior talents are lacking particularly in key areas such as risk management, systems development, and alliance building including outsourcing management.

Domestic banking institutions need to attract the very best people, especially those that have acquired experience in the more developed financial markets. These people can either be Malaysians working abroad or foreigners who have interest to work in Malaysia. In this regard, the wage moratorium (which had since been uplifted), and penalty for staff pinching will be gradually removed.

To further improve staff mobility, banking institutions will be expected to take conscious efforts to establish efficient mechanism for redistribution of staff within the industry and sourcing for new talents. This could be done through, for instance, setting up of a single website for recruitments among the banking institutions.

Similarly, banking institutions, together with BNM and IBBM will design a comprehensive training programme to retrain staff who have been affected by the rationalisation process in order to improve their mobility and hence facilitate their redeployment into other areas in the financial sector where there are new manpower requirements.

To complement these measures, the role of unions will also be harnessed so as to bring about greater awareness and change of mindset among employees with regard to the need for banking institutions to increase productivity, efficiency and effectiveness and become performance based.

Recommendation 3.5:

Uplift restriction on employment of expatriates

The ability of banking institutions to attract best talents should contribute to the transfer of technology. However, despite the more liberal policy on the employment of expatriates in the recent years, there is little evidence of significant improvements and transfer of skills taking place in the banking industry. Given the lack of expertise in specific areas of banking and finance, the need for international talents in specific areas remains. However, it is in the interest of the country over the long term to develop its own pool of domestic skills and best talents. In this way, domestic banking institutions will not only provide job opportunities but reduce their reliance on foreign experts. However, in the immediate term, new talents from competent expatriates should serve to energise the industry. The employment of the expatriates could be made on a contractual basis with more flexible remuneration packages.

Recommendation 3.6:

Set up board committees to further improve corporate governance

The key principles of corporate governance are that members of the Board of Directors (BOD) act as representatives of all the owners (shareholders), and potentially of other stakeholders, in their oversight of executive management actions. This means:

- Ensuring directors are qualified, have the necessary information available to exercise their

responsibilities, can veto management decisions that are not in the interests of their constituents, and are compelled to do so through some level of personal liability; and

- Those shareholders (and, potentially, other stakeholders) have the ability to discipline directors who do not perform up to their expectation.

In order to further enhance corporate governance in the long term, it is proposed that:

- All banking institutions be required to establish the following Board Committees, in addition to the existing required committees i.e. Audit Committee, Credit Committee, Asset and Liability Committee:
 - **Nominating Committee** - Responsible for nomination of directors and committee assignments. This committee should comprise of only non-executive directors. The purpose of a Nominating Committee is to counter-balance the influence of executive directors, in response to legitimate concerns of over powering and dominant stature of some owner-managers, to ensure that appointees are suitably qualified. The Nominating Committee should also be responsible for overseeing the composition of the BOD.
 - **Management Development and Compensation Committee**(a compensation committee is already required) - The primary purpose of this committee is to evaluate the performance of management and ensure that executives are

appropriately compensated, given their contribution to the creation of shareholder value.

- **Risk Management Committee** - Responsible for all risk management policies and processes, including market risk management, credit risk management and operations risk management. This committee is not responsible for taking particular market risk positions or credit decisions. It is, essentially, responsible for reviewing decisions made by the Credit Committee and Asset and Liability Committee when these decisions contravene the policies and guidelines that have been established. This 'division of powers' in regard to risk management is a powerful tool for ensuring disciplined and consistent application of risk management principles.

The above committees should be chaired by non-executive directors. However, in certain cases, executive directors may also be appointed to chair the above committees subject to conditions to be set by BNM. Regular attendance is required for the Board meetings and Board Committee meetings, as per BNM's Guideline on Duties and Responsibilities of Directors and Appointment of Chief Executives (BNM/GP1). This is to ensure that directors have full knowledge and understanding of their institution or relevant function and bear responsibility for its performance.

- To facilitate the desired level of transparency of performance outcomes to shareholders through provision of summary benchmark data, annual analyst briefings by publicly listed financial

institutions would be mandated immediately after announcement of the Annual Report and the Annual General Meeting. The purpose is to ensure that analysts have the opportunity to understand and educate existing and potential shareholders the drivers of performance as well as the strategic strengths and weaknesses of the individual banking institution.

Recommendation 3.7:

Allow group rationalisation and facilitate the operation of one-stop financial centre

In the pursuit of improving competitiveness, efficiency and effectiveness in the delivery of banking products and services, there has been a global trend for financial institutions to create one-stop financial centres that offer wide ranging facilities to customers. This phenomenon involves the conduct of businesses, traditionally carried out solely by either commercial banks, merchant banks, finance companies or stockbroking companies. The ability to offer customers a broad range of financial services through the same distribution channel will be the key to building stronger customer knowledge and relationships - crucial sources of competitive advantage for banking institutions. Research findings indicate that having such centres enable financial institutions to benefit from both revenue and cost synergies through cross-selling products and consolidating back-office processes and rationalising branch operations.

Thus, in order to increase efficiency and effectiveness of banking institutions in meeting the increasingly more differentiated demands of their customers, a

wider scope of operations of one-stop financial centres should be considered over the long term. This could include allowing banking institutions involved in cross-selling to consolidate their balance sheets and operate as a single entity holding multiple licenses, subject to prudential considerations. This will require a review of the present licensing requirement and laws regulating the operations of banking institutions in the country. In the immediate term, there are potential benefits of cross-selling and rationalisation of operations that are already permitted by BNM.

Recommendation 3.8:

Encourage strategic alliances

Equity alliances are one of the possible means for domestic banking institutions to catch up to international standards in terms of skills, technology, culture and scale. Significant benefits stand to be derived for domestic banking institutions from alliances with other banking institutions and non-banking institutions. This includes opening up new growth avenues through access to new markets or skills. Alliances between international financial institutions are widespread and fast increasing. Financial institutions in other countries are making increasing use of mergers and equity alliances for a range of reasons, namely, to access skills and scale, access new customers and delivery channels, cut costs, develop new products and access cutting-edge technology.

Moving forward, alliances will be encouraged either in the form of a joint venture (incorporated or unincorporated), an equity swap, a minority equity stake or a contractual alliance. International alliances

would also be considered subject to the prevailing permissible equity participation level. Competition and innovation among banking institutions will also be encouraged through alliances between bank and non-banking institutions such as telecommunications operators, satellite TV providers, and ICT companies as well as between domestic and foreign banking institutions.

Recommendation 3.9:

Streamline the regulation of discount houses and merchant banks to level the playing field

Leveling the playing field between discount houses and merchant banks would allow fair competition among players in the domestic market. Due to the convergence in the activities of these two players, leveling the playing field will enhance competition and reduce possibility of regulatory arbitrage by players in the same group. The streamlining of regulation would be in the areas of the reserve requirement, risk weightings on assets as well as scope of activities undertaken.

Recommendation 3.10:

Encourage mergers between merchant banks and stockbroking companies or discount houses of the same group to create full-fledged investment banks

The merchant banks should be developed into full-fledged investment banks, so as to be at par with international investment banks and to have the ability to undertake trading and brokerage activities, apart from merely providing advisory services. As such, mergers between merchant banks and discount

houses, and between merchant banks and stockbroking companies within the same financial group will be encouraged and facilitated to reduce duplication and improve efficiency.

To facilitate this process, the legal and regulatory framework governing the banking and securities industries would need to be fine-tuned and harmonised. Investment banks would be supervised by both BNM and the Securities Commission (SC). Appropriate regulatory and supervisory mechanisms would be formulated to govern the operations of the investment banks. This is to ensure that there are no regulatory gaps or that there is no excessive regulatory burden for the investment banks arising from the dual regulatory environment.

Recommendation 3.11:

Encourage ownership of banking institutions by institutional investors

Long-term growth of the domestic banking industry depends substantially on the availability of financial and non-financial support from shareholders, in terms of capital for business expansion, skills and experience as well as commitment to pursue business strategies. Hence, it is necessary to ensure that the owners of banking institutions are able to commit their resources for the development of strong banking institutions and a dynamic financial sector. Over the long term, such support could come from institutional investors that have an understanding and strategic interest in developing the financial services industry. Historically, the majority of domestic banking

institutions is either family-owned businesses or controlled by prominent individuals. Hence, the development of these banking institutions largely depends on the capacity of the individuals to inject new capital and provide the necessary resources and expertise. Furthermore, the premium attached to owning a banking license is high, given that no new license has been issued for some time. This has to some extent contributed to the slow consolidation of the banking industry.

Moving forward, greater participation of the institutional investors in the financial sector will be encouraged in order to develop and nurture the much needed shareholders' activism to drive performance improvements among domestic banking institutions. The legal provision of section 46 of the BAFIA which limits the shareholding of a banking institution to not more than 20% for corporations and 10% for individuals, will be strictly enforced such that the ownership structure of domestic banking institutions and their holding companies will improve. A divestment of shares over a reasonable time frame would be introduced to meet this objective.

Recommendation 3.12:

Encourage outsourcing of non-core functions

Outsourcing is a potentially useful tool in assisting banking institutions to neutralise the scale advantage enjoyed by larger institutions, to cut costs, and to focus the banking institutions' attention on developing strong skills in niche areas. It allows institutions to concentrate their resources and energies on developing a set of core competencies.

It will also allow the banking institutions to access scale and skill improvements in core areas of their business, as well as enhance the customer service level. Well-developed core competencies provide competitive advantage against existing and future competitors. Focused and well-established relationship will improve the competitive advantage.

In the rapidly changing marketplace and the pace of technological advancements, outsourcing can decrease the risk of investing in outdated technology, shorten upgrade times and potentially create better customer responsiveness. In the current environment of technological change, flexibility is particularly important for the banking institutions.

Areas that can be outsourced by banking institutions on a contractual basis are low-skill processes that are not crucial to the strategic positioning of the institution. These include back-office processes such as data entry, data conversion, transaction processing, payroll functions and certain ICT functions such as coding and technical design. Other ICT processes such as website services, network management and advanced data analysis can also be considered.

There are several alternatives with respect to outsourcing. While using the services of locally based providers could be an attractive option, some banking institutions may want to set up in-house units or pooled arrangements between few banking institutions to obtain scale advantage. Consideration however needs to be made with respect to the sharing of information and the secrecy provision specified in section 97 of BAFIA. Some flexibility however can

be accorded to outsourcing by banking institutions for it to achieve a discernible effect on costs and jobs allocation.

Recommendation 3.13:

Require management of banking institutions to give greater attention to the development of ICT

Given the speed of changes in technology, the large ICT investment by banking institutions, however, does not necessarily guarantee against obsolescence, scalability and flexibility in the future. Therefore, attention at the highest senior management level will be vital to ensure the formulation of appropriate ICT strategies. The investment should aim at allowing maximum flexibility and expandability in the future. The ability to discern trends and developments in ICT and hence, appreciate the potential impact on the institutions is critical. ICT should be regarded as a strategic tool to create value, and not simply an operational tool to enhance work processes. Examples would be in the use of customer relationship management (CRM) tool to analyse customer profiles and behaviours for better marketing and strategic focus and the application of customer-managed relationships (CMR) that allow better understanding of customers' needs. Hence, the ability to contribute to the development of technology within the banking institutions will be part of the core competencies to be expected of senior management in the future.

Recommendation 3.14:

Encourage the development of new delivery channels

Innovative and more efficient delivery channels such as internet and mobile phones will become an

increasingly essential part of a modern banking system. It will offer banking institutions significant advantage in customer retention, customer acquisition and service cost reduction. Skills and brands can be developed and promoted through these channels, which have been important for success in other high technology services such as TV/broadband banking. High technology services such as internet banking offers a unique value proposition to consumers and is growing fast globally. The internet improves accessibility to banking products and services, and can be harnessed not just as mere delivery channels but as new business venture through the setting up of virtual banks by banking institutions.

In this regard, banking institutions will be allowed and encouraged to embrace these innovative approaches. At the same time, minimum standards will be imposed to ensure that such innovations do not compromise financial stability and integrity. Thus, its regulatory framework will balance the various trade-offs between efficiency and financial system stability.

Recommendation 3.15:

Adopt 'what is not prohibited is allowed' regulatory philosophy and phase out product pre-approval requirement

The present approach involves pre-approval requirement restriction on activities to be undertaken by banking institutions. Participation and introduction by banking institutions in these new services is subject to the approval requirement.

Although some restrictions are necessary for prudential purposes or consumer protection, the requirement for approval to conduct activities that are not clearly forbidden has been viewed as an impediment to innovation.

The uncertainty among banking institutions as to the regulatory requirements for new approaches to be approved has contributed to the uncertainty and has been a disincentive to innovative ventures. As such, banking institutions have tended to remain with their traditional approaches.

In addition, this has been aggravated by the lack of pressure for banking institutions to improve efficiency and effectiveness in the absence of aggressively demanding customers and shareholders.

A move to the approach of 'what is not prohibited is allowed' should provide more certainty to banking institutions to new and innovative banking activities from regulatory perspective. The adoption of this philosophy however must be complemented with efforts by banking institutions to improve the level of product transparency and consumer education. Banking institutions would be required to increase product transparency and improve access to product information as well as to make available an effective mechanism to address and provide resolution for consumer complaints.

In addition, a more efficient structure involving Banking Mediation Bureau (BMB) as an efficient means to address consumer complaints will need to be implemented.

Recommendation 3.15.1:

Replace product pre-approval requirements with a simple new product notification process

A simpler product notification process will give incentive for investment in new and innovative products. Banking institutions will be encouraged to invest in research and development to develop products that can capitalise on their areas of expertise. The notification process will be sufficient to ensure that regulators are aware of market development on new products. Intervention with corrective actions shall still be possible for cases of improper disclosures to ensure that there is adequate protection for consumers against wrong and misleading information on banking products. BNM will also have the right to recall products that have been introduced by banking institutions which have detrimental effects to the consumers or the stability of the financial system.

Recommendation 3.15.2:

Outline guidelines for all applications for regulatory exemptions

Following the above recommendation, a set of clear guidelines for applications for regulatory exemptions to ensure that banking institutions provide the relevant information would be issued by BNM. This will contribute to reduce the response time for approval of new banking products and give incentive for innovation. The reasons for rejection of products will be communicated to the banking institutions to indicate the nature of the regulatory concerns.

Recommendation 3.16:

Deregulate pricing and rules of association on rates, fees and charges gradually

A key element in driving performance improvement in domestic banking institutions is to increase substantially the competitive intensity in the industry. This will drive the specialisation, focus and agility that will be required to build sustainable competitive advantage for core domestic banking institutions. At the heart of increased competition is the need for market-determined prices.

As the ability of banking institutions to price their product improves over time, the present rule on pricing and imposition of fees and charges on selected products and services would be further liberalised. This would seek to:

- Avoid high lending margins, possibly through tacit agreements not to price below the base lending rates;
- Avoid overpricing to certain customer segments, and credit rationing on others that could possibly happen in an environment where price cap is imposed; and
- Facilitate product bundling for segment-specific bundled products with segment-targeted pricing, which is potentially a key source of competitive advantage for domestic banking institutions when competing with specialised market player.

Price limitations would be removed together with an effective monitoring of price collusion among banking institutions to ensure that collusive

behaviour does not emerge. Another precondition would be an effective market-driven consumer protection framework where consumers are able to exercise their rights and have recourse to legal protection to address potential problems.

Recommendation 3.17:

Mandate all banking institutions to be rated

One of the important elements in building capacity of banking institutions is the implementation of measures that aim to exert and improve market discipline. This is particularly important as regulation plays a lesser role in determining market outcomes. Under a more liberalised environment, the activities of banking institutions will be subject to the scrutiny of market players and hence there will be greater demand for transparency. Banking institutions' performance will be measured against a broad spectrum of financial benchmarks that will reveal the key strengths and weaknesses of the banking institutions.

To ensure that banking institutions are consistently aware of the role of market forces in evaluating their performance, measures to enhance market discipline will need to be implemented. Therefore, it is recommended that the banking institutions be rated by at least a local rating agency. The rating should serve to inform consumers and investors the level of risks in the banking institution. A precondition to this is an enhanced level of consumer education and depositors' understanding of financial information. Improvement in the level of transparency and accountability of rating agencies

would also be an important prerequisite for the implementation of this recommendation.

Recommendation 3.18:

Encourage competition and participation of banking institutions in areas currently served by fringe institutions

Fringe institutions include savings institutions, housing credit institutions, leasing companies, factoring companies and credit token companies.

Altogether, these institutions account for less than 4% of total assets and less than 5% of total deposits in the financial system. These fringe institutions therefore have limited impact on the efficiency, effectiveness and stability of the overall financial system.

In the long term, banking institutions would be expected to increase their participation in the areas currently served by fringe institutions. While some of the fringe institutions will survive the competition and expand, some of them may be phased out or be taken-over by banking institutions. It is not possible to forecast who the future winners in each market will be. The end game will depend not only on the degree of market orientation of the financial system, the regulatory framework but also on the evolution and transformation of the real sector. The options are open as long as there is a comparative advantage in a competitive market where the institutions operate under the same rules.

As the business focus of fringe institutions becomes broader and riskier, it will be necessary for the regulatory framework to evolve accordingly. For mortgage building societies, for instance, the initial

business focus on end-financing, has now been shifting towards financing housing developments. As the risk of the business has increased and in order to promote a level playing field among the financial institutions, it will be necessary for the authorities to exercise a certain form of prudential regulatory control over their activities to ensure that consumer protection and investors' interests are preserved.

Recommendation 3.19:

Facilitate the development of a conducive tax regime

While certain tax exemptions have been granted to drive banking businesses, particularly those involving mergers and acquisitions, certain aspects of the tax framework may need to be reviewed further to provide incentives to encourage financial prudence and innovation. This relates to, in particular, facilitating greater research and development activities, thereby encouraging innovation among banking institutions.

Recommendation 3.20:

Merge the associations of banks, merchant banks and finance companies into a single association

While the financial sector is progressing towards greater consolidation, efforts should be taken by the three respective associations to converge by establishing an association with wider and broader memberships of financial institutions. The current efforts of the three associations can be assimilated and streamlined in the merged association, whereby the scope of work can be more exhaustive and conclusive in dealing with the issues relating to the financial institutions. On training, the synergy obtained through cross memberships can further enhance the skill level and understanding of the staff in the financial institutions. The merged association is hoped to undertake further consumer education programme and develop a close network of professionals with similar prudential behaviour and

identity. A website detailing their products and services, as well as educational materials on current issues could be established.

II. Promoting Financial Stability

Maintenance of stability in the financial sector is one of the core objectives of the FSMP and will remain an important challenge for regulators. Banking institutions should be resilient to systemic and external shocks and be in a position to provide high quality service to consumers throughout the transition process of the implementation of the FSMP. An important aspect of this is the regulatory framework and having a set of risk-adjusted prudential regulation and supervision to ensure safe and sound institutions and the protection of the interest of all stakeholders, as well as the development of an efficient and reliable infrastructure. A careful balance will be made between the need for protection and stability against the need to attain efficiency and competitiveness.

Strong, Risk-Adjusted Prudential Regulation and Supervision

In moving towards a market-based supervisory framework, the regulatory framework would need to be adapted accordingly. Flexibility is vital in order to accommodate the rapid technological advances and avoid stifling innovation. The challenge for the regulator would be to ensure continuous surveillance of market developments and the evaluation of trade-offs between encouraging innovation and maintaining stability. These would

include implementing the following measures:

- Strengthen corporate governance and risk management capabilities of banking institutions;
- Continue implementing risk-based supervision with incentives for strong performers and more focused supervisory attention for weak institutions;
- Strengthen consolidated supervision of financial conglomerates;
- Refine capital adequacy risk weightings in response to new market developments and based on the risk profile of loan books;
- Introduce legally binding arrangements for banking institutions to implement examiners' findings;
- Enhance surveillance of the financial sector to provide early warning signals to impending problems; and
- Implement a transparent and clearly structured early warning system and set of prompt corrective measures for weak institutions.

These recommendations are discussed in the following sections. Corporate governance and risk management are already covered in Section I of this chapter.

Recommendation 3.21:

Continue implementing risk-based supervision with more focused supervisory attention for weak institutions

It is recommended that BNM continues to conduct its supervisory function using the risk-based approach where on-site examination will be focused on a few high risk areas. Banking institutions with higher degree of risk would be continuously monitored

and subject to more regular and intense on-site examination. As an added incentive for the banking institutions, the proposed set up of the deposit insurance fund as discussed in Section III of this chapter will require contribution from banking institutions based on a risk-based approach.

Recommendation 3.22:

Refine calculation of risk weightings for the purpose of capital adequacy calculations

A more sophisticated and differentiated treatment of different risk classes shall be developed to take into account the risk profile of loan exposures to different sectors of the economy, besides incorporating the market risk. The aim of this measure is to be able to assess the required capital for the institution, depending on the risk profile of that particular institution. Besides the above, the revised risk-weighted capital adequacy framework places greater reliance on the assessment of credit risk, through internal ratings or use of external ratings to determine risk weights.

Recommendation 3.23:

Implement a system of incremental enforcement actions

Incremental enforcement actions against problem banking institutions shall be developed to implement examiners' findings. These will be divided into informal and formal enforcement actions.

Informal enforcement actions may include board resolutions (declaration by the BOD outlining a plan to deal with identified weaknesses), and memorandum of understanding (MOU), outlining specific actions an institution must take to address and correct identified weaknesses or non-compliances. Unlike board resolutions, the MOU will be drafted by BNM and signed by the members of the board of affected banking institutions. On

formal enforcement actions, these will be imposed by BNM on banking institutions, which were found to be operating unsatisfactorily as highlighted by the examiners' findings. This may include a written agreement or capital directives, cease and desist orders, penalties, and prompt corrective actions required for institutions with weak capital positions. The purpose of the formal enforcement actions is to ensure that banking institutions seek remedial actions on the findings raised by the examiners. The formal enforcement actions must have a legal standi. This will therefore require amendments to the BAFIA or specific regulations to be gazetted.

Recommendation 3.24:

Implement a transparent and clearly structured early warning system and set of prompt corrective measures for weak banking institutions

The transparency of intervention process to banking institutions will be an important incentive for banking institutions to avoid adverse publicity and reputation. This is to facilitate enhanced corporate governance among banking institutions. An explicit codification of the trigger points would also result in making the intervention process more consistent and meaningful. The prompt corrective actions will be taken in cases where specific early warning indicators reached identified levels such as declining risk-weighted capital ratio (RWCR) which indicate deterioration in the overall safety and soundness of banking institutions.

However, the transparency of the intervention process will be managed so as to avoid any

the implementation of the consolidated supervision is an efficient information sharing and coordination among the different regulatory bodies.

Efficient and Stable Infrastructure

An efficient and stable financial system needs to be built on a solid foundation made up of interconnected financial infrastructure. Four elements of the necessary infrastructure include:

- Deep and liquid **capital markets** allowing institutions to broaden their product offering and manage their risk exposures. Through balance sheet structuring, investment choices for consumers can be diversified, and contribute to macro-level stability (This is covered by the Capital Market Masterplan by the SC);
- Efficient and reliable **payments system** promotes efficiency and inspires consumer confidence in banking institutions and in the wider financial system;
- Use of **electronic trading platforms** in the foreign exchange and money market to improve efficiency and the accessibility level in the market; and
- Strong **consumer protection infrastructure** protects consumers, promoting public confidence in the system (Recommendations in this area will be covered in Section III of this Chapter).

Recommendation 3.27:

Increase efficiency and competition in the payments system

As we move forward, the efficiency of the payments system should be enhanced to support the needs of the financial system. The financial system would require a payments system that is capable to facilitate settlement between various financial players and for various types of instruments in the market. In this regard, a flexible, proactive and effective regulatory framework for the payments system would be adopted by BNM in its oversight of the payments system. The framework would seek to improve the efficiency of the payment-related infrastructure while maintaining the safety and integrity of the payments system. The regulatory framework would provide a holistic view of the payments system and would cover the following areas:

- BNM policy objectives in payments system;
- Scope of regulatory oversight by BNM on payments system;
- Policies on the conventional payment mechanisms (e.g. Automated Teller Machines [ATM], debit, credit and charge cards) as well as payment mechanisms made possible by the advent of internet (e.g. e-money, e-cheques, barter trade exchange);
- Minimum criteria and standards including security standards for service providers to be authorised to provide payment services; and
- Minimum standards to address consumer related issues such as transparency of fees and

charges, privacy of consumer information, as well as consumer education and awareness programmes.

Recommendation 3.28:

Allow market forces to shape developments in the payments system while BNM assumes the role of regulator

As the payments technology and the structure of the financial services industry are changing rapidly, it would be more efficient and effective for the market forces to play a pivotal role in the development of the payments system. Allowing greater competition will increase innovation in payments system, particularly for the retail payments system. By driving competition further and allowing alternative payments system and gateways, greater dynamism and efficiency would be encouraged in the existing payments system providers. Recognising this, BNM will adopt a facilitative rather than a developmental role, especially in the retail payments system. However, BNM would need to ensure that minimum security standards are met when new systems are introduced.

Recommendation 3.29:

Allow incumbent foreign banks to set up shared ATM network

Currently, the foreign banks individually manage a limited number of ATM machines. The presence of an alternative ATM network operated by foreign banks will drive further dynamism in the traditional payment networks and provide an alternative payment channel for the consumers. In the long run, there is a possibility for the domestic ATM operator,

Malaysian Electronic Payment System Sdn Bhd (MEPS) to initiate a merger between the two networks to form a single ATM network. While this could be an optimal solution, the decision by MEPS with regards to its future strategies should be based on the business value of the alternatives.

Recommendation 3.30:

Allow use of electronic communication networks and electronic trading platform

The significant growth of the internet has contributed to the increased popularity of electronic communication networks and electronic trading systems. While this could lead to a disintermediation of traditional players, these advancements in technology have enabled the incumbent players to reap greater opportunities and extend their market reach. In this regard, domestic financial institutions and brokers should seek efficiency gains by conducting transactions through electronic means with respect to their operations in the foreign exchange and money market. Regulatory flexibility would be accorded to encourage efficient use of technology for provision of transaction systems that can provide measurable cost savings to the participants.

III. Meeting Socioeconomic Objectives

Another primary objective of the FSMP is meeting the social objectives of Malaysia, particularly with regard to:

- Access to funding by priority sectors in the economy (SMIs, low-cost housing and Bumiputera entrepreneurs);

- Providing advisory services to small borrowers;
- Providing banking services in rural areas;
- Funding of specific industries (agriculture, shipping and infrastructure); and
- Consumer protection.

Access to Funding by Priority Sectors

Priority sectors such as the SMIs are essential sub-sectors of the economy that require financing. While the development of low-cost houses and lending to Bumiputera community seek to raise standards of living and improve the socioeconomic balance, the SMIs contribute more significantly to the economic transformation and growth of the country. Over time, SMIs will be increasingly more significant such that it will become a vital foundation of the economy, hence, bringing larger volume of businesses to banking institutions. Banking institutions need to maintain good long-term relationship and understand the businesses of SMIs.

While it is important to ensure adequate financing to these sub-sectors, such provision of financing should be consistent with the objective of developing an efficient banking sector. The present approach would be reviewed and enhanced as embodied in the following recommendations:

Recommendation 3.31:

Introduce an expanded credit guarantee scheme

Lending to priority sectors by the banking institutions should be implemented through mechanism that has least distortion on the efficient

working of the sector (Access to funding to priority sectors from other sources is covered in chapters 6 and 7). Presently, there are three lending targets imposed on the banking institutions, namely lending to SMIs, lending to the Bumiputera community and low-cost houses. While the banking institutions as a group, have always met, the overall lending targets, some banking institutions have had difficulty in meeting the individual lending targets for SMIs during the crisis years.

Overtime, as price deregulation takes place, the lending targets can be gradually replaced with an expanded and more efficient credit guarantee system. Such a framework will ensure that continuous access to financing by these sectors while at the same time avoid homogeneity in bank strategy and the maintenance of duplicated infrastructure, as well as weakening the credit system. The fiscal cost to the Government under this arrangement will be in the form of higher guarantee funds that need to be allocated to the Credit Guarantee Corporation (CGC). The CGC will play a larger role in guaranteeing the priority sectors, especially the SMIs. At the same time, Cagamas would play a role in supporting loans extended to the low-cost houses. Besides introducing more attractive financing schemes, CGC has taken a number of steps recently to improve its operations, including opening of new branches all over the country as well as strengthening its funding structure. This will prepare CGC for the enhanced role in the expanded guarantee scheme.

In the new framework to be introduced, CGC is expected to expedite application and the approval process by the setting up of a portal whereby SMIs can apply for loans with CGC guarantee directly. Under such arrangement, the CGC would then solicit from banking institutions their proposed lending rates and guarantee requirements for the loan. Among the prospective lenders, CGC would select the best offer, which is the one with the lowest price as well as lowest guarantee requirement. The scheme, once fully operational would require full participation from the banking institutions. The size of CGC's funding would therefore be further increased through mandatory contribution from all banking institutions, in amounts equivalent to their directed lending target financing. Prior to the removal of the existing lending targets, the banking system's overall compliance with specified targets will be monitored. The lending targets would be gradually removed when the banking institutions have developed the ability to support these priority sectors, and BNM is assured that these sectors will have continued access to financing.

Recommendation 3.32:

Require provision of advisory services on financial planning and management to SMIs and small borrowers

As SMIs and small borrowers become increasingly important customers of banking institutions, the financial support expected from the banking institutions will need to go beyond mere funding. Recognising the business opportunities in the future, based on the earning potential of some of these enterprises, banking institutions would therefore be

expected to establish long-term relationship with these borrowers and dedicate resources for provision of a more comprehensive financial support including advisory services on financial planning and management. This would contribute towards better financial understanding and management among these borrowers.

Recommendation 3.33:

Allow banking institutions to rationalise their branch network and relocate branches, subject to certain conditions

In terms of number of branches in the country to the number of population, certain areas are found to be under-branched, where certain geographic locations in the country are not served by any banking institution while there is a high concentration of banking institutions in the urban areas. There is therefore a need to improve the dispersion of the branches in the country through a branch rationalisation exercise. The rationalisation of branches by banking institutions is also necessary for the banking institutions to achieve the right mix of target market and achieve cost savings.

In order to ensure that all areas are served by a banking institution, it is recommended that all areas currently served by banking institutions are to be continuously served by at least one banking institution. The banking institution would be allowed to rationalise their branches as long as there is one branch of a bank serving the area where the branch is to be closed. In order to be equitable, future branches, particularly in the rural areas should be

undertaken by banking institutions that currently have lower-than-average number of rural branches.

Over the longer term, established banking institutions can form alliances to serve the rural areas and create value proposition through tailored products and delivery channels. The channels of delivery can be provided in the form of alliances with retail outlets or with the post offices, so that the institution does not have to build its own network of branches and can thereby decrease its cost base. The supermarket/post office for example can have one multi-function ATM and one employee with a connected computer to the head office. All credit applications would be sent to a central or regional credit centre and replenishment of cash can be outsourced.

Consumer Protection Infrastructure

A crucial aspect of stability in the financial system relates to its ability to undergo the transition to deregulation and increasing competition without resulting in disruption in the level or reliability of services to consumers. The need to protect consumers from potential unfair practices by banking institutions will continue to be one of the main areas of responsibilities of BNM.

Moving towards a supervised market-driven financial system, BNM would need to be less involved in a 'hands-on' way to regulate and supervise the financial sector, and thereby avoid micro-managing the industry. Nevertheless, as part of its social obligation to the country, BNM will continue to ensure that necessary infrastructure is put in place to protect customers from possibilities of unfair practices by banking institutions. Consumer education and awareness are essential to achieve this objective and to ensure that the level of information and guidance to the public will be enhanced.

Recommendations in this section are aimed at ensuring adequate and effective consumer protection in an increasingly market oriented financial system. The recommendations are made under six headings, namely:

- Initiate an active and structured consumer education programme;
- Increase transparency on the performance of banking institutions and the profile of new products;
- Establish legal redress for consumers;
- Expand the operations of the Banking Mediation Bureau (BMB);
- Introduce anti-trust regulation; and
- Set up a deposit insurance fund.

Recommendation 3.34:

Initiate an active and structured consumer education programme

A crucial element in making the FSMP a success is the development of active consumerism. Active consumerism can only be developed with the public having a strong understanding of the products and services of the banking institutions. In view of this, BNM and the banking institutions would need to undertake a structured consumer education programme to educate consumers on retail products and services. The public needs to be informed of the roles and functions of the financial players and the various types of financial instruments being offered. The programme would be comprehensive involving publishing articles in mainstream media and other publications, roadshows and integrating into the curriculum in schools and institutes of higher learning.

Recommendation 3.35:

Increase product-specific and institutional transparency and move towards full disclosure

Product transparency shall be improved through the implementation of full disclosure requirement for retail financial products. In moving towards a standard full disclosure model for products, the following actions shall be taken:

- Develop clearly defined guidelines for comparable disclosure of all fees, interest rates, yields, and other standard product features. The objective would be to achieve more complete disclosure (i.e. product information) to consumers for all financial products;
- Develop a dictionary of common terms used to describe and compare products;
- Require institutions to test initial marketing and disclosure documents with focus groups to ensure that they are easily understood by a representative sample of the population of Malaysia;
- Standardise disclosure rules in formats consistent with internationally recognised best practices to allow clear and transparent analysis and comparison of product features and associated risks; and
- BNM maintains the right *ex post facto* to require an institution to recall product or material that is deemed misleading and reissue clarifying materials.

With regard to institutional transparency, BNM/GP8 'Guidelines on the Specimen Financial Statements for the Banking Industry' would need to be reviewed to ensure that the guidelines are in line with the developments in accounting standards and to enable depositors and investors to gauge the relative strengths of individual banking institutions.

Recommendation 3.36:

Encourage consumers to pursue formal administrative and legal redress

Formal administrative and legal redress should be taken by consumers if they suffer harm due to purchase of financial products and services. This requires banking institutions to set up their own complaint desks to tackle issues brought to them by their clients. The next course of action for the consumer to take is to bring the matter up to the BMB. The BMB was set up to provide redress for consumers aggrieved with the service taken from banking institutions involving financial loss such as ATM-related matters. In this instance, consumers are encouraged to put up complaints against banking institutions, failing which, legal recourse should be taken under the court of law.

Recommendation 3.37:

Expand the operations of BMB to cover full range of retail banking-related consumer complaints

In order for the BMB to undertake the above recommendation, the operations of BMB would be expanded as part of measures to enhance consumer protection against fraudulent and negligent behaviours by banking institutions and their staff. In order for the BMB to play a greater role, its funding and staffing would need to be increased correspondingly. The BMB would have the power to be an independent mediator in the case of all consumer complaints. The BMB would also assume

the primary role in educating banking consumers of their rights and means of channeling their complaints, and available courses of actions.

Recommendation 3.38:

Implement anti-trust regulation

Anti-trust regulation will be developed to define the process by which abuses are brought to the attention of and to be dealt with by BNM. This will be developed over the long term as banking institutions begin to specialise and gain strength and dominance in specific areas. Such regulation will address monopolistic behaviours and be implemented together with the expanded role of the BMB. BNM would monitor whether there is collusion among banking institutions to fix prices which could be detrimental to the consumers.

Recommendation 3.39:

Establish a deposit insurance fund

During the recent crisis, the Government issued a blanket guarantee on deposits and interbank placements. A 100% guarantee of deposits places a considerable financial burden on the Government, a burden that, to avoid moral hazard, should partly be borne by banking institutions. It is therefore recommended that a deposit insurance fund be established. Contribution into this fund would be risk-adjusted. This will serve two purposes, that, it offsets the moral hazard created by a blanket guarantee or insurance scheme; and it creates an incentive for prudent management in line with the FSMP recommendation to move towards performance-based prudential regulation. The depositors on the other hand should be assured that the fund will protect small deposits.

Approach to Implementation

The above recommendations would be implemented and sequenced so as to minimise disruption and dislocation and to maximise the benefits to be achieved. For this purpose, safeguards will be in place, and the necessary milestones need to be met to move to the next stage of development. It is essential however, that a certain momentum is maintained during the implementation period, but at the same time, ensure that the transition is smooth for consumers and facilitate the objective of building an effective, efficient and resilient banking sector. In this regard, BNM will oversee and manage the implementation with the aim of speeding up the transition where possible. The implementation will be made through a consultative and iterative process, involving the stakeholders, namely the banking institutions and relevant public authorities.

In overseeing the implementation of the recommendations, the following areas will be monitored:

- **Efficiency, effectiveness and resilience of domestic banking institutions**

This process is to be conducted by assessing the progress of the industry and, within that, progress of domestic banking institutions as a group. The performance of the banking institutions as a group in the assessment will be important in order to determine the speed of transition to be undertaken. Key indicators that will be used to

evaluate the progress include tangible pace of product innovation, critical ratios on cost efficiency, market penetration as well as the magnitude of lending margins which will be indicative of the level of competition in the market. The progress of individual domestic banking institutions will also be continually assessed. The objective of this assessment process is to identify the domestic banking institutions that will potentially emerge as the 'winners' in the future. The assessment of individual banking institutions will involve assessing improvements in innovation, the adoption of best practices especially in the area of risk management, the ability to improve shareholders' value and sound application of business strategies. In addition, key ratios will also be analysed to assess the level of efficiency and resilience of individual banking institutions. Should certain domestic banking institutions lag behind industry standards, radical measures including allowing smaller but high performing banking institutions to take over large but under-performing banking institutions, will be taken to specifically increase the level of efficiency and effectiveness in the domestic banking institutions concerned;

- **Stability**

A review will be undertaken to decide how fast, and the means by which to move ahead with the specific recommendations made in this report and to determine the pace of its implementation given the broader implications on the industry and macro-economic stability; and

- **Consumer protection and socioeconomic objectives**

The objective is to promote a more market-oriented consumer protection, and assess the degree of achievement that has been realised and the trade-offs that need to be made as the recommendations are progressively being implemented. The result of this assessment will influence the pace of the transition and the policy option to be pursued.

The desired change intended by the FSMP shall be the result of the combined effort of all relevant parties in the financial sector. While it is motivated by the need to be successful, it would also be tampered with a sense of practicality and reality of the environment.



chapter four
insurance sector

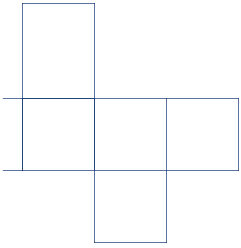
Malaysia's insurance industry has achieved significant progress in the last decade.

The insurance industry was brought under the supervision of BNM in 1988. The close supervision of solvency and market conduct and the strengthened regulatory framework enforced in the 1990s were aimed to enhance the professional standards in the industry and consumer confidence.

Marked improvements are evident in the operational management and financial standing of insurers as well as the more positive public perception of the industry as demonstrated by the trends that have emerged. During the period from 1988 to 1999, key insurance indicators show that:

- the market penetration increased significantly from 11.4% to 31%;
- the total paid-up capital of the industry and average capitalisation per insurer increased by 532.4% and 476% respectively;
- the industry's trading ratio improved from 308.5% to 175.7%, indicating that insurers are much less highly geared;
- the total insurance fund assets and average asset base per insurance fund increased by 545.9% and 521% respectively;
- the technical reserves of general insurers strengthened from 122.6% of net premiums to 170.3%; and
- the retention ratio of general insurance business rose from 75.6% to 87.8%.

Notwithstanding this, the insurance industry in Malaysia is relatively small by international standards. However, with the projected economic growth, a large proportion of the population will reach levels of per capita income that will significantly increase the demand for risk and savings-type products. The ability of the domestic insurance industry to capture a share of this growth will depend on the ability of insurers to maintain their competitive positions both within the industry specifically, as well as the financial sector generally, in the face of new challenges and the changing financial and economic environment.



- distribution channels such as independent financial advisers, banks, telephone, direct mail and the internet should be further developed;
- measures should be taken to improve the productivity and quality of the agency force; and
- the range of products available in the market should be expanded to include more sophisticated products. This will require a higher level of investments in research and development to support more initiatives in product innovation.

This process will be managed, taking into account the interests of financial system stability and consumer protection. Some elements of regulation, necessary in the past, would now need to be adapted to encourage the more rapid development of the domestic insurance industry and to stimulate performance improvement. Much of the regulatory framework currently in place was designed to develop and strengthen the domestic insurers in this rapidly changing industry. Regulation has been successful at putting domestic insurers on a sound footing, with costs declining, commissions under control and solvency ratios stable. The stage has now been reached for elements of the regulatory framework to be adapted to the changing environment to accelerate the development of the domestic insurance industry in step with external developments taking place across the global insurance market. In addition, the increasing linkages between the insurance industry and the banking sector need to be managed. As the borders between insurers, asset managers and

banks continue to blur, and as banks and insurers increasingly begin to take advantage of the opportunities of bancassurance and of multi-product personal financial advisers, it will be increasingly important to ensure that regulation and supervision across the sectors are aligned.

Vision and Objectives

The overall objective is to build an efficient, effective and stable financial sector that supports both the needs of the real economy and the socio-economic objectives of the country. The aim is also to build at the core of the financial system, strong domestic institutions that provide Malaysian consumers with world-class products and services, while meeting international commitments to liberalisation of the sector in the medium term.

To this end, recommendations have been developed to implement a programme that will build the capabilities of domestic insurers to compete effectively, while ensuring that Malaysian consumers have access to the best products and services that meet their requirements. Ultimately, the desired end game is an insurance industry that:

- is an effective mobiliser of long-term savings to support economic growth;
- is financially resilient to market volatility and competitive pressures;
- adopts international best business and management practices;

- is at the cutting edge of innovation with a broad range of products for consumers at competitive prices;
- conducts business through a broad range of distribution channels for the convenience of consumers;
- displays high ethics and professional standards; and
- is more productive and cost-efficient.

Recommendations

The desired end game envisioned for the Malaysian insurance sector will be achieved in three phases as follows:

PHASE I

Building the capabilities of domestic insurers

Under this phase, insurers will be allowed greater operational and management flexibility to develop and optimise on skills, scale and technology. Recommendations include deregulatory measures in specific aspects of business activities that will encourage innovation in the market, allow insurers access to a broader product range, enable them to leverage on distribution channels and promote increased levels of competition within the domestic market.

PHASE II

Promoting consolidation and strengthening incentives for improved performance

Under this phase, concerted measures will be taken to establish the foundation necessary to support a greater role for market discipline to complement regulation and supervision of the insurance industry. The same foundation will also serve to prepare the industry for the progressive liberalisation in the third phase. The focus under Phase II will be on strengthening the financial resilience of insurers and enhancing consumer protection. The expected results of the recommendations under this phase are domestic industry consolidation and the convergence of performance standards in the domestic industry towards best practice and performance benchmarks.

PHASE III

Stimulating innovation through progressive liberalisation

With the necessary foundations in place, measures will be taken under Phase III to progressively liberalise the insurance sector. This will provide Malaysian consumers with greater access to world-class products

and services. The process of gradual liberalisation is also expected to act as a powerful catalyst to hasten the development of the domestic industry to international standards. Opportunities for entry into the market will be made available under this phase.

The detailed recommendations under each phase are set out below. The order in which the recommendations are presented under Phase I and II do not necessarily indicate their order of implementation. Given some overlap between the objectives of building domestic capabilities, and promoting consolidation and strengthening incentives for improved performance, some of the recommendations under Phase II will be implemented together with the Phase I recommendations.

I. Building the Capabilities of Domestic Insurers

Recommendation 4.1:

Remove restrictions on outsourcing

Consonant with trends towards the disintegration of the business system across many industries worldwide, restrictions on outsourcing have already been to a large extent removed for most of an insurer's business support functions. To enable insurers to further develop their core competencies and effective business strategies, remaining restrictions on the outsourcing of non-core business activities by insurers, including the accounting, investment, collection, payment and distribution functions, will also be removed.

Recommendation 4.2:

Allow all players in the market to operate via the internet

Insurers and reinsurers will be allowed to conduct insurance business over the internet which is rapidly growing in importance and expected to have a profound impact on the competitiveness and efficiency of the insurance industry, especially in the general insurance sector.

Recommendation 4.3:

Promote incentives for the growth of bancassurance

Among the critical conditions identified for the successful growth of bancassurance is the ability of banks to own insurers and distribute insurance and pension products, as well as the ability of banks and insurers to share customer information. Currently, insurers are already permitted to distribute their products through banks operating in Malaysia.

To further promote the growth of bancassurance:

- favourable consideration will be given to banks or bank-holding companies which wish to acquire or increase their interests in insurers under the industry consolidation exercise; and
- flexibility will be accorded to insurers and banks in bancassurance partnerships to share customer information.

Recommendation 4.4:

Remove the 'file-and-use' system for life insurance products in the long term

The current requirement for insurers to submit particulars of new life products and changes to existing life products at least 30 days before the products are offered to the public will be maintained to ensure fair terms and proper disclosure to

prospective policyholders. It is also necessary to prevent 'product dumping' by insurers seeking to win market share and to ensure that insurers are able to finance the new business growth.

However, as the market matures in the long term and as regulations on product transparency and consumer protection mechanisms develop further, a review of the 'file-and-use' system will be made.

Recommendation 4.5:

Open up the pension industry to insurers

To increase the market share of domestic life insurers, the management of pension funds by insurers will be further promoted. A step in this direction has already been taken with the recent move to allow employees to use their contributions to the Employees Provident Fund (EPF) for the purchase of annuities from a panel of insurers. The social and economic impact of the EPF annuity scheme on the insurance industry is being closely monitored and will be carefully considered before further opening up of the pension industry is pursued. The consideration of any move in this direction will take into account the nation's interests in achieving the most efficient and effective management of its pension funds.

Recommendation 4.6:

Uplift restrictions on employment of expatriates

To accelerate the development of skills and expertise in the insurance industry, particularly in the current dynamic business environment, existing restrictions on the number of expatriate specialists that may be employed by insurers will be removed for both domestic as well as foreign insurers. Domestic insurers

are expected to benefit most from the inflow of foreign talent since the transfer of knowledge across borders already takes place among the foreign insurers.

Recommendation 4.7:

Remove restrictions on opening branches

Current restrictions on the opening of branches by insurers are intended to ensure that insurers do not expand beyond their capacities in a manner that would put their financial positions at risk. To avoid limiting the potential for insurers to achieve higher market penetration and profitability, the restriction on the number of new branches will be removed first for domestic insurers, and subsequently for foreign insurers. Approvals for new branches however, will be subject to an assessment of the financial capacity of the insurer to sustain its expansion plans.

Recommendation 4.8:

Allow insurers to distribute other personal financial service (PFS) products

To enable insurers to make more effective use of the agency force and other distribution channels, insurers will be allowed to distribute PFS products other than insurance on behalf of licensed third parties. This is in keeping with the trend towards the emergence of one-stop financial service providers that offer consumers a broad range of savings and investment options. It will also allow insurers to compete with other providers of financial services such as banks which are already allowed to offer a range of financial products, including insurance, as third party distributors.

Recommendation 4.9:

Introduce independent financial advisers (IFAs)

Consumers in Malaysia currently find it difficult to obtain professional independent advice on financial options, including insurance, that will most effectively meet their financial needs. Different forms of representations received from various tied agents and distributors who act for, and are remunerated by particular financial institutions tend to make comparisons between alternative solutions difficult for consumers.

Therefore, certified IFAs who can represent a broad range of competing financial service providers will be introduced in Malaysia. Products sold by IFAs for other institutions may include insurance policies, unit trusts, bonds, shares, mortgage loans, savings accounts and term deposits. Requirements on the certification, admission and standards of 'best advice' for IFAs would need to be developed. Mechanisms, including an ombudsman function, for consumers to seek recourse against any misconduct by IFAs will also have to be in place before IFAs are introduced into the market.

Recommendation 4.10:

Introduce reinsurance quota regulations

Prior to lifting the existing voluntary cessions to the national reinsurer, Malaysian National Reinsurance Berhad (MNRB), the maximum reinsurance cession rates will be specified for certain lines of business, the level depending on the availability of domestic capacity to absorb those risks. This is aimed at

ensuring that the goal of optimising national retention capacity is not compromised with the eventual removal of voluntary cessions to MNRB.

Recommendation 4.11:

Remove voluntary cessions to MNRB

To enhance competition in the reinsurance sector to the benefit of insurers and ultimately consumers, voluntary cessions to MNRB will be gradually removed. The market agreement governing the voluntary cessions to MNRB is subject to regular revisions with a view to progressively reducing the percentage of business required to be ceded to MNRB.

Recommendation 4.12:

Allow qualified players to sell takaful products

To foster a competitive and innovative takaful sector to complement conventional insurance, qualified players will be licensed under the Takaful Act 1984 to sell takaful products. The opportunity to offer takaful products will allow for the development of a niche market for domestic players.

Recommendation 4.13:

Remove caps on operating expenses

The existing cost control guidelines have served the industry well in the past by instilling financial discipline among insurers and promoting healthy competition. However, with the rapid changes taking place in the market, driven in large part by technological advances, such cost controls may be perceived to inhibit insurers from making large investments necessary to remain relevant and competitive.

To spur the development of a more efficient and effective insurance sector, the limits on operating expenses (including management expenses, agency commissions and agency-related expenses) and restrictions on agency structure will be gradually removed. The expected effects include greater management freedom for insurers to make investment decisions to improve their long-term competitive positions, attract and retain best talent, and create value to increase market share. While operating expenses may rise in the short term, the more price competitive environment and more consolidated market will contain operating expenses and in the process, stimulate the growth of alternative and more efficient distribution channels.

Recommendation 4.14:

Encourage commission disclosure

With the abolition of cost controls, insurers will be encouraged to disclose the amount of commissions paid to agents. Disclosure promotes transparency by providing consumers with information on the pricing structure of products sold by insurers, hence enabling consumers to make more informed decisions between alternative products available in the market.

Recommendation 4.15:

Deregulate pricing of general insurance products

While tariffs applicable to the dominant motor and fire classes of business in the general insurance sector have been effective in controlling unhealthy undercutting, they have also kept overall prices for general insurance products relatively higher than in most deregulated markets.

With the marked improvements in financial discipline and market conduct among insurers over the last decade and the more stringent solvency requirements introduced under the Insurance Act 1996, measures will be taken to progressively deregulate the pricing of fire and motor insurance products. The deregulation of compulsory motor insurance pricing will be pursued at a later stage as the premium rates for this class are already currently below cost. In lieu of tariffs, a 'file-and-use' system similar to that currently employed for life insurance products will be introduced for certain classes of business. To avoid 'product dumping' in the short term, insurers will not be allowed to introduce products with rate plans that have expected negative margins.

Apart from more competitive prices for consumers, price deregulation in the general insurance sector is also expected to have additional benefits in the form of:

- accelerated consolidation as a result of pressures on profit margins;
- increased specialisation and greater product sophistication as insurers begin to develop unique value propositions and products for different segments of the market in order to remain competitive;
- growth of alternative distribution channels to reduce business acquisition costs;
- development of more sophisticated pricing techniques to reduce cross-subsidisation between product lines; and
- greater efficiency in the industry as insurers strive to maintain profit margins by exercising more control over their expense and claims costs.

II. Promoting Consolidation and Strengthening Incentives for Improved Performance

Recommendation 4.16:

Increase the statutory minimum paid-up capital of insurers

To accelerate the consolidation process that will enable domestic insurers to capture the size and scale needed to compete effectively in a more deregulated and liberalised market, the statutory minimum paid-up capital required to be maintained by direct insurers will be increased progressively. Innovative players with unique value propositions should still be able to raise funds to meet the new capital requirements, while players with no distinctive competitive advantages will be compelled to consolidate.

Recommendation 4.17:

Strengthen 'fit and proper' regulations for board members and senior management

Given the increasing importance placed on the role of directors in corporate governance, and with it, greater responsibilities expected to be shouldered by directors, it is essential that the boards of insurers comprise members who possess the necessary educational qualification and experience in insurance or related fields which will enable them to effectively discharge their governance responsibilities. Accordingly, 'fit and proper' regulations prescribed under the Insurance Act 1996 will be strengthened to explicitly specify the minimum required qualification or experience for

directors and senior management executives of insurers. The new requirements will be enforced for all new appointments as well as reappointments.

Recommendation 4.18:

Encourage the introduction of performance incentives and evaluation processes

Performance incentives and evaluation processes will be established to ensure that board members and senior management act to increase shareholder value over time. In this respect, insurers will be encouraged to adopt best practices relating to the formation of nominating and remuneration committees responsible for developing policies on the appointment and remuneration of directors and senior management executives. The committees, consisting wholly or mainly of non-executive directors will also make recommendations on board appointments and carry out annual assessments of the effectiveness of the board as a whole as well as individual directors.

Insurers will also be required to make disclosure of compensations to senior management and directors in the annual report. Minimum disclosure of total compensations paid in aggregate will be required, with insurers free to disclose individual compensations at their discretion.

Recommendation 4.19:

Raise the entry requirements for the agency force

There is uniform consensus in the industry that the pre-contract examinations are too simple and theoretical, both in the life and general insurance sectors. There is a need to raise entry requirements

for the agency force. To this end, pre-contract examinations which individuals must pass to qualify as agents will be updated in line with higher standards applied in more developed markets.

Recommendation 4.20:

Introduce additional compulsory exams as part of continuing education programmes for agents

To ensure that agents continuously upgrade their knowledge and skills, additional compulsory examinations and/or practical tests will be introduced. Agents will be required to pass these examinations/tests after a certain period of service to be allowed to continue to operate as agents.

Recommendation 4.21:

Further strengthen performance-based supervision

Effective solvency supervision is vital to maintaining stability in the industry under more deregulated and competitive market conditions. To support this, supervisory systems and reporting requirements will be continually updated in tandem with developments in the market and changing risk profiles. This includes reviewing and updating performance indicators used as early warning signals and enhancing the statutory annual and quarterly returns. Indicators of contagion risks across banking and insurance sectors arising from structural or business linkages will also be developed to support the consolidated supervision of financial groups.

Recommendation 4.22:

Ensure effective enforcement of regulations

An important aspect of managing consolidation and the stability of the insurance system as competition intensifies is defining a standard intervention process

for troubled insurers. The Insurance Act 1996 already provides for the direction and control of defaulting insurers by BNM. These provisions will be reviewed to assess their adequacy in the light of experience gained from the recent Asian financial crisis and will be enhanced accordingly to ensure the effective enforcement of solvency regulations.

Recommendation 4.23:

Establish prudential risk management standards

International developments with respect to minimum capital adequacy ratios for insurers will be monitored. In the long term, the introduction of a risk-based capital model that applies different capital requirements for different risk profiles based on an insurer's asset structure and business mix will be considered. The decision of whether to adopt a similar model for Malaysia will depend on various factors, including an assessment of its ability to accurately capture and quantify risk exposures and the development of deep and liquid capital markets for risk in Malaysia.

Recommendation 4.24:

Remove investment restrictions

To allow insurers more flexibility to optimise their returns on capital allocations, the minimum required percentage of investments in Malaysian Government papers and maximum limit on investments in investment-grade bonds for the purpose of meeting the solvency margin requirement will be removed.

Recommendation 4.25:

Expand the role of the existing ombudsman

In a more deregulated market, the long-term supervisory focus will shift towards observing market conduct and acting on breaches of regulation. This will require the strengthening of consumer protection regulations and wider avenues for consumers to seek recourse in the case of misconduct by an insurer, agent, financial planner or adviser. To

achieve this, the role of the existing Insurance Mediation Bureau will be extended to encompass a broader ombudsman function (with avenues for appeal) which includes counselling, advising and adjudicating in disputes between policyholders and their own or third party insurers. Consumers will also be able to obtain general support and assistance in dealing with insurers and insurance intermediaries.

Recommendation 4.26:

Introduce 'best advice' regulations

To raise the professional standards of intermediaries, 'best advice' regulations, which hold intermediaries liable for their advice on sales of life and general insurance products will be introduced. The regulations will apply to tied agents, company representatives, brokers, IFAs and financial planners.

The regulations will require an intermediary to obtain sufficient information about a client to enable him to render best advice on financial products to meet the needs of the client. Under 'best advice' regulations, a tied agent or company representative is bound not to sell any product that he knows to be unsuitable for a client. Where he does not have a suitable product in his portfolio to meet the client's needs, he should refer the client to another company or intermediary. The regulations will also provide avenues for a consumer to take action and seek compensation against an intermediary that did not render him best advice.

Recommendation 4.27:

Strengthen regulations on unfair trade practices

In a more competitive market environment, regulations on unfair trade practices will be strengthened to ensure fair competition and market conduct. Regulations will be introduced to prohibit insurers from engaging in any unfair trade practices, including misrepresentations through false or misleading statements, entering into any agreement to commit any act of boycott, coercion or intimidation resulting in a market monopoly, making or permitting any unfair discrimination that is not properly justified between policyholders and knowingly committing or performing as a general business practice unfair claims settlement practices.

III. Stimulating Innovation Through Progressive Liberalisation

Recommendation 4.28:

Allow new insurance licences for innovative players

As a major stimulus to innovation by incumbent insurers, a limited number of new licences in specialised lines of business will be considered for new players with innovative value propositions. In addition to creating value for consumers with new products and potentially more efficient service levels offered by new players in the market, their entry will also drive incumbent insurers to improve their performance and invest in research and development and business strategies that will lead to greater efficiency and innovation in the industry. New licences will be issued selectively. Only concrete

proposals which demonstrate real value propositions that are feasible will be considered for approval.

Recommendation 4.29:

Allow financial and non-financial institutions to buy direct insurers

Subject to satisfactory progress being made in the consolidation of the insurance industry, new acquisitions of shares in insurers by financial and non-financial institutions will be considered (currently restricted to encourage mergers and acquisitions among insurers). This is expected to create business synergies that will further increase the level of insurance penetration in Malaysia.

Recommendation 4.30:

Open up the reinsurance industry fully to foreign competition

Given the nature of the reinsurance industry globally, and the enormous economies of scale needed, the development of a domestic reinsurance industry is neither feasible nor desirable. The admission of foreign reinsurers into the domestic market has helped to enlarge national capacity, facilitate the transfer of technical expertise to the domestic industry and contain reinsurance premium outflows. Retention levels in Malaysia have increased significantly over the last decade, particularly in the general insurance sector. Licences will therefore, be offered to new foreign entrants for the conduct of professional reinsurance business in Malaysia in addition to the number already offered and issued under the World Trade Organisation (WTO) Agreement.

Recommendation 4.31:

Increase caps on foreign equity

Malaysia's commitments under the WTO Agreement currently limit foreign equity in insurers to 30% for new foreign shareholders and 51% for original foreign owners of insurers. To promote the development of new product offerings and technical skills in the industry over the long term, the foreign equity limit for new entrants will be relaxed. However, the liberalisation of ownership by new foreign entrants will be sequenced accordingly to follow the development of a core of strong domestic insurers.

Approach to Implementation

While the recommendations adopt a market-driven approach towards capability building, performance improvement and industry consolidation, the transition towards the end game will be carefully managed to ensure that Malaysian consumers have access to products and services meeting international standards and at competitive prices.

The recommendations will be implemented in phases under a managed transition plan over a period of ten years. The transition path, designed to minimise instability in the industry and ensure rapid but sustainable reform, is being initiated with measures to strengthen the performance of incumbent insurers and encourage industry consolidation. Liberalisation of the insurance sector will follow once incumbent insurers are adequately strengthened to participate in the new business environment

expected to emerge following liberalisation. The ultimate goal will be to provide world-class products and services to Malaysian consumers while maintaining stability in the domestic industry.

Besides phasing in the transition, specific reviews of the development of the industry will also be undertaken to assess the extent to which the recommendations under each phase have been achieved. A task force will be formed to undertake the reviews. The task force will perform reviews (based on objective criteria and benchmarks which will be developed for this purpose) of the progress of the industry as a whole as well as that of domestic institutions on an individual and group basis. In addition, the task force will also recommend remedial measures where progress is found to be less than satisfactory. Based on these reviews, the pace at which subsequent measures under the Masterplan should be implemented will be determined, taking into account the interests of consumers and the industry.

chapter five
islamic banking
and takaful

Background

The Islamic banking and takaful industry has made steady progress since the establishment of the first Islamic bank in 1983 and the formation of the first Islamic insurance company (takaful) in 1984.

As at end-2000, the Islamic financial sector was represented by two Islamic banks, 47 conventional banking institutions (17 domestic commercial banks, four foreign-owned banks, 14 finance companies, five merchant banks and seven discount houses) participating in the Islamic Banking Scheme (IBS), an Islamic money market, two takaful companies and a broad range of financial products. Upon completion of the merger exercise among the domestic banking institutions, the number of conventional banking institutions participating in the IBS will be 33, comprising of nine domestic commercial banks, four foreign-owned banks, eight finance companies, five merchant banks and seven discount houses.

The significance of Islamic banking has been on a progressive upward trend, recording an average annual growth of 49% in terms of assets over the period 1995-1999. During the year 2000, the Islamic banking sector continued to register a strong asset growth of 30% to RM47.1 billion whilst deposits and financing increased to RM35.9 billion and RM20.9 billion, respectively. In terms of performance relative to the banking system, as at end-2000, the share of Islamic banking assets increased to 6.9%, whilst deposits and financing increased to 7.4% and 5.3%, respectively. The delivery channels have also improved significantly as there are more than 2,200 branches of Islamic banks and IBS banks offering Islamic banking products and services. Islamic banking has also spurred efforts by other non-bank financial intermediaries such as the development financial institutions, savings institutions and housing credit institutions to introduce Islamic schemes and instruments to meet their customer demands. In addition, the capital market has seen the rapid growth of Islamic debt securities and equity markets. To complement these developments, the Labuan IOFC has also embarked on a serious effort to establish an International Islamic Financial Market to stimulate the creation of liquidity and financial instruments as well as enhance investment opportunities aimed at greater mobilisation of Islamic funds.

On takaful activities, the takaful fund assets of both family and general takaful have registered an average annual growth of 68% for the period 1986-2000. Over the same period, total takaful contribution recorded an average annual growth of 47%. On the family takaful business, the total participation in force increased from RM16.7 million in 1986 to RM25.6 billion in 2000.

Although the performance of the Islamic banking and takaful industry has been encouraging, it is still relatively insignificant compared with conventional banking and insurance. The current market penetration level of Islamic banking of 6.9% in terms of assets implies a significant potential still remains untapped. On takaful business, the level of market penetration in terms of takaful certificates over the total population is only 2% compared with a market penetration of 28.4% for conventional insurance business. It is therefore timely to formulate specific strategies to develop further Islamic banking and takaful. Moving forward, these strategies will also contribute to strengthening Malaysia as a regional Islamic financial centre.

The ability of the Islamic banking and takaful industry to capture a more significant market share in a rapidly evolving and challenging financial environment is dependent on the strategic positioning of the domestic industry players to maintain the competitive edge and become market leaders. Specifically, the Islamic banking and takaful industry is expected to face the following challenges:

- Increased competition as a result of globalisation and financial liberalisation. The emergence of global conventional players in Islamic banking business is clearly evident particularly in the area of structuring Syariah-compliant investment and financing deals;
- Increasing role of technology in shaping the microstructure of business and financial markets, contributing to enhanced efficiency and competitiveness; and
- New generation of well informed consumers demanding differentiated and sophisticated products.

Against this backdrop, in order for the Islamic banking institutions (comprising of Islamic banks and IBS banks) and takaful operators to become leaders in the industry, compete effectively and at the same time preserve their niche, there is a need to:

- Strengthen their institutional and operational capacities and build their resilience to operate successfully in a highly competitive globalised environment;
- Improve their efficiency and effectiveness to be at par with international best players; and
- Intensify research and development efforts in Islamic financial product innovation. This will involve Islamic banking institutions (IBIs) and takaful operators to consider the possibility of forging strategic alliances to tap the research and development expertise developed outside the banking and insurance industry to create the range of Islamic financial products capable of meeting the customer requirements.

Vision and Objectives

The overall objective is to create an efficient, progressive and comprehensive Islamic financial system that contributes significantly to the effectiveness and efficiency of the Malaysian financial sector while meeting the economic needs of the nation. The specific recommendations are formulated with a view of building the capabilities of IBIs and takaful operators to compete effectively and to increase the significance of their market share in the financial system. In addition, the underpinning financial infrastructure needs to be strengthened to support the expansion of Islamic banking and takaful operations envisaged.

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

- Constitute 20% of the banking and insurance market share with an effective contribution to the financial sector of the Malaysian economy;
- Represented by a number of strong and highly capitalised IBIs and takaful operators offering a comprehensive and complete range of Islamic financial products and services;
- Underpinned by a comprehensive and conducive Syariah and regulatory framework;
- Supported by a dedicated institution (Syariah commercial court) in the judiciary system that addresses legal issues related to Islamic banking and takaful;

- Supported by a sufficient number of well-trained, high calibre individuals and management teams with the required expertise; and
- Epitomise Malaysia as a regional Islamic financial centre.

Recommendations

The set of recommendations presented seeks to build the necessary foundations in terms of capacity building, the provision of infrastructure and regulatory framework development, to achieve the vision and objectives outlined above. The efforts by BNM need to be complemented by that of the IBIs and takaful operators to bring about the crystallization of an efficient, progressive and comprehensive Islamic banking and takaful industry. The recommendations are therefore designed to focus on three main areas:

- **Institutional capacity enhancement**
Strategic steps will be taken to prepare the Islamic banking and takaful industry players to be among the best managed institutions, capable of capitalising on the unique features of Islamic banking and takaful to achieve significant competitive edge. The recommendations involve measures to ensure that the scarcity of skilled manpower in Islamic banking and takaful are adequately addressed. In addition, the development of management teams and the continuous application of benchmarking to elevate the performance level will be given due focus.

- **Financial infrastructure development**

Specific measures will be taken to promote a healthy competitive culture among the Islamic banking and takaful players and create sufficient market depth to build distinct competitive advantage in a dynamic financial environment. Among the initiatives in this direction entail the issuance of new Islamic banking and takaful licenses as well as the stimulation of Islamic financial engineering in product development and risk management. The emergence of the International Islamic Financial Market in Labuan is expected to play a complementary role in spurring the development of the domestic Islamic financial market by facilitating cross border access to global markets, players and expertise.

- **Regulatory framework development**

Concerted efforts will be directed to create a separate and viable platform for Islamic banking and takaful to function effectively in parallel with conventional banking and insurance. The legal, regulatory and Syariah framework of Islamic banking and takaful will be strengthened further through the review of the existing laws and guidelines governing the industry. Code of ethics will be one of the core determinants in disciplining the industry with less emphasis on central bank's intervention.

I. Institutional Capacity Enhancement

Recommendation 5.1:

Introduce a benchmarking programme

Benchmarking is essential for IBIs to be at par with international best practices. Hence, a benchmarking programme will be introduced to facilitate IBIs in evaluating their relative efficiency, identifying the performance gaps and formulating strategies to improve and deliver the best results.

Recommendation 5.2:

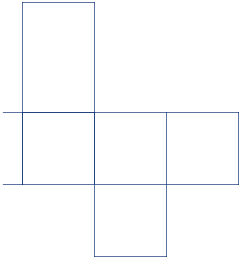
Enhance knowledge and expertise

To increase the pool of bankers and takaful operators who are knowledgeable and competent, efforts will be directed to promote human capital development to support the envisaged growth of the industry via:

- Establishing an industry-owned institution on Islamic banking and finance dedicated to train and supply a sufficient pool of Islamic bankers and takaful operators as required by the industry; and
- Requiring IBIs and takaful operators to commit adequate budget allocation for skills development to enhance knowledge and expertise in the field of Islamic banking and takaful.

Complementary measures will also be taken to create and increase awareness amongst the public on the concept and advantages of Islamic banking and takaful as well as customer education on misperceptions. This will be achieved by:

- Encourage IBIs and takaful operators to embark on regular promotional programmes on Islamic banking and takaful. IBIs and takaful operators will be encouraged to form strategic alliance with institutions of higher learning to enhance knowledge on Islamic banking and takaful; and



- Enhance the teaching of Islamic banking and takaful in school curriculum and in institutions of higher learning.

Recommendation 5.3:

Build strong management teams

To build capable and innovative management teams committed to Islamic banking and takaful, the employment of experienced and qualified staff, including expatriates to facilitate transfer of knowledge and expertise will be encouraged. The recruitment of expatriates will complement the efforts made to build the skills of the domestic industry players.

Recommendation 5.4:

Grant incentives to structure Islamic private debt securities (PDS)

As part of the effort to nurture major domestic players as well as market makers in the Islamic capital market, IBIs will be given incentives to originate and arrange Islamic PDS.

II. Financial Infrastructure Development

Recommendation 5.5:

Increase the number of Islamic banks to stimulate competition

In order to capitalise on competition as the driving force for growth, the number of full-fledged Islamic banks will be increased over the medium term. As an

interim measure, efforts will be directed to develop potential eligible players by reviewing the Islamic Banking Division (IBD) structures and formulating policies to strengthen these IBD models. This will also provide the basis to identify potential players that have achieved the critical mass with the adequate infrastructure and that are ready to operate as full-fledged Islamic banks.

To stimulate greater competition and to accelerate greater international integration, consideration will be given to issue Islamic banking licenses to qualified foreign Islamic banking players that have presence in the global Islamic banking industry.

Recommendation 5.6:

Increase the number of takaful operators

New takaful operators will be licensed to achieve the following:

- To accelerate the expansion of takaful business in parallel with the relatively advanced Islamic banking;
- To inject greater market competition in terms of pricing, product innovation, customer service and operational efficiency;
- To facilitate retakaful among takaful operators in line with Syariah principles;
- To promote ASEAN Retakaful International (L) Ltd.

as the leading retakaful operator in the region;
and

- To promote Malaysia as a centre for takaful expertise.

Recommendation 5.7:

Deepen the Islamic financial market

To further promote Malaysia as an Islamic financial centre, a deep market structure will be developed to fulfil the diverse and sophisticated requirements of customers whilst safeguarding the soundness and integrity of the financial system as a whole. In this respect, measures will be directed to:

- Intensify research and development efforts in the field of Islamic banking and finance. These initiatives will be undertaken independently by the IBIs as well as on a collective basis via the industry-owned research and training institute;
- Devise a comprehensive approach to risk management and appropriate mechanisms to mitigate risks. This is due to the different contractual relationship in Islamic financial transactions between IBIs and their customers thus giving rise to distinct risk attributes. It is also important for the asset and liability committee in IBIs to focus on building a financially sound portfolio to sustain the competitive edge of IBIs in a dual banking environment; and
- Encourage the application of mudharabah and musyarakah financing via the setting up of a special fund or subsidiary to undertake these modes of financing. IBIs need to carry out studies

to identify the potential areas in which these modes of financing will be most feasible.

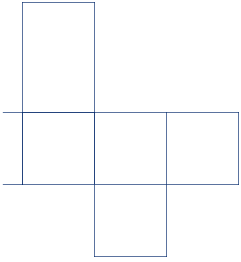
III. Regulatory Framework Development

Recommendation 5.8:

Strengthen the regulatory framework for Islamic banking

The impetus for future growth has to emanate from a separate regulatory platform in order for the industry to break away from its infancy stage and focus on its own set of banking principles. As such, emphasis will be given towards:

- Strengthening the Islamic Banking Act (IBA) 1983 taking into account the distinct characteristics of Islamic banking while not compromising the regulatory and prudential aspects. The revised IBA will create a conducive environment for Islamic banks to move towards a supervised market approach and framework;
- Fine-tune the BAFIA to accommodate the unique characteristics of Islamic banking. IBS banks will be further regulated to ensure that the risk management profile of the banking institutions with regard to Islamic banking operations are adequately addressed and monitored;
- Developing a regulatory framework for Islamic banking by introducing a separate capital adequacy, statutory reserve and liquidity requirement both for Islamic banks and IBS banks; and
- Harmonising the Syariah opinions on Islamic banking and finance to enhance efficiency and promote market development.



Recommendation 5.9:

Improve the regulatory framework for takaful

A comprehensive regulatory and supervisory framework will be developed to support the sound expansion of the takaful industry. Among the main areas covered are as follows:

- Review the Takaful Act 1984 and subsidiary legislations to address the existing inadequacies of the acts;
- Progressively increase the statutory minimum paid-up capital of takaful operators to equip them with sufficient capital base to strengthen their capacity to grow and absorb greater risks. An enhanced capital base for takaful operators will also improve their ability to compete effectively in the domestic market and subsequently, at the international level;
- Introduce accounting standards for takaful business and draft Model Accounts for takaful operators; and
- Monitor and refine further the code of ethics and standard market practices for takaful operators.

Recommendation 5.10:

Establish an effective legal structure

One of the pre-conditions to sustain the continuous growth of Islamic banking and takaful is a comprehensive legal infrastructure to seek any legal redress arising from Islamic financial transactions. A sufficient number of competent lawyers and judges equipped with sound knowledge and expertise in both Syariah and civil laws is needed to handle legal matters on Islamic financial contracts to promote

confidence amongst the industry practitioners and customers. In this regard, steps will be taken to:

- Form a committee to establish a Syariah commercial court dedicated to deal with legal matters on Islamic banking and takaful. In the interim, an Islamic banking tribunal will be formed to serve as a foundation for the ultimate establishment of the proposed court; and
- Design dedicated awareness and training programmes for judges and lawyers on Islamic banking and takaful, to be conducted by the industry-owned research and training institute in consultation with the Judiciary and Bar Council.

Recommendation 5.11:

Create a favourable tax regime

Formulation and amendments to tax policies to take into consideration the impact on Islamic banking and takaful to avoid creating barriers in adopting Islamic banking concepts and takaful products.

Approach to Implementation

The implementation of the master plan for Islamic banking and takaful will be undertaken under three phases:

PHASE I

Strengthening the operational and institutional infrastructure

Under this phase, the focus of implementation will be to prepare a viable platform for the sound expansion of Islamic banking and takaful. This involves improving the prevailing operational structure of IBIs, establishing the industry-owned

research and training institute, formulating an effective Syariah and regulatory framework, preparing a preliminary legal structure as well as creating market depth. Efforts to enhance the capabilities of IBIs and takaful operators will also begin under this phase to prepare them for increased competition under Phase II. In addition, the first phase will entail the identification of potential IBS banks (domestic) and insurance companies deemed eligible to be accorded new Islamic banking license and takaful license under the second phase.

PHASE II

Stimulating competition and upgrading the infrastructure

Under the second phase, new licenses will be issued to qualified domestic industry players to stimulate increased competition. The focus under the second phase will be to enhance performance as well as to upgrade the infrastructure of the Islamic banking and takaful industry.

PHASE III

Raising performance standards through progressive liberalisation and ensuring an effective infrastructure

Phase III will involve the issuance of Islamic banking license to qualified foreign Islamic banking players which would drive improved performance, leading to enhanced efficiency and financial innovation in the industry. In addition, measures will be directed to ensure the development of a comprehensive and effective infrastructure to support the financial operations of IBIs and takaful operators in a more liberalised environment.

chapter six
development
financial institutions

Background

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

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

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

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

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

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

Vision and Objectives

It is envisaged that DFIs would continue to progress and assume a significant role in addressing the development strategies of the nation by complementing the established banking institutions to meet financing requirements of the changing economy. The DFIs would continue to provide financing to promote the industrial sector, the services sector and the modernisation of the

agriculture sector, thus providing support to the development of these sectors. The DFIs would also continue to maintain their role as niche providers of capital financing for projects which require medium to long-term financing in the industrial, manufacturing, services and agriculture sectors.

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

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

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

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

In summary, the objective is to achieve the following:

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

Recommendations

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

Recommendation 6.1:

Define clearly the strategic focus and role of the DFIs

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

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

- Sectors which banking institutions are not equipped with the expertise to appraise, including projects involving complex industrial and agricultural technology;
- Sectors or projects which require lenders to assume venture-type risks which should not be funded from depositors' funds; and
- Projects requiring longer term funding which are not normally provided by the banking institutions.
- As **specialised institutions**, the DFIs should enhance their range of facilities through product and service innovation to sustain growth in the specialised areas. Emphasis should also be given in providing value-added advisory, consultancy and technical assistance supported by strong research capabilities.

Recommendation 6.2:

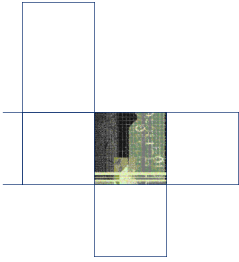
Enhance institutional capacities and operational structure

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

- Formulate comprehensive policies and operational procedures in line with the organisational objectives. DFIs' financing policies should ensure that loans and investments are provided with the

proper viability study, credit evaluation and risk assessments;

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



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

Recommendation 6.3:

Enhance performance measurement

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

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

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

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

Recommendation 6.4:

Introduce a systematic framework for sourcing funds

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

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

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

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

Recommendation 6.5:

Continue Government's support to the DFIs

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

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

Recommendation 6.6:

Strengthen corporate governance

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

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

Recommendation 6.7:

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

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

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

Recommendation 6.8:

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

An effective RSA should have the following attributes:

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

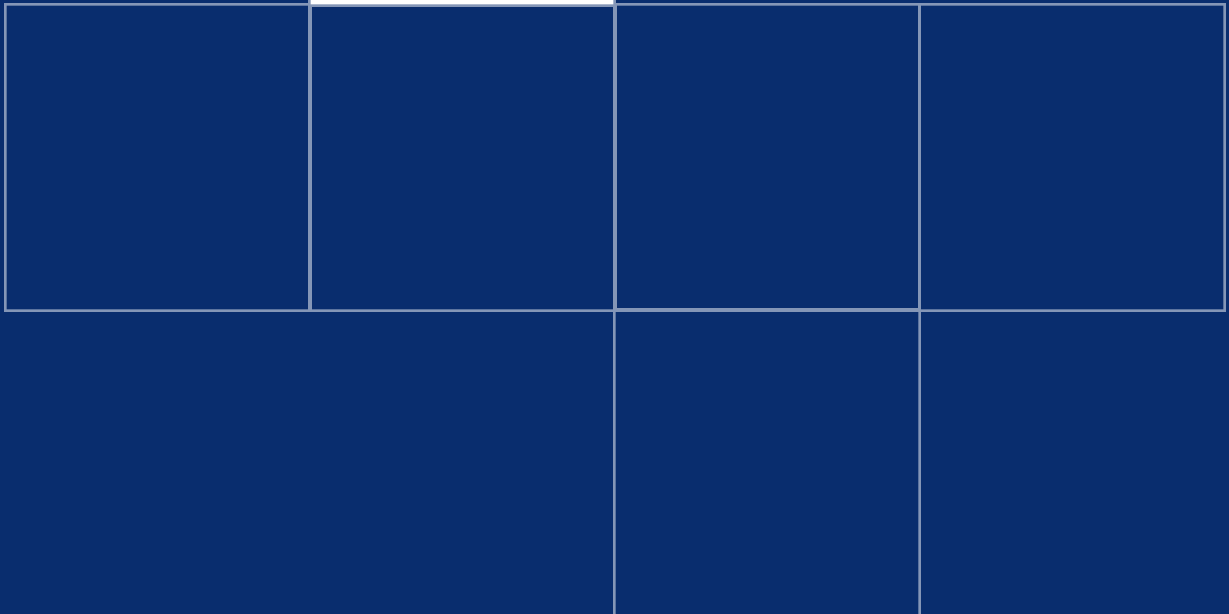
- Facilitate effective coordination and communication among policy makers and the DFIs.

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

Approach to Implementation

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

chapter seven
alternative modes
of financing



Introduction

Traditional sources of funding through the banking institutions continue to be the main source of financing for economic activities.

As the economy transforms into one in which service and productivity will drive growth, different sources of financing are required whereby risks should be borne by those most able to absorb them.

The financial sector infrastructure will need to change to accommodate the substantial financing requirements of new activities and industries. Going forward, while financial institutions would need to transform to remain innovative and responsive to demands of their customers, efforts need to be directed to facilitate financing by non-banks for high-risk ventures. These include financing for knowledge-intensive and technology-intensive start-up enterprises where only ideas (intangible collateral) are principal assets. As such, these knowledge-intensive and technology-intensive enterprises will need alternative forms of financing to complement traditional financing sources. These alternative modes of financing include among others, venture capital and credit enhancements such as financial guarantee insurance and agriculture insurance.

I. Venture Capital

Malaysia's venture capital (VC) industry is still at an infant stage of development. While progress has been made in developing Malaysia's VC industry since the first VC company began operations in 1984, further development is required if Malaysia is to move into the next stage of development and become more technology and knowledge based. Recognising the importance of VC as an alternative form of financing, the Government has over the years been very supportive of the VC industry. Efforts have been focused on creating a favorable environment for VC activities to thrive. These include among others the Multimedia Super Corridor initiative; the tax incentives for the VC industry; the establishment of special VC funds; the establishment of technology parks; the enactment of the necessary legal framework to protect intellectual property rights; the enhancement of the Kuala Lumpur Stock Exchange (KLSE) and the setting up of the Malaysian Exchange of Securities Dealing and Automated Quotation (MESDAQ) as viable exit routes for VC companies; the formulation of a National Action Plan for Industrial Technology Development; and the establishment of the Malaysian Technology Development Corporation and the Malaysian Technology Forum (see Box on Measures Taken to Promote the VC Industry).

In line with the rapid growth in the technology sector in the region, Malaysia needs to undertake further measures to create a more conducive environment for the development of the Malaysian VC industry. At the end of 1999, 30 VC companies (VCCs) have been established, with a total fund size of RM1.8 billion. As such, the VC industry currently

represents 0.15% of the total assets of the domestic financial system. Similarly, VC financing, as a percentage of Gross Domestic Product (GDP), remains low at only 0.05%.

Going forward, in order to be able to meet the new financing needs of the economy effectively and efficiently, the Malaysian VC industry needs to be further developed. Specifically:

- The skills and expertise levels of local venture capitalists to evaluate start-up ventures, particularly technology-intensive ventures need to be strengthened;
- Local venture capitalists need to increase their risk appetite towards new technology start-up ventures in order to reap the opportunities of investing in companies with high potential;
- The local VCCs should build their global networks to acquire the extensive global contacts that can provide Malaysian start-up ventures with the necessary export market opportunities and partnership prospects;

Measures Taken to Develop the VC Industry

The Government has introduced several measures to promote the development of VC industry in Malaysia. These measures include:

Special Funds for VC Industry

- A fund of RM200 million was launched to finance high-tech projects. Bank Industri Malaysia Berhad was restructured to become Bank Industri dan Teknologi Malaysia Berhad and is managing the fund.
- Two VC funds for high-tech projects of RM150 million were launched. BNM channeled RM100 million each to Mayban Ventures Capital Company Sdn Bhd and Commerce Technology Ventures Sdn Bhd. These two companies contributed another RM50 million each. Total funds available for start-up companies amounted to RM300 million.
- A RM120 million fund, MSC Venture One, was launched by the Malaysian Development Corporation Sdn Bhd (MDC) to provide VC financing to information technology and multimedia companies.

Tax Incentives

VCCs are given full income tax exemption for a period of 10 years or the lifespan of the fund, whichever is shorter, provided that 70% of the funds invested in venture companies are at start-up, seed capital and early stage financing.

The Government also recognised that a holistic solution is needed to promote a well-developed venture capital industry in Malaysia. In this regard, the Government has put in place many of the crucial ingredients to catalyse the development of a venture capital community. These building blocks include:

- the Multimedia Super Corridor initiative, including Cyberjaya and smart schools;
- the setting up of Technology Park Malaysia and incubation centres;
- the acceleration of the university building programme, including technology universities such as the Multimedia University;
- the establishment of research institutes such as MIMOS Berhad and SIRIM Berhad;
- an effective legal framework to protect intellectual property rights, including the implementation of Cyberlaws;
- the establishment of the Malaysian Technology Development Corporation;
- the establishment of MESDAQ to provide a viable exit mechanism;
- the establishment of the Human Resource Development Fund; and
- the development of the knowledge-based economy Master Plan.

Apart from these efforts, the private sector has also taken initiatives in the development of the VC industry:

- the establishment of the Malaysian Venture Capital Association;
- the first business plan competition, Venture 2001, was launched on 3 November 2000, with the objective of converting potential ideas into actual business, attracting venture capital companies and fostering an entrepreneurial environment in Malaysia.

These other factors should be developed gradually in tandem with the development of the VC industry.

Recommendations

A holistic approach should be taken in developing a vibrant VC industry. Success in developing the VC industry requires that measures are taken to develop other related areas mentioned above (e.g. community of risk taking entrepreneurs, knowledge workers, credit culture, business angels, etc). These other elements must be developed in tandem with the VC industry. The recommendations for this holistic approach to the development of a vibrant VC industry have been proposed by BNM to the Government earlier. These recommendations include the establishment of a one-stop centre for VC, the establishment of a VC Fund, tax incentives for the VC industry and the liberalisation of the MESDAQ listing rules. Some of these recommendations have subsequently been announced in the Government 2001 Budget and are now in various stages of implementation. The recommendations also include those developed following discussions with other Government agencies, including The Office of the Science Advisor, Prime Minister's Department (recommendations 7.6 - 7.12 are drawn from the Report on Strategies for Strengthening the Venture Capital Industry in Malaysia to Support National Technology-Based Business Agenda and Report on Strategies for Promoting Business Angel Financing in Malaysia).

Recommendation 7.1:

Establish a 'one-stop' centre for VC

Recognising the need to ensure that there is accountability in promoting the VC industry and to ensure that the development of the VC industry is given priority and coordinated, the establishment of a 'one-stop' VC centre is necessary. This has now been announced in the 2001 Budget. The 'one-stop' VC centre will chart the strategic direction for the Malaysian VC industry and act as a single reference point for all Government initiatives and incentives.

In addition, the 'one-stop' centre will coordinate and ensure that other elements are developed in tandem with the VC industry in order to ensure that a holistic approach is taken to develop the VC industry.

Recommendation 7.2:

Establish a RM500 million VC Fund

A RM500 million VC Fund is being set up to increase the availability of VC financing in the economy and in the process, stimulate more new ventures, particularly the information communication technology industry. To ensure that the VC Fund is effectively utilised, the option for the management of the Fund to be outsourced to private sector corporations/individuals who possess the necessary expertise is being considered.

Recommendation 7.3:

Introduce further tax incentives for the VC industry

Tax incentives to further promote the growth of the VCCs, has been announced in the 2001 Budget. These tax incentives are in the form of tax deductions

Recommendation 7.8:

Provide training to VC professionals

To upgrade the expertise of local VC professionals to conduct due diligence, technology assessments and business appraisals, training needs to be provided. Suitable organisations should be identified and then accredited to provide training to VC professionals. Institutions of higher learning should also take the initiative to develop such training programmes.

Recommendation 7.9:

Increase the awareness of Malaysians regarding the roles and significance of business angels

Efforts should be initiated to inform Malaysians of the role and significance of business angels and to convey to Malaysians as to who is eligible as a business angel and how they can provide business financing, in particular at the seed and start-up stage of a business venture. A concerted effort should be put in place, whereby selected media can be used to regularly promote business activities. This is to encourage high net worth individuals to invest their investible funds in venture companies e.g. technology based businesses. The 'one-stop' VC centre could assume the role to coordinate this initiative.

Recommendation 7.10:

Establish more business angel clubs and networks

More angel clubs and networks should be established in Malaysia to facilitate communications between, and meeting with angels and entrepreneurs. These clubs will provide discussion avenues for angels seeking investments and entrepreneurs looking for funds.

Recommendation 7.11:

Establish more matching services

Matching services are organisations that help to match entrepreneurs looking for investors with VCCs/business angels. In particular, matching services should be established in strategic areas where high technology businesses are located such as in the Multimedia Super Corridor and Kulim High Tech Park.

Recommendation 7.12:

Establish technology appraisal centres in promoted high technology sectors

Technology appraisal centres that focus on the promoted high technology sectors should be established to enhance the capability and competency to assess technology-based business proposals. These centres will also help VCCs/business angels to assess technology-based business proposals.

II. Establishment of a Financial Guarantee Insurer

The development of the private debt securities (PDS) market has become even more urgent with the increased diversification of the Malaysian economy. A well functioning domestic bond market would not only provide borrowers with an alternative source of funding, but would also spread some of the credit risks associated with debt financing from the banking sector to the investing public. As the economy expands in depth and breadth, the financing for economic growth should emanate from a variety of sources. While bank borrowings should remain a significant source, the equity and bond market would be an important complement to bank borrowings. The measures initiated by BNM to promote the development of the ringgit bond market can be found in the box on Major Measures

Taken to Promote the Development of the Ringgit Bond Market. As of 1 July 2000, the Securities Commission became the single regulator for the bond market. To further support the development of the bond market, BNM has proposed the setting up of a financial guarantee insurer (FGI).

A FGI provides an unconditional and irrevocable guarantee of an insured obligation's principal and interest payments when due. The financial guarantee insurance policy provides for regularly scheduled payments of principal and interest on defaulted bonds – as opposed to prepayment of all outstanding principal and interest. The insurance (evidence of the insurer's favourable opinion on a bond, supported by the guarantee) enhances the credit quality of an issue, with the FGI essentially 'renting out' its claims-paying ability rating to the issuers of PDS. The primary economic value of the insurance to the debt issuer is the interest cost savings resulting from the difference between the market yields on an insured bond and on a similar bond without the enhancement.

The setting up of a FGI in Malaysia is envisaged to contribute to the development of the bond market through the following:

- **Diverting systemic risks from the banking sector**
Following the privatisation of non-financial public enterprises since the mid-1980s, much of the credit to finance growth, shifted from the public sector to the banking system, particularly in the late 1980s and early 1990s. This development arose partly due to a less developed capital market. The establishment of the FGI will help to spread out the risks in the financial system and add to the financial guarantee capacity of the financial system.
- **Mobilisation of domestic savings to fund long-term infrastructure projects**
Financial guarantee insurance would provide the mechanism for infrastructure projects to have greater access to fixed rate funding of longer maturities. This will minimise financing costs, maturity mismatching and therefore, reduce project risks associated with funding. As the long-term bond market develops, investors will have more quality bonds for investment and it will enhance liquidity in the bond market.
- **Better opportunity for credit enhancement**
Compared with the current situation of relying only on banking institutions for guarantees, bond issuers will have better opportunities of getting the credit rating of their bonds enhanced and at relatively cheaper cost through financial guarantee insurance.
- **Ensure payment obligations**
In the case of bank guaranteed bonds, any default would trigger repayment of the entire guaranteed amount, whereas financial guarantee insurance will allow payment of interest and capital obligations based on scheduled payment commitments. This would provide issuers with breathing space to restore their financial position. It would also enhance the asset liability management of the bond subscribers.

III. Financing the Agriculture Sector

The latter half of the 1980s witnessed a rapid expansion in the manufacturing sector as the domestic economy made a structural shift from being a primary commodity-based economy to one in which the manufacturing sector assumed a greater role. At the same time, the agriculture sector faced

Major Measures Taken to Promote the Development of the Ringgit Bond Market

The bond market in Malaysia has developed significantly in terms of market size, the wider range of instruments and products and a higher level of market efficiency. The progress made has enhanced the role of the bond market in supporting economic growth and transformation. Major positive developments to date include:

Infrastructure and Institutional Building

- Dec 1986** The national mortgage corporation, Cagamas Berhad was established.
- Jan 1989** A Principal Dealer (PD) System was introduced to promote a market-making scheme in government and selected securities in the fixed income market. The role of PD is to secure maximum participation in the auction of the papers and to provide liquidity through their continuous market-making activities.
- Jan 1990** A 'scripless' book-entry securities trading and funds transfer system, known as SPEEDS was launched. SPEEDS allows for the confirmation, transfer, recording and settlement for trades in securities electronically.
- Nov 1990** Rating Agency of Malaysia Berhad (RAM), the first credit rating agency in Malaysia, was incorporated.
- May 1992** All applications to issue private debt securities (PDS) were required to obtain a minimum rating of BBB for long-term papers and P3 for short-term papers from a recognised rating agency.
- Mar 1994** Cagamas Berhad issued the first mortgage bond based on Islamic principles known as Cagamas Mudharabah bond.
- Oct 1995** A second rating agency, the Malaysian Rating Corporation Berhad (MARC) was established.
- Jan 1996** SPEEDS was enhanced to act as the central depository/paying agent for unlisted PDS.
- Jun 1996** Incorporation of the Institut Peniaga Bon Malaysia (Malaysian Institute of Bond Dealers) to represent the interest of participants in the bond market.
- Aug 1996** A committee comprising SC, Registrar of Companies, BNM and rating agencies was formed with the purpose of promoting inter-agency cooperation among the various authorities in the bond market as well as to eliminate gaps in regulations and minimise duplications.
- Aug 1996** Amendment to the Companies Act 1965 to widen the investor's base and to simplify the requirements on the submission of prospectus.
- Sep 1996** Introduction of the Fully Automated System for Tendering (FAST) to improve the overall efficiency of the tendering procedures for government securities and Cagamas securities.
- Jul 1997** FAST was upgraded to include tendering of corporate commercial papers and medium-term notes.
- Sep 1997** Inaugural issuance of RM1 billion Khazanah Benchmark Bond with the aim to create a benchmark yield curve for the Ringgit bond market.
- Oct 1997** Setting-up of the Bond Information and Dissemination System (BIDS) to provide the market with centralised and comprehensive real-time data and to promote bond market awareness.
- Jul 1999** The deferred net settlement protocol (SPEEDS) was replaced with a real-time gross settlement system (RENTAS) to enhance liquidity and reduce settlement risks.

- Oct 1999** Ringgit Bond Market Internet Homepage was launched.
- Mar 2000** An auction calendar for Malaysian Government Securities was announced to develop a benchmark yield curve, enabling investors to structure the maturity of their portfolios.

Regulatory Framework

- Jan 1989** The Guidelines for the Issuance of Private Debt Securities was introduced by BNM.
- Jan 1990** Code of Conduct and Market Practices for Scripless Trading in the Malaysian Securities Market were introduced.
- Mar 1993** The setting up of Securities Commission (SC).
- Jun 1999** The National Bond Market Committee (NBMC) was established to provide overall policy direction and to rationalise the regulatory framework for the orderly development of the corporate bond market.
- Jul 1999** The Code of Conduct and Market Practices for Malaysian Scripless Market Under the Real Time Electronic Transfer of Funds and Securities (RENTAS) System were introduced to facilitate the conversion from the SPEEDS system to the RENTAS system.
- Oct 1999** The Capital Market Master Plan was initiated.
- Apr 2000** General permission was granted by the Controller of Foreign Exchange for the issuance of private debt securities so long as the proceeds from the bond issues were not used to finance investments abroad or refinancing off-shore borrowings.
- Jul 2000** SC was made the single regulator for all matters pertaining to the issuance of private bonds by the private sector.
New guidelines and regulations were introduced to the market to facilitate an efficient issuance process, widening the issuer and investor base.
Amendments to the Banking and Financial Institutions Act 1989 (BAFIA) to allow more players to undertake repurchase agreement (repo) with the licensed financial institutions.

Fiscal and Financial Incentives

- Jan 1989** Waiver from stamp duty for all instruments relating to the issue and transfer of company bonds, which issue had been sanctioned by BNM.
- Jan 1992** Tax exemption on interest earned by individuals investing in bonds (other than convertible loan stock) issued by public companies listed on the Kuala Lumpur Stock Exchange.
- Jan 1993** Tax exemption on interest earned by individuals investing in bonds (other than convertible loan stock) issued by a company rated by RAM or MARC.
- Oct 1994** Withholding tax for foreign investors on interest earned was reduced from 20% to 15%.
- Oct 1995** Tax exemption on interest income received by unit trusts and listed closed-end funds from corporate bonds (other than convertible loan stock).
- Jan 2000** Waiver from stamp duty for all instruments relating to the issue and transfer of private debt securities, which issue has been approved by BNM and SC (on instruments executed on or after 30 October 1999 but not later than 31 December 2000 for the purpose of securitisation).

declining prices of rubber and cocoa which affected hectareage of the crops and made the development of agricultural food crops less attractive. A combination of these factors caused the contribution of the agriculture sector to GDP to decline from 20.8% in 1985 to 16.3% in 1990 and to stabilise at 9.2% - 9.8% since 1997.

In order to restore balanced growth in the economy, the Government has taken steps to revitalise the agriculture sector. The Third National Agricultural Policy (NAP3), which was launched in 1999, provides the policy framework for the growth of the agriculture sector up to the year 2010. The focus of NAP3 is two-fold. The first is to develop linkages in the use of resource-based products to increase value added in manufacturing activities. Secondly, food crop production will be increased by transforming the sector into large-scale and commercialised farming.

During the NAP3 period, the agriculture sector is targeted to achieve a growth rate of 2.1% per annum. The NAP3 targets will require significantly greater private sector participation. The growth target requires a total investment of RM32 billion over the next ten years in the agriculture sector with estimated contributions from the private sector of RM21 billion (RM11 billion from the public sector).

The financing of the agriculture sector has essentially been from three major sources, namely, the banking system, development agencies (FELDA and Sabah Development Bank) and rural credit institutions (Bank Pertanian Malaysia (BPM), Bank Kerjasama

Rakyat Malaysia Bhd and farmers' organisations and co-operatives). As at end-1999, financing from the banking system accounted for the largest share (65.8%) of the total loans to the agriculture sector. However, loans extended to the agriculture sector was only 2.4% of total loans extended by the banking system as at end-November 2000. This essentially reflected a combination of factors including, low demand for new investment in agriculture, the lack of skills among bankers to evaluate agricultural projects and on the part of borrowers, the lack of skills in loan application procedures.

BNM has been working with the Ministry of Agriculture and the banking institutions to address the issue of availability of credit to finance activities in the agriculture sector. In order to meet the financing requirement under NAP3, several options have been considered. At the same time, efforts are being directed to enhance the operations and efficiency of BPM to enable the bank to play a more effective role in providing credit to the agriculture sector.

In supporting the NAP3's objectives, BNM is also working with the insurance industry to identify and ensure the availability of insurance coverage and services required under the NAP3. In this connection, a task force on agriculture insurance has been set up consisting representatives from BNM, the Ministry of Agriculture, BPM and insurers, to develop the appropriate insurance protection and services for the agriculture sector to complement the other efforts on enhancement of credit sources for financing of agriculture activities.

Recommendations

Recommendation 7.13:

Establish a one-stop agriculture research and development centre as well as a comprehensive and integrated information database

To facilitate banking institutions in their assessment of the specialised risks involved in agriculture financing, a one-stop agriculture research and development centre and a comprehensive information database should be established. It is to provide players in the agriculture sector as well as banking institutions and insurers access to the one-stop centre in an efficient, structured and cost-efficient manner. The database should be integrated and contain the most current and pertinent information pertaining to the agriculture sector. Access to this one-stop centre will help to enhance the knowledge, skills, expertise and experience of bankers and insurers as well as other interested parties regarding the key information on the agriculture sector. To expedite loan processing, the one-stop centre could also provide endorsements as to the viability of a specific agriculture project prior to borrowers submitting their loan applications to the banking institutions.

Recommendation 7.14:

Develop structured and systematic training programme for borrowers

All successful borrowers, in particular, the small-scale farmers, be required to undergo a specified, structured training programme in a systematic manner so as to ensure an orderly development of the players in the agriculture sector.

Recommendation 7.15:

Establish a risk-distribution mechanism that will reduce the risks to the financial institutions and at the same time, reduce borrowing costs through a guarantee and insurance protection scheme

Recommendation 7.15.1:

Establish an agency to provide guarantees

For the purpose of the guarantee scheme, the role of BPM should be expanded to provide guarantees on agriculture-related loans in view of its existing infrastructure in terms of expertise, experience and its extensive branch network. The shareholding structure of BPM should be restructured and diversified to include financial institutions, similar to the shareholder structure of the Credit Guarantee Corporation Berhad. Apart from providing guarantees, BPM should also provide various other ancillary advisory services such as marketing, distribution and the identification of new markets in agricultural activities.

Recommendation 7.15.2:

Diversify insurance protection schemes

The range of insurance products should be diversified to cater for the unique features of the various subsectors within the agriculture sector. To facilitate the formulation of premium and design of different products, it is imperative that certain parameters such as the total planted hectareage, production cost and expected losses to be identified at the outset. In addition, the services of consultants would also be required in view of the lack of experience, expertise and knowledge in underwriting agriculture risks and pricing of insurance cover.

Insurance coverage should be made compulsory and available, especially, for the smaller players in the industry, given their vulnerability. In particular, small players should also be required to obtain protection on a collective basis to achieve economies of scale.

Recommendation 7.16:

Provide subsidies to the agriculture industry

As in many countries with a successful and developed agriculture sector, direct financial assistance should be provided in the form of subsidies, especially the small scale farmers. The subsidy would act as a means to help reduce the insurance costs which is expected to be high, given the risks involved. The subsidies can be funded through annual budgetary allocations by the Government.

Recommendation 7.17:

Grant tax exemptions

Apart from subsidies, financial assistance can also be in the form of tax exemptions. Incentives in the form of exclusion of the amount set aside in general and specific provisions as well as interest-in-suspense on loans channeled to the agriculture sector from the assessment of taxable income can be considered.

In addition, where there are insurance pools, contingency subsidies should also be extended in the event of adverse natural disasters and catastrophes, as experienced during the recent Nipah virus outbreak. This is an important consideration in order to ensure the pool has sufficient financial resources for its continued existence.

chapter eight
labuan international
offshore financial
centre

| | | | |
|--|--|--|--|
| | | | |
| | | | |

Background

Labuan was declared as an International Offshore Financial Centre (IOFC) in October 1990 to complement the activities of the domestic financial market in Kuala Lumpur, strengthen the contribution of financial services to Gross National Products of Malaysia as well as develop the island and areas within its vicinity.

Specifically designed legislation and regulations, primarily based on experiences of other IOFCs around the world, provide the framework for business in the IOFC.

Combined with a flexible and favourable tax treatment and low cost of setting up and operating in the IOFC, this framework has succeeded in attracting substantial numbers of international businesses to domicile in Labuan, including 60 world leading banks, 78 insurance and insurance-related companies, and 20 trust companies. These institutions conduct the core businesses of the IOFC.

Of significance is that the players in the IOFC come from a highly diversified country of origin, reflecting growing global awareness as well as recognition and acceptance of the IOFC as an attractive, viable and cost-efficient financial centre.

The IOFC operates in a rapidly changing and increasingly competitive marketplace. Its business environment and business rules of the game have continuously evolved to become more business friendly. With the rapid advancements in information technologies, business strategies are now changing and geographical location is no longer a major deciding factor.

The ability of the IOFC to remain competitive depends heavily on its innovative capability, efficiency and market orientation. The IOFC and its players must stay forward-looking and agile in the new financial climate as well as constantly promoting new business solutions and technologies such as efficient delivery channels. Of importance, to enhance the IOFC growth prospects, is the collaboration and smart partnership between the government and the private sector to drive this process.

While the IOFC's regulatory framework is favourable and market driven, it is balanced with prudential requirements in line with accepted international regulatory practices and standards. The regulatory regime places strong emphasis on the preservation of its reputation as a credible centre, free of undesirable activities.

In the early years of the IOFC, the strategic focus was on attracting the critical mass of core and top players that can provide services and products to investors investing in this region. The quality and reputation of the players have been instrumental in the shaping of an active and clean offshore industry in the IOFC. Having succeeded in this, the thrust is now to build on the strength and expertise of the existing players, and encourage proactive expansion of the scope and breadth of services and products in the IOFC.

The efforts to attract more players to the IOFC will continue. The increase in the number of players in addition to the banks, insurance companies, trust companies, Islamic institutions, are other support service providers such as legal and accounting firms. This is also important to generate further expansion in economic activity for the island. In attracting new players to the IOFC, target groups should be identified. The overall development of Labuan, however, cannot rely on just the offshore financial services industry. Labuan needs to develop other complementary industries such as tourism, manufacturing industries and education.

Vision and Objectives

The IOFC in the future is not only a centre that thrives on the offshore financial services, but also one, which is developed holistically to support the development of the island, and plays an effective complementary role to the domestic financial market. Several areas can be further developed in the IOFC. These include enhancing the Islamic banking business with the establishment of an international Islamic financial market as well as developing the banking and insurance sectors to become a significant regional hub while taking the lead in retakaful business. The recommendation to set up a financial exchange and electronic commerce facilities has now been implemented. Labuan is also now being promoted as a meeting and conference centre in addition to tourism to enhance the development of Labuan as an IOFC.

Recommendations

The ensuing recommendations are made in three main areas as follows:

- i. Promote and diversify further the financial players and activities in the IOFC;
- ii. Promote the development of Islamic banking and retakaful business; and
- iii. Develop and strengthen the capital market, e-commerce and the ancillary activities.

I. Promote and Diversify Further the Financial Players and Activities in the IOFC

Recommendation 8.1:

Develop an active International Offshore Financial Centre for Malaysia

Malaysia needs an active offshore financial centre that is able to support the increasing demands of the domestic economy. Expansion of the local businesses abroad for instance requires a complete chain of financial services ranging from advice on the investee company, place of business to financing the project in foreign currency. Demands for assistance in arranging financial swaps and issuance of PDS are becoming more prevalent in the growing Malaysian economy. Offshore financial institutions also provide competition to the onshore banks. In this regard, the offshore financial institutions play an important complementary role in the Malaysian financial

system. Measures to strengthen the position of the IOFC will continue to be taken as follows:

- Offshore banks and offshore insurance companies would continue to have the rights of first refusal to offshore business services required by Malaysian corporates, financial institutions and the Government. These entities on the other hand are expected to make their presence felt in the local industry by providing competitive and efficient services and products; and
- In managing the transition to greater international competition envisaged in the liberalisation of the Malaysian financial markets, priority will be accorded to international competitors who are based in Labuan and have the necessary skills, manpower and systems located in Malaysia. This will be done gradually, as has already taken place through the ringgit loan and investment windows that have been made available to Labuan offshore banks.

Recommendation 8.2:

Review existing rules and regulations to facilitate expansion in the scope of core businesses

New business should be explored and developed to widen the scope of offshore business in the IOFC. In this regard, a review will be made on the existing rules and regulations, which is deemed to impede the progress and further development of the offshore business. The legislation needs to be

reviewed to facilitate new businesses, and at the same time allow the offshore service providers to maximise their capabilities and expertise to expand their businesses. The areas that can be considered are:

- Incorporation or registration of various other types of offshore companies, which can be used for administrative and operational efficiency purposes, by both non-residents and residents. These include external companies– a company that is incorporated in one jurisdiction but carries on business in another jurisdiction, and managed foreign domiciled companies– the administration of companies that are registered outside the IOFC;
- The trust companies in the IOFC are domestic companies incorporated under the Companies Act 1965, and are subject to domestic rules and tax. The domicile status of Labuan trust companies needs to be changed to that of offshore companies to facilitate their dealings and to encourage foreign trust companies to be based in Labuan. An immediate impact from the increase in the number of trust companies to the local economy would be on employment given that trust companies are more labour-intensive than the other industries. In the interim, trust companies in Labuan are allowed to manage trust companies of other jurisdictions in order to expand the horizon of their business, as well as to maximise the available administrative skills and experience in Labuan;
- In the area of insurance, the IOFC can be developed as a centre for innovation of new and sophisticated insurance products and services. The

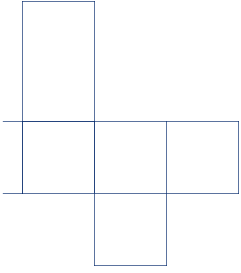
policy direction for the future development of the offshore insurance industry includes developing the IOFC as an active reinsurance and captive centre, including rent-a-captive business. In this regard, the number of insurance companies, knowledge, skills and expertise needs to be enhanced;

- There is a need to rationalise the roles of offshore banks to fully complement their activities with that of the domestic financial market. The critical mass that has been attained in the offshore banking industry can be further enhanced through the entry of more banks, both conventional and Islamic. Financial institutions with sound track record, accorded with a good credit rating by acceptable rating agencies, supervised by a relevant regulatory body and that conform to the accepted standards of international practices will be encouraged to set up their operations in the IOFC. There will not be any compromise on quality and prudence, as the entry to the IOFC will continue to be restricted to sound and well managed institutions; and
- Facilitate the setting up of its treasury centres for multinational corporations, and financial institutions, particularly for the offshore banks.

Recommendation 8.3:

Adopt a consultative and market driven approach to create a conducive tax and business environment

The IOFC is not designed to be a tax haven. The conducive tax environment in the IOFC reflects its efficiency in lowering the cost of operations for offshore companies. Continual review and assessment of tax structure will be done to ensure Labuan remains competitive and



attractive. Towards this end, the Labuan Tax Advisory Council, a consultative body comprising tax experts, practitioners and regulators, has been formed. It is a smart partnership that will maximise the tapping of expertise and knowledge for the positive development of the IOFC.

This smart partnership concept will also be extended to cover the development of businesses and products for the IOFC. A Business Consultative Council, similar in nature to the Consultative Council of Labuan that has already been established will also be set up. Industry leaders and individuals with wide experience will be invited to be members of the business council.

Recommendation 8.4:

Benchmark against the best to maintain the low-cost operating environment

In order to be competitive, the IOFC has to maintain its low-cost operating environment which it enjoys today. In this regard, benchmarking against the leading IOFCs around the world in various areas of business will be established to ensure that the IOFC will always be competitive, especially in terms of pricing and cost of doing business. A study showed that the cost of operation in Labuan is one-third of the other financial centres in this region. Labuan should strive to further improve its competitiveness to attract more players and investors.

Recommendation 8.5:

Establish a well-balanced regulatory policy and supervisory framework

Offshore centres are under intense international scrutiny to comply with best standards of prudential supervision and regulation. The supervisory practice and legal framework in the IOFC is currently in

accordance with internationally accepted standards. These however need to be continually assessed and upgraded to ensure that they remain in line with the latest international supervisory requirements. At the same time, there is a need to balance between conducive and stringent regulatory environment. The necessary supervisory structures have been set up within LOFSA to conduct on-site inspection so as to preserve the IOFC as a reputable offshore centre conducive to quality players and genuine investors. Furthermore, the legislation on money laundering is now being finalised to safeguard the IOFC from being used for such activities.

II. Promote the Development of Islamic Banking and Takaful Business

Recommendation 8.6:

Strengthen Islamic banking and finance as well as Islamic insurance (takaful)

The strong Islamic banking, finance and takaful foundation already established in Malaysia provides a platform from which Labuan can be developed with a strategic focus on Islamic products and services. There is also a growing interest in Syariah-based financial services and products in the global financial market. These opportunities for the development of a niche market in Islamic banking, finance and retakaful can be pursued in the following initiatives:

- **Development of the International Islamic Financial Market (IIFM)**

Given the rapid growth in Islamic funds and growing interest in Islamic financing and investment globally, there is a strong basis to build a broader, deeper and more liquid Islamic financial market. This would allow issuers, investors and

intermediaries access to the same benefits of liquidity and price discovery that are available to conventional players in conventional markets. It would be a key contributor to the expansion of Islamic financing globally and, an essential precondition to the Islamic system to compete with the conventional system. Additionally, this is clearly an important driver to the efficiency, effectiveness and stability of Malaysia's own increasingly important Islamic banking sector. Once the IIFM is fully developed (which would encompass a money and capital market), it would have a synergistic role in enhancing the flexibility and risk management requirements of domestic Islamic financing.

- **Establishment of a consultative financial markets Syariah Advisory Council (SAC)**

This is to provide input for the development of Islamic banking, finance and takaful in the IOFC. As the champion for the development of the market, the IOFC has a crucial role to play in defining the standards and rules required to make the market function smoothly. It will provide the first mover advantage in building a critical mass of market participants and position Malaysia as a centre for Islamic finance with spin-off benefits for the economy. To ensure that the SAC has the credibility and acceptance in the global financial community, it will have international representatives, scholars and practitioners with strong credentials and wide experience.

- **Increase the number of Islamic players in the IOFC**

To develop the Islamic niche in the IOFC by building a critical mass of players and providing a range of Islamic financial instruments, interested financial institutions and takaful

operators would be invited to set up Islamic operations in Labuan IOFC as participants in the IIFM. In particular, Islamic institutions from the Middle East will be encouraged to set up operations in Labuan. As for Islamic instruments, the Government and large Malaysian conglomerates will be encouraged to capitalise on the readily available large investor market generated by the IIFM to issue Islamic financial instruments.

- **The IOFC to develop retakaful business with global reach and capacity**

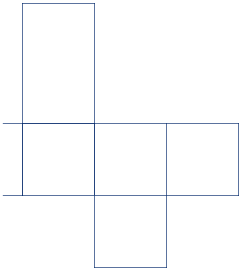
The growth of takaful and Malaysia's expertise in developing Islamic insurance products has gathered momentum. Globally, there are less than 40 takaful/retakaful operators, mostly based in Saudi Arabia and Sudan. Estimates indicate that the takaful sector would grow by 25%-40% annually. There is currently also no strictly Islamic reinsurance available globally. The retakaful business remains an important potential area of business. There is therefore an opportunity for Malaysia, with Labuan as the natural domicile for the industry, to develop the global retakaful business in the longer term.

III. Develop and Strengthen the Capital Market, E-Commerce and the Ancillary Activities

Recommendation 8.7:

Enhance the Labuan International Financial Exchange (LFX)

The LFX was officially launched on 23 November 2000. It is a global exchange that provides listing and trading facilities for a wide range of financial and non-financial products (as well as Islamic products), including mutual funds, bonds, derivatives, insurance-linked products and, possibly, intellectual



properties. There are abundant opportunities for offshore players in the LFX including to provide custodial, depository, clearing and trustee services, other than being licensee as listing sponsors and trading agents. The LFX can be a major exchange capitalising on its many advantages including it being a one stop financial exchange, its extensive use of multimedia and internet, simplicity in its operations, customer orientation, and competitive listing fees.

At its early stage of operations, the support and participation of resident companies is important not only to promote market activity and add liquidity, but also to build international confidence and interest in the LFX. In this regard, domestic securities firms should be allowed to participate in the LFX, either as a listing sponsor or trading agents. Malaysian companies should give priority to the LFX when they plan to list their foreign bonds or other securities in international bourses.

Given its international accessibility, the LFX can also play a regional role by offering its platform to be a bourse for regional countries which do not have exchanges of their own. At the same time, the LFX can be used as a window for Malaysians wishing to invest abroad. The LFX can be a window for domestic institutions to expand their international business activity. The availability of a wide range of products and services will contribute to the overall efficiency of the Malaysian economy.

Recommendation 8.8:

Enhance the e-commerce gateway (ECG)

The IOFC needs to leverage the internet to effectively and efficiently reach out to the global market place. The ECG, that was launched on 23 November 2000, is a financial portal allowing access to information on products and services, including

real time pricing, available in the IOFC. With this electronic infrastructure and the conducive business environment in Labuan, global e-commerce operators are encouraged to set up domicile in Labuan. In time, this portal will be developed into a full-fledged e-commerce site with a focus on Islamic products, bringing together a variety of third party providers of Islamic services. Other businesses and other financial services activities such as a clearing-house for financial payments, a marketplace for financial products and backroom operation activities will be encouraged.

The ECG can also be the means for submission of statutory documents and statistical information to LOFSA, reducing the flow and handling of physical documents as well as improving the speed of processing.

Due to its wide reach and multimedia capabilities, the ECG can also be used as a marketing tool. Information on products and services can be widely disseminated, and easily accessed by market players. However, like traditional forms of business, e-commerce needs to be appropriately regulated. In the case of Labuan, the legislation for such activity should neither be too restrictive nor be too liberal. There has to be a balance between too much control which will discourage businesses and the lack of control which may allow unfavourable activities to be conducted.

It is therefore opportune to revive the concept of twinning Labuan with the Multimedia Super Corridor (MSC). Under this concept, MSC companies may enjoy MSC benefits in Labuan, while Labuan offshore companies can also capitalise on the MSC facilities. By this, Labuan could enhance the usage of its presently underutilised state-of-the-art technology infrastructure. Given that the LFX has

offered itself as a listing and trading platform for MSC companies, this link can be extended to other Labuan institutions under the twinning concept.

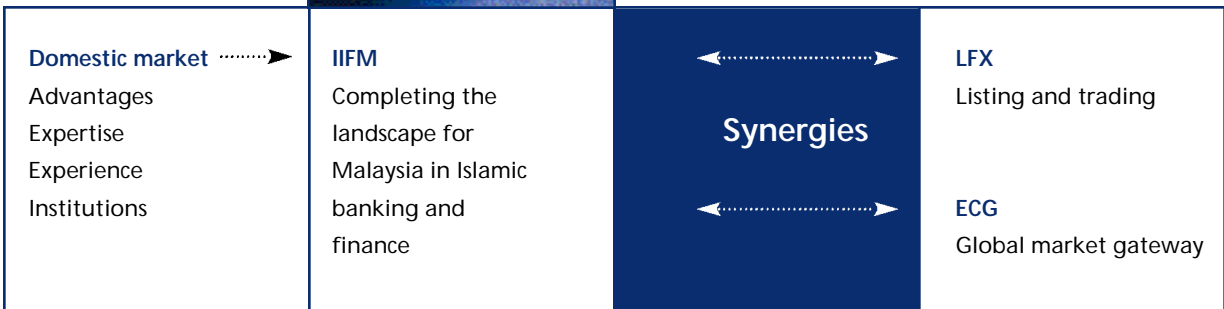
Recommendation 8.9:

Maximise potentials of Labuan IOFC by developing other complementing economic measures

The development of the IOFC to drive the island has to be complemented by similar developments in other sectors. This will maximise the potentials and synergies that the IOFC has with other economic sectors. In this context, the following should be implemented:

- **Labuan as a centre of educational excellence**
The quiet and conducive atmosphere of

Positioning Labuan IOFC with the key linked initiatives



Labuan's pleasant surroundings, coupled with the availability of excellent high-tech communications facilities, low operating costs and skilled workforce, gives the island the potential to be a choice education center. Local and foreign learning institutions should be encouraged to set up branches on the island. Labuan is already home for Universiti Malaysia Sabah-Kampus Antarabangsa Labuan that specialises in offshore finance and multimedia with the capacity of accommodating 6,000 students. To fully develop into a world-class centre of educational excellence, strong study alliances with the private sector would be needed. Training institutions such as the BIMB Institute of Research and Training (BIRT) could provide valuable input in designing the syllabus for Islamic banking studies.

- **Labuan as a tourist centre and as health plus convalescence resort**

Promoting tourism industry in Labuan would have positive spillover effects on the local economy and the offshore industries. Most other offshore centres evolved from a successful tourism industry. In the case of Labuan, the island was made an IOFC first, and now the move to successfully develop the tourism industry. Labuan as a retiree paradise is in line with the planned building of an 18-hole golf course and retirement homes. Retirees, from the region and other parts of the world, will be attracted to set up homes in Labuan. A Retirement Package Incentive, covering PR status, can be offered to high net worth retirees.

- **Labuan as a free-trade zone**

Another measure to attract more high value added industries that require intensive manpower but do not cause pollution to the environment,

is to introduce the free tax status to identified industries, and free trade zone status to be accorded during a promotional period of two years, on a first come first serve basis.

- **Labuan as a Meeting, Conference, Exhibition Centre (MICE)**

Labuan has all that it takes to be a MICE, with its state-of-the-art telecommunication facilities, excellent conference centre, world class hotels, institutions of higher learning and major key players. Training institutes such as Malaysian Insurance Institute, Institut Bank-Bank Malaysia, BIRT should be encouraged to hold their seminars and courses in Labuan to increase awareness of the IOFC.

- **Accessibility**

Most essential is that the accessibility to the island should be enhanced. Labuan should have more flights from Kuala Lumpur, Kota Kinabalu and Kuching and from other regional capitals such as Singapore, Hong Kong, Tokyo, Taipei, Shanghai, Seoul, Manila and Jakarta. In tandem with its role as the centre for offshore business, Labuan should have an 'open sky' policy to allow for increased access.

Approach to Implementation

The development of the IOFC is the long-term agenda of the Malaysian government. The implementation of the above recommendations would be pursued according to the broad long-term plan. The government will work with the industry to provide the necessary support needed for this process. The government will continue to be responsive and adopt market driven, consultative and pro-active approach in developing the IOFC.

summary of
recommendations

Summary of Recommendations

Chapter 3: Banking Sector

- 3.1: Develop industry-wide benchmarks to drive performance improvement in domestic banking institutions
- 3.2: Improve awareness of best practices and conduct focused training
- 3.3: Enhance credit skills and monitor the requirement for accreditation of credit officers and managers
- 3.4: Remove restrictions on salaries and staff mobility in banking industry
- 3.5: Uplift restriction on employment of expatriates
- 3.6: Set up board committees to further improve corporate governance
- 3.7: Allow group rationalisation and facilitate the operation of one-stop financial centre
- 3.8: Encourage strategic alliances
- 3.9: Streamline the regulation of discount houses and merchant banks to level the playing field
- 3.10: Encourage mergers between merchant banks and stockbroking companies or discount houses of the same group to create full-fledged investment banks
- 3.11: Encourage ownership of banking institutions by institutional investors
- 3.12: Encourage outsourcing of non-core functions
- 3.13: Require management of banking institutions to give greater attention to the development of ICT
- 3.14: Encourage the development of new delivery channels
- 3.15: Adopt 'what is not prohibited is allowed' regulatory philosophy and phase out product pre-approval requirement
 - 3.15.1: Replace product pre-approval requirements with a simple new product notification process
 - 3.15.2: Outline guidelines for all applications for regulatory exemptions
- 3.16: Deregulate pricing and rules of association on rates, fees and charges gradually
- 3.17: Mandate all banking institutions to be rated
- 3.18: Encourage competition and participation of banking institutions in areas currently served by fringe institutions
- 3.19: Facilitate the development of a conducive tax regime
- 3.20: Merge the associations of banks, merchant banks and finance companies into a single association
- 3.21: Continue implementing risk-based supervision with more focused supervisory attention for weak institutions
- 3.22: Refine calculation of risk weightings for the purpose of capital adequacy calculations
- 3.23: Implement a system of incremental enforcement action
- 3.24: Implement a transparent and clearly structured early warning system and set of prompt corrective measures for weak banking institutions

- 3.25: Enhance surveillance of the financial sector through the use of modern technology
- 3.26: Develop comprehensive framework for consolidated supervision of financial conglomerates
- 3.27: Increase efficiency and competition in the payments system
- 3.28: Allow market forces to shape developments in the payments system while BNM assumes the role of regulator
- 3.29: Allow incumbent foreign banks to set up shared ATM network
- 3.30: Allow use of electronic communication networks and electronic trading platform
- 3.31: Introduce an expanded credit guarantee scheme
- 3.32: Require provision of advisory services on financial planning and management to SMIs and small borrowers
- 3.33: Allow banking institutions to rationalise their branch network and relocate branches, subject to certain conditions
- 3.34: Initiate an active and structured consumer education programme
- 3.35: Increase product-specific and institutional transparency and move towards full disclosure
- 3.36: Encourage consumers to pursue formal administrative and legal redress
- 3.37: Expand the operations of Banking Mediation Bureau to cover full range of retail banking-related consumer complaints
- 3.38: Implement anti-trust regulation
- 3.39: Establish a deposit insurance fund

Chapter 4: Insurance Sector

- 4.1: Remove restrictions on outsourcing
- 4.2: Allow all players in the market to operate via the internet
- 4.3: Promote incentives for the growth of bancassurance
- 4.4: Remove the 'file-and-use' system for life insurance products in the long term
- 4.5: Open up the pension industry to insurers
- 4.6: Uplift restrictions on employment of expatriates
- 4.7: Remove restrictions on opening branches
- 4.8: Allow insurers to distribute other personal financial service products
- 4.9: Introduce independent financial advisers
- 4.10: Introduce reinsurance quota regulations
- 4.11: Remove voluntary cessions to Malaysian National Reinsurance Berhad
- 4.12: Allow qualified players to sell takaful products
- 4.13: Remove caps on operating expenses
- 4.14: Encourage commission disclosure
- 4.15: Deregulate pricing of general insurance products
- 4.16: Increase the statutory minimum paid-up capital of insurers
- 4.17: Strengthen 'fit and proper' regulations for board members and senior management
- 4.18: Encourage the introduction of performance incentives and evaluation processes
- 4.19: Raise the entry requirements for the agency force

- 4.20: Introduce additional compulsory exams as part of continuing education programmes for agents
- 4.21: Further strengthen performance-based supervision
- 4.22: Ensure effective enforcement of regulations
- 4.23: Establish prudential risk management standards
- 4.24: Remove investment restrictions
- 4.25: Expand the role of the existing ombudsman
- 4.26: Introduce 'best-advice' regulations
- 4.27: Strengthen regulations on unfair trade practices
- 4.28: Allow new insurance licences for innovative players
- 4.29: Allow financial and non-financial institutions to buy direct insurers
- 4.30: Open up the reinsurance industry fully to foreign competition
- 4.31: Increase caps on foreign equity

Chapter 5: Islamic Banking and Takaful

- 5.1: Introduce a benchmarking programme
- 5.2: Enhance knowledge and expertise
- 5.3: Build strong management teams
- 5.4: Grant incentives to structure Islamic private debt securities
- 5.5: Increase the number of Islamic banks to stimulate competition
- 5.6: Increase the number of takaful operators
- 5.7: Deepen the Islamic financial market
- 5.8: Strengthen the regulatory framework for Islamic banking
- 5.9: Improve the regulatory framework for takaful
- 5.10: Establish an effective legal structure
- 5.11: Create a favourable tax regime

Chapter 6: Development Financial Institutions

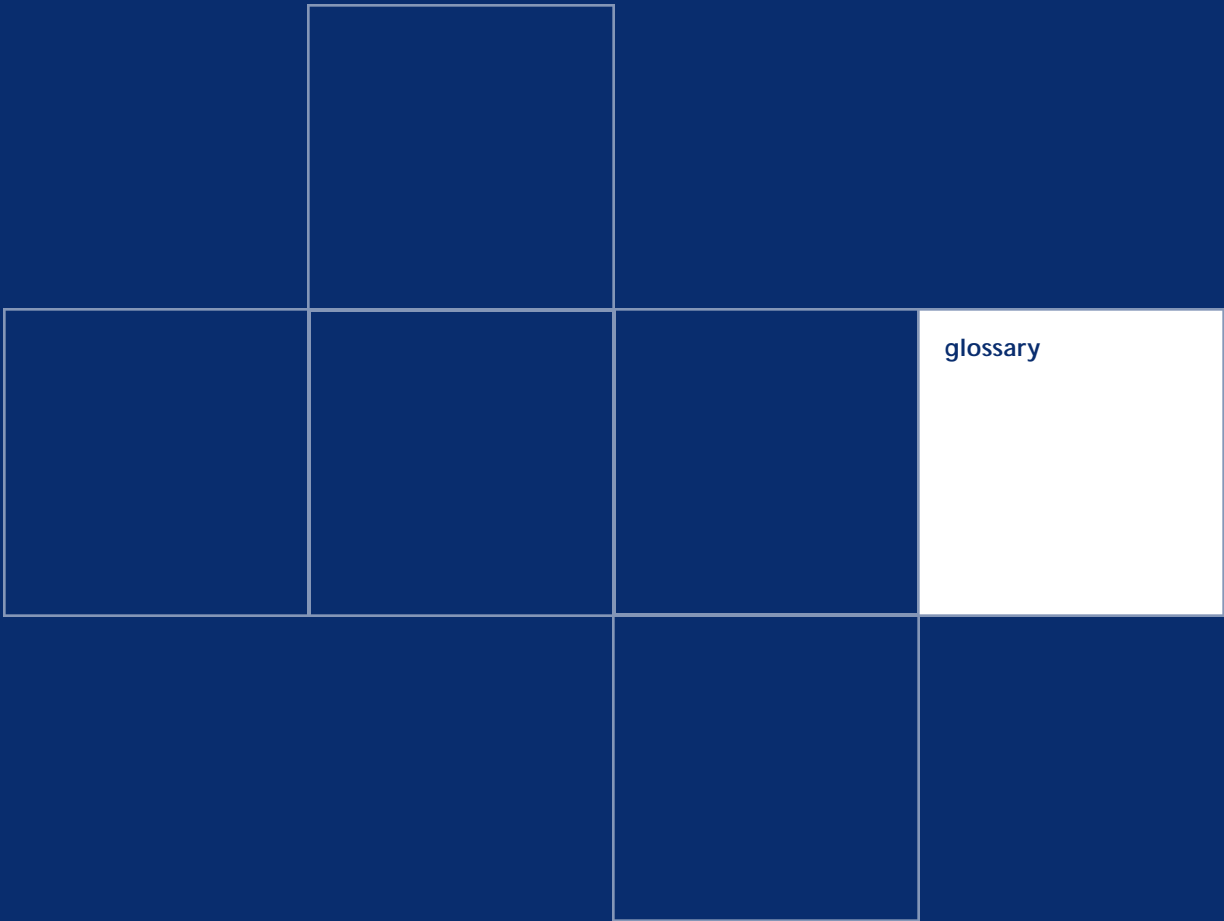
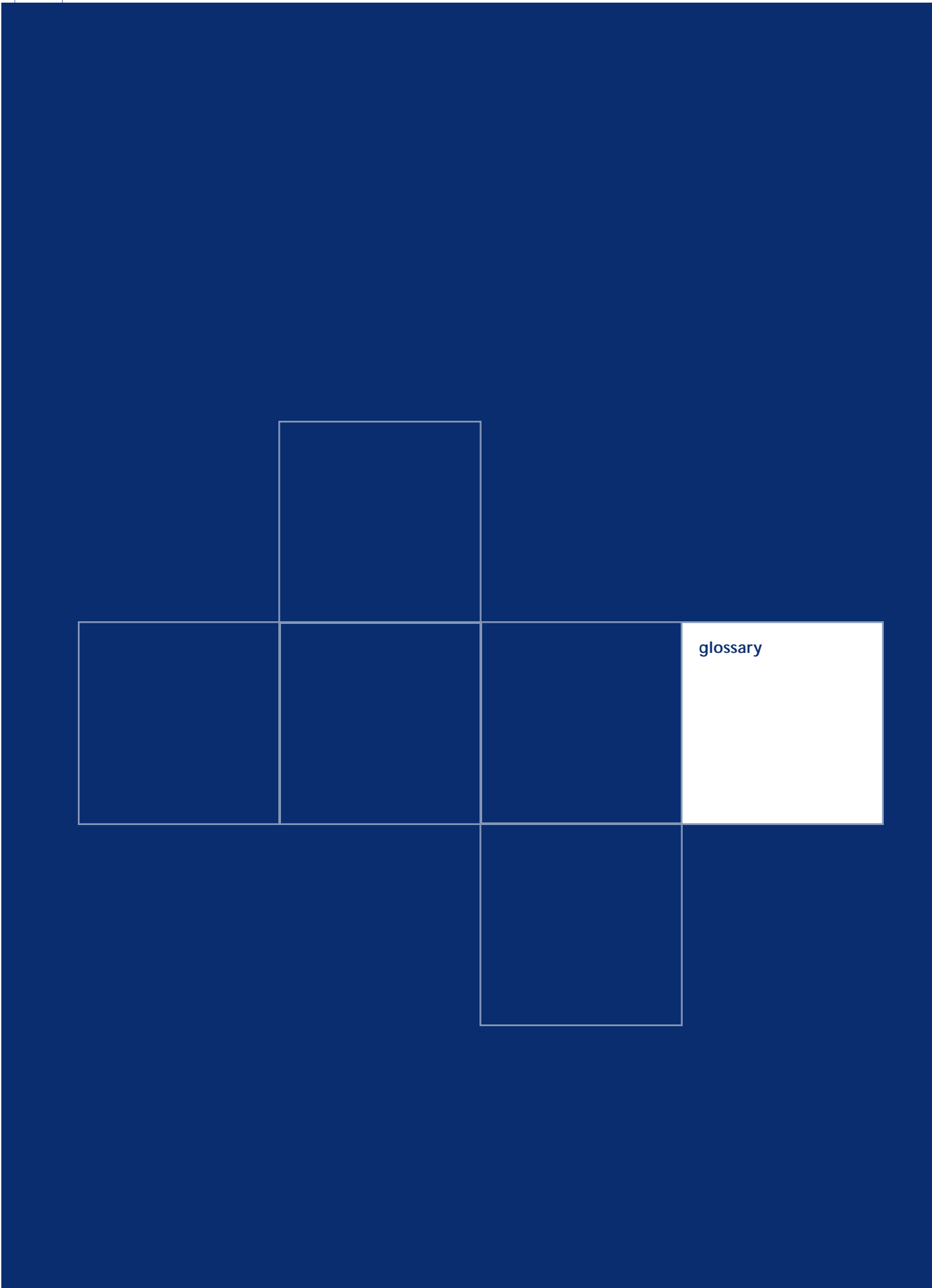
- 6.1: Define clearly the strategic focus and role of the DFIs
- 6.2: Enhance institutional capacities and operational structure
- 6.3: Enhance performance measurement
- 6.4: Introduce a systematic framework for sourcing funds
- 6.5: Continue Government's support to the DFIs
- 6.6: Strengthen corporate governance
- 6.7: Establish a legislative framework to provide for regulation and supervision of DFIs
- 6.8: Establish a single Regulatory and Supervisory Authority to strengthen the supervision of DFIs

Chapter 7: Alternative Modes of Financing

- 7.1: Establish a 'one-stop' centre for VC
- 7.2: Establish a RM500 million VC Fund
- 7.3: Introduce further tax incentives for the VC industry
- 7.4: Liberalise the MESDAQ listing requirements
- 7.5: Establish Islamic VC funds
- 7.6: Increase the sources of financing to the VC industry
- 7.7: Enhance the promotion of VC investment opportunities in Malaysia
- 7.8: Provide training to VC professionals
- 7.9: Increase the awareness of Malaysians regarding the roles and significance of business angels
- 7.10: Establish more business angel clubs and networks
- 7.11: Establish more matching services
- 7.12: Establish technology appraisal centres in promoted high technology sectors
- 7.13: Establish a one-stop agriculture research and development centre as well as a comprehensive and integrated information database
- 7.14: Develop structured and systematic training programme for borrowers
- 7.15: Establish a risk-distribution mechanism that will reduce the risks to the financial institutions and at the same time, reduce borrowing costs through a guarantee and insurance protection scheme
 - 7.15.1: Establish an agency to provide guarantees
 - 7.15.2: Diversify insurance protection schemes
- 7.16: Provide subsidies to the agriculture industry
- 7.17: Grant tax exemptions

Chapter 8: Labuan International Offshore Financial Centre

- 8.1: Develop an active International Offshore Financial Centre for Malaysia
- 8.2: Review existing rules and regulations to facilitate expansion in the scope of core businesses
- 8.3: Adopt a consultative and market driven approach to create a conducive tax and business environment
- 8.4: Benchmark against the best to maintain the low-cost operating environment
- 8.5: Establish a well-balanced regulatory policy and supervisory framework
- 8.6: Strengthen Islamic banking and finance as well as Islamic insurance (takaful)
- 8.7: Enhance the Labuan International Financial Exchange (LFX)
- 8.8: Enhance the e-commerce gateway (ECG)
- 8.9: Maximise potentials of Labuan IOFC by developing other complementing economic measures



glossary

Glossary

Anti Trust Regulation Legislation to control monopoly and collusive practices of institutions that do not favour competition.

Bancassurance The marketing of insurance products through banks distribution channels or the combination of banking products with insurance products.

Banking and Financial Institutions Act 1989 (BAFIA)
An Act that governs the licensing and regulation of institutions carrying on banking, finance company, merchant banking, discount house and money-broking businesses and for the regulation of institutions carrying on certain other financial businesses deemed to fall under the provisions of the Act.

Banking Institutions Commercial banks, finance companies and merchant banks.

Banking Mediation Bureau(BMB) A bureau that acts as a middle party between customers of the financial institutions and the financial institutions and serves to provide a channel of communication to resolve issues brought forward by both parties.

Benchmarks Financial and non-financial standards that are indicative of the best practices that are used to judge the performance of financial institutions and to provide a basis for comparison between a financial institution and the other.

Business Angels Business angels are private informal venture capitalists who provide capital and skills to the high-risk, early-stage new ventures.

Cagamas Berhad Cagamas Berhad is the national mortgage corporation that was established in 1986 to set the initial impetus for the development of asset securitisation and private debt securities in the Malaysian market.

CAMEL BNM uses the CAMEL (Capital adequacy, Asset quality, Management competence, Earnings capacity and Liquidity position) rating system for all banking institutions to assess the overall strength, safety and soundness of each individual banking institution. It helps to identify weak banking institutions that require greater supervisory attention from BNM.

Capital Adequacy Risk Weightings The ratings that are assigned to each class of asset under the risk-weighted capital ratio (RWCR) framework.

Captive Insurance Business An insurance business where the insured is a related company or associate corporation of the insurer.

Commercial Banks Banking institutions that provide retail banking services, trade financing facilities, treasury services, payment services and custodial services. The BAFIA defines commercial banks' business to include receiving deposits on current accounts, deposit accounts, savings accounts or other similar accounts and pays or collects cheques drawn by or paid in by customers, as well as dealing in the provision of finance and such other business as BNM with the approval of the Minister may prescribe.

Commissions A payment made by an insurer to an insurance agent, usually expressed as a percentage of premiums.

Corporate Governance The system by which companies are directed and controlled that takes into account the interest of all stakeholders (the relationship between the shareholders, directors and management of a company, as defined by the corporate charter, by-laws, formal policy and rule of law).

Credit Guarantee Corporation (CGC) The CGC was established in 1972 to assist small and medium-sized enterprises (SMEs), especially those with inadequate collateral or without collateral or track record to gain ready access to credit, and to complement the Government's efforts in promoting and developing businesses in priority sectors. This is achieved through providing various guarantee schemes on loans granted to SMEs.

Deposit Insurance Fund A repository established through the premium contributions from deposit-taking institutions and is a form of protection for depositors in the event of the financial failure of their banks or savings institutions.

Development Financial Institutions (DFIs)* Institutions that have been established by the Government to give financial assistance to certain priority sectors of the economy. The DFIs are largely funded by the Government.

Discount Houses Non-banking institutions that deal in the business of receiving short term deposits and funds and investing those funds by trading in Malaysian Government Securities, Treasury Bills or such other investments as may be prescribed by BNM.

Due Diligence Inquiries for the purposes of timely, sufficient and accurate disclosure of all material statements, information and documents.

Early Stage Financing Financing provided to companies that have completed the product development stage and require further funds to initiate commercial manufacturing and sales.

Early Warning System A system that provides indicators of potential adverse performance of the financial system and individual financial institutions.

Exit Route/Mechanism Process where venture capitalists liquidate their investments by selling the shares back to the management, selling the shares to a third party in a private transaction or liquidating the investment in the public share market through initial public offering.

* Bank Pembangunan dan Infrastruktur Malaysia Berhad, Bank Industri dan Teknologi Malaysia Berhad, Export-Import Bank Malaysia Berhad, Malaysia Export Credit Insurance Berhad, Bank Pertanian Malaysia, Malaysian Industrial Development Finance Berhad, Sabah Development Bank Berhad, Borneo Development Corporation (Sabah) Sdn Bhd, Borneo Development Corporation (Sarawak) Sdn Bhd, Credit Guarantee Corporation, Sabah Credit Corporation, Bank Kerjasama Rakyat Malaysia Berhad and Bank Simpanan Nasional.

Finance Companies Financial institutions that offer deposit account, savings account or other similar account, as well as provide credit facilities and conduct leasing business, business of hire-purchase, including that which is subject to the Hire-Purchase Act 1967 and business of acquiring rights and interests in a hire-purchase, leasing or other similar transactions, as well as any such other business as BNM, with the approval of the Minister, may prescribe.

'Fit and Proper' Regulations Minimum criteria prescribed under the Insurance Act 1996 for determining whether a person is a fit and proper person to hold the position of a director, chief executive officer or manager of a licensed insurer, insurance broker or adjuster.

Foreign Banks Banking institutions that are wholly owned by foreign entities and are locally incorporated as subsidiaries in Malaysia since 1 October 1994.

Fringe Institutions Institutions which provide ancillary financial services. These include savings institutions, housing credit institutions, leasing companies, factoring companies and credit token companies.

General Insurance A contract by which an insurer undertakes to indemnify the insured for loss arising from the occurrence of an insured peril such as accident, sickness, fire, flood, liability and burglary.

Independent Financial Adviser (IFA) An individual or firm that provides advice on financial products. Unlike tied agents, IFAs are not committed to the products of any one financial institution and can therefore sell products from a range of competing financial institutions.

Interbank GIRO (IBG) The IBG system is developed to facilitate electronic interbank payments for third party transactions of less than RM50,000 which are not accepted by the Real Time Electronic Transfer of Funds and Securities system (a real time gross settlement system).

Internet Banking Banking products and services offered by banking institutions on the Internet through access devices including personal computers, and other intelligent devices.

Investment Banks Banking institutions that provide wide range of wholesale banking products and services which may include corporate lending, corporate finance, merger and acquisition-related services, structuring, marketing, trading and brokerage services on capital market products (covering fixed income, equity and equity-linked products, commodity and commodity-linked products), asset management and other advisory and research services.

Islamic Banking Act 1983 An Act to provide for the licensing and regulation of Islamic banking business.

Islamic Banking Division (IBD) A division in conventional banking institutions participating in the Islamic Banking Scheme, which is responsible for all aspects of Islamic banking operations.

Islamic Banking Scheme (IBS) A scheme which allows conventional banking institutions to offer Islamic banking products and services using their existing infrastructure.

IBS Banks Conventional banking institutions participating in the Islamic Banking Scheme.

Licensed Institutions Any institution licensed and regulated under the BAFIA, and being supervised by BNM. These institutions include commercial banks, finance companies, discount houses, merchant banks and money brokers.

Life Insurance A contract by which an insurer undertakes to pay a specified amount of money on death or survival of the insured person to the beneficiaries under the contract, and includes extensions of cover for personal accident, disease or sickness.

Malaysian Electronic Payment System Sdn Bhd (MEPS) MEPS is a payment consortium owned by domestic banking institutions that was established to consolidate and operate the switching, clearing and settlement operations of the ATM networks.

Merchant Banks Banking institutions that conducts the business of receiving corporate deposit, provision of finance, provision of consultancy and advisory services relating to corporate and investment matters, making or managing investments on behalf of any person and any such other business as BNM, with the approval of the Minister, may prescribe. Merchant banks are expected to operate in the wholesale banking business.

Mudharabah A financing agreement between the capital provider (bank) and entrepreneur (customer) to enable the entrepreneur to carry out business activities on a profit-sharing basis. The distribution of profit is according to a pre-determined ratio agreed upon earlier. In the case of losses beyond the control of the entrepreneur, the capital provider will bear all financial losses.

Musarakah A joint venture financing agreement between two parties or more to engage in a specific business activity aimed at making profit. Distribution of profits will be apportioned according to an agreed ratio. In the event of losses, all parties will bear the losses in proportion to their equity participation.

Net Premiums Gross premiums less all reinsurance premiums payable.

Outsourcing The practice of sub-contracting certain functions and administration of an institution to third parties.

Personal Financial Service Products Financial products that cater to the financial needs of individuals. This includes banking, insurance and investment products or a combination of these products.

Premiums The monetary consideration payable once or periodically by a policy owner to an insurer in return for the insurance coverage provided.

Provision for Outstanding Claims The amount set aside for outstanding claims, including incurred but not reported claims.

Reinsurance The transfer of all or part of an insurance risk that has been assumed by an insurer to another insurer in return for a premium.

Rent-a-captive Insurance A captive insurer is authorised by LOFSA to provide insurance or reinsurance to any other person.

Reserves for Unexpired Risks The amount of net premiums set aside by an insurer in respect of risks which are still unexpired at the end of the accounting period.

Retention Ratio The ratio of net premiums to gross direct and reinsurance accepted premiums, less reinsurances within Malaysia indicating the proportion of premiums retained in the country.

Risk-Weighted Capital Ratio (RWCR) This ratio is a key indicator of the capital adequacy of banking institutions. The RWCR is a framework set by the Bank for International Settlements (BIS), which sets the desired level of capital against risk-weighted assets.

Seed Capital Financing Stage where financing is provided for research and for developing an initial concept or prototype, before a business has reached the start-up phase.

Set of Prompt Corrective Measures A set of measures that serves to immediately rectify or remedy the problems faced by the financial institutions.

Solvency Surplus of assets over liabilities.

Start-up Financing Financing provided to companies for product development and initial marketing. Companies may be in the process of being set up or may have been in business for a short time but have not sold their product commercially.

Stockbroking Companies Companies that deal primarily with transactions involving stock.

Strategic Alliances Co-operation between two or more financial institutions in areas that are beneficial and that provide a competitive advantage to the parties involved.

Syariah Islamic law.

Takaful Mutual guarantee provided by a group of people against a defined risk or catastrophe befalling one's life, property or any form of valuable things.

Takaful Operators A company which carries on takaful business.

Technical Reserves Comprise reserves for unexpired risks and provision for outstanding claims.

Trading Ratio The ratio of net premium income to shareholders' funds.

Trust Company A company registered to carry on any economic activity as a trustee, agent or administrator etc.

Venture Capital Venture capital refers to equity investments in growing, unlisted and more risk oriented companies. The investment scope covers companies at all stages of maturity, with the investors providing value added services such as management skills and network to the companies.

Venture Companies Start-up companies that venture into high risk new technology businesses.

Virtual Banking Provision of banking products and services through the internet, telephone and other forms of electronic channels where there is no physical contact between the customer and the banking institutions.

Voluntary Cessions An arrangement whereby all general insurers cede to the national reinsurer (Malaysian National Reinsurance Berhad) a predetermined percentage of their business over and above their own net retention up to the limits specified for the various classes of general insurance business.