

Sources and Uses of Funds of the Financial System

Total assets of the financial system continued to increase strongly by RM198.1 billion or 21.6% to RM1,117.2 billion at the end of 1997 (an increase of RM171.5 billion or 22.9% in 1996). The growth was contributed mainly by a sharp increase in total assets of the banking system, which rose by RM181.4 billion or 28.7%, compared with an increase of RM116.1 billion or 22.5% in 1996. Concomitantly, the banking system

remained as the largest financial intermediary, accounting for 72.8% of total assets of the financial system at the end of 1997 (68.7% in 1996). Within the banking system, the commercial banks (including Bank Islam) recorded a significant increase in their total assets, reflecting strong growth of loans and advances as well as placement of deposits with other financial institutions. Consequently, their share of total assets of the financial system increased from 39.6% at the end of 1996 to 43.6% at the end of 1997.

Table 4.1
Assets of the Financial System

	Annual change		As at end 1997	
	1996	1997		
	RM billion		% share	
Banking system	116.1	181.4	813.2	72.8
Bank Negara Malaysia	8.3	12.2	109.0	9.8
Commercial banks ¹	68.6	122.5	486.6	43.6
Finance companies	27.9	32.6	152.4	13.6
Merchant banks	7.0	10.3	44.3	4.0
Discount houses	4.3	3.8	20.9	1.9
Non-bank financial intermediaries	55.4	16.7	304.0	27.2
Provident, pension and insurance funds	27.5	24.0	191.0	17.1
<i>Employees Provident Fund</i>	18.5	15.0	132.4	11.8
<i>Other provident & pension funds</i>	3.3	3.5	21.9	2.0
<i>Life insurance funds</i>	3.4	3.6	24.5	2.2
<i>General insurance funds</i>	2.3	1.9	12.2	1.1
Development finance institutions ²	1.4	2.0	15.3	1.4
Savings institutions ³	3.0	1.2	19.4	1.7
Other financial intermediaries ⁴	23.5	-10.5	78.3	7.0
Total	171.5	198.1	1,117.2	100.0

¹ Includes Bank Islam Malaysia Berhad.

² Includes Malaysian Industrial Development Finance Berhad (MIDF), Bank Pertanian Malaysia, Borneo Development Corporation, Sabah Development Bank Berhad, Sabah Credit Corporation, Export - Import Bank Malaysia Berhad, Bank Pembangunan Malaysia Berhad and Bank Industri Malaysia Berhad.

³ Includes National Savings Bank, Bank Kerjasama Rakyat and co-operative societies.

⁴ Includes unit trusts (ASN, ASB, ASW 2020 and ASM Mara), building societies, Pilgrims Fund Board, Credit Guarantee Corporation, Cagamas Berhad, leasing companies, factoring companies and venture capital companies.

Total assets of the non-bank financial intermediaries (NBFIs) rose at a much slower pace of RM16.7 billion or 5.8% in 1997, compared with a growth of RM55.4 billion or 23.9% in 1996. As a result, their share of total assets of the financial system declined from 31.3% at the end of 1996 to 27.2% at the end of 1997. The slower growth was due mainly to a decline in total assets of unit trust funds by RM22.5 billion (an increase of RM15.1 billion in 1996), following a sharp fall of stock prices since the second quarter of 1997 which adversely affected the value of their investments. At the same time, a slower accumulation of assets by the provident, pension and insurance funds group also contributed to the slower growth in total assets of the NBFIs. In particular, the growth in assets of the Employees Provident Fund (EPF) moderated to 12.8% (18.7% in 1996), due partly to the lower net contributions and slower growth in the number of contributors.

During the year, the bulk of funds continued to be sourced from deposits placed with the financial system, which grew by RM94.6 billion or 20.8% (RM90.9 billion or 24.9% in 1996) to account for 47.8% of the total increase in resources of the financial system. As in previous years, the banking institutions (comprising the commercial banks, finance companies, merchant banks and discount houses) accounted for the bulk of the increase in these deposits, mobilising 83% of total deposits of the financial system (82.8% in 1996). In terms of holders, the deposits were held mainly by the non-financial private sector, comprising individuals and business enterprises. Non-financial private sector deposits

Table 4.2
Sources and Uses of Funds of the Financial System

	Annual change		As at end 1997	
	1996	1997		
	RM billion		% share	
Sources:				
Capital and reserves	30.8	-6.4	103.1	9.2
Currency	2.1	3.5	24.5	2.2
Deposits	90.9	94.6	550.0	49.2
Borrowings	2.1	22.7	31.1	2.8
Funds from other financial institutions	6.0	42.7	98.7	8.8
Insurance and provident funds	19.8	22.3	169.2	15.1
Other liabilities	19.8	18.7	140.6	12.6
Total	171.5	198.1	1,117.2	100.0
Uses:				
Currency	0.9	1.3	4.1	0.4
Deposits with other financial institutions	7.4	69.2	215.8	19.3
Bills	-0.1	5.0	21.3	1.9
<i>Treasury</i>	-2.0	2.0	3.9	0.3
<i>Commercial</i>	1.9	3.0	17.4	1.6
Loans and advances	78.5	102.4	486.7	43.6
Securities	42.2	10.5	213.0	19.1
<i>Malaysian Government</i>	6.1	-0.8	66.8	6.0
<i>Foreign</i>	0.3	0.4	0.8	0.1
<i>Corporate</i>	71.0	14.0	138.5	12.4
<i>Others</i>	-35.2	-3.1	6.9	0.6
Gold and foreign exchange reserves	6.2	-10.8	57.1	5.1
Other assets	36.4	20.5	119.2	10.7

placed with the financial system rose by RM57.9 billion or 22.4% (RM55.3 billion or 27.1% in 1996). The slower growth rate of the deposits reflected the moderation in economic activities in the second half of 1997. Fixed deposits continued to account for the bulk of the deposits placed by the non-financial private sector, accounting for 77.4% of the increase in total deposits. By maturity, fixed deposits continued to be concentrated in shorter-end maturities. On the other hand, savings deposits declined by RM5 billion (+RM7.8 billion in 1996), largely on account of a decline in savings deposits mobilised by the commercial banks and finance companies.

Contractual savings with provident funds and contribution to insurance funds remained a major source of funds for the financial system, expanding by RM22.3 billion or 15.2% (RM19.8 billion or 15.6% in 1996), to account for 15.1% of total funds of the financial system. However, a notable development in 1997 was a significant increase in funds obtained

from other financial institutions (RM42.7 billion) and borrowings (RM22.7 billion), which accounted for 21.6% and 11.5% respectively of the increase in total resources of the financial system. This reflected the tight liquidity situation in the banking system as growth in total deposits fell short of loan growth. As a result, the banking system had to rely on the interbank money market as well as placements by Bank Negara Malaysia (BNM) to meet their funding requirements. Meanwhile, capital and reserves of the financial system declined by RM6.4 billion, due mainly to the adverse impact of the sharp fall in the stock market on the level of reserves and profitability of unit trust funds which fell by RM22.3 billion.

The bulk of funds mobilised was utilised to finance loan operations of the financial system, followed by deposits with other financial institutions, in particular in the form of interbank placements, and investment in securities. Despite the moderation in economic growth in the latter part of 1997, total loans and advances extended by the financial system continued

Table 4.3
Non-Financial Private Sector Deposits¹ with the Financial System²

	Annual change		As at end 1997	
	1996	1997		
	RM billion		% share	
Deposits ³ with:				
Commercial banks	38.8	46.2	221.1	69.7
Finance companies	11.7	9.8	61.7	19.5
Merchant banks	2.2	1.8	12.0	3.8
Discount houses	1.2	-1.9	3.7	1.2
National Savings Bank	0.7	0.1	6.0	1.9
Others	0.7	1.9	12.5	3.9
Total	55.3	57.9	317.0	100.0
Demand deposits	6.4	1.1	36.7	11.6
Fixed deposits	36.3	44.9	205.5	64.8
Savings deposits	7.8	-5.0	40.0	12.6
NIDs ⁴	1.9	13.7	18.3	5.8
Repos ⁵	2.9	3.2	16.5	5.2
Fixed deposits				
Of which:				
Up to 1 year	33.3	39.4	179.5	56.6
More than 1 year	3.0	5.5	26.0	8.2

¹ Refers to deposits of business enterprises (excluding NFPEs) and individuals.

² Excludes provident and insurance funds and other financial intermediaries.

³ Refers to demand, savings and fixed deposits, negotiable instruments of deposit and repos.

⁴ Refers to negotiable instruments of deposit.

⁵ Refers to repurchase agreements.

Table 4.4
Direction of Credit¹ to Non-Financial Private Sector

	Annual change		As at end 1997	
	1996	1997		
	RM billion		% share	
Loans and advances	90.6	91.3	456.0	76.7
<i>Agriculture</i>	1.0	1.7	9.3	1.5
<i>Mining & quarrying</i>	-0.2	0.7	1.6	0.3
<i>Manufacturing</i>	4.7	9.3	65.8	11.1
<i>Housing</i>	8.2	14.2	62.4	10.5
<i>Construction²</i>	24.7	25.6	90.8	15.3
<i>Business services</i>	3.3	-0.9	9.6	1.6
<i>General commerce</i>	3.1	4.9	30.1	5.1
<i>Transport & storage</i>	2.3	6.4	13.4	2.2
<i>Purchase of shares</i>	9.4	11.7	36.1	6.1
<i>Consumption credit</i>	12.1	10.7	53.5	9.0
<i>Others</i>	22.0	7.0	83.4	14.0
Investment in corporate securities	71.0	14.0	138.5	23.3
Total	161.6	105.3	594.5	100.0

¹ Excludes credit to non-financial public enterprises.

² Includes loans for real estate.

to expand strongly by RM102.4 billion or 26.7% (RM78.5 billion or 25.7% in 1996), to account for 51.7% of the increase in total resources of the financial system. The bulk of the increase in loans and advances was channelled to the non-financial private sector, which rose by RM91.3 billion or 25% (RM90.6 billion or 33.1% in 1996). Except for the business services sector, loans and advances extended to all other sectors of the economy registered increases during the year. Of concern was the high proportion of loans and advances channelled to the less productive sectors (broad property, consumption credit and for the purchase of shares), which together accounted for 68.1% of the increase in total loans and advances extended to the non-financial private sector. Meanwhile, loans and advances extended to the manufacturing sector recorded a strong growth of RM9.3 billion or 16.4% (RM4.7 billion or 9.1% in 1996).

In contrast, investment in corporate securities by the financial system, consisting mainly of the holding of stocks and shares, recorded a slower growth of RM14 billion or 11.2% (RM71 billion or 132.5% in 1996). In particular, there was a marked decline of RM19.6 billion in investment in corporate securities by unit trust funds (an increase of RM13.2 billion in 1996). The slowdown in growth was in tandem with the weak stock market performance prevailing for the most part of 1997, which dampened stock prices

as well as the overall investment climate. Deposits with other financial institutions increased significantly by RM69.2 billion or 47.2% (RM7.4 billion or 5.3% in 1996). The increase was accounted for by a sharp growth in interbank placements by BNM and the banking system, reflecting the banking system reliance on the interbank money market to meet its funding requirements. Meanwhile, gross holdings of gold and foreign exchange reserves of BNM declined by RM10.8 billion to RM57.1 billion at the end of 1997 (an increase of RM6.2 billion in 1996), reflecting mainly the intervention operations in the second half of 1997 following pressures on regional currencies.

Management of Banking System

Policy Direction

The year 1997 was a challenging year for the banking industry, as it had to cope with the rapid and sharp fall in equity prices and the value of the ringgit, as a result of the contagion effects of the regional financial crisis. Following a period of relative stability and a decade of high growth, the banking system entered this crisis from a position of relative strength. At the end of June, the banking system had a non-performing loan (NPL) ratio of 3.6%, while loan loss reserves (specific provisions, general provisions and interest-in-suspense) amounted to 92% of total NPL. As early as 1995, measures had been introduced to reduce exposure to the more volatile sectors of the economy. These measures were reinforced with further measures to limit the amount of credit facilities granted for the purchase of shares and to finance specified types of property in March 1997, just prior to the crisis (please see Monetary Measures in 1997 in chapter 2, for details). As the currency crisis intensified, the high credit growth had to be moderated more rapidly, given the potential risks and the adverse implications on financial stability. Monetary policy was also tightened further during this period. In addition, more stringent requirements on the prudential standards governing the classification of NPL were imposed. This included the shortening of the period in arrears for classifying loans of RM1 million and below as "sub-standard" and "doubtful" (please see Banking Measures in 1997 in this chapter, for details). These measures were complemented by the requirement for banking institutions to abide by their own estimates on credit growth for the rest of 1997, and for 1998, which should see credit growth slowing down to 25% by end-1997, 20% by March 1998 and 15% by the end of 1998.

Banking Measures in 1997

Institutional and Market Development

Two-Tier Regulatory System: In 1997, a new incentive was offered under the Two-tier Regulatory System (TTRS) that permits the rationalisation of group operations and conduct of cross-institutional business within eligible banking groups. Under this framework, Tier-I banking institutions within a group had been allowed to freely cross-sell, through agency arrangements, banking products and services belonging to one another as well as financial products and services belonging to other financial institutions within the group, such as insurance services, stockbroking services and mutual fund products. In addition, Tier-I banking institutions would also be allowed to freely combine their internal operations among themselves.

The incentives form part of the continuing efforts by BNM to establish a core of strong and competitive banking institutions. The incentives would provide opportunities for the Tier-I banking institutions to maximise synergy from their existing group structure and to achieve economies of scale from the rationalisation of internal operations. Strategically, delivery channels for the group could be significantly enhanced through shared branches and on-line computer networks. Through their cross-selling activities, customers would be able to avail themselves of a broad spectrum of financial products offered by the various institutions within the group from any one of the service outlets of the Tier-I banking institutions. Economically, cost savings and operational synergy would be obtained by integrating common functions and eliminating duplicate activities. The combination of internal operations would also permit a more consolidated view of financial risk and consistency in policy application across the group. In this regard, it was envisaged that this measure would place these banking institutions in a more strategic position to compete in an increasingly competitive and liberalised global environment. To date, two qualified banking groups are in the process of actively implementing such arrangements.

Bond Information and Dissemination

System: A Bond Information and Dissemination System (BIDS) was launched on 1 October 1997 to provide comprehensive market information on domestic debt securities to market participants. BIDS is a computerised system which centralises the collection and dissemination of information on Scripless Securities Trading System (SSTS) securities and private debt securities (PDS). The information provided include the terms and conditions of issuance, details of deals done and relevant news on the debt securities market.

The members of BIDS comprise commercial banks, merchant banks, discount houses, Cagamas Berhad and the rating agencies. The ready access and transparency of information provided by BIDS were expected to improve liquidity and widen the type and number of market participants, thereby promoting further development of the primary and secondary markets. At a later stage, the membership of BIDS would be widened to include the finance companies, money brokers as well as other market participants. In recognising the dynamics of the debt securities market and the role of the PDS market as an important source of large-scale and long-term financing for economic development, BIDS would be continually enhanced to improve its efficiency in providing transparency of information and facilitating development of the domestic debt securities market.

Prudential Measures

Classification of Non-Performing Loans and Suspension of Interest on Non-Performing Loans:

With effect from financial year beginning 1 January 1998, the period in arrears for classifying a loan as non-performing by banking institutions was reduced from six months to three months. Banking institutions were also required to claw back and suspend the interest accrued-but-not-received to day one of default on any loan which became non-performing. Similarly, the standard yardstick for loans of RM1 million and

below to be classified as “sub-standard” had been reduced from a period in arrears of six months to three months; “doubtful” from 12 months to six months; and “bad” from 24 months to 12 months.

The revision to BNM's “Guidelines on the Suspension of Interest on Non-Performing Loans and Provision for Bad and Doubtful Debts” (BNM/GP3), which was made during the 1998 Budget announcement in October 1997, was to enable early identification and monitoring of problem loans as well as to bring the current practice closer to international standards. The anticipated slowdown in credit and economic growth in the months ahead could result in cash flow difficulties for borrowers and consequently, deterioration in their credit quality. Hence, the revised guideline would facilitate early recognition of any deterioration in a bank's loan portfolio and enable prompt remedial action to be taken by the bank's management, if necessary.

Minimum Requirement for General Provision for Bad and Doubtful Debts: With effect from financial year beginning 1 January 1998, BNM has also raised the minimum level of general provisions for bad and doubtful debts to be maintained by banking institutions to 1.5% of total loans (net of specific provision and interest-in-suspense).

Since 1990, the minimum level of general provisions for bad and doubtful debts was set at 1% of total loans (net of specific provision and interest-in-suspense). However, the need for banking institutions to increase their resilience and build up their reserves as additional buffer against possible future loan losses would become more crucial in the years ahead. In anticipation of such a need, BNM raised the minimum level of general provisions required together with the package of economic reforms made in the 1998 Budget.

Risk-Weighted Capital Requirement – Measurement of credit exposure for interest rate and foreign exchange related derivative contracts: With effect from 1 June 1997, all banking institutions were required to value their credit exposure for interest rate and foreign exchange related contracts by using the “current exposure method” instead of the “original exposure

method”. Credit exposure would be calculated as follows:

The total replacement costs (obtained by marking-to-market) of all its contracts with positive value

plus

The total amount of potential future exposures calculated by multiplying the notional value of each contract by an “add-on” factor

The above standards were made in line with the changes in international standards set by the Bank for International Settlements (BIS). Under the previous “original exposure method”, banking institutions were permitted to use a static valuation method whereby the expected credit exposure value was estimated and fixed at inception of the contract and remained unchanged throughout the life of the contract irrespective of future volatility of the underlying rates. Consequently, such a method might result in a possible understatement of exposure if the underlying rates were subsequently to move more than expected initially; or result in overstatement of exposure if actual exposure values declined significantly during the life of the transaction, resulting in inefficient utilisation of capital to support derivative activities.

The “current exposure method” provided a more updated and continuously revised exposure of a contract as it progressed to maturity. Marking-to-market measured the current credit exposure of a contract, while the “add-on” factor estimated the potential exposure of the contract that might be further incurred over time. The adoption of the above method would ensure that the credit exposure values were constantly updated and in line with current market conditions, especially during times of severe interest rate and currency fluctuations.

However, BNM's revised standards differed slightly from the BIS standards in terms of the quantification of risk. As Malaysian banking institutions operate mainly in the local interest rate and foreign exchange market, the set of “add-on” factors used in estimating the potential future exposure was revised based on risks arising from the local interest rate and foreign exchange rate environment. The “add-on” factors were arrived at after taking into consideration the movements in the ringgit interest rate and

exchange rates of the Malaysian market over a considerable period of years. This approach had resulted in higher exposure values compared with the BIS standards, in which the set of “add-on” standards were more attuned towards interest rate and currency volatility of the G-10 countries.

Disclosure Requirements for the Financial Statements of Banking Institutions: With effect from 17 October 1997, the Bank had further increased the level of transparency in the annual financial statements of banking institutions. The additional disclosure requirement would provide improved information to depositors and investors to assess the financial soundness of banking institutions, and assist in the comparison of one institution with another. Details of the additional disclosure requirements are as follows: -

(a) Director’s Report on Business Strategy and Outlook

Highlight the business plan and strategy during the financial year and the outlook of the institution for the coming year in the director’s report. The report should also comprise a post event evaluation and the institution’s direction for the coming year in dealing with the challenges posed by the business and economic environment.

This disclosure requirement was intended to bring to the forefront the role of the directors of banking institutions in planning the institution’s business strategy and forecast for the financial year. This would serve as a challenge to the directors to play a more prominent and active role in managing prudently the direction of business of the banking institutions, which will now come under greater public scrutiny.

(b) Sectoral Concentration of Loans

Disclose the sectoral concentrations of credit exposure according to industry or economic sector.

Given that business risks vary greatly among different industry segments, sectoral breakdowns would provide better information value for the users of financial statements to assess the risk profile of the financing given by banking institutions.

(c) Non-Performing Loans

Disclose the amount of non-performing loans, the ratio of non-performing loans to total loans, movements in specific and general provisions for bad and doubtful debts and movements in interest-in-suspense.

This information would enable better analysis and monitoring of the performance of the banking institutions’ loan portfolio.

(d) Capital Adequacy

Disclose the components of Tier-1 capital and Tier-2 capital as provided under the Basle Capital Accord to provide a better understanding on the capital strength of the banking institution. Details of the risk-weighted assets according to the various categories of risk-weights would also be disclosed.

Capital had always been given prominent consideration in the assessment of financial soundness of a banking institution by central banks and creditors alike. Capital provides depositors and creditors with a cushion against an institution’s losses. To date, capital remains a widely accepted yardstick with which to judge an institution’s ability to accommodate risk. Internationally, the Basle Capital Accord had also refined capital adequacy to a sophisticated level based on a risk-adjusted concept. Because of the importance of capital as a basis for a wide range of financial judgements, disclosure on the components of a banking institution’s capital and the broad risk profile of an institution’s credit exposure serves as a valuable source of information for all interested parties.

(e) Bank Rating

State in the annual report whether they had been rated by external agencies. Any banking institution that had been rated would be required to disclose the rating, name of the rating agency and when the rating was made. The disclosure must also be accompanied by a description of the rating grades used by the rating agency concerned.

Credit rating would strengthen market discipline, as banking institutions would have

strong incentive to ensure that their credit rating compared favourably with those of other institutions. The prominent disclosure of a credit rating should

serve to strengthen the inducements for banking institutions to adopt prudent practices and maintain high standards of financial health.

The focus of policy was aimed at containing asset inflation in the early part of the year, given that house prices had risen by 12.9% in 1996, while share prices on the Kuala Lumpur Stock Exchange had risen by 24.4% on the Main Board and 93% on the Second Board. As stock prices fell and the ringgit depreciated, in the aftermath of the currency crisis, policy was directed towards maintaining financial stability and restoring confidence in the banking system. In this regard, several prudential measures were introduced to require early recognition of any deterioration in the loan portfolio, so that prompt remedial action would be taken by the management of the banking institutions. While the imposition of more stringent requirements would impact on the profitability of the banking institutions in the immediate term, these measures were necessary in the light of the expected slowdown in economic growth that would affect the cash flows of borrowers. These measures brought the standards in line with international best practices, as well as demonstrated the resolve of policy to deal head-on with potential risks to credit quality. The industry had even been more pro-active, as 47 banking institutions had adopted the more stringent rules in 1997, ahead of the implementation date of 1 January 1998. Prompt pre-emptive action to recapitalise those banking institutions in need of additional capital, arising from deterioration in their loan portfolio, would avoid the destabilising impact of rising NPL on the banking system.

The requirement for greater disclosure, including disclosure of the rating of the institution, can be expected to have the desired effect of imposing greater market discipline on the banking institutions, and encouraging corporate governance. This would also enable investors to assess the financial health of a banking institution. Towards this end, banking institutions are required to publish data on their loan exposures by industry as well as changes in NPL and provisions, in addition to details on their capital strength. To discourage concentration of lending in the property sector, further measures were introduced in December, whereby no new credit facilities were allowed to be granted to

property projects where construction had not yet commenced, while the viability of implemented projects had to be re-examined in the light of a changed economic environment.

As the crisis unfolded, concerns emerged among depositors, leading to a shift of funds from the smaller institutions to the larger banking institutions. The smaller banking institutions essentially experienced heavy withdrawals of deposits arising from unfounded rumours on their health. As the affected institutions were solvent, and their liquidity problems were the result of segmentation in the money market and the shift of deposits to the larger institutions, BNM provided short-term collateralised liquidity support to these institutions to preserve confidence in the banking system. In addition, BNM assured the public that deposits, both the principal amount and interest earned, were guaranteed by the Government.

Despite the prevailing environment and the more stringent provisioning and classification requirements for NPL, the performance of the banking system in calendar year 1997 was encouraging, with pre-tax profit of RM7.9 billion. For financial year 1996, the industry had recorded a pre-tax profit of RM8.7 billion, which was the highest level on record. The return on assets for the calendar year 1997 as a whole amounted to 1.3%, while the return on equity stood at 19%, both of which were reasonably good given the peak of 2% and 27% respectively in financial year 1996. Total NPL amounted to 5.7% at the end of 1997, while the capital adequacy ratio at 10.6% remained well above the minimum requirement of 8%. The loan loss reserves, including collateral, was at a comfortable 173.6% of total NPL. The banking system has been able to absorb the shocks, and has emerged resilient. The banking system as a whole remains sound. At the institutional level, BNM's stringent stress test showed that four banking institutions would have to increase their capitalisation in order to meet the minimum 8% capital requirement in the event that the stringent conditions materialised. Nevertheless, these institutions remained solvent.

The liquidity problems experienced by some small finance companies provided the impetus to these institutions to forge alliances to become bigger and stronger entities. To facilitate this process, five finance companies were identified to be the anchor companies to spearhead mergers. It was envisaged that by 31 March 1998, the respective finance companies would have identified and agreed on the merger partners as well as the terms and conditions of the mergers. Arising from this exercise, the number of finance companies would be significantly reduced. Mergers would not only promote further consolidation of the banking system, but would strengthen the capital base of the banking institutions and provide the cushion against unanticipated risks. Furthermore, adequate capital of a minimum size was necessary in order for a banking institution to remain relevant in a competitive and global world. Three mergers were instituted in 1997, namely, DCB Bank with Kwong Yik Bank, DCB Finance with Kwong Yik Finance, and United Overseas Bank with Chung Khiaw Bank.

While BNM would encourage the push for a core of strong domestic banking institutions under the Two-Tier Regulatory System, the Bank also called on the banking institutions to take stock of their progress and evaluate how successful they had been in achieving the stated objective. Banking institutions have also been requested to re-examine their expansion plans, especially in the light of resource constraints and concerns over their rapidly expanding loan portfolio. The broad objective for strong institutions is not only a matter of size but also to enhance their resilience in adjusting to unanticipated shocks.

At the same time, the Bank would continue with efforts to review its regulatory and supervisory framework to ensure that they remain relevant and effective in promoting the maintenance of a sound

and stable banking system. Development efforts would also continue to promote a more competitive financial system, with broad and deep markets, so that the economy would be able to raise financing in a more efficient manner.

Performance of the Banking System

Following nine consecutive years of robust economic growth and a buoyant economy in early 1997, the banking institutions continued to experience strong performance in the first half of 1997. The NPL had been on a downward trend, and the banking system's profits had increased each year in tandem with the rapidly growing economy. Based on performance in the first half of the year, the banking system was expecting another record year in terms of profitability.

However, the environment changed drastically in the second half of 1997. The sharp fall in the value of the ringgit beginning in July 1997, accompanied by the sharp drop in share prices on the Kuala Lumpur Stock Exchange, strongly affected the earnings and overall performance of the banking sector in the second half of 1997. In the second half of 1997, banking institutions had to accept slower credit growth, rapidly rising interest rates, increasingly tight liquidity conditions, tougher loan provisioning requirements and higher incidence of problematic borrowers. Nevertheless, the banking system managed to turn in encouraging results for calendar year 1997.

Profitability

The preliminary pre-tax profit of the banking system for calendar year 1997 amounted to RM7.9

Table 4.5
Banking System: Performance in 1997

	Net increase	of which:			
	1997/1996	First half 1997		Second half 1997	
	RM million	RM million	% of net increase	RM million	% of net increase
Loans	88,272	48,479	54.9	39,794	45.1
Deposits	76,031	39,432	51.9	36,598	48.1
Non-performing loans (% of total loans) ¹	11,565	1,427	12.3	10,138	87.7
		3.6		5.7	

¹ Refers to position as at end-June and end-December 1997 respectively.

billion, of which 66.8% or RM5.3 billion was earned in the first half of 1997.

The slowdown in profitability during the second half of 1997 was mainly due to the turbulence in financial markets in the region. The impact was seen in rising NPL, higher cost of funds, squeeze on interest margins, and significantly higher loan loss provisions. The higher provisions were largely the result of the sharp increase in net specific provision of RM2.5 billion charged in the second half of the year, as against RM0.3 billion charged in the first half of the year, and adoption of the revised BNM Guideline on the Suspension of Interest on Non-Performing Loans and Provision for Bad and Doubtful Debts. General provisions also increased from RM1 billion during the first half of the year to RM1.4 billion during the second half of the year due to increases in the loan base and the requirement for a higher minimum level of provisioning.

All the three groups of banking institutions registered a significant decline in profitability in the second half of 1997. The decline for commercial banks was the highest, on account of an unusually large pre-tax loss reported by one commercial bank for the six months ended 31 December 1997. For finance companies, the decline in pre-tax profit was largely due to an increase in loan loss provisions and shrinking interest margins on their fixed rate loan portfolio. In addition, the downturn in the motor industry had affected their traditional hire-purchase business. Apart from the substantial increase in loan loss provisions and shrinking interest margins, the decline in the pre-tax profit of the merchant banks in the second half of 1997 was also attributed to the sharp decline in their traditional fee-based activities, resulting in a marked drop in fee-based income. The contribution by the finance companies and merchant banks towards the pre-tax profit of the banking system fell from 17.4% and 11.2% in the first half of 1997 to 14.4% and 7.8% respectively in the second half of 1997.

Although the banking system experienced higher net interest income during the second half of 1997, the increase was offset by the decrease in non-interest income and significant increase in loan loss provisions of RM2.6 billion (+190.5%). During the second half of 1997, the banking system recorded a marginal increase of 1% or RM40 million in

Table 4.6
Banking System: Unaudited Income and Expenditure

	For the calendar year 1997			
	First half	Second half	Change	
	RM million			%
Interest income net of interest-in-suspense (<i>Interest-in-suspense</i>)	22,310 249	27,175 245	4,865 -4	21.8 -1.6
Less: Interest expense	14,248	18,590	4,342	30.5
Net interest income	8,062	8,585	523	6.5
Add: Non-interest income	2,750	2,195	-555	-20.2
Less: Loan loss provision	1,365	3,964	2,599	190.5
Personnel Cost	2,003	1,980	-23	-1.2
Overheads	2,134	2,197	63	3.0
Profit before tax	5,310	2,639	-2,671	-50.3
Of which:				
<i>Commercial banks</i>	3,794	2,051	-1,743	-45.9
<i>Finance companies</i>	923	381	-542	-58.7
<i>Merchant banks</i>	593	207	-386	-65.1

administrative costs. Expenditure on overheads increased by 3% or RM63 million in the second half of the year, mainly due to administrative expenses incurred by the opening of new branches, renovations and relocation of branches.

Reflecting the tight liquidity situation prevailing in the market during the second half of the year, which resulted in the rapid rise in interest rates on deposits, gross interest expense recorded a significant increase of 30.5% in the second half of 1997. Average cost of deposits for the banking system increased from 6.5% per annum as at end-1996 to 6.9% per annum as at end-June 1997 and to 8.1% per annum as at end-1997.

Following deteriorating results in the second half of the year, the key performance indicators of the banking system showed a decline when compared to the first half of the year. Return on assets (ROA) deteriorated from 0.9% in the first half to 0.4% for the second half of the year. Reflective of this, the return on equity (ROE) declined from 10.7% to 5.7% for the second half of 1997. For the calendar year as a whole, the ROA and ROE were 1.3% and 19% respectively, which were reasonable in the context of the prevailing economic environment.

Table 4.7
Banking System: Capital Strength

	As at end			
	Dec. 1996		Dec. 1997	
	RWCR	Tier-1 capital	RWCR	Tier-1 capital
	(%)			
Commercial banks	10.8	9.3	10.3	8.9
Finance companies	9.8	8.1	10.6	8.5
Merchant banks	11.7	10.3	13.3	11.4
Banking system	10.6	9.3	10.6	9.0

Capital

Total shareholders' funds of the banking system increased by RM6.4 billion or 18.1% to RM41.9 billion as at end-June 1997. The increase in shareholders' funds was mainly from the injection of capital totalling RM3.9 billion through rights issues and profits which were ploughed back into reserves. The significant build-up of the capital base during the first half of the year provided adequate cushion for the three groups of banking institutions to absorb provisions arising from deterioration in asset quality.

The capital base of the banking system increased by RM13.7 billion or 33.5% in 1997 to RM54.7 billion. All the three groups of banking institutions registered significant increases in their capital base during the year, with merchant banks registering an increase of 45.2%, followed by finance companies (+36.8%) and commercial banks (+31.2%). The decline in risk-weighted capital ratio (RWCR) of the commercial banks was partly due to the loss made by one commercial bank in the second half of 1997.

The banking system as a whole remained adequately capitalised as indicated by the RWCR which stood at 10.6% as at end-December 1997, against the minimum requirement of 8%. Of this, tier-1 capital ratio amounted to 9%.

Direction of Lending

As a pre-emptive measure to contain asset price inflation, BNM had in March 1997 issued guidelines on lending to the broad property sector and for the purchase of shares and units of unit trust funds. Under these guidelines, loans to the broad property

sector were subject to the limit of 20% of a banking institution's total loans outstanding, while loans for the purchase of stocks and shares (including units of unit trust funds) were subject to the limit of 15% of a banking institution's total loans outstanding (30% in the case of a merchant bank). Following the introduction of these guidelines, banking institutions began to channel more of their credit towards the productive sectors of the economy, although growth in lending to the broad property sector remained strong.

Restrictions were also placed on hire-purchase loans for passenger vehicles in that finance companies were not allowed to provide financing in excess of 70% of the purchase price of non-commercial passenger vehicles, while the repayment period of these loans was restricted to not more than five years.

In order to slow down overall credit growth and to ensure that available resources were channelled to productive uses, banking institutions in October were required to submit plans on their credit growth for the rest of 1997 and for 1998. The credit plans were also intended to complement fiscal measures announced by the Government in the 1998 Budget, which were announced in October 1997. In addition, banking institutions were directed to channel more resources to the productive sectors of the economy and to place low priority on the property sector (excluding bridging and end-financing for residential properties costing RM150,000 and below) and for share financing.

In spite of the introduction of the guidelines on lending to the broad property sector in March 1997 and the subsequent currency and stock market turmoil, the net increase in loans to the broad property sector remained significant throughout the year, amounting to RM16.7 billion in the first half and RM18.5 billion in the second half of 1997. This was mainly due to the disbursement of loans already committed prior to the introduction of the guidelines, coupled with exemption given to several types of loans: for the construction of residential properties costing RM150,000 and below; for the development of infrastructure projects, public utilities and amenities; for the purchase and construction of industrial buildings and factories; and for the purchase of owner-occupied residential properties, whether landed or otherwise. As a result, growth in loans to the construction sub-sector was sustained

Table 4.8
Banking System: Loans by Sectors

	As at end		Change	Share of new loans
	Dec. 1996	Dec. 1997		
	RM million			%
Manufacturing	53,447	63,248	9,801	11.1
Broad property sector	104,660	139,874	35,214	39.9
Wholesale, retail, restaurants & hotels	27,501	34,695	7,194	8.1
Financing, insurance & business services	32,640	36,055	3,415	3.9
Purchase of securities	24,584	39,122	14,538	16.5
Consumption credit	41,518	53,568	12,050	13.7

at the same pace throughout the whole of 1997, while growth in loans for the purchase of residential properties picked up in the second half. However, loans for the purchase of non-residential properties slowed down in the second half of 1997, while real estate loans stagnated throughout the whole of 1997 as both were not exempted in the guidelines.

As a percentage of total loans, loans to the broad property sector amounted to 33.2% as at end-1997 (end-1996: 31.4%). Nevertheless, the banking system as a whole complied with the guidelines on lending to the broad property sector issued in March 1997 with an exposure to the non-exempted sector of the broad property sector of 13.1% of total loans outstanding as at end-1997, against the maximum of 20%. The exposure was 13.4% for the commercial banks and 10.5% for the finance companies. Only the merchant banks narrowly exceeded the limit with an exposure of 21.1%.

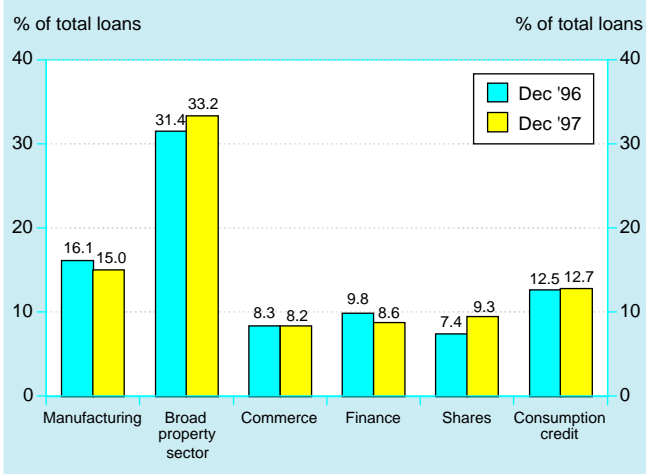
Loans for the purchase of stocks and shares registered a strong growth of RM12.2 billion in the first six months of 1997. However, following the stock market turmoil, loans for the purchase of stocks and shares only increased by RM2.3 billion in the second half of the year. As a percentage of total loans, loans for the purchase of securities (including loans to stockbrokers) amounted to 9.3% as at end-1997 (end-1996: 7.4%), well within the maximum limit of 15% (30% in the case of the merchant banks) stipulated in the guidelines. The exposure was 9.1% for the commercial banks, 5.8% for the finance companies and 20.1% for the merchant banks.

Loans to individuals for the purchase of stocks and shares rose by only RM0.6 billion in the second half of 1997, against the increase of RM2.6 billion in the first half of 1997. Meanwhile, loans to stockbrokers fell by RM1.5 billion in the second half of 1997 as compared with the increase of RM1.8 billion in the preceding half-year period. Total loans to individuals and stockbrokers constituted 4.4% (end-1996: 4.6%) and 0.7% (end-1996: 0.8%) respectively of total loans as at end-1997.

With the cap on lending to the property sector and marked slowdown in lending for the purchase of stocks and shares, banking institutions were encouraged to channel credit to the more productive sectors of the economy, particularly the export-oriented industries. Hence, credit to the manufacturing sector and for general commerce (wholesale, retail, restaurants and hotels) picked up strongly in the second half of the year, with a net increase of RM5.9 billion (first half: RM3.9 billion) and RM5 billion (first half: RM2.2 billion) respectively. As a percentage of total loans, lending to the manufacturing sector fell from 16.1% as at end-1996 to 15% as at end-1997, while the share of general commerce was maintained at 8.2%. Another productive sector experiencing a surge in funding by the banking institutions was transport, storage and communications. Lending to this sector increased by RM4 billion in the second half of 1997 (first half: RM2.5 billion) to account for 3.1% (end-1996: 2%) of total loans outstanding as at end-1997.

Loans for consumption rose by RM7.8 billion in the first half of 1997. In the second half, loans for consumption increased by only RM4.3 billion. The

Graph 4.1
Banking System: Direction of Lending



total increase for 1997 was RM12.1 billion or 29%. The lower increase in the second half was influenced largely by the slowdown in loans for the purchase of passenger cars towards the end of the year, following the tightening of hire-purchase lending for non-commercial passenger vehicles in October 1997. Other contributing factors were the channelling of more loans to the productive sectors of the economy, and the slowing down of credit growth in response to the changing business environment. In addition, consumers were also seen to be restraining their spending in view of the uncertain economic environment. As a percentage of total loans, consumption credit rose marginally from 12.5% as at end-1996 to 12.7% as at end-1997. Of this, loans for the purchase of passenger cars extended by the finance companies amounted to RM32.1 billion or 29.6% of the finance companies' total loans as at end-1997 (end-1996: RM24.5 billion or 28.6%).

To ensure that the loan growth of the banking institutions was in line with the growth in deposits, banking institutions were required to slow down their credit growth. In this regard, they were required to submit their credit plans for 1997 and 1998. Based on these credit plans, credit growth for the banking system as a whole was expected to slow down to 25% by the end of 1997, 20% by end-March 1998 and 15% by the end of 1998. Total loans outstanding as at end-1997 amounted to RM402 billion representing an increase of 25.9% over the amount as at end-1996 (RM319.2 billion). The actual credit growth for 1997 narrowly exceeded the target, largely attributed to drawdown of committed lines. Nevertheless, the slower loan growth and large resource surplus of RM13.8 billion registered for the month of December 1997 compared with a consistent resource gap registered since July 1997, indicated that the call for slower credit growth was beginning to produce the desired results. Consequently, the loan-deposit ratio, which had risen from 89.3% as at end-1996 to peak of 95.8% as at end-November 1997, fell to 92.7% at the end of the year.

Asset Quality

The quality of loans deteriorated towards the end of 1997. Expressed as a percentage of total loans, NPL for the banking system rose from 3.6% as at end-June 1997 to 5.7% as at end-1997. The increase in NPL was partly due to the adoption by 47 banking institutions of the new guidelines on recognition of NPL well ahead of the implementation

date. If the new guidelines were applied to the banking system as a whole, the level of NPL would increase to 6.8% as at end-1997. The increase in NPL was most significant in the case of finance companies, where NPL had risen from 4.3% as at end-June 1997 to 7.8% as at end-1997 while that of the merchant banks, at 4.5% at end-1997, was the lowest.

Notwithstanding the deteriorating asset quality, the current NPL level was way below the peak of 30.1% as at end-1988, when the default period for recognising NPL was 12 months. Loan loss provisions and security coverage amounted to 173.6% of NPL as at end-1997 for the banking system as a whole. In view of the relatively low NPL and comfortable level of loan loss provisions, the asset quality problem of the Malaysian banking system as a whole was manageable.

In terms of NPL by sector, the quality of loans to the broad property sector was one of the areas of concern because of the size of the banking system's loan exposure to the sector. Loans to this sector

Table 4.9
Banking System: Non-performing Loans by Sectors

	As at end			
	Jun. 1997		Dec. 1997	
	RM million	% of total loans to the sector	RM million	% of total loans to the sector
Agriculture	320	4.6	511	6.7
Mining & quarrying	48	4.5	143	10.2
Manufacturing	2,733	4.8	3,441	5.4
Electricity	7	0.2	28	0.6
Community, social & personal services	212	3.1	266	3.9
Broad property sector	5,957	4.9	8,656	6.2
Wholesale, retail, restaurant & hotels	990	3.3	1,605	4.6
Transport, storage & communications	290	3.2	517	3.9
Financing, insurance and business services	400	1.1	1,240	3.4
Purchase of securities	323	0.9	2,780	7.1
Consumption credit	2,395	3.9	4,177	6.6
<i>Credit card loans</i>	384	9.9	461	10.4
<i>Personal use</i>	871	6.4	855	5.7
<i>Purchase of consumer durables</i>	137	5.9	258	14.5
<i>Purchase of transport vehicles</i>	1,003	2.4	2,603	6.2
Other	230	2.2	680	6.0
Total	13,906	3.6	24,044	5.7

Table 4.10
Banking System: Loan Loss Coverage

	As at 31 December 1997	
	Loan loss provision (% of NPL)	Provision + collaterals (% of NPL)
Commercial banks ¹	73.9	193.7
Finance companies	48.4	126.3
Merchant banks	67.4	235.3
Banking system ¹	64.6	173.6

¹ Includes one commercial bank which incurred heavy losses for the six-month period ended 31 December 1997.

accounted for 33.2% of total loans as at end-1997. As at end-June 1997, NPL of this sector stood at RM6 billion or 4.9% of total loan exposure to the sector. By end-1997, this had risen to RM8.7 billion or 6.2% of total loans outstanding to this sector. Within the broad property sector, real estate loans accounted for the highest NPL of 11.6%, followed by construction (6.3%), purchase of non-residential properties (5.5%) and purchase of residential properties (4.6%). Although NPL in respect of real estate loans was high, total real estate loans accounted for only 4.3% of the banking system's total loans outstanding as at end-1997.

In the midst of the stock market turbulence, the quality of loans for the purchase of securities was also an area of concern. As at end-June 1997, NPL for loans for the purchase of securities amounted to RM0.3 billion or 0.9% of total loans outstanding to this sector. Following the sharp fall in share prices on the Kuala Lumpur Stock Exchange in the second half of 1997, the NPL of this sector swelled to RM2.8 billion or 7.1% of total loans outstanding to the sector as at end-1997. Nevertheless, loans for purchase of securities

Table 4.11
Banking System: Outstanding Loan Loss Provision

	As at end			
	Jun. 1997		Dec. 1997 ^p	
	RM million	% of total loans	RM million	% of total loans
Commercial banks ¹				
Interest-in-suspense	1,825	0.7	1,809	0.6
Specific provision ²	1,935	0.7	2,826	1.0
General provision ²	5,138	2.0	6,088	2.1
Total provision	8,898	3.4	10,723	3.7
Non-performing loans	9,233	3.5	14,508	5.0
Finance companies				
Interest-in-suspense	843	0.9	913	0.8
Specific provision ²	963	1.0	1,426	1.3
General provision ²	1,530	1.5	1,777	1.6
Total provision	3,336	3.4	4,116	3.8
Non-performing loans	4,240	4.3	8,497	7.8
Merchant banks				
Interest-in-suspense	63	0.3	90	0.4
Specific provision ²	95	0.4	170	0.7
General provision ²	397	1.8	440	1.9
Total provision	555	2.5	700	3.0
Non-performing loans	433	2.0	1,039	4.5
Banking system ¹				
Interest-in-suspense	2,731	0.7	2,812	0.7
Specific provision ²	2,994	0.8	4,422	1.0
General provision ²	7,065	1.9	8,305	2.0
Total provision	12,789	3.4	15,539	3.7
Non-performing loans	13,906	3.6	24,044	5.7

¹ Includes one commercial bank which incurred heavy losses for the six-month period ended 31 December 1997.
² Includes provision under SPTF.
^p Preliminary

remained relatively small, accounting for only 9.3% of total loans outstanding for the banking system as a whole.

Table 4.12
Banking System: Lending to Broad Property Sector (BPS)

	As at end					
	Dec. 1996		Jun. 1997		Dec. 1997	
	Breakdown of BPS	NPL as % of total loans to the sector	Breakdown of BPS	NPL as % of total loans to the sector	Breakdown of BPS	NPL as % of total loans to the sector
	(%)					
Real estate	17.4	5.7	14.6	10.1	12.9	11.6
Construction	26.6	6.6	29.1	4.8	30.4	6.3
Residential	38.7	4.3	36.7	3.6	36.6	4.6
Non-residential	17.3	3.7	19.6	3.6	20.1	5.5

The turbulence in financial markets had also affected the repayment patterns of borrowers pertaining to loans for the purchase of transport vehicles (passenger cars and commercial vehicles). As at end-June 1997, NPL for this sector stood at RM1 billion or 2.4% of total loans to this sector. By end-1997, this had increased to RM2.6 billion or 6.2% of total loans to this sector. Similarly, NPL relating to credit card loans and loans for purchase of durable goods also deteriorated and were among the highest at 10.4% and 14.5% respectively. However, they were insignificant in terms of overall loan exposure of the banking system, accounting for 0.4% and 1.1% respectively of total loans outstanding as at end-1997 respectively. By contrast, the NPL of the manufacturing sector appeared relatively stable in spite of the crisis. Although NPL of this sector deteriorated slightly from 4.8% as at end-June 1997 to 5.4% as at end-1997, this was partly due to the new loan classification policy adopted by a number of banking institutions.

Liquidity

Liquidity in the banking system was ample during the early part of 1997 but was relatively tight towards the end of the first half following the pressure on the ringgit, which was under speculative attack in mid-May. Liquidity continued to tighten in the second half of the year, following the currency and stock market crisis. The situation was further aggravated by strong demand for credit and flight of deposits from smaller banking institutions, particularly the finance companies to larger banking institutions.

The deposit rates of the three groups of banking institutions rose significantly in the second half of the year reflecting the tight liquidity condition in the market. The average three-month deposit rates for commercial banks and merchant banks rose from 7.4% in June 1997 to 9.1% and 11.5% respectively in December 1997, while the three-month deposit rate of the finance companies rose from 7.6% to 10.3%. Similarly, the three-month weighted average Kuala Lumpur Interbank Offered Rate (KLIBOR) increased from 7.8% in June 1997 to 8.5% in December 1997. As a result, the average base lending rate (BLR) of commercial banks increased from 9.5% in June 1997 to 10.3% in December 1997, while the average BLR of finance companies increased from 10.9% to 12.2%.

The higher deposit rates compared with interbank rates had led to a sharp increase in interbank borrowing by banking institutions as it was cheaper to fund their operations from the interbank market. Nevertheless, as banking institutions were constrained from being too dependent on the interbank market as a source of funding, they had to resort to borrowing from non-interbank market sources, especially from the corporates. This had pushed up the cost of funds of banking institutions resulting in a broad divergence between lending based on cost-plus and lending based on BLR. The liquidity flows in the system improved, however, with the reduction in the Statutory Reserve Requirement by 3.5 percentage points in February 1998. This measure did not lead to an increase in the liquidity of the system as BNM deposits with the banking system were not rolled over on maturity.

External Liabilities

Recognising the nature of banking operations and activities, foreign exchange exposures of the commercial banks were limited to a specified net open position. The net open position was set based on the shareholders' funds and dealing capacity of each banking institution. This limit essentially served as a built-in safeguard to ensure that commercial banks maintained a prudent level of exchange rate risk. The foreign exchange exposures of the commercial banks as measured by the net open position stood at only –RM0.7 billion as at end-December 1997. The exposure was certainly not worrisome as it accounted for only 0.14% of the total assets of the commercial banks. Furthermore, net external liabilities of the commercial banks as at end-December 1997 amounted to RM25 billion, representing only 5% of total assets of the commercial banks.

Of the total external liabilities of the commercial banks, the external liabilities of the locally-incorporated foreign banks amounted to RM16.5 billion or 34% of the total external liabilities of the commercial banks. Of these, more than half were in the form of borrowings from their head offices and affiliates abroad.

Regional Exposure

The financial crisis faced by the East Asian region in the second half of 1997 had altered the risk profile of Malaysian banks with credit exposure to countries

Table 4.13
Exposure of Malaysian Banks to East Asian Region
as at 31 December 1997

Country	Overseas Branches	Labuan Offshore Units	Total	
			US\$ million	%
Indonesia	349	651	1,000	42.4
Thailand	201	224	425	18.1
Korea	36	33	69	2.9
Philippines	57	805	862	36.6
Total	643	1,713	2,356	100.0
Non-performing loans	141	343	484	

severely affected by the turbulence. The regional exposure was, nevertheless, confined to seven banking institutions through the operations of their overseas branches and Labuan offshore units. As at 31 December 1997, the exposure of seven banking institutions, including their Labuan offshore units, in the form of loans and investments to Indonesia, Thailand, Korea and the Philippines amounted to US\$2.4 billion. Of the US\$2.4 billion, 72.7% or US\$1.7 billion represented exposure effected through their Labuan offshore units. The total exposure of Labuan offshore units to these four countries represented 19.2% of their total assets. The amount, however, represented only 2.9% of the total assets of the seven Malaysian banks.

Although this regional exposure was insignificant compared with the total assets of the seven banking institutions, the management of these institutions nevertheless had been monitoring closely the status of this exposure. As at 31 December 1997, US\$484 million or 20.5% of the total exposure was classified as non-performing. The Bank encouraged these banking institutions to require their Labuan offshore units to recognise any potential problems early and to build up provisions for their regional exposure.

The regional financial crisis has also changed the economic environment for the operations of the banking system. The turbulence has to varying degrees tightened the liquidity and weakened the balance sheets of some banking institutions, thereby affecting their performance. Banking institutions found themselves operating in a more difficult economic and business environment in 1997. Nevertheless, the

banking system, as a whole, remained resilient, and the banking institutions, solvent. This, to a large extent, reflects the stringent regulatory framework in which the banking system operates, and the introduction of several appropriate pre-emptive measures to address any potential risks arising from the crisis.

Islamic Banking

Islamic banking continued to record progress in the midst of the financial crisis. Assets expanded by 76.5% to RM17.9 billion while financing recorded a strong growth of 75% to RM10.8 billion. Total deposits mobilised registered a growth of 36.2% to RM9.9 billion during the year. The shareholders' funds of the Islamic bank and the interest-free banking fund amounted to RM1.3 billion, while profit before taxation and zakat amounted to RM153 million in 1997.

Table 4.14
Islamic Banking: Key Data

	As at end of		% change	
	1996	1997	1996	1997
Number of financial institutions	50	52	11.1	4.0
Commercial banks	25	24	8.7	-4.0
Finance companies	21	22	16.7	4.8
Merchant banks	3	5	-	66.7
Islamic bank	1	1	-	-
Total assets (RM million)	10,133	17,881	63.5	76.5
Commercial banks	3,653	9,078	79.2	148.5
Finance companies	1,853	2,924	184.6	57.8
Merchant banks	665	677	156.8	1.8
Islamic bank	3,962	5,202	22.0	31.3
Total deposits (RM million)	7,264	9,895	47.5	36.2
Commercial banks	2,667	5,153	52.8	93.2
Finance companies	966	1,170	154.9	21.1
Merchant banks	348	349	510.5	0.3
Islamic bank	3,283	3,223	19.6	-1.8
Total financing (RM million)	6,143	10,750	75.9	75.0
Commercial banks	2,125	4,706	152.1	121.5
Finance companies	1,225	2,190	170.4	78.8
Merchant banks	393	503	70.9	28.0
Islamic bank	2,400	3,351	22.1	39.6
Financing-deposits ratio (%)	84.6	108.6	12.7	24.1
Commercial banks	79.7	91.3	31.4	11.6
Finance companies	126.8	187.2	7.3	60.4
Merchant banks	112.9	144.1	-290.6	31.2
Islamic bank	73.1	104.0	-0.7	30.9

Although total deposits recorded a growth in 1997, deposits actually registered a decline of 2% (RM200 million) in the second half of 1997, compared with an increase of RM2.8 billion in the first half of 1997. The situation would have been worse if not for the dramatic increase in demand deposits, which recorded a growth of 119.7% as at end-1997. Islamic demand deposits gained popularity given that a number of Islamic banking institutions offered returns on outstanding balances to their depositors. In addition, the increase in demand deposits was also attributed to the shifting of government agencies' accounts previously held with BNM branches to SPTF commercial banks and Islamic bank.

Despite the forecast of a slower loan growth in the banking sector by the end of the year, growth in total Islamic financing rose sharply, particularly in the second half of 1997. During the year, total financing rose from RM6.1 billion at end-1996 to RM10.8 billion at end-1997. It recorded a moderate growth of 29.5% in the first half of 1997 and was much stronger in the second half of 1997, increasing by 36.7%. The exposure of Islamic banking to the broad property sector was significantly large as compared with other sectors and constituted 40.2% of total financing. The high demand for broad property sector financing, particularly in the second half of 1997, was partly due to the increasing trend of the BLR as against the fixed-rate nature of Islamic financing. Under an environment of rising interest rates, borrowers began to seize the opportunity to lock in their cost of long-

Table 4.16
Islamic Banking: Direction of Lending

	Annual change		As at end 1997
	1996	1997	
	RM million		
Agriculture	113	41	194
Mining and quarrying	2	68	73
Manufacturing	168	358	1,283
Electricity	26	10	99
Real estate and construction	537	1,177	2,293
Housing	532	1,039	2,024
General commerce	150	195	524
Transport and storage	186	461	720
Financial, insurance and business services	247	-230	306
Purchase of stocks and shares	-102	625	1,128
Consumption credit	340	125	633
Others	454	738	1,475
Total	2,651	4,607	10,750

term financing under Islamic property financing which was cheaper as compared with conventional financing over the long run.

The tight liquidity situation has put pressure on the operations of Islamic banking. The current turmoil revealed a structural weakness in Islamic banking operations particularly under a volatile economic environment. In Malaysia, 90% of Islamic financing are negotiated on fixed-rate terms such as Murabahah, Bai' Bithaman Ajil and Al-Ijarah Thumma Al-Bai'. Conventional banking has the flexibility to adjust upward the interest rates on borrowing accordingly to reflect the higher cost of funds. Comparatively, the return from financing under Islamic banking would decline under this environment and contribute to lower deposit rates to depositors. In essence, Islamic banking could not react swiftly under the current interest rate environment due to the absence of a floating-rate option. Thus, the lagging factor resulted in a mismatch whereby the financing-deposit ratio registered an increase from 84.6% as at end-1996 to 108.6% as at end-1997. To accommodate the shortfall, Islamic banking institutions had to resort to Mudharabah placements from the Islamic money market which amounted to RM2.6 billion as at end-1997.

The National Syariah Advisory Council for Islamic Banking and Takaful (the Council), established on 1 May 1997, held its inaugural meeting on 8 July 1997. The Council comprised

Table 4.15
Islamic Banking: Deposits by Type & Institutions

	Annual change				As at end 1997
	1996		1997		
	RM million	%	RM million	%	RM million
Current deposits	509	50.8	1,808	119.7	3,319
Commercial banks	373	119.6	1,474	215.2	2,159
Islamic bank	136	19.7	334	40.4	1,160
Savings deposits	524	58.3	398	28.0	1,821
Commercial banks	293	86.9	223	35.4	853
Finance companies	58	207.1	43	50.0	129
Islamic bank	173	32.4	132	18.7	839
Investment deposits	1,304	43.1	425	9.8	4,755
Commercial banks	256	23.4	789	58.4	2,141
Finance companies	529	150.7	161	18.3	1,041
Merchant banks	291	510.5	1	0.3	349
Islamic bank	228	15.0	-526	-30.1	1,224

10 members, including a foreign representative from Sudan. During the year, the Council convened three meetings and among opinions issued were on new Islamic financial instruments and the practices of banking and takaful operations.

Other Financial Institutions

Discount Houses

The operations of the discount houses continued to expand, albeit at a slower pace in 1997. Total resources of the industry rose by RM3.8 billion or 22% in 1997, compared with an increase of RM4.3 billion or 33.9% in 1996. As in previous years, the increase was due mainly to higher deposits which accounted for 94% of the increase in total resources.

Reflecting the tight liquidity in the system during the second half of 1997, the increase in total deposits (including repos) mobilised by the discount houses moderated to RM3.6 billion or 21.7% in 1997 (an increase of RM4.2 billion or 34.1% in the previous year). The increase in deposits was mainly placed by commercial banks (RM2.3 billion) and finance companies (RM1.8 billion). In terms of deposits by type, call money increased by RM2 billion or 36.6% in 1997 (an

increase of RM2.4 billion or 76% in 1996), accounting for 57.2% of the increase in total deposits during the year. Similarly, fixed deposits recorded a smaller increase of RM1.2 billion or 11.5% in 1997 (RM2.1 billion or 24.5% in 1996).

Consonant with the expansion in total resources, total investment of the discount houses increased by RM2.4 billion in 1997, compared with the increase of RM4.7 billion in 1996. The bulk of the increase was invested in private debt securities (PDS), which rose by RM2.7 billion, due to the higher return and the increased availability of PDS in the market. In contrast, investment in Malaysian Government Securities (MGS) and negotiable instruments of deposits declined because of their lower yields compared with yields on PDS and lower primary issues of MGS.

During the year, the discount houses also expanded their fee-based activities. The industry lead-managed, co-managed and arranged the issuance of PDS amounting to RM1.4 billion (RM0.4 billion in 1996), while the total amount underwritten by the discount houses was RM2.7 billion in 1997. The number of discount houses appointed as principal dealers remained unchanged at three in 1997.

Table 4.17
Discount Houses: Sources and Uses of Funds

	Annual change		At end 1997
	1996	1997	
	RM million		
Sources:			
Shareholders' funds	199	217	851
Deposits	4,166	3,550	19,927
Others	-21	7	167
Total	4,344	3,774	20,945
Uses:			
Investment	4,746	2,371	18,500
Treasury bills	-54	0	0
Government securities	155	-323	311
Bankers acceptances	-763	-43	4,296
Negotiable instruments of deposit	316	-236	365
Cagamas papers	112	-111	458
Private debt securities	4,781	2,702	11,872
Others	199	382	1,198
Loans to licensed institutions	425	1,395	2,186
Others	-827	8	259

National Savings Bank

Total resources of the National Savings Bank (NSB) increased by RM167 million or 2.4% to RM7.1 billion at the end of 1997 (RM861 million or 14.2% in 1996). The moderation in growth in total resources was due to the decline in deposits which accounted for 75.8% of total resources. However, this decline was offset by the increase in the Premium Savings Certificates and other current liabilities. The total amount of deposits mobilised fell by RM71 million or 1.3% in 1997 (an increase of RM634 million or 13.2% in 1996), in tandem with the decline in the number of active account holders which fell to 8.5 million at the end of 1997 from 9.2 million at the end of 1996. In December 1997, NSB closed all inactive GIRO accounts, namely accounts which had outstanding balances of less than RM10 and had been inactive for more than two years. In terms of deposits by type, although the deposits mobilised through the GIRO scheme declined by RM192 million or 7.5% in 1997, it continued to be the most popular deposit scheme,

accounting for 44% of total deposits. The growth in fixed deposits increased strongly by 23.5%, while savings deposits declined by 9.6%. The higher fixed deposits mobilised during the year could be due to higher deposit rates offered by NSB which ranged from 9.35% to 9.45% per annum in 1997, compared with a range of 7.20% to 7.25% per annum offered in the previous year. Meanwhile, the Islamic savings scheme introduced in 1994, continued to gain popularity as evident from its increase by RM12.3 million or 57.5% to RM34 million. With the extensive publicity and attractive prizes offered, the number of Premium Savings Certificates sold during the year increased by 7.9% to 583,289 certificates valued at RM604 million.

During the year, NSB invested about 56.9% of its total resources in various types of investment certificates. As in previous years, in accordance with the statutory requirement, the bulk of the resources was invested in MGS, which accounted for 35.8% (RM1.4 billion) of the total investment as at end-1997. Other investments were in the form of trustee stocks (RM904 million), Government promissory notes (RM501 million), unquoted shares (RM485 million) and non-trustee stocks (RM219 million).

Reflecting the expansion in economic activities, lending operations of NSB increased significantly. Total loans outstanding increased by RM448 million or 31% to RM1.9 billion at end-1997 (RM352 million or 32.1% in 1996). The bulk of the outstanding loans continued to be extended to individuals, accounting for RM1.8 billion or 91.9% of total loans outstanding. Of this, RM873 million or 48.9% was utilised for hire-purchase financing and RM738 million or 38.9% was granted for the purchase of houses. Corporate and subordinate loans extended also increased, albeit marginally by RM1.1 million or 0.7% to account for a share of 8.1% of total loans outstanding. As in the previous year, NSB allocated about 2.5% of its total loans outstanding for doubtful debts. This provision was higher than the minimum requirement for general provisions of the banking industry, which was at least 1.5% of total loans outstanding net of specific provisions and interest-in-suspense.

In 1997, several branches of NSB were merged, resulting in the total number of branches and sub-branches being reduced to 469 from 475 at the end of 1996. In addition, savings account facilities were also provided in 621 permanent and 21 mobile post offices. During the year, three new automated teller machines (ATMs) were installed, bringing the total number of ATMs to 595 by the end of 1997.

Table 4.18
National Savings Bank

	Annual change		At end 1997 ^p
	1996	1997 ^p	
	RM million		
Deposits ¹	634	-71	5,380
Savings	-52	-162	1,520
Fixed	250	274	1,437
Save-As-You-Earn	-3	20
GIRO	427	-192	2,369
Others	9	12	34
Premium Savings Certificate	113	135	604
Investments (book value)	589	-331	4,042
Malaysian Government Securities	-151	-511	1,446
Other investments	740	180	2,596
Total loans	371	458	1,945
Total loans (after provision for doubtful debts)	352	448	1,896
Number of NSB branches ²	-5	-6	482
Number of post offices with NSB facilities	6	6	642
Number of account holders (' 000)	-165	-680	8,471

¹ Includes interest credited

² Includes mini-branches and sub-branches

^p Preliminary

Provident and Pension Funds

Total resources of the 12 **provident and pension funds (PPF)** surveyed by BNM grew by 13.7% (18.8% in 1996) to RM154.3 billion at the end of 1997. Accumulated contributions in contributors' accounts formed the bulk (90.7%) of the resources, while reserves and other liabilities accounted for the balance. Accumulated contributions in contributors' accounts amounted to RM139.9 billion at the end of 1997 (RM121.7 billion at the end of 1996), with the bulk (94%) placed with the Employees Provident Fund (EPF). Growth on an annual basis moderated to 15% from 16.9%, due largely to lower net contributions as well as lower dividends credited during the year. Another contributory factor was the slower growth in the number of contributors of 3.9% (5.1% in 1996) to 16.9 million at the end of 1997.

Net contributions to the PPF during 1997 declined for the first time since 1987, by 1.3% to RM10.3 billion. Similarly, net contributions as a percentage

Table 4.19
Provident and Pension Funds: Selected Indicators

	1995	1996	1997 <i>p</i>
	RM million		
As at end			
Number of Contributors ('000)	15,448	16,231	16,872
Accumulated Contributions	104,103	121,704	139,905
Assets	114,192	135,715	154,254
<i>Of which: Investments in Malaysian Government Securities</i>	<i>41,190</i>	<i>40,952</i>	<i>40,029</i>
During the year			
Contributions	11,853	14,535	16,671
Withdrawals	3,677	4,105	6,376
Net Contributions	8,176	10,431	10,296
Dividends Credited	6,833	8,196	8,172
Income	7,498	9,630	10,217

p Preliminary

Source: Employees Provident Fund, Pensions Trust Fund, Social Security Organisation, Armed Forces Fund, Malaysian Estates Staff Provident Fund, Teachers Provident Fund and six other private provident and pension funds.

of gross national savings decreased to 9.8% (11.4% in 1996). This reflected the moderation in gross contributions and the sharp rise in withdrawals, particularly for the Investment of Members Saving Scheme. Gross contributions expanded at a slower pace of 14.7% given that the growth of 22.6% in the previous year was exceptionally high following a one percentage point increase in the minimum rate of contribution to the EPF. The 1998 Budget announcement in October 1997 to increase the maximum tax deduction allowed on employers' contributions to the EPF or other approved provident

funds from 17% to 19% did not have a significant impact on gross contributions in 1997, with only two months of the year remaining.

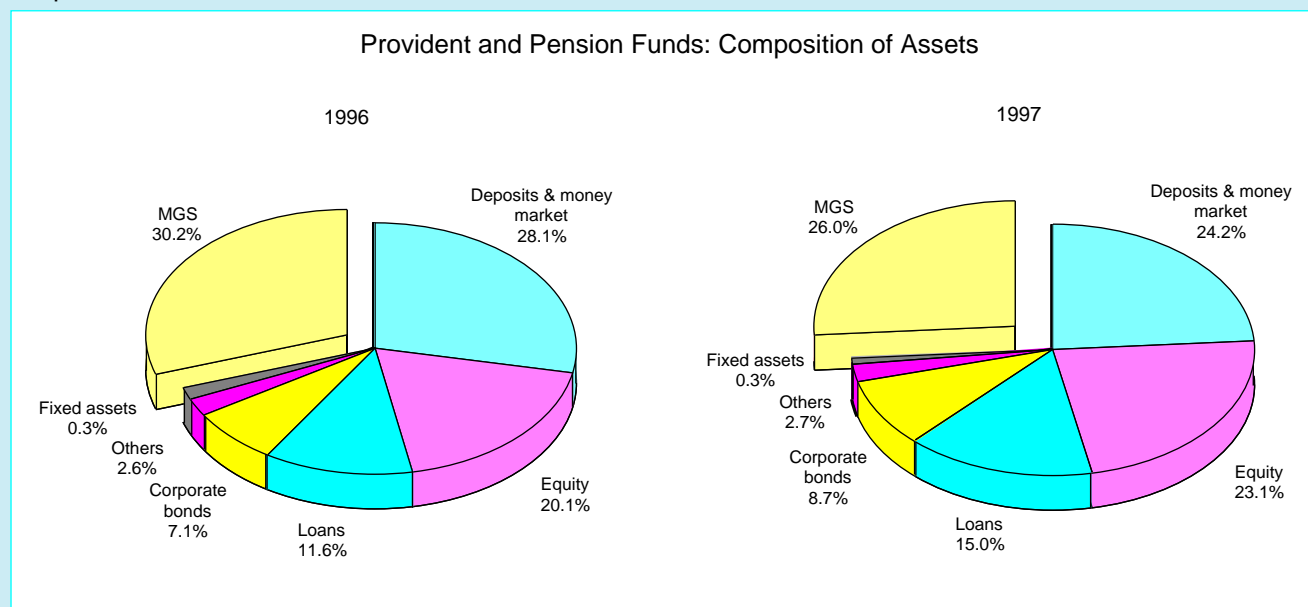
Total withdrawals increased sharply by 55.3% (11.6% in 1996) to reach RM6.4 billion in 1997, reflecting the cumulative effects of the liberalisation of EPF withdrawal schemes. The bulk of the withdrawals from the EPF was effected under the Age 55 Withdrawal Scheme (39.6% or RM2.2 billion) and the Housing Withdrawal Scheme (23.6% or RM1.3 billion). Withdrawals to invest in approved fund management institutions under the Investment of Members Saving Scheme were allowed in November 1996 following amendments to the EPF Act. Such withdrawals grew strongly by nearly 19 times to reach RM627 million, accounting for 11% of total withdrawals from the EPF in 1997.

Another factor that contributed to the moderation in accumulated contributions was the lower amount of dividends credited to contributors' accounts in 1997. Dividends credited decreased marginally by 0.3% in 1997, attributed partly to the lower dividend rate of 6.7% (7.7% in 1996) declared by the EPF, as well as the substantially slower expansion in income of 6.1% (28.4% in 1996).

In terms of the composition of the assets of the PPF, the trend in the shift away from Government papers into private papers continued. Holdings of Malaysian Government

Graph 4.2

Provident and Pension Funds: Composition of Assets



Securities (MGS) declined progressively, accounting for 26% of total assets at the end of 1997 (30.2% at the end of 1996), in view of the lower amount of MGS outstanding as the healthy financial position of the Government reduced its need for new borrowings. However, investments in private papers, namely, loans, corporate bonds and equity, increased in importance, rising by 47.1%, 38.6% and 30.7% respectively to account for higher shares of 15%, 8.7% and 23.1% in their asset portfolio. The higher shares of loans and corporate bonds reflected mainly the increased participation of the EPF in financing privatised infrastructure projects. Similarly, the higher share of equity was primarily a result of the increase in the portion of equity in the asset portfolio of the EPF from 15% to 19% following approval by the Ministry of Finance on 16 August 1997 to allow the EPF to increase its exposure limit to equity investments from 15% to 25%.

In 1997, the EPF continued to play its role in promoting house ownership among the lower-income group, by providing financing for the construction of low- and medium-cost houses through its subsidiary, Malaysia Building Society Berhad (MBSB). As at the end of 1997, MBSB had undertaken housing development projects at four sites (three in Peninsular Malaysia and one in Sarawak) for the construction of 46,854 units.

Pilgrims Fund Board

The activities of the Pilgrims Fund Board continued to expand in 1997. Total resources mobilised by the Board amounted to RM6.1 billion at the end of 1997, representing an increase of 30.2% or RM1.4 billion (37.5% or RM1.3 billion in 1996). The increase in resources reflected the rapid expansion of its operations which included the increase in the number of depositors as well as favourable investment returns during the year. The total number of depositors increased by 8.6% to 3,205,885 at the end of 1997 compared with 2,951,004 in the previous year. Similarly, the number of members registered with the Board to perform the pilgrimage was higher at 25,474 in 1997 (25,326 in 1996).

Total balances held by depositors, including bonuses credited, rose by 33.3% or RM1.4 billion (37.2% or RM1.2 billion in 1996), accounting for 93% of the total resources mobilised at the end of 1997 (91% at the

end of 1996). During the year, withdrawals of deposits increased by 24.3% to RM1.2 billion, while deposits increased by 21.4% to RM2.1 billion, resulting in a net increase in deposits of RM982 million. By maintaining the bonus rate at 9.5% per annum, the amount of bonuses credited to depositor's accounts increased by 34.3% to RM440 million.

The Board invested the bulk of its investible funds in corporate securities. Investments in corporate securities rose by 54.2% to RM3 billion (27.6% to RM1.9 billion in 1996), accounting for 48.7% of total assets in 1997. Of these investments, 50.8% was in unquoted shares, mainly in the plantation and industrial sectors, and 49.2% in quoted shares. Although investments in short-term instruments declined by 7.9% to RM2 billion in 1997 (RM2.2 billion in 1996), they accounted for 33% of total assets. Largely due to the higher share of investments in corporate securities, gross dividends received by the Board increased by 48.5% to RM180 million (-24.8% or RM121 million in 1996). During the year, income earned from other investments increased by 44% from RM335 million to RM482 million.

Industrial Finance Institutions

Asset growth of the industrial finance institutions in 1997 was marginally higher than the preceding year. The increase in assets was due mainly to the expansion in loans which accounted for more than half of the increase, and investments. The increase in assets was funded by capital injection and borrowing.

As the industrial finance institutions are not licensed to conduct deposit-taking activities from the public, they have traditionally relied heavily on borrowing to fund their asset growth. Established primarily to promote development programmes in the agricultural, industrial and international trade and export sectors, they are able to access cheap resources from the Government and international development funds, like the ASEAN-Japan Development Fund and the Overseas Economic Co-operation Fund of Japan.

Borrowing by industrial finance institutions increased significantly by 25.5% in 1997 (12.3% in 1996) to account for 70.3% of the increase in the total liabilities. The increase in borrowings was

Table 4.20
Industrial Finance Institutions: Changes in Direction of Lending

Sector	Year					
	1995/94		1996/95		1997/96	
	RM million	%	RM million	%	RM million	%
Real estate & construction	318	38.1	683	62.0	569	51.6
Manufacturing	187	22.4	115	10.5	214	19.4
Agriculture	-63	-7.5	18	1.6	23	2.1
General commerce	64	7.7	105	9.5	19	1.7
Mining & quarrying	2	0.2	-3	-0.3	8	0.7
Transport & storage	-1	-0.1	-26	-2.3
Other	327	39.2	184	16.7	295	26.8
Total	834	100.0	1,102	100.0	1,102	100.0

mainly by Export-Import Bank of Malaysia Berhad (RM467.7 million), Malaysian Industrial Development Finance Berhad (RM338.6 million) and Sabah Development Bank Berhad (RM244.2 million). There were no significant changes in the foreign borrowings of industrial finance institutions in 1997, except Export-Import Bank of Malaysia Berhad which recorded an increase of RM155 million.

The other major source of funding in 1997 was capital funds, which accounted for 28.7% of the total increase in the liabilities of the industrial finance institutions. The increase in capital funds was due mainly to the increases in paid-up capital of Export-Import Bank of Malaysia Berhad (RM120 million), Bank Industri Malaysia Berhad (RM120 million) and Sabah Development Bank Berhad (RM100 million).

The loan growth of the industrial finance institutions in 1997 was 22.1% compared with 28.4% in 1996. As in the previous year, loans to the real estate and construction sector took the largest share of the increase in loans. However, the quantum had reduced from two-thirds of the total increase in loans in 1996 to only one-half in 1997. Notwithstanding this, the industrial finance institutions' exposure to the real estate and construction sector continued to remain high at 35.3% of total loans outstanding as at the end of 1997 (1996: 31.7%). Loans extended to the manufacturing sector accounted for one-fifth of the increase in loans in 1997 (10.5% in 1996) to account for 34.3% of total loans outstanding as at end 1997 compared with 37.5% as at end 1996. The balance of the loan increase was channelled to the other sectors of the economy.

Financial Markets

The financial markets in Malaysia experienced turbulence in 1997 following the contagion of the regional financial crisis. Significant adjustment was evident in the capital, money and foreign exchange markets. While stable conditions prevailed in the early months of the year, the domestic financial markets experienced several waves of shocks during the course of the year.

Strong corporate activity and increased private investment outlays led to an increase in net long-term funds raised in the capital market to RM33.4 billion during the year. An equal amount of funds was raised by the private sector in the form of equity and private debt securities. Funds tapped from the stock market were noticeably lower late in the year as investor sentiment weakened. In April, initial concerns were raised over the impact of prudential measures that had been implemented on the banking system, and the direction of international interest rates, on corporate performance. The general sentiment deteriorated during the second half of the year as the effects of the regional crisis worked through the economy and eroded investor confidence. As a result of the bearish sentiment, prices and the value of shares on the Kuala Lumpur Stock Exchange (KLSE) fell by half, an unprecedented development in the history of the Malaysian stock market. Stock prices registered sharp declines on three occasions: in April, August and again in October-November. Total trade transacted was higher than in the previous year although the value decreased, as the overwhelming selling activities vis-a-vis buying activities led to lower transacted prices. By the end of the year, the KLSE was ranked seventh in the Asia-Pacific

region and second in ASEAN from fourth and first respectively a year ago.

In the foreign exchange market, trading increased significantly, with activity reaching a peak in July as speculative activity affected a number of currencies in the region and on account of outflows of funds from the domestic equity market. The money market experienced a similar expansion in the volume of trading, reflecting the strong demand for funds in an environment of tight liquidity conditions. Reliance on the interbank market became greater during the latter part of the year when a number of small banking institutions faced large deposit withdrawals.

The greater volatility in the equity market and increased uncertainties in the foreign exchange market contributed towards increased hedging activity on the Kuala Lumpur Options and Financial Futures Exchange (KLOFFE), as reflected in the substantially higher turnover of the KLSE Composite Index futures contracts. In contrast, the trading volume of the 3-month Kuala Lumpur Interbank Offered Rate (KLIBOR) futures on the Malaysia Monetary Exchange (MME) remained moderate. The low turnover in the last quarter was attributed to the distortion and fragmentation of the KLIBOR futures market and its related cash market, as well as the growing uncertainty in the direction of interest rates.

The Bank continued to accord priority to the development of financial markets as part of the overall development of the financial system, in order that the system would become more strongly market-oriented, with diversity and depth. The objective was for the financial system to have available a variety of instruments and a sufficiently large number of players.

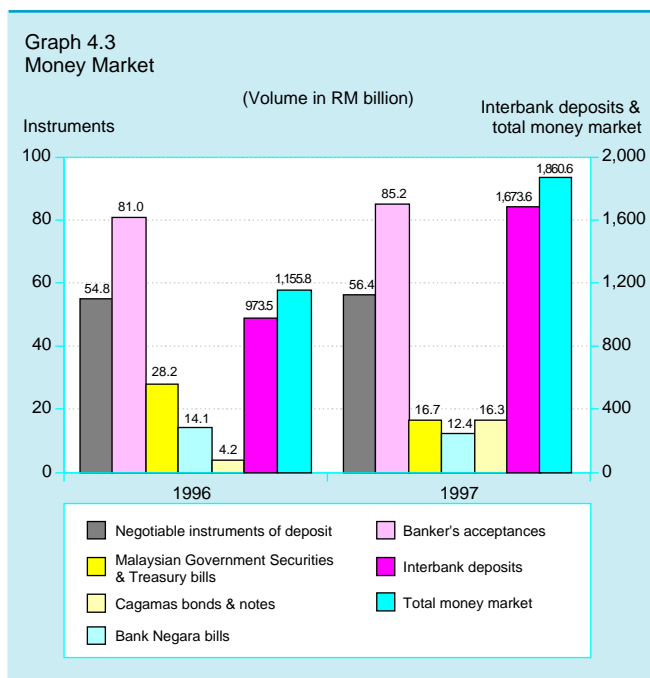
Towards this end, the Bank increased the number of principal dealers as part of the effort to promote an active money market through a principal dealer system that consisted of dynamic and performance-oriented market makers. The privileges of the principal dealers were also reviewed. As the size of operational capacity became increasingly important, and to increase their participation, the Bank raised the minimum capital requirement for finance companies wishing to participate in the money market. The Bank was mindful that the existence of an efficient money market would enhance the effectiveness of the transmission of monetary

policy. In the bond market, the launching of the Bond Information and Dissemination System, a comprehensive data collection and dissemination system on the local bond market, reflected the commitment of the Bank towards more efficient dissemination of information and greater efficiency of the market.

Priority was also directed towards improving and strengthening the financial infrastructure, as well as increasing the breadth of other financial markets. The measures included the enhancement of the market infrastructure of the KLSE through sectorisation of the Second Board companies, full prescription of all non-equity counters into the central depository system and shortening of the settlement period from seven days to five days after the transaction date; amendments and revisions to policies and guidelines by the Securities Commission on the issue and offer of securities and release of new guidelines on the offering of securities of foreign-based companies; and introduction of additional products on the MME such as the All-Or-None order and the serial month KLIBOR futures.

Money Market

The volume of funds traded in the **money market** expanded significantly in 1997, reflecting the strong demand for funds to finance credit expansion in an environment of tight liquidity conditions. Total volume of funds traded increased significantly by 61% to RM1,861 billion or an average monthly volume of RM155 billion in 1997 (31% growth in 1996). The increase in total transactions was contributed mainly by the 72% increase in trading in interbank deposits to RM1,674 billion. The higher interbank trading was due to greater reliance on the interbank market to meet funding requirements given the tight liquidity in the banking system as reflected in the resource gap of RM6.6 billion in 1997. Taking into account the compliance with the statutory reserve requirement, the gap would have been higher at RM20.5 billion. The increase in trading volume was also reflective of higher turnover rates as transactions were concentrated at the shorter-end of the market. The greater reliance on the interbank market during the last four months of 1997 was particularly evident among a number of small banking institutions which faced withdrawals of deposits during this period. This development led to the share of overnight transactions increasing to 83% of all deposit transactions in the last four months of the year (79% for 1997 as a whole, 76% for 1996).



Meanwhile, trading in money market instruments increased more modestly by 2.7% to RM187 billion. This was primarily due to the slower growth in the transactions volume of two of the most heavily transacted instruments, namely, negotiable instruments of deposit (NIDs) and banker's acceptances (BAs), which jointly comprised 75% of the total volume of papers traded in the market. The slower growth in these two instruments was attributed to higher interest rates in 1997. The uptrend in interest rates resulted in declining prices for NIDs and BAs, which discouraged secondary trading. In the case of Malaysian Government Securities (MGS), there was a marked decline in secondary trading following a reduced primary issue of RM3 billion in 1997 (RM6 billion in 1996). The thinner trading in MGS also reflected market players' preference to hold MGS to meet the liquid asset requirement. Availability of assets to meet this requirement was affected by the maturity of RM6 billion of Bank Negara Bills in 1997. The decline in MGS trading was, however, mostly offset by an increase in the trading of Cagamas notes. This, combined with the relative stability in the trading volumes of other instruments, resulted in an overall marginal increase in the total volume of money market instruments traded.

As part of the policy towards promoting an active money market through a principal dealer system that consists of dynamic and performance-oriented market makers, the Bank increased the number of principal dealers (PDs) to 16 in 1997 with the appointment of three more PDs on 1 January 1997.

The merging of two of the PD banks in 1997 brought the total number of PDs to 15 at the end of 1997. As the size of operational capacity became an increasingly important competitive factor in the money market, and in efforts to increase participation of PDs in the growth of the financial market as a whole, the Bank raised the minimum capital requirement for finance companies wishing to participate in the money market. With the emphasis on strength of participation and level of activity, finance companies were required to have a minimum shareholders' funds of RM100 million effective 1 January 1997. This minimum was raised further to RM350 million on 1 January 1998 and will be raised again to RM600 million effective 1 January 1999. To further promote trading in the money market, changes were introduced to the privileges given to PDs. Where previously PDs were allowed to net off holdings of excess liquid assets from their eligible liabilities base (subject to a limit of RM50 million), effective 16 May 1997, each PD could deduct from its eligible liabilities base 15% of its sales or purchases of these specified instruments in the secondary market, whichever was lower.

The **Islamic interbank money market (IIMM)** recorded another year of significant improvement in activity. Total volume, encompassing transactions in Mudharabah interbank investment (MII), the Islamic interbank cheque clearing system (IICCS) and interbank trading of Islamic papers, increased significantly by 176% to RM134 billion in 1997. The rise in total volume was attributed to an increase in the volume of MII transacted and greater use of the IICCS to meet funding requirements under the tighter liquidity conditions. Similar to the conventional money market, the volume of trading in papers was also relatively unchanged in the IIMM. Nevertheless, growth of the IIMM as a whole was much faster than the conventional money market. Consequently,

Table 4.21
Islamic Interbank Money Market

	1995	1996	1997
	RM million		
Mudharabah Interbank Investment	1,125	28,742	92,259
Islamic Interbank Cheque Clearing System	2,460	3,513	25,540
Islamic Papers	5,983	16,417	16,274
Total	9,568	48,672	134,073

by end-1997, in terms of relative size, the IIMM trading volume equalled 7.2% of the conventional money market volume in 1997 (4.2% in 1996).

Foreign Exchange Market

The average daily volume of interbank foreign exchange transactions (spot and swap transactions) effected through the eight foreign exchange brokers in the Kuala Lumpur foreign exchange market increased by 65.6% during the year, from RM3.2 billion in 1996 to RM5.3 billion in 1997. The sharp increase reflected the increased number of transactions as well as higher value for each transaction, amidst volatile trading conditions. The activities in the foreign exchange market were dominated by the transactions of the United States dollar against the ringgit. Total transactions in the United States dollar rose to RM1,215 billion from RM686 billion in 1996, accounting for 92.1% of total transactions for the whole year. Transactions in the United States dollar for Deutsche Mark and Japanese yen accounted for 4.3% and 2.4% respectively.

Activity in the foreign exchange market peaked in July in the wake of increased speculative activity on the ringgit in the aftermath of developments in Thailand. The sales of ringgit were also caused by the outflow of funds from the equity markets in Malaysia to markets abroad, particularly the United States. Thereafter, trading activity moderated but picked up again in November and December following increased volatility and commercial demand for the United States dollar for year-end activities. The offshore financial institutions were the major buyers of the United States dollar for the ringgit in the swap market during the year, reflecting

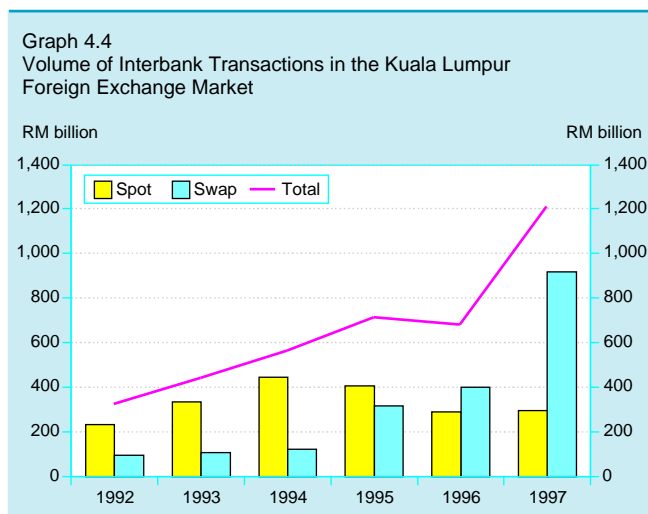
speculative activity against the ringgit in the wake of the regional currency crisis.

Capital Market

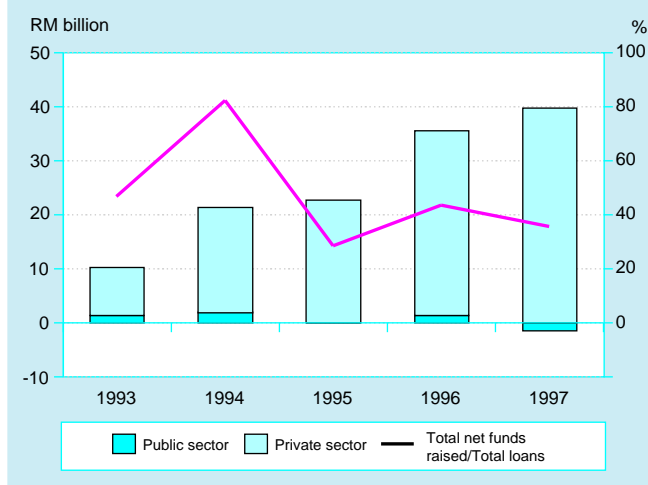
Net long-term funds raised in the capital market reached an unprecedented level of RM33.4 billion in 1997 (RM31.8 billion in 1996) representing the fourth consecutive year of growth. While the public sector reduced its recourse to the capital market, the private sector continued to dominate the market, a trend evident since 1989. The predominance of the private sector in the market reflected primarily strong corporate activity and increased private sector investment outlays following an extended period of high economic growth. Stock market sentiment weakened initially at the end of the first quarter as concerns emerged over international interest rates and the introduction of pre-emptive measures to curb credit for less productive activities. Reflecting the contagion effects of the regional financial crisis in the second half-year, economic activity and, hence, corporate activity moderated somewhat, dampening further stock market sentiment. As a result, activities in the primary market showed some signs of moderation. In terms of sources of financing, the ratio of net funds raised in the capital market to total loans extended by the banking system fell to 46% from 53% a year ago. This was attributable to the more stringent approval requirement for new issues of private debt securities (PDS) announced in 1996 as well as the much dampened stock market sentiment, which discouraged the number of prospective issuers seeking new funds.

In tandem with the favourable financial position of the public sector since 1990, the public sector progressively reduced its recourse to the capital market. During the year, the position of the public sector changed to record a net redemption of RM1.4 billion, the last occasion being in 1995 (RM35.2 million). In 1996, net funds raised amounted to RM1.3 billion. Two issues of Malaysian Government Securities (MGS) of RM1 billion and RM2 billion each (RM6 billion in 1996) were raised in part to offset the redemption of the securities during the year, as well as to meet the demand of the banking institutions to fulfil their liquid asset requirements.

A notable development in the Government securities market was the maiden issue of Khazanah Bonds in September, with the objective of developing the benchmark yield curve for the ringgit bond



Graph 4.5
Total Net Funds Raised in the Capital Market
By the Public and Private Sectors



market. The bonds, issued based on the Mudharabah concept, with no coupon or interest payment, had a face value of RM1 billion and tenure of three years. The issue was expected to prelude a series of subsequent and regular issues of benchmark bonds, initially with a tenure of three years to be extended up to 10 years within five years of its introduction.

In contrast to the net repayment by the public sector, net funds raised by the private sector amounted to RM34.8 billion, representing an increase of 14.2% from 1996. In terms of composition, the equity market mobilised a larger amount of RM18.2 billion or 52.4%, while the balance was raised from the PDS market.

In the equity market, about half of the funds was tapped from rights issues (RM8.5 billion or 46.8%). Other forms of corporate securities issued comprised initial public offers (RM4.8 billion or 26.1%), private placements and restricted offers-for-sale (RM3.1 billion or 17.1%) and special issues (RM1.8 billion or 10%). One third of the rights issues was raised by banking institutions to strengthen their capital base as well as to further expand their businesses. Together with the largest rights issue during the year of RM1.5 billion to develop the Bakun Hydroelectric Dam, these issues accounted for approximately half of the total amount sourced from rights issues. In the case of new listings, the number of issues and amount of funds raised were sustained at 88 issues totalling RM4.8 billion (92 issues amounting to RM4.1 billion in 1996). Most of the newly listed companies were also in the Second Board (63), with the remaining

25 companies being listed on the Main Board. Of significance were two developments that occurred late in the year as the regional financial crisis eroded investor confidence and worsened market sentiment. Firstly, the stock market witnessed for the first time, the failure of 15 companies to post a premium over their offer price on the listing date. These companies in fact, closed at a discount to their offer price. More importantly, 13 of these 15 issues occurred in the last two months of 1997, suggesting that investor confidence had reached its lowest. Secondly, related to this, the number of cases of undersubscription of shares was more pronounced, and one company had to abandon its plan to list on the stock exchange after its failure to meet with the minimum subscription level as set out in its prospectus. The weak market sentiment, coupled with these developments, caused several companies to lower their rights issue price and one issuer to abort its rights issue. The dampened market sentiment also discouraged a number of prospective issuers from seeking new funds. As part of the measures to strengthen economic stability and instill confidence in the financial system, a freeze on submissions for new listings, rights issues, and corporate restructuring was imposed on 5 December,

Table 4.22
Funds Raised in the Capital Market

	1996	1997 <i>p</i>
	RM million	
By Public Sector		
Government Securities (gross)	6,000	3,000
Less Redemptions	3,809	3,648
Less Government Holdings	-74	-1
<i>Equals</i> Net Federal Receipts	2,265	-647
Khazanah Bonds	-	794
Govt. Investment Issues (net)	-900	-1,400
Malaysia Savings Bond (net)	-34	-155
Net Funds Raised	1,331	-1,407
By Private Sector		
Shares	15,924	18,225
Debt Securities ¹	17,038	19,546
Less Redemptions	2,515	2,998
<i>Equals</i> Net Issues	14,523	16,548
Net Funds Raised	30,448	34,773
Total Net Funds Raised	31,779	33,366
Short-term Papers and Notes (net) ²	3,811	4,946
Total	35,590	38,312

¹ Excludes debt securities issued by banking institutions.

² Refers to commercial papers and Cagamas Notes only.

p Preliminary.

while no new approvals would be given. The only exceptions were strategic investments that generated foreign exchange and savings.

In the PDS market, net funds raised amounted to RM16.5 billion in 1997 (RM14.5 billion in 1996). The higher funds raised were reflective of increased capital investment in line with the sustained economic growth. The bulk of the PDS was raised by the finance, insurance and business services and manufacturing sectors. In terms of purpose, the PDS issued was predominantly for capital investment (69.9% of total), with debt refinancing and mergers and acquisitions accounting for 17.1% and 12.3% respectively of the total issued. In terms of composition, the bulk of the funds was raised through Islamic bonds (26.9% of the total gross funds raised in the PDS market), Cagamas bonds (26.4%), conventional bonds (19.6%) and bonds with warrants (16.9%). As in 1996, the largest issue of Islamic bonds of RM2.2 billion was by Kuala Lumpur International Airport Berhad. On the other hand, Cagamas improved on its previous record of RM4.7 billion raised from 16 issues in 1996 to RM5.2 billion from 13 issues in 1997. The three-year tenure remained most popular, accounting for eight issues. The increased issuance of the bonds reflected mainly the larger amount of housing loans purchased by Cagamas as part of the strategies undertaken by the banking institutions to better manage their liquidity

positions as liquidity conditions tightened towards the end of the year.

The year 1997 was a landmark in the history of the Malaysian stock market as the **Kuala Lumpur Stock Exchange (KLSE)** experienced its sharpest correction ever, with both its prices and value reduced by half. In early 1997, expectations were for the buoyant market activity that prevailed at the end of 1996 to continue, supported by foreign investor interest. Reflecting the optimistic outlook, share prices and trading volume on the KLSE rose in tandem, with the volume of turnover reaching a high of 9.2 billion units in February, the highest since January 1996, and the Kuala Lumpur Composite Index (KLCI) culminating in a three-year high of 1,271.57 points on 25 February. The net price/earnings ratio of the KLCI was 27.61 at the end of February. Similarly, the overwhelming interest in the Second Board companies, which was most intense in 1996, persisted into the early part of 1997, so that the Second Board Index (SBI) climbed to a high of 680.25 points on 19 March, and its monthly net price/earnings ratio reached the historical peak of 57.74 in February.

The uptrend was, however, halted in April for several reasons: concerns over the direction of international interest rates; the introduction of

Table 4.23
New Issues of Private Debt Securities (excluding Cagamas Bonds), by Sector and Purpose (RM million)

Sector	Purpose									
	Capital Investment	Debt Refinancing	Mergers & Acquisitions	Others	Total	Capital Investment	Debt Refinancing	Mergers & Acquisitions	Others	Total
	1996					1997				
Agriculture, Forestry and Fishing	-	-	-	-	-	32	181	-	-	214
Mining and Quarrying	-	-	-	-	-	-	-	-	-	-
Manufacturing	1,377	626	1,222	9	3,234	2,879	411	310	5	3,604
Construction	2,116	219	252	11	2,598	1,063	161	824	21	2,069
Electricity, Gas and Water	1,017	-	-	-	1,017	1,691	522	-	-	2,213
Transport, Storage and Communications	2,602	284	-	-	2,886	2,260	-	-	-	2,260
Finance, Insurance, Real Estate and Business Services	219	100	-	-	319	2,044	1,183	600	70	3,897
Government and Other Services	436	-	-	-	436	-	-	-	-	-
Wholesale, Retail Trade, Hotels and Restaurants	369	559	951	4	1,883	84	-	33	3	120
Total	8,136	1,788	2,425	24	12,373	10,053	2,458	1,767	99	14,377

measures to curb excessive lending to the property sector and for the purchase of stocks and shares; and the announcement of plans to shorten the settlement period from seven days after the transaction date to five days. As a result, by end-April, the KLSE experienced a significant fall, with the KLCI declining by 10.2% and the monthly turnover registering a lower amount of RM38.8 billion (average of RM49.9 billion per month in the first three months of 1997).

The bearish sentiment worsened in July, with the market weighed down by concerns over the speculative pressures on the ringgit following the de facto devaluations of both the Thai baht and the Philippine peso. A series of developments further exacerbated the poor sentiment: the revised rating outlook for Malaysia and major Malaysian banks by an international rating agency; the designation of all 100 components of the KLCI; the suspension of short-selling through the prohibition of securities borrowing and lending; and the restriction on non-commercial related offer-side swap transactions. The consequence was the sharpest fall in the KLSE for the year, when the KLCI dipped by 20.6% in August.

The combination of domestic and regional developments continued to influence the performance of the KLSE for the rest of the year. In September, the lifting of the 100 designated KLCI components gave the market some temporary respite. However, the announcement to allow companies to buy back their own shares had limited success in boosting market confidence. Sentiment was depressed again in October, triggered by the contagion effects of the speculative attack on the Hong Kong dollar which precipitated a global stock market plunge, and the Korean won. As a result, the KLCI fell by 18.4% and 17.9% in October and November respectively. The depreciation of the ringgit since July led to higher interest rates and a moderation in domestic economic activity. These developments dampened market sentiment as corporate earnings would be lower.

The depressed sentiment since April pushed all the major price indices significantly lower by the end of 1997. The KLCI, the Exchange Main Board Share (EMAS) Index and the SBI declined by 52%, 56.5% and 71.7% respectively during the year. The largest decline registered by the SBI was not unexpected, given the clear evidence of a significant overvaluation

Graph 4.6
KLCI and Ringgit

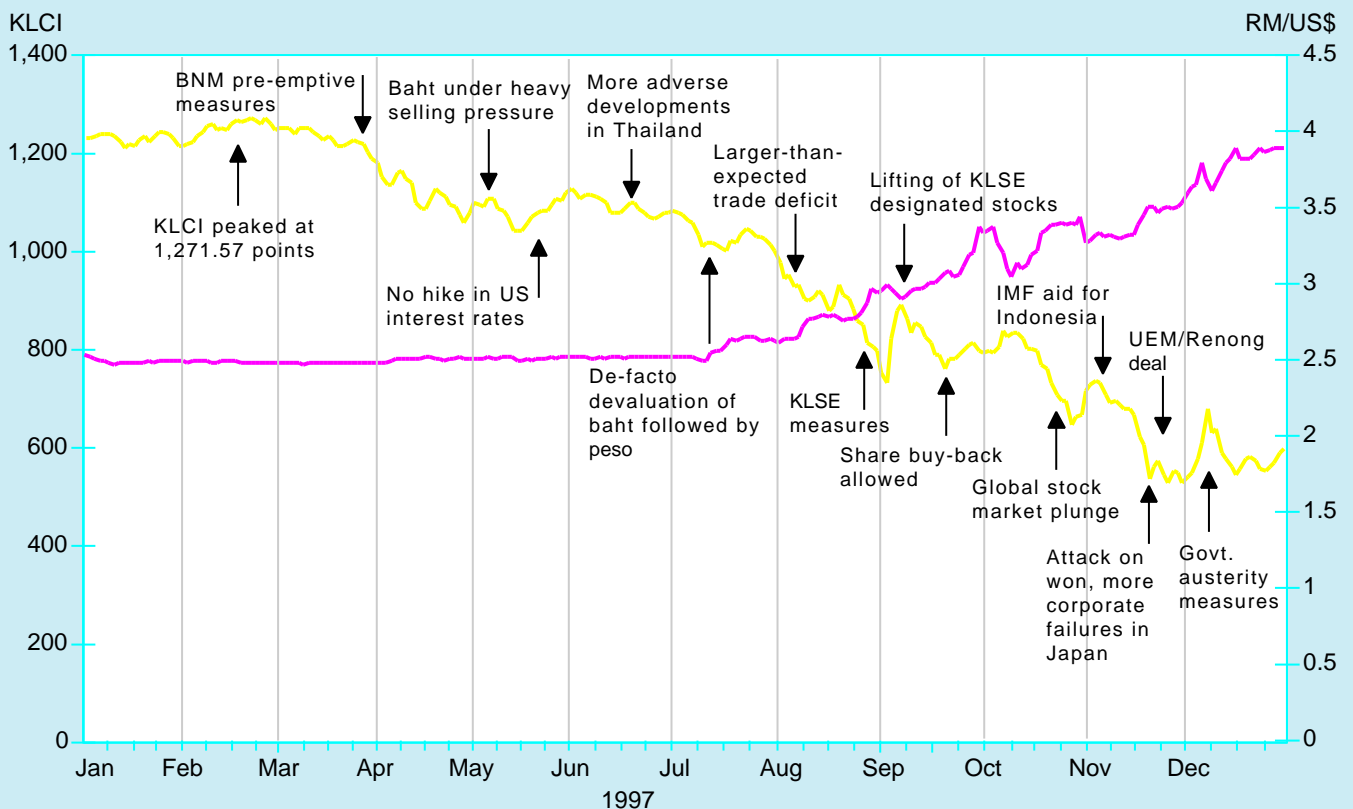


Table 4.24
Kuala Lumpur Stock Exchange: Selected Indicators

	1996	1997
Price Indices		
Composite	1,237.96	594.44
EMAS	347.67	151.21
Second Board	576.31	162.93
Total Turnover		
Volume (billion units)	66.5	72.8
Value (RM billion)	463.3	408.6
Daily Turnover		
Volume (million units)	268.0	294.0
Value (RM million)	1,868.0	1,647.4
Market Capitalisation (RM billion)	806.8	375.8
Market Capitalisation/GDP (%)	322.9	135.6
Total No. of Companies Listed	621	708
Net P/E Ratio	28.6	10.3
Market Liquidity: Turnover		
Value/Market Capitalisation (%)	57.4	108.7
Market Concentration: 10 Most		
Highly Capitalised Stocks/ Market Capitalisation (%)	26.8	35.9
Average Paid-Up Capital of Stockbroking Firms (RM million)	67.3	72.0

in the Index as early as in the last quarter of 1996. The overvaluation was reflected by the marked deviation of its net price/earnings ratio (49.08) from the historical level then (29.36). The most vulnerable sectors in the economy, namely, the construction, mining, property and finance sectors, recorded price declines in the vicinity of 70%. The restriction on lending for property and the announcements in the 1998 Budget and in December on the postponement of infrastructure projects did not bode well for these sectors. On the other hand, the shares of the finance sector, particularly banking institutions with high exposures to the property and stock markets, were also subject to strong selling activities. Selling pressures intensified as sentiment in the stock market weakened further with mounting concerns over bad loan problems. In addition, the voluntary commitment of the banking institutions in October 1997 to a credit plan implied lower expected earnings for the banking institutions in the near future.

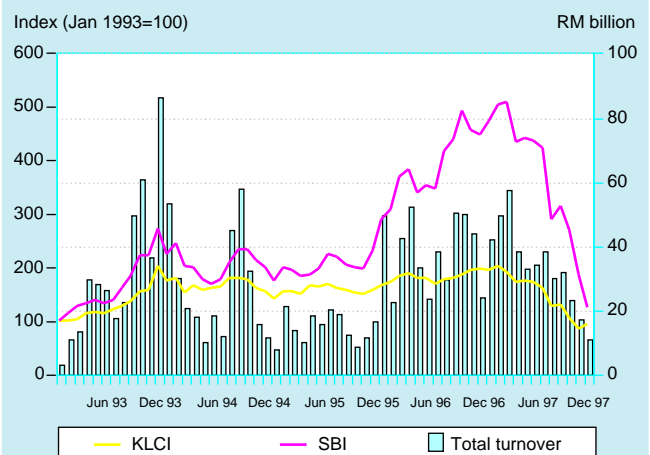
On the turnover front, the volume of turnover transacted increased by 9.5% to 72.8 billion units while the value of turnover declined by 11.8% to RM409 billion. Similarly, on a daily average basis, total trade rose to 294 million units but declined,

in value terms, to RM1.6 billion. This anomaly emerged because of the overwhelming selling activities vis-a-vis buying activities which resulted in lower transacted prices. Interest was mainly concentrated in the property (15.7% of the total trade), trading/services (14.9%), Second Board (14.4%) and finance sectors (13.5%). Trading in the construction and finance stocks was higher compared to the previous year, reflecting the weak sentiment in these sectors. On the other hand, the most significant decline in turnover was in the Second Board, from the exceptionally large share of 28.6% of total turnover in 1996 to 14.4%. Market liquidity, as measured by the turnover value to market capitalisation ratio, improved during the year. While the ratio rose from 57.4% in 1996 to 108.7% in 1997, the increase was partly attributed to the significant decline in market capitalisation.

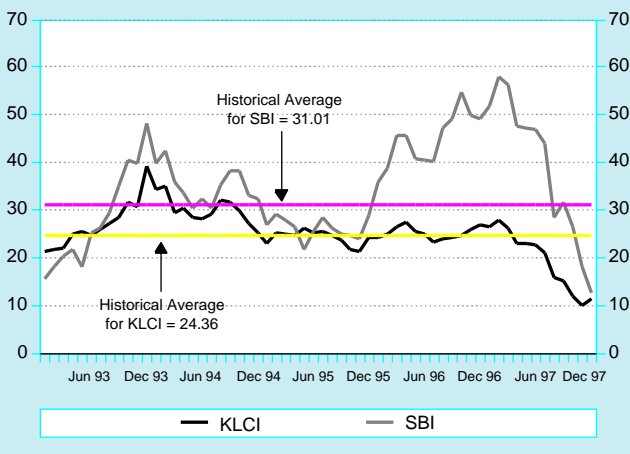
Overall, these developments reduced the market capitalisation of the KLSE by 53% (rise of 42.6% in 1996) to RM376 billion or 135.6% of the nation's gross domestic product (GDP) at the end of the year (RM807 billion or 322.9% of GDP at the end of 1996). In terms of the United States dollar, this decline was the third largest in the Asia-Pacific region after Thailand and Korea. As a result of this, the KLSE was ranked seventh in the region and second in ASEAN after Singapore (fourth in the region and first in ASEAN at the end of 1996). In terms of prices, all regional markets (excluding Australia and New Zealand) closed lower, although the fall in the KLCI was the second after Thailand.

During the third quarter, several measures were implemented by the KLSE to restrain the sharp fall

Graph 4.7
Kuala Lumpur Composite Index, Second Board Index and Total Turnover



Graph 4.8
Net Price Earnings Ratios of Kuala Lumpur
Composite Index and Second Board Index



in the market and to restore investor confidence. The most notable was the designation of the 100 components of the KLCI on 28 August 1997 whereby investors were required to deposit their share scrips in the central depository system before selling could take place, and pay cash up front before acquiring shares. In addition, short-selling in the market was effectively suspended by prohibiting the borrowing and lending of securities. Given that the former measure was perceived most adversely by the market, it was rescinded on 5 September. To boost market confidence, listed companies were allowed to buy back their shares following an amendment made to the Companies Act, 1965. As at the end of 1997, four companies had proceeded to buy back their shares.

Other measures included the joint-establishment of a standby fund of RM500 million between the KLSE and the Securities Clearing Automated Network Services (SCANS) in November to provide financial assistance to troubled stockbroking firms. By the end of 1997, the KLSE had placed five stockbroking firms on trading restrictions. The restrictions stipulated that the stockbroking firms were allowed to conduct or execute only selling transactions and make purchases upon the receipt of 100% up-front payment. In addition, they were prohibited from making margin purchases and dealing in direct business transactions and any other activities which would increase their risk or exposure.

The market infrastructure of the KLSE was further enhanced during the year: the sectorisation of the Second Board companies since March resulted in the division of the companies into five sectors,

namely, consumer products, industrial products, construction, trading/services and finance; the full prescription of all the non-equity counters into the central depository system at the end of June meant that all settlement and clearing activities in the KLSE had effectively become scrippless; the implementation of the T+5 Rolling Settlement System on 18 August shortened the cash and share settlements to five business days after the transaction date instead of seven days, thus bringing the KLSE closer to international standards; and the extension of trading hours in the KLSE by 30 minutes with trading commencing at 9 a.m., effective 5 December.

During the year, the Securities Commission (SC) introduced several measures as a part of the on-going exercise to ensure the growth and orderly development of the capital market:

- The Guidelines for the Public Offering of Securities of Foreign-based Companies with Listing and Quotation on the KLSE were released in April 1997. Among the requirements of the Guidelines were that only primary listings were allowed; the minimum issued and paid-up capital was RM50 million or the equivalent; more than 50% of the capital was to be held by Malaysians or the single largest Malaysian shareholder was to hold 33% of the capital; more than 50% of the total tangible assets was to be situated outside Malaysia; the forecast after-tax profit was to be at least RM6 million; and there was to be a minimum of two Malaysian directors. As at the end of 1997, no application for listing of foreign-based Malaysian companies was received.
- Several amendments were also made to the Policies and Guidelines on the Issue/Offer of Securities (Issues Guidelines):
 - For Main Board companies seeking listing on the KLSE, the minimum issued and paid-up capital was increased to RM50 million from RM40 million while that of Second Board companies, to at least RM10 million but less than RM50 million from at least RM10 million but less than RM40 million.
 - For Main Board companies, the historical profit performance was amended to satisfy either a track record of three years with an after-tax profit of not less than RM4 million per annum and an aggregate after-tax profit of not less than RM25 million over the three years or a track record of five years, with an after-tax

profit of not less than RM2 million per annum and an aggregate after-tax profit of not less than RM25 million over the five years. No change was made to the historical performance of Second Board companies.

- Updates and revisions were made to the dealings by directors; public offerings; listing of property development companies; private placements of securities; reverse take-overs and back-door listings; related party-transactions; information and documents; and submission of proposals.
- The framework on the proposed over-the-counter market or the Malaysian Exchange of Securities Dealing and Automated Quotation (MESDAQ) was announced in February. MESDAQ would be the market where high-technology and small companies with good growth potential could raise their capital for expansion. MESDAQ was also expected to be an important prerequisite for the successful development of the Multimedia Super Corridor. The admission requirements of MESDAQ were generally less stringent than those of the KLSE. Among the important requirements were for eligible companies to be those involved in a single business or a complementary set of businesses, with particular focus on technology-based and technology-related operations such as advanced electronics, biotechnology, environmental technology, advanced materials, information technology, aerospace technology, telecommunications and education/training; and a minimum paid-up capital of RM2 million. However, a track record on profit was not required. While the operations of MESDAQ were initially planned to begin in the fourth quarter of 1997, they had been postponed given the current depressed sentiment.

In the **PDS market**, the most significant development during the year was the improvement of the infrastructure through the launch of the Bond Information and Dissemination System (BIDS) in October. BIDS is a computerised information system that collects and centralises data on the local bond market, and disseminates the data to market participants. Its establishment was motivated by the need to improve the access to, and transparency of, information on the bond market, thereby further enhancing the development of the secondary market, improving liquidity and facilitating the efficient pricing of new issues, as well as increasing the breadth of the market. Since the launch of the first phase

in October, BIDS had been providing information on both primary and secondary activities, including information on all outstanding PDS and MGS, Treasury bills, Bank Negara bills and Cagamas securities. In the next phase to be launched in 1998, the system would be enhanced further, notably, with the inclusion of information on short-term papers. The intention is to continually enhance the infrastructure to keep pace with developments in the debt securities market.

Activities in the **rating industry** moderated in 1997, reflecting the environment of rising interest rates amidst tight monetary policy. In addition, the regional financial crisis and resultant economic slowdown prompted many companies to reduce or defer their corporate exercises and capital expenditure. During the year, Rating Agency Malaysia Berhad completed 51 rating exercises totalling RM13.5 billion, lower than in the preceding year (93 issues totalling RM17.3 billion in 1996). This brought the total number of issues rated since its establishment in November 1990 to 414 totalling RM68.7 billion. The number of ratings was equally divided between the short- and medium-term papers, and long-term bonds. Malaysian Rating Corporation Berhad had its first full year of operations in 1997. It rated 23 corporate debt issues totalling RM11.1 billion in 1997 (six issues totalling RM1.9 billion in the last four months of 1996).

Secondary trading of **MGS** declined from RM25.4 billion in 1996 to RM12.4 billion in 1997, attributed to the smaller amount of MGS issued during the year. Given that redemptions (RM3.6 billion) exceeded the amount issued (RM3 billion), most holders particularly the banking institutions preferred to hold on to existing securities as well as the newly issued securities to meet their statutory liquidity requirements. The first issue of the 10-year RM1 billion MGS in October was oversubscribed by 238% at the weighted average price of the successful bids or coupon rate of 7.284%, while the second issue in November of RM2 billion with a tenure of five years was oversubscribed by 272% at the coupon rate of 8.157%. As in the previous year, there was no issue of Government Investment Issues.

Activities of the **unit trust industry** expanded in 1997 despite the generally depressed market sentiment in the KLSE. During the year, six unit trust funds were launched (10 in the preceding year), while one unit trust management company

Table 4.25
Unit Trust Industry: Selected Indicators

	As at end							
	1996				1997			
	ASN, ASB & ASW 2020	Other Govt./State Backed Funds	Private Funds	Total	ASN, ASB & ASW 2020	Other Govt./State Backed Funds	Private Funds	Total
No. of Unit Trust Funds *	3	24	47	74	3	24	53	80
No. of Unit Trust Mgt. Cos.	1	9	20	30	1	9	21	31
No. of Unitholders (million)	6.6	0.7	0.7	8.0	6.8	0.7	0.8	8.3
Units in Circulation (billion)	27.9	3.7	7.4	39.0	32.0	3.9	9.3	45.2
Net Asset Value (RM billion)	48.9	4.0	7.1	60.0	27.1	1.5	5.0	33.6
NAV/Market Capitalisation of KLSE (%)	6.0	0.5	0.9	7.4	7.2	0.4	1.3	8.9
Net Sales of Units (RM billion)	3.3	...	1.0	4.3	1.6	0.2	1.6	3.4

* Refers to funds already launched.

Source: Securities Commission

(five in 1996) was established. Units in circulation rose by 6.2 billion units to 45.2 billion units, compared with a moderately larger increase of 7.1 billion units in 1996 which was spurred by the launch of Amanah Wawasan 2020. Reflecting the weak sentiment in the KLSE, the net asset value of the unit trust industry fell by 44% to RM33.6 billion. As this decline was smaller than that registered by the KLCI, EMAS Index and SBI, the ratio of the industry's net asset value over the total market capitalisation of the KLSE improved from 7.4% in 1996 to 8.9% in 1997. In addition, an encouraging development was the absence of any significant withdrawals of funds by unit holders, contrary to the general expectation in a depressed market. There was, in fact, a noticeable increase, albeit smaller, in investment in unit trust funds by RM3.4 billion (RM4.3 billion in 1996).

On the regulatory front, the SC announced in May, the first revision to the Guidelines on Unit Trust Funds which were issued in March 1994. The thrust of the revision was to liberalise the Guidelines to allow fund managers to exercise greater product differentiation and innovation. Towards this end, unit trust funds were allowed to invest, within limits, in unlisted securities, other collective investment schemes, and futures and options. The revision also aimed at enhancing the skills and professionalism of the industry, as well as transparency in the industry through the adoption of better disclosure requirements. Another important development was the implementation of a new framework for the marketing and distribution of unit trust products which became effective on 31 January. Under the new requirements, persons who wished to market and

distribute unit trust products would have to be registered with the Federation of Malaysian Unit Trust Managers (FMUTM). The implementation and administration of the Guidelines on Marketing and Distribution of Unit Trusts had since been undertaken by FMUTM.

Financial Futures

The Kuala Lumpur Options and Financial Futures Exchange (KLOFFE) continued to offer only one product, namely, the **Kuala Lumpur Stock Exchange Composite Index futures (FKLI)** contract in 1997. Trading in the FKLI contract increased significantly, with the total and average daily turnover rising to 382,974 and 1,544 contracts respectively (77,281 and 312 contracts respectively in 1996). The Derivatives Liquidity Ratio, representing the ratio of the turnover value of the futures to the turnover value of the component stocks, also rose from 0.2 in 1996 to 0.5 in 1997.

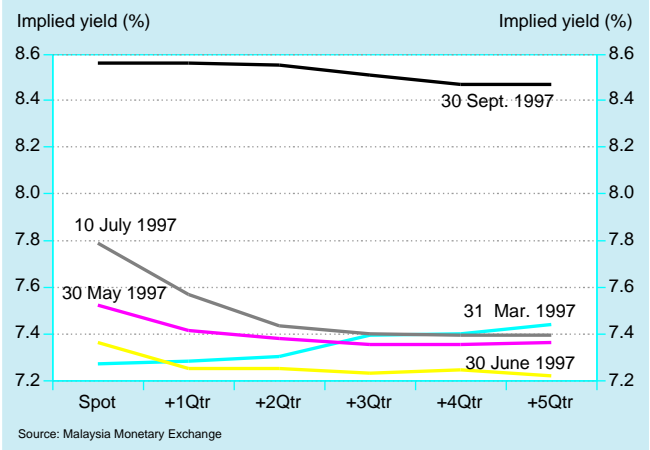
Turnover expanded progressively from 10,901 contracts in January to reach a record of 61,236 contracts in September. Trading remained buoyant in the last quarter, averaging 52,949 contracts a month. Trading volume was particularly high since August, reflecting the greater volatility in the cash market. The high volume was due mainly to increased hedging activities in response to the uncertainties in the foreign exchange market. This was apparent from the rising share of trade by foreign institutions (mainly hedgers), which accounted for 49% of the trading volume on KLOFFE in the last quarter of 1997 (37% and 43% in the second and third quarters of 1997). The overall

improved performance in 1997 could also be attributed to the increased awareness of futures trading, particularly among retail investors, through the various education programmes organised by KLOFFE. The trading volume of the domestic retail sector rose substantially to 30% of the total volume in 1997, from 19% in 1996. Nevertheless, foreign institutions continued to account for the bulk of the trading volume in 1997 (46%).

Reflecting the increased interest in FKLI trading, the size of KLOFFE, measured in terms of “open interest”, increased from 1,312 positions at the end of 1996 to a record level of 13,470 positions on 24 December, before declining moderately to 7,614 positions at the end of the year. As part of its future development plans, KLOFFE is working closely with relevant authorities to launch equity index options and individual equity options.

In 1997, only one contract, namely, the **3-month Kuala Lumpur Interbank Offered Rate (KLIBOR) futures** was traded on the Malaysia Monetary Exchange (MME). Trading volume remained moderate, with the total turnover increasing to 76,382 contracts or an average daily turnover of 309 contracts (average daily turnover of 273 contracts in 1996). The monthly turnover reached a peak of 13,893 contracts in July but declined rapidly thereafter to only 1,196 contracts in December, the lowest monthly turnover since its launch in May 1996. The low turnover especially in the last quarter of 1997 could be attributed partly to the distortion and fragmentation in the KLIBOR futures market and its related cash market. This resulted in an increase in the basis risk which made hedging more costly. In addition, the growing uncertainty surrounding

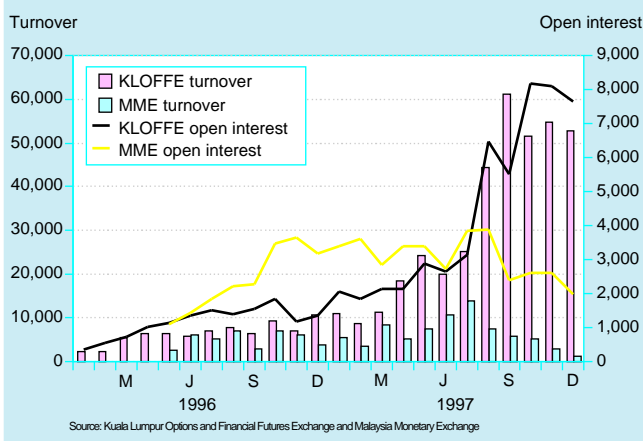
Graph 4.10
Three Month KLIBOR Futures Implied Yield in 1997



the direction of interest rates forced market makers to quote wider bid-ask spreads (50-90 ticks in December compared with 5-7 ticks in July), thereby contributing to the low turnover. Despite these developments, the market makers continued to play their role of market-making and accounted for the bulk of the trading (49%) in 1997 (46% in 1996).

Against a background of rising interest rate expectations, the implied yields on the KLIBOR futures shifted upwards throughout most of 1997, particularly from September. In the first four months of 1997, the implied yields were relatively steady, with the yields on the spot month contracts trading in the range of 7.16%-7.38%. The stable trend was, however, interrupted by a sharp increase in the underlying KLIBOR fixing rate in May arising from the shortage of ringgit in the foreign exchange market following pressures on the ringgit. Consequently, a slightly inverted implied yield curve developed, as market expectations were for the exceptionally high underlying interest rates to be temporary. As pressure on the ringgit subsided and liquidity improved in the second half of June, the implied yield curve shifted downwards towards the end of the month. However, a second round of speculative activity on the ringgit occurred in July, causing an even sharper increase in the underlying KLIBOR fixing rate. Reflecting this, the implied yield curve again inverted and shifted upwards, with the implied yield on the spot month contract rising to 7.79% on 10 July from 7.36% at the end of June. Thereafter, the implied yield curve moved upwards progressively until the end of the year, reflecting market expectations of higher interest rates as well as tighter liquidity conditions in the money market in the future. The implied yield on the spot month

Graph 4.9
KLOFFE & MME: Turnover and Open Interest

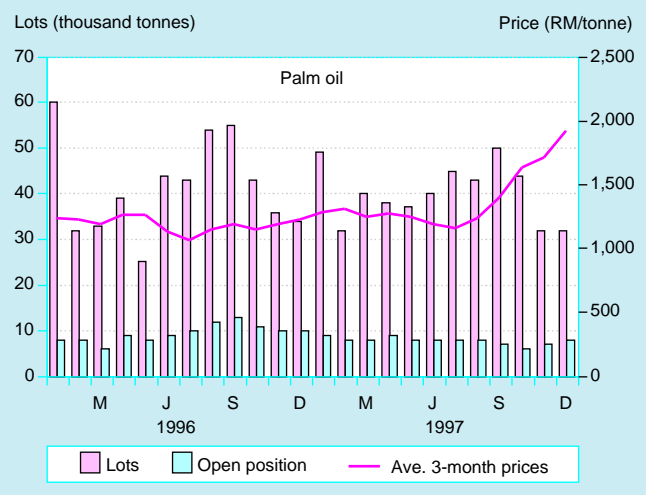


contract rose from 8.56% at the end of September to 10.45% at the end of December.

The size of MME, as measured in terms of “open interest”, declined to 1,946 contracts at the end of 1997 from 3,162 contracts a year ago. Notable developments in MME in 1997 included the introduction of the All-Or-None (AON) order in May and the serial month KLIBOR futures in November. The AON order enables users to obtain a single price for large orders when trading in blocks of 50 or more contracts. The two serial month KLIBOR futures contract would be listed at any one time other than the four quarter months available on the standard 3-month KLIBOR futures, and this would enable users to hedge in these additional months. As a result, there would be closer matched hedging, thereby reducing basis risk. As at the end of 1997, 92 serial month contracts had been traded.

Activity in the Kuala Lumpur Commodity Exchange (KLCE) in 1997 remained confined to the trading of **crude palm oil (CPO) futures** contracts. The trading volume was lower even though CPO production was at the peak of its cycle and prices had increased significantly arising from the valuation gains, following the depreciation of the ringgit since July 1997. The trading volume declined by 2.8% to 484,323 lots or equivalent to 12.1 million tonnes of CPO in 1997 (1996: -5.3% or 498,118 lots or equivalent to 12.3 million tonnes), while the ratio of total CPO futures volume traded to actual production declined by 14% (134% compared to 148% in 1996). Following the depreciation of the ringgit, the CPO prices had increased steadily and this was later reinforced by

Graph 4.11
Futures Trading on the KLCE



the Indonesian Government’s decision to restrict and subsequently ban exports of palm oil in the first quarter of 1998. As CPO futures prices had trended upwards during the year from RM1,067 in January to RM1,910 in December, the price range for CPO futures also widened substantially to RM843 compared with RM340 in 1996. The increase in CPO futures prices was also more pronounced towards the end of the year. Consequently, there were numerous occasions of limit-up and limit-down in the traded CPO futures prices, as a result of which the volume of CPO futures trade moderated in the last two months of 1997. While the daily turnover at the KLCE averaged above 2,000 lots in the first ten months of 1997, it moderated to 1,961 lots at the end of 1997. Total open positions declined to 7,785 lots at the end of 1997 as compared with 9,897 lots at the end of 1996.