# 4 The Financial Sector

## Sources and Uses of Funds of the Financial System

The full effect of the regional financial crisis was felt in the financial system where total assets declined by RM21.4 billion or 1.9% to RM1,093.1 billion at the end of 1998 (an increase of RM195.5 billion or 21.3% in 1997). This decline in the total assets of the financial system resulted mainly from a fall in the assets of the banking system by RM45.3 billion or 5.6% compared with an increase of RM180.2 billion or 28.5% in 1997. The decline in assets of the banking system partly reflected the non-performing loans (NPLs) sold to and managed by Pengurusan Danaharta Nasional Berhad (Danaharta), of RM13 billion. The banking system continued to be the largest financial intermediary, accounting for 70.1% of the total assets of the financial system at the end of 1998 (72.9% at the end of 1997). Within the banking system, the finance companies experienced declines in total assets resulting mainly from a fall in loans and advances, due to the tight liquidity conditions in early 1998, the higher interest rates, particularly during the first half-year, contraction in economic activity as well as more cautious lending policies as their balance sheets deteriorated. The lending activity of finance companies was also constrained by the merger and other restructuring exercises which were undertaken during 1998. The commercial banks (including Bank Islam), in turn, experienced declines in total assets reflecting the fall in deposit placements with other financial institutions. Consequently, their share of total assets in the financial system declined from 13.7% and 43.6% to 11.3% and 42% respectively at the end of 1998. The decline in the share of total assets of the commercial banks, however, was mitigated by the transfer of the assets of five finance companies which were absorbed by the parent commercial banks under the exercise to rationalise the finance companies.

**Table 4.1**
**Assets of the Financial System**

| | Annual change 1997 | Annual change 1998 | As at end 1998*p* | |
|---|---|---|---|---|
| | RM billion | | | % share |
| **Banking system** | **180.2** | **–45.3** | **766.7** | **70.1** |
| Bank Negara Malaysia | 12.2 | 15.8 | 124.7 | 11.4 |
| Commercial banks[1] | 121.4 | –26.2 | 459.2 | 42.0 |
| Finance companies | 32.6 | –28.8 | 123.6 | 11.3 |
| Merchant banks | 10.2 | –5.1 | 39.2 | 3.6 |
| Discount houses | 3.8 | –1.0 | 20.0 | 1.8 |
| **Non-bank financial intermediaries** | **15.3** | **23.8** | **326.4** | **29.9** |
| Provident, pension and insurance funds | 22.6 | 22.6 | 212.2 | 19.4 |
| *Employees Provident Fund* | *15.1* | *15.6* | *148.0* | *13.5* |
| *Other provident & pension funds* | *3.3* | *3.2* | *24.8* | *2.3* |
| *Life insurance funds* | *2.8* | *2.9* | *26.6* | *2.4* |
| *General insurance funds* | *1.5* | *1.0* | *12.8* | *1.2* |
| Development finance institutions[2] | 2.0 | 4.5 | 19.8 | 1.8 |
| Savings institutions[3] | 1.2 | –1.1 | 18.3 | 1.7 |
| Other financial intermediaries[4] | –10.5 | –2.2 | 76.1 | 7.0 |
| **Total** | **195.5** | **–21.4** | **1,093.1** | **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 Kerja sama 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.

*p* Preleminary

Total assets of the non-bank financial intermediaries (NBFIs) increased at a faster pace of RM23.8 billion or 7.9% in 1998, compared with a growth of RM15.3 billion or 5.3% in 1997. As a result, their share of total financial system assets increased from 27.1% at the end of 1997 to 29.9% at the end of 1998. The faster growth reflected mainly the sustained high growth of the assets of the provident, pension and insurance funds (RM22.6 billion or 11.9%), the significant increase (231.4%) in the assets of the Export-Import Bank of Malaysia (Exim Bank) due to the increase in loans extended by Exim Bank, following the transfer of the Export Credit Refinancing (ECR) Scheme from Bank

**Table 4.2**
**Sources and Uses of Funds of the Financial System**

| | Annual change 1997 | Annual change 1998 | As at end 1998*p* | |
|---|---|---|---|---|
| | RM billion | | | % share |
| **Sources:** | | | | |
| Capital and reserves | –3.1 | –3.9 | 102.4 | 9.4 |
| Currency | 3.5 | –4.0 | 20.5 | 1.9 |
| Deposits[1] | 82.5 | 28.4 | 523.1 | 47.9 |
| Borrowings | 24.3 | –18.3 | 14.4 | 1.3 |
| Funds from other financial institutions[1] | 55.4 | –88.5 | 66.1 | 6.0 |
| Insurance and provident funds | 21.6 | 20.2 | 188.7 | 17.3 |
| Other liabilities | 11.4 | 44.6 | 177.9 | 16.3 |
| **Total** | **195.5** | **–21.4** | **1,093.1** | **100.0** |
| **Uses:** | | | | |
| Currency | 1.2 | –0.8 | 3.2 | 0.3 |
| Deposits with other financial institutions | 72.5 | –67.5 | 151.6 | 13.9 |
| Bills | 5.1 | –6.8 | 14.6 | 1.3 |
| *Treasury* | *2.0* | *–0.1* | *3.8* | *0.3* |
| *Commercial* | *3.1* | *–6.7* | *10.9* | *1.0* |
| Loans and advances | 101.4 | 0.1 | 485.7 | 44.4 |
| Securities | 4.6 | 18.5 | 225.6 | 20.6 |
| *Malaysian Government* | *–1.5* | *5.5* | *71.6* | *6.5* |
| *Foreign* | *0.8* | *0.0* | *1.3* | *0.1* |
| *Corporate* | *7.8* | *9.6* | *141.8* | *13.0* |
| *Others* | *–2.4* | *3.4* | *10.9* | *1.0* |
| Gold and foreign exchange reserves | –10.8 | 39.2 | 96.3 | 8.8 |
| Other assets | 21.6 | –4.1 | 116.1 | 10.6 |

[1] Effective 1998, the statutory reserves of banking institution have been reclassified as "Funds from other financial institutions" rather than "Deposits". In this regard, data from prior years have also been revised accordingly.

*p* Preleminary

Negara Malaysia (BNM) to Exim Bank, and the significant increase in the assets of Bank Industri Malaysia Berhad (78%) due mainly to the transfer of deposits from Kewangan Industri Berhad following its absorption by Bank Industri. The increase in the assets of the provident, pension and insurance funds accounted for 94.7% of the total increase in the assets of the NBFIs.

During the year, deposits placed with the financial institutions increased by RM28.4 billion or 5.7% (RM82.5 billion or 20% in 1997). Reflecting the contraction in economic output, the banking institutions (comprising commercial banks, finance companies, merchant banks and discount houses) experienced a decline in deposits, mainly on account of the decrease in demand deposits placed with the commercial banks. Nevertheless, deposits maintained its position as the main source of funds, accounting for 47.9% of total sources of funds at the end of 1998 (44.4% in 1997). Similarly, the banking institutions continued to be the largest mobiliser of deposits, accounting for 86.6% of total deposits of the financial system (92.2% in 1997). In terms of holders, the deposits were held mainly by the non-financial private sector (comprising individuals and business enterprises). During the year, their deposits placed with the financial system rose by only RM11.5 billion or 3.6% (RM62.2 billion or 24% in 1997), in tandem with the sharp slowdown in income. As in previous years, fixed deposits continued to account for the bulk of the deposits placed by the non-financial private sector, accounting for 118.7% of the increase in total deposits while demand deposits registered a decline of RM5.2 billion or 13.9%. By maturity, fixed deposits continued to be concentrated in shorter-end maturities.

Contractual savings with provident funds and contributions to insurance funds continued to be a major source of funds for the financial system,

**Table 4.3**
**Non-Financial Private Sector Deposits[1] with the Financial System[2]**

| | Annual change 1997 | Annual change 1998 | As at end 1998*p* | |
|---|---|---|---|---|
| | RM billion | | | % share |
| Deposits[3] with: | | | | |
| Commercial banks | 48.7 | 5.0 | 228.6 | 68.7 |
| Finance companies | 10.4 | 4.0 | 66.3 | 19.9 |
| Merchant banks | 1.6 | –0.5 | 11.3 | 3.4 |
| Discount houses | –1.9 | 0.0 | 3.8 | 1.1 |
| National Savings Bank | 0.6 | 0.4 | 6.9 | 2.1 |
| Others | 2.8 | 2.5 | 15.8 | 4.8 |
| **Total** | **62.2** | **11.5** | **332.7** | **100.0** |
| Demand deposits | 1.8 | –5.2 | 32.2 | 9.7 |
| Fixed deposits | 47.3 | 13.6 | 221.5 | 66.6 |
| Savings deposits | –3.8 | 2.3 | 43.5 | 13.1 |
| NIDs[4] | 13.7 | 0.1 | 18.5 | 5.5 |
| Repos[5] | 3.2 | 0.6 | 17.1 | 5.1 |
| Fixed deposits | | | | |
| Of which: | | | | |
| Up to 1 year | 42.3 | 19.0 | 201.4 | 60.5 |
| More than 1 year | 5.0 | –5.4 | 20.1 | 6.0 |

[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.

*p* Preleminary

expanding by RM20.2 billion or 12% (RM21.6 billion or 14.7% in 1997), to account for 17.3% of total funds mobilised by the financial system in 1998. Funds obtained from other sources registered strong growth, reflecting mainly gains from foreign exchange revaluation experienced during the year. The increase in these sources of funds were offset by the decline in funding from borrowings, as BNM reduced its lending to the banking institutions following the release of funds to the banking institutions through the reduction in the statutory reserve requirement (SRR). Similarly, the year also saw a significant decline in funds obtained from other financial institutions reflecting mainly the reduction in interbank placements, consonant with the slowdown in lending activity.

As at the end of 1998, the bulk of funds mobilised were utilised to finance the loan operations of the financial system, followed by investment in securities and deposits with other financial institutions. Concomitant with the economic contraction experienced in 1998, total loans and advances extended by the financial system grew marginally by only RM96.7 million. However, including the NPLs of the financial system sold to and managed by Danaharta during the year, total loans and advances extended by the financial system would be higher amounting to RM505.4 billion. Loans and advances to the non-financial private sector declined by RM10.9 billion with significant declines recorded for loans and advances extended for the purchase of shares (–20.5% or RM7.3 billion) and consumption credit (–11.4% or RM6.5 billion). However, loans and advances extended to the broad property sector increased by RM6.5 billion. The bulk of the increase was absorbed by housing loans (RM6.1 billion). As a group, loans and advances extended for these purposes accounted for 52.7% of total loans and advances extended to the non-financial private sector.

**Table 4.4**
**Direction of Credit[1] to Non-Financial Private Sector**

| | Annual change 1997 | Annual change 1998 | As at end 1998*p* | As at end 1998*p* |
|---|---|---|---|---|
| | RM billion | RM billion | RM billion | % share |
| Loans and advances | 94.6 | –10.9 | 448.3 | 76.0 |
| *Agriculture* | *1.3* | *0.2* | *9.2* | *1.6* |
| *Mining & quarrying* | *0.3* | *0.3* | *1.5* | *0.3* |
| *Manufacturing* | *1.7* | *–0.8* | *57.3* | *9.7* |
| *Housing* | *10.9* | *6.1* | *65.3* | *11.1* |
| *Construction[2]* | *26.7* | *0.4* | *92.3* | *15.6* |
| *Business services* | *–0.8* | *0.0* | *9.6* | *1.6* |
| *General commerce* | *7.9* | *–0.4* | *32.6* | *5.5* |
| *Transport & storage* | *5.2* | *1.6* | *13.8* | *2.3* |
| *Purchase of shares* | *11.3* | *–7.3* | *28.4* | *4.8* |
| *Consumption credit* | *13.9* | *–6.5* | *50.3* | *8.5* |
| *Others* | *16.3* | *–4.4* | *88.2* | *14.9* |
| Investment in corporate securities | 7.8 | 9.6 | 141.8 | 24.0 |
| **Total** | **102.3** | **–1.4** | **590.1** | **100.0** |

[1] Excludes credit to non-financial public enterprises.
[2] Includes loans for real estate.

*p* Preleminary

In contrast, investment in corporate securities by the financial system recorded a stronger growth of RM9.6 billion or 7.2% (RM7.8 billion or 6.2% in 1997). In particular, the banking institutions' holdings of corporate securities increased by RM7.5 billion due mainly to investments in Danaharta and Danamodal bonds during the year. Holdings of corporate securities by pension and provident funds also increased in 1998. Deposits placed with other financial institutions, however, declined significantly by RM67.5 billion or 30.8% (increase of RM72.5 billion or 49.4% in 1997). This decline was mainly the result of the reduction in statutory reserves placed by banking institutions with BNM and the decline in the placement of deposits by BNM with banking institutions. In addition, interbank placements also registered a decline reflecting the slowdown in lending activity. Meanwhile, gross holdings of gold and foreign exchange reserves of BNM increased significantly by RM39.2 billion to RM96.3 billion at the end of 1998 (a decline of RM10.8 billion in 1997), reflecting mainly Malaysia's large trade surplus in 1998, foreign currency loans from both official and private financial institutions as well as the revision in the accounting policy effective September 1998, to recognise the foreign exchange revaluation gain/loss.

## Management of the Banking System

The year 1998 proved to be one of the most challenging period for the banking system. The financial turmoil which hit the region in mid-1997 following the devaluation of the Thai baht had its full effect on the economy in 1998. The thrust of banking policies in 1998 was, therefore, twofold, aimed at crisis management to stabilise the banking system in the immediate term and building a strengthened and more resilient banking sector over the medium and longer term. Short-term measures were introduced to ensure the continued smooth and efficient functioning of the intermediation process. At the same time, the consolidation, rationalisation and reform of the banking sector were initiated through mergers, the setting up of an asset management company, a bank recapitalisation agency and a corporate debt restructuring committee. These measures were introduced as part of the strategy to achieve the longer-term objective of a well-developed and strengthened banking sector.

## *Stabilisation Measures*

Stabilisation measures were introduced in March 1998 to address key vulnerabilities in the banking system. Even though the banking system was in a strong position at the onset of the crisis, weaknesses, some structural in nature, began to emerge as the crisis worsened particularly towards the end of 1997. During the early months of 1998, the turmoil in the regional markets resulted in increased volatilities and uncertainties in the domestic financial markets and economy. One year into the crisis and signs of recovery among the Asian countries were not in sight. At the same time, inefficiencies in the distribution of liquidity within the system began to surface that affected the smooth functioning of the loan intermediation process. While the banking system as a whole remained sound and resilient amidst the crisis, some individual banking institutions were faced with severe liquidity constraints which caused them to bid interest rates upwards to a level that would not justify returns on investments for viable businesses. The fragmented finance company industry in particular, became a potential source of vulnerability which could have posed a systemic threat to the health of the overall system if allowed to deteriorate further. Priority was therefore given to rationalise and consolidate the finance company industry into fewer but stronger institutions through mergers. To further strengthen the resilience of the finance companies to withstand shocks in the changing economic and financial environment, a larger capital was prescribed to give additional buffer for the finance companies to absorb higher risks. A stronger capital base would accordingly enhance the risk-bearing capacity of the finance companies. In this regard, the minimum capital funds of the finance companies was increased from the existing RM5 million to RM300 million by mid-1999. The minimum requirement would be further raised to RM600 million by end-2000. In addition, the risk-weighted capital ratio of the finance companies was increased from 8% as prescribed under the Basle Capital Accord to 9% by end-1998 and to 10% by end-1999. Prudential regulations were also tightened and supervisory efforts intensified, with emphasis placed on early identification of problem loans and solvency issues. Efforts were also taken to enhance transparency on the financial position of individual banking institutions as well as the banking system.

As in any economy, the small- and medium-sized industries (SMIs) have an important role in providing the linkages between the various subsectors within the Malaysian economy. Under the prevailing difficult conditions, the SMIs were not spared from the adverse effects of the crisis. Given the importance of their operations, the strains on their cashflows had affected their debt servicing capability leading to deteriorating financial health that had, in some cases, affected their viability. Access to financing also became increasingly limited. Thus, to ensure that viable SMIs continued to have access to credit, a Fund for Small and Medium Industries was set up with an initial allocation of RM1 billion in January 1998 to provide financing to the SMIs at a maximum lending rate of 10% per annum. Reflecting the commitment of the Government to resolve the financial problems facing the SMIs, the allocation under the Fund was increased by RM500 million to RM1.5 billion in May 1998. The list of participating institutions was also expanded to include all commercial banks, 10 identified finance companies, all merchant banks and four development finance institutions, whilst the maximum lending rate under the Fund was reduced to 8.5% per annum in December 1998.

Efforts also continued to be directed to meet the nation's socio-economic objective of promoting home ownership. Towards the end of the first quarter, the contraction in construction activities had also affected the construction of low- and medium-cost residential properties, while the demand for such residential properties remained high. There was therefore a need to ensure the continuous supply of affordable houses to meet such demand. Towards this end, BNM and Syarikat Perumahan Negara jointly allocated RM2 billion for the Special Scheme for Low and Medium Cost Houses in May 1998 to provide bridging finance to developers for the construction of residential properties costing RM150,000 and below at the maximum lending rate of 10% per annum. The maximum lending rate was further reduced to 8.5% per annum in December 1998.

## *Economic Recovery Measures*

By the end of the first half of the year, the regional financial markets continued to be volatile and uncertain and the effect on the domestic economy became evident as the economic contraction became increasingly severe. While BNM had released liquidity into the system to support the financing needs of the economy, the banking institutions had become reluctant to provide new lending thereby posing a threat to the functioning of the intermediation process. The worsening economic condition coupled with the prolonged crisis had shifted the focus of the banking institutions. Banking institutions became pre-occupied with preserving their balance sheet and managing the deterioration in the quality of their loan portfolio as well as erosion in capital instead of generating new businesses. The rising incidence of non-performing loans (NPLs) had also resulted in banking institutions being overly cautious in their lending activities. As a result, many viable businesses were not able to obtain financing.

Access to financing is a crucial precondition towards economic recovery. Economic recovery measures were needed to create an environment that is conducive for business activities to operate. The need for a comprehensive solution was never more pressing and critical now than before. Measures were introduced to remove the risks and concerns that have emerged in the system. In the second half of the year, Pengurusan Danaharta Nasional Berhad (Danaharta), an asset management company, was set up as a pre-emptive measure to remove the NPL distraction from the banking institutions to enable them to refocus on their lending activities. Danaharta aimed to ensure that the level of NPLs in the banking system remained at manageable proportions. Danamodal Nasional Berhad (Danamodal) was subsequently set up to recapitalise those banking institutions whose shareholders were unable to raise the additional capital. These two agencies were further complemented by the setting up of the Corporate Debt Restructuring Committee (CDRC) to provide a mechanism for the banking institutions and debtors to work out feasible debt workout solutions. Given that the cases dealt with by the CDRC involved those with loans exceeding RM50 million, special loan rehabilitation units were established in individual institutions to manage distressed loans involving smaller amounts. (For a more comprehensive write-up, please refer to Box VI on "Restructuring the Banking Sector")

Weaker business expectations and over-cautious lending attitude of the banking institutions resulted in the outstanding loans of the banking system declining sharper than expected. Meanwhile, activities in the real sectors contracted during the first three quarters of the year. Concomitant with the slowdown in economic activities, it was evident that the initial estimate for loan growth of 15% for 1998 as submitted by the banking institutions in their credit plans had to be reassessed. In responding to the unfavourable developments prevailing in the domestic economy, the loan growth expectations for the year was subsequently revised downwards to 8%. The 8% loan growth for the banking system as a whole, would ensure that sufficient resources would be provided to the real sector to generate new economic activities. Banking institutions with financial constraints, however, were not expected to meet the 8% growth.

Whilst the Fund for Small and Medium Industries became a cheaper source of financing for the SMIs, these funds were extended primarily to fund the working capital requirements of the SMIs. As a large number of the SMIs was facing NPL problems, access to financing for this group of borrowers became limited. In view of this, the Government has set up the Rehabilitation Fund for Small and Medium Industries with a total allocation of RM750 million to provide financing at a maximum lending rate of 5% per annum, where part of the financing could be utilised to restructure the NPLs of SMIs.

Revisions in prudential norms which have direct influence on the credit behaviour of banking institutions and borrowers were announced as temporary measures in response to the prevailing economic condition without compromising on principles of strong supervision and financial prudence. The earlier tightening of the classification period for NPLs was relaxed from three months to six months. While tightening the classification period for NPLs was beneficial in bringing forward the recognition of problem loans, its implementation during periods of economic uncertainties and rising NPLs was not timely. The three-month ruling deterred banking institutions from their prime role of providing financing fearing that such course of action might undermine the quality of their balance sheets. As a result, viable businesses and activities were adversely affected. In addition, as the economic contraction resulted in many businesses experiencing cash flow problems, borrowers stopped

# Banking Measures in 1998

**Disclosure Requirements for the Banking Institutions:** The disclosure requirements in the banking institutions' half-year financial statements were tightened in 1998. Individual banking institutions are required to publish in greater detail the half-yearly income and expenditure statement and provide information on capital adequacy, non-performing loans (NPLs), breakdown of their commitments and contingencies, movements in specific provision, general provision and interest-in-suspense as well as sectoral credit exposure according to economic sectors. In addition, the banking institutions are required to disclose the breakdown of their off-balance sheet items and their respective on-balance sheet credit risk equivalents in their annual financial statements.

This disclosure requirement is intended to promote market discipline by encouraging prudent behaviour by the management of banking institutions so that their financial position would compare positively with others. The information published would also enable more timely monitoring of the performance of the banking institutions by all stakeholders.

**Guidelines on the Classification of NPLs:** With effect from financial year beginning 1 January 1998, the default period for classifying a loan as non-performing was lengthened from three months to six months. The treatment for rescheduled and restructured credit facilities was also clearly defined. A rescheduled credit facility is one whose repayment terms have been modified but the principal terms and conditions of the contract have not changed significantly. This would include lengthening the repayment tenor of the facility. A restructured credit facility is one in which the terms and conditions have been modified principally, including changing the type or structure of facilities or other facility terms mainly to assist projects or businesses which are still viable. Loans which have been rescheduled can be reclassified as performing when repayments under the rescheduled terms have been complied with for a continuous period of six months, instead of the previous requirement of twelve months. Loans which are restructured for the first time can be reclassified as performing immediately after the completion of the relevant documentation. For subsequent restructuring, the loan will remain classified as non-performing until repayments under the restructured terms have been complied with for a continuous period of six months.

The change in the classification requirement and treatment of rescheduled/restructured facilities is intended to provide some breathing space for borrowers to regularise their accounts before being classified as non-performing, and will encourage borrowers to continue servicing their loans to avoid their loans from being classified as non-performing. Given the close linkages between the health of the banking sector and the performance of the economy, the redefinition of NPL would help strengthen the banking sector as business activities are given the opportunity to recover, thereby improving the debt servicing capacity of the corporate sector and ultimately the asset quality of banking institutions.

**Guidelines on Provisions for Substandard Debts:** With effect from financial year beginning 1 January 1998, banking institutions were required to provide 20% specific provisions against the uncollateralised portion of sub-standard loans. Banking institutions were also required to set aside provisions for off-balance sheet items where the banking institution faced credit risk from the failure of counter parties to fulfil their contractual obligations.

These requirements are mainly to increase the resilience of the banking institutions and ensure the build-up of their reserves as additional buffer against potential loan losses for accounts which exhibit some risk of loss due to adverse factors whilst, at the same time, streamlining the provisioning policy with international best practices. However, banking institutions with high loan loss reserves as determined by Bank Negara Malaysia (BNM) would not automatically be required to make provisions for their sub-standard loans.

**Guidelines on Single Customer Limit:** With effect from 25 March 1998, the limit on single customer exposure was reduced from 30% to 25% of total capital. Banking institutions were also required to comply with the single customer limit on a consolidated group basis. The lowering of the limit was to reduce the concentration of risk to a single customer by taking into account the exposure of all institutions in the group to a single customer.

**Risk-weighted Capital Ratio - Compliance Requirement:** With effect from financial quarter ended 31 March 1998, banking institutions were required to comply with the minimum risk-weighted capital ratio on a consolidated basis every quarter rather than annually.

The prolonged regional financial crisis and weak domestic economy had resulted in strains on the financial position of some of the finance-related subsidiaries of domestic banking institutions. If left unattended, losses experienced by the subsidiaries will eventually erode the capital base of their parent banking institutions.

This new requirement will enable BNM to monitor the capital adequacy position of banking institutions on a consolidated basis in a timely manner. Early recognition of capital erosion would also provide banking institutions ample time to plan and work out recapitalisation solutions.

**Reduction of Liquid Asset Ratio:** With effect from 3 September 1998, the liquid asset ratio requirement for commercial banks was reduced from 17% to 15% of their total eligible liabilities.

The funds released from the divestment of liquid assets can be used by banking institutions to improve their funding position and increase their loanable funds. The reduction has also enabled the gradual phasing in of the new liquidity framework introduced by BNM.

**New Liquidity Framework:** In July 1998, BNM introduced a new liquidity framework to replace the present liquid asset ratio requirement for the banking institutions. To ensure a smooth transition, banking institutions are given up to 1 January 2000 to migrate to the new framework. All banking institutions will be required to comply with the new framework by 1 January 2000.

Under the new framework, the liquidity needs of a banking institution is assessed based on its ability to match its short-term liquidity requirement arising from maturing obligations with maturing assets. Banking institutions will be required to make projections on the maturity profile of their assets, liabilities and off-balance sheet commitments in a series of maturity ladder to assess their potential future liquidity surplus and shortfall. To ensure that there is sufficient liquidity to meet their liability obligations in the near term, banking institutions will be required to maintain, as a minimum requirement, adequate liquidity surplus not only to meet expected obligations but also to sustain unexpected heavy withdrawals for at least one month.

The new framework aims to create awareness among banking institutions of their funding structure and their ability to handle short to medium-term liquidity problems. Besides providing BNM with better means of assessing the present and future liquidity position of banking institutions, the framework will encourage a more efficient and proactive management of liquidity among banking institutions. The framework also recognises individual banking institutions' strengths and weaknesses in managing their assets and liabilities portfolio. Banking institutions that manage their liquidity profile prudently and efficiently will no longer be required to hold high amounts of liquid assets. The efficient matching of assets and liabilities will allow better utilisation of funds.

The new liquidity framework will also help reduce the existing price distortion on liquid assets, in particular, Malaysian Government Securities and Cagamas bonds, due to the captive demand created under the present liquid asset ratio requirement. This will promote a more market-oriented pricing of such papers and eventually lead to a more active secondary market development.

**Cagamas Securitisation Scheme on Hire-Purchase and Leasing Loans:** On 12 December 1998, BNM announced the implementation of a securitisation scheme on hire-purchase and leasing loans with recourse by Cagamas. The scheme will be subject to the following regulatory requirements:-

- Half of the proceeds from the sale of hire-purchase and leasing receivables will be subject to statutory reserve requirement while the new Cagamas debt securities issued to finance the purchase of hire-purchase and leasing debts will be regarded as Tier-1 Cagamas debt securities and accorded liquid asset status under the present liquidity framework and Class I liquefiable assets under the new liquidity framework.

- The recourse commitment by the selling institutions for loans sold under the new scheme would be treated as an off-balance sheet liability and be accorded a credit conversion factor of 100% while investment by banking institutions in the Cagamas debt securities will carry a risk-weight of 10%.

With more than 50% of the finance companies' loan portfolio comprising of hire-purchase and leasing, the scheme is expected to assist the finance companies in diversifying their funding sources and create additional liquidity to fund their lending activities. As Cagamas normally purchases loans on a 3- to 5- year basis, the scheme would also provide the much needed long-term financing to the financial institutions in order to minimise the liquidity and interest rate mismatch that currently arise from the funding of these assets through short-term deposits.

servicing their loans once their accounts were classified as non-performing. Thus, the lengthening of classification period for NPLs gave borrowers time to regularise their accounts, which ultimately benefited the banking institutions in terms of improved asset quality. While the classification period was lengthened to six months, other prudential rules were retained. A non-performing account would continue to be classified as bad when it had been in arrears for 12 months or more, while accrued interest previously recognised as income would be clawed back to day one of default. In addition, as part of the effort to promote greater transparency, the industry numbers for the NPLs based on both three-month and six-month classifications are published on a monthly basis. The lengthening of the classification period was also balanced with the mandatory requirement for all banking institutions with gross NPL ratios above 10% to sell their NPLs to Danaharta at market determined prices.

As the economy contracted and as activities in the capital market became extremely thin during the first three quarters of the year, the ability of shareholders to raise additional capital was also constrained. In this regard, compliance with the increased minimum capital funds of RM600 million by the finance companies and risk-weighted capital ratio of 10% was deferred until such time when the economy has recovered and the capital market has stabilised.

In an attempt to enhance the degree of transparency, banking institutions were required to publish key financial indicators on a quarterly basis. Nevertheless, as the crisis deepened, more attention was accorded towards managing sources of vulnerabilities arising from the crisis. The quarterly publication posed a heavy administrative burden on the banking institutions. In this regard, the requirement on the quarterly publication of financial indicators was temporarily uplifted so as to reduce the administrative burden of the banking institutions and at the same time, enable banking institutions to shift their focus on their operations. Banking institutions are, however, still required to make public their financial indicators on a semi-annual basis.

Measures were also put in place to contain further accumulation in the supply of high-end properties through the restriction on the provision of bridging finance to developers for the development of properties exceeding RM250,000. The prohibition includes the construction of residential properties, shop houses, hotels, resorts, office buildings, golf courses, clubs and shopping complexes. However, financing to end-buyers for the purchase of properties in both the primary and secondary markets is not affected by the prohibition. The restriction of financing would contain the entry of new properties into the market while at the same time assist in reducing the excess supply in the respective segments in the property market.

## Box VI

# *Restructuring the Banking Sector*

### Background

Against the background of changing external and domestic conditions in the 1990s, Bank Negara Malaysia (BNM) continued with efforts to develop and reform the banking system in order to ensure that the banking system was well-placed to meet the challenges arising from the changing environment. Policies were, therefore, directed at:

- creating a core of domestic banking institutions which are well managed and highly capitalised, to meet the challenges of liberalisation and to spearhead the development of the financial sector;
- broadening and deepening the financial markets as well as strengthening the financial infrastructure to enable the sector not only to meet the changing needs of the domestic economy, but also to be a sector of economic growth;
- improving the overall level of efficiency and competitiveness of the sector; and
- accelerating the development of the bond market.

Over this decade, the legislative framework for the supervision of the banking institutions was further strengthened, following the review of the various banking legislations in the aftermath of the 1985-86 recession. The Banking and Financial Institutions Act 1989 (BAFIA), which came into effect in October 1989, provided a framework for an integrated supervision of the Malaysian financial system. In addition, the Government has adopted measures designed to increase the efficiency and soundness of the financial system, including measures to achieve credit growth that is in line with the overall macroeconomic growth, while at the same time reducing excessive banking institutions' exposure to the vulnerable sectors of the economy. Other prudential measures introduced include refining the capital adequacy framework, greater information disclosure and improving the risk management of banking institutions. The supervisory and regulatory framework has also constantly been structured to be consistent with international standards and best practices. Compliance with the Basle Committee's "Core Principles for Effective Banking Supervision" was already at an advanced stage before the onset of the crisis.

With the measures in place to achieve the long-term objectives, the banking system was in a position of strength at the onset of the financial crisis. This was reflected in terms of the quality of the asset portfolio and the level of capitalisation of the banking sector. As at end-June 1997, the net non-performing loan (NPL) ratio was at a low of 2.2% and the risk-weighted capital ratio (RWCR) of the banking system was 12%, exceeding the minimum requirement of 8%.

The regional crisis, however, exerted pressures on the currency and stock markets, causing the ringgit to depreciate and the Kuala Lumpur Composite Index to drop by about 35.1% and 44.8% respectively in the second half of 1997. As the financial crisis persisted, the effects on the economy and the financial system began to be felt. While policies had already been put in place to strengthen economic fundamentals as well as to stabilise the financial system, it was recognised that pre-emptive action was necessary to deal with the vulnerabilities of the banking sector. While some banking institutions were facing difficulties, the banking system as a whole remained sound.

Structural weaknesses in the financial system also became more evident. Strong loan growth between 1994-1997, which averaged about 25% per annum, had led to the high loan exposure of the banking system. In addition, the underdeveloped bond market has also resulted in the banking sector providing a significant portion of the private sector financing, thereby increasing the concentration of risk in the banking sector. Although total financing of the nation amounted to RM722 billion at the end of 1998, this was mainly by the banking system (about 57% of the total financing), mainly because of the privatisation programme. The share of public sector debt declined while external debt was kept low by prudential regulations. As such, financing private sector growth was met mainly by the banking system.

In this environment of prolonged volatility in the financial markets, the finance companies became vulnerable given the highly fragmented nature of the industry (39 companies) and the nature of their business which focused mainly on hire-purchase financing and consumption credit, which was adversely affected by the rising interest rates and slowdown in the economy.

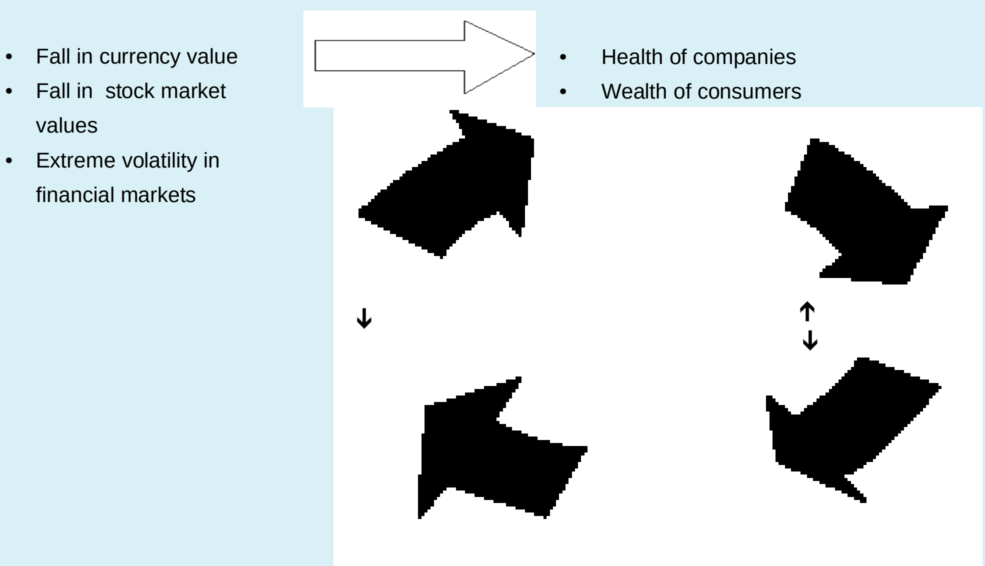
The prolonged financial crisis and subsequent contraction of the economy led to some deterioration in the quality of the asset portfolio of the banking institutions, with the net NPL to total loans ratio increasing to 8.9% as at end-June 1998. Banking institutions became increasingly preoccupied with managing their existing asset portfolio, self-imposing a credit squeeze mentality in their lending activities. The reluctance of the banking institutions to lend combined with higher interest rates caused severe difficulties for individuals and businesses, including viable businesses to obtain financing. This slowed down the prospects of economic recovery. At the same time, the rising level of NPLs also eroded the capital base of a number of banking institutions. While the RWCR for the banking system as a whole remained well above the minimum of 8%, a number of banking institutions required recapitalisation.

If these challenges were not addressed, the economy would be plunged into a vicious cycle, thus hampering economic recovery as illustrated in Chart VI.1 below.

Confidence needed to be restored rapidly in the financial markets in general and the banking sector in particular. If the lack of domestic and/ or external confidence were to persist, economic development would be hampered. The longer this behaviour persists, the more drastic the measures would be needed to restore stability and the higher its costs would be. In view of the worsening economic and financial conditions, the priority of policy since May 1998 was to minimise the contractionary effects of the crisis on the real sector and to further strengthen the financial system, given the critical role of the banking system in supporting the economic recovery.

In order to achieve this, the Government implemented a series of measures to promote

**Chart VI.1**
**The Vicious Cycle of the Current Crisis**



economic recovery. These measures included reducing interest rates, injecting greater liquidity into the banking sector and formulating a comprehensive plan to restructure the banking sector. The restructuring plan for the banking sector, which was initiated by the Government well before the NPL ratio reached double-digit levels, was comprehensive and pre-emptive in nature.

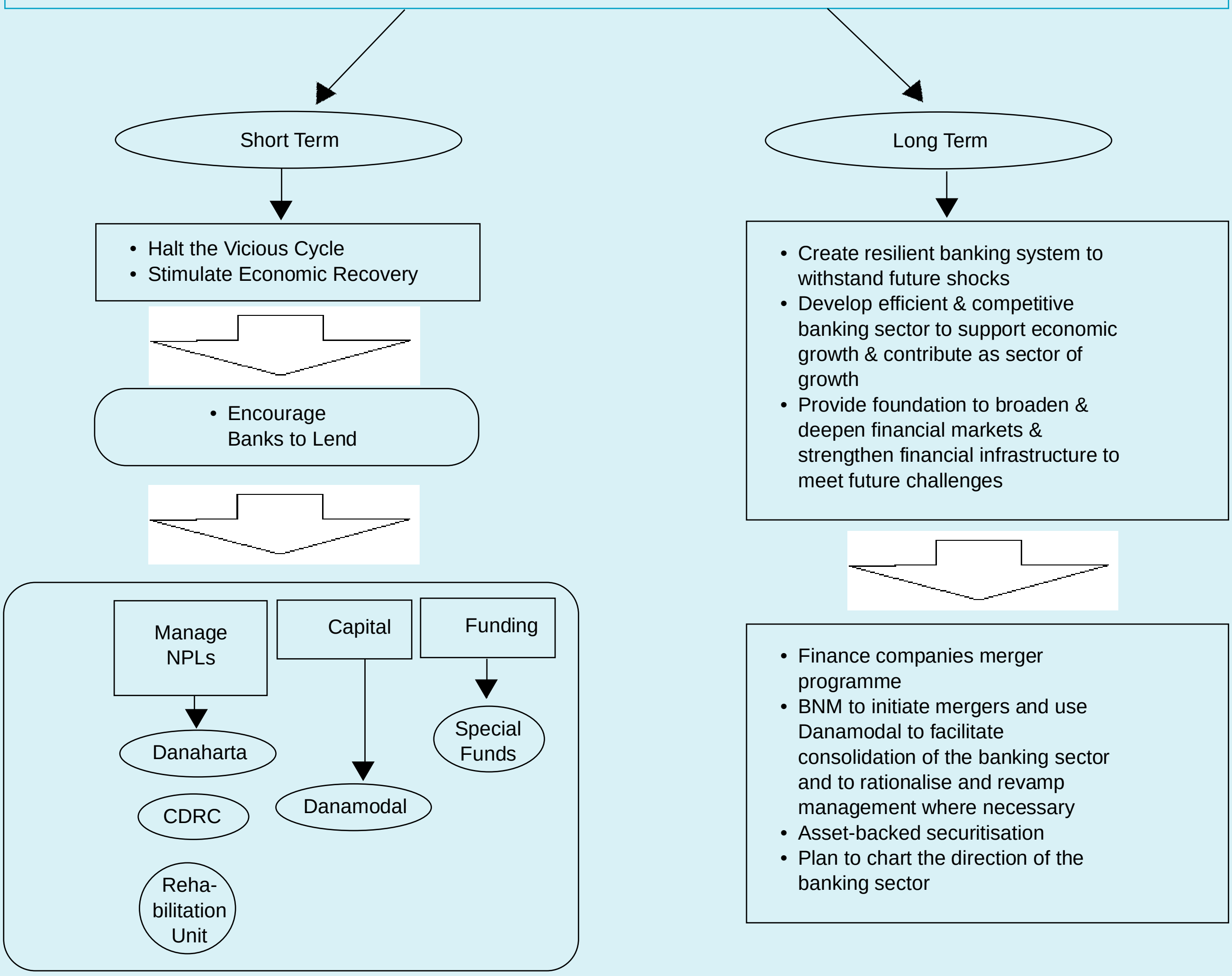
## Banking Sector Restructuring

The restructuring plan was aimed at achieving the objectives illustrated in Chart VI.2 below.

The Government adopted a four-pronged approach to strengthen the resilience of the banking sector through a merger programme, the setting up of an asset management company, Pengurusan Danaharta Nasional Berhad (Danaharta); a special purpose vehicle, Danamodal Nasional Berhad (Danamodal); and the Corporate Debt Restructuring Committee (CDRC).

As the crisis had exposed the vulnerability of the finance companies, a merger programme for the finance companies was announced in January 1998 to consolidate and rationalise the industry. While this was consistent with the longer-term objective of creating a core of domestic banking institutions to meet the challenges of increased liberalisation, it also represented part of the overall pre-emptive strategy to increase the resilience of the finance companies to withstand risks arising from the economic slowdown. The merger exercise was however, market-driven, with BNM facilitating the process. On completion of the exercise in 1999, the number of finance companies would be reduced by more than half from the original 39.

**Chart VI.2**
**Objectives of the Banking Sector Restructuring Plan**



In view of the NPL problem in the banking sector, the Government established Danaharta, an asset management company, to purchase NPLs from banking institutions and manage these NPLs in order to maximise their recovery value. The speed at which Danaharta was set up and the financial commitment extended by the Government clearly demonstrated the serious intention of the Government to restructure and strengthen the banking sector. Danaharta, like the other asset management companies in the world, operated within the broad concepts of rehabilitation, restructuring and maximising recovery value of the assets.

While Danaharta would not purchase the entire NPL portfolio from the banking system, it would ensure that the residual NPLs in the banking sector remain at manageable levels at all times. To ensure that banking institutions utilise Danaharta to remove their NPLs, banking institutions with gross NPL ratio exceeding 10% are required to sell all their eligible NPLs to Danaharta, otherwise they would have to write down the value of these loans and restructure them. Banking institutions which required recapitalisation from Danamodal are also required to sell their eligible NPLs to Danaharta. The acquisition of NPLs by Danaharta would enable Danaharta to rehabilitate these loans in the most effective and efficient manner.

Danaharta would also assist the restructuring of the corporate sector. Once banking institutions have sold their NPLs to Danaharta, Danaharta would then be able to impose conditions on the borrowers which may include, amongst others, the reconstruction or rehabilitation of the underlying assets and identified cash flows. Danaharta also has the powers to appoint Special Administrators into viable companies that faced temporary cash flow problem. With the assistance from Danaharta and Danamodal, both the banking institutions and corporate sector would then be restructured.

Once the banking institutions are relieved of their burden in managing their NPL portfolio, they would be in a better position to resume their lending activities. However, the sale of NPLs to Danaharta would usually result in banking institutions incurring losses as Danaharta would purchase the NPLs at fair market value. Hence, recapitalisation of certain of these banking institutions became necessary to enable banking institutions to undertake additional businesses and risks and to encourage these banking institutions to resume their lending activities. The recapitalisation, under normal times, would usually be achieved through the effort of the banking institution's own shareholders. Given the current economic environment, the ability of shareholders of banking institutions to raise capital on their own was not expected to be very forthcoming. Hence, to facilitate the recapitalisation exercise of banking institutions, a special purpose vehicle, Danamodal, was established to address the constraints faced by the shareholders to recapitalise the banking institutions to healthy levels.

Danamodal would only inject capital into viable banking institutions on commercially viable terms and market principles. Due diligence reviews would be conducted by international investment bankers to determine the viability of the banking institutions and recapitalisation requirements. In all its capital injection exercises, Danamodal would adhere strictly to the "first-loss" principle where the existing shareholders would be required to bear all losses before the recapitalisation by Danamodal. The "undercapitalised" banking institutions would also have to sell all their eligible NPLs to Danaharta and comply with a comprehensive set of performance indicators.

As a strategic shareholder in these recapitalised banking institutions, Danamodal would then be able to institute micro reforms through its nominees appointed on the respective Boards of these banking institutions. Such reforms would include, amongst others, sound risk management practices and credit culture, good corporate governance and higher operational efficiencies. Danamodal, in its role as a strategic shareholder, may also facilitate mergers in line with BNM's objective to consolidate and rationalise the banking sector.

As the health of the corporate sector and banking sector are intertwined, the establishment of Danaharta and Danamodal would not be sufficiently comprehensive to arrest the problems in the banking sector. In view of the severity of the financial crisis, many corporates were also adversely affected. A number of the corporate sector debts have either been classified as non-performing or exhibiting signs of potential default. Hence, restructuring these corporate debts to ensure that viable corporates continue to receive financing is crucial in order to generate new economic activities and support the economic recovery process.

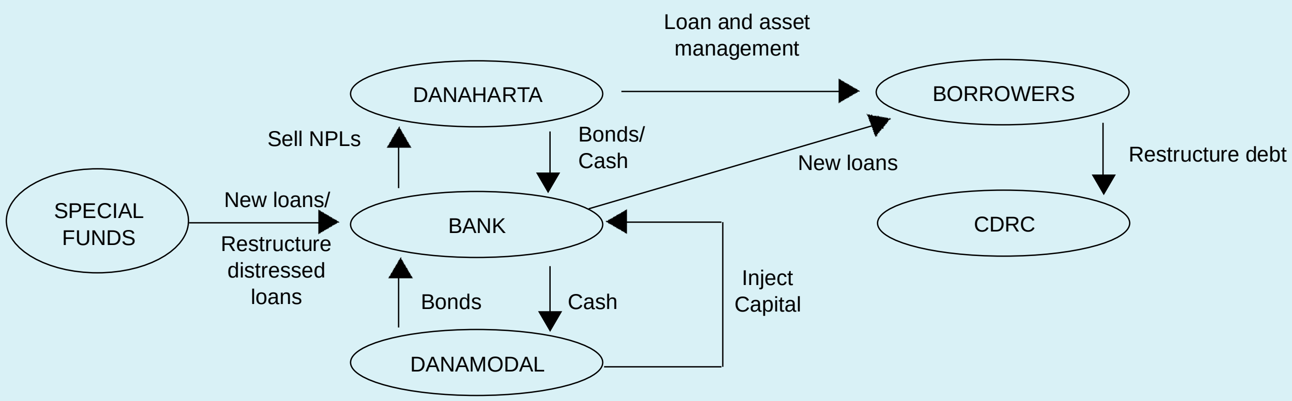
To facilitate the restructuring of corporate debt, a Corporate Debt Restructuring Committee (CDRC) was set up to provide a platform for both the borrowers and the creditors to work out feasible debt restructuring schemes without having to resort to legal proceedings. An increasing number of borrowers in financial difficulties had initially sought legal protection under Section 176 of the Companies Act 1965 rather than negotiating for loan restructuring. With the setting up of CDRC, borrowers would be able to direct their debt restructuring to CDRC. Under the CDRC debt restructuring framework, Creditor Committees comprising banking institutions would be formed to work out the debt restructuring. These restructuring efforts would be conducted based on market-driven principles to ensure that there would be a win-win situation for both the borrowers and the creditor banking institutions. The restructuring of the corporate sector debts would expedite the recovery of the corporate sector which would in turn strengthen the health of the banking institutions. If the process under CDRC could not obtain consensus among the banking institutions, Danaharta would assist by buying over these NPLs from the dissenting banking institutions, thereby facilitating the restructuring process. (Operational details of Danaharta, Danamodal and CDRC are elaborated in the Annex.)

Danaharta, Danamodal and CDRC are interdependent and complementary, representing a comprehensive and coherent plan towards strengthening the banking sector. The complementary nature of these measures is illustrated in Chart VI.3 below.

Given that the measures were interdependent, it was critical that the functions of Danaharta, Danamodal and CDRC were co-ordinated to ensure that these institutions operated in a cohesive and structured manner to achieve the desired objectives. In this regard, a Steering Committee, chaired by the Governor of Bank Negara Malaysia, was established to oversee and monitor the policies, operations and progress of Danaharta, Danamodal and CDRC. The Committee, which meets fortnightly, ensures that the operations of these institutions are well co-ordinated and complement each other, and to keep track of their progress. In addition, mechanisms are also in place to ensure that the activities of Danaharta, Danamodal and CDRC are appropriately sequenced.

In addition to Danaharta, Danamodal and CDRC, the Government has also established several special funds to provide funds at reasonable cost to promote investment in the priority sectors. These special funds include the Fund for Small and Medium Industries (RM1.5 billion), the Special Scheme for Low and Medium Cost Houses (RM2 billion) and Rehabilitation Fund for Small and Medium Industries (RM750 million). The Rehabilitation Fund for Small and Medium Industries was established to provide financial assistance to viable small- and medium-sized industries

**Chart VI.3**
**Overview of Danaharta, Danamodal & CDRC**



that are facing NPLs and temporary cash flow problems.

## Progress of Restructuring Plan as at 15 March 1999

**Danaharta**

Danaharta has purchased and managed NPLs amounting to RM21.7 billion from the financial system, of which RM15.1 billion was from the banking system. These NPLs accounted for 20% of NPLs of the banking system as at end of December 1998. With the removal of NPLs from the banking system, the net NPL ratio of the banking system based on the 6-month classification declined from 8.1% as at end-September 1998 to 7.6% as at end-December 1998.

**Danamodal**

Danamodal has injected capital into 10 banking institutions in the form of Exchangeable Subordinated Capital Loans (ESCL) amounting to RM6.15 billion. This increased the RWCR of the banking system from 11.2% as at end-June 1998 to 11.9% as at end-January 1999, hence, increasing the capacity of banking institutions to generate new lending.

Danamodal has also signed Definitive Agreements with seven banking institutions to convert the ESCL into permanent Tier-1 and/or Tier-2 capital. To strengthen the management of these banking institutions, Danamodal has appointed Chairmen, Deputy Chairmen and Executive Directors into the respective Boards of six recapitalised banking institutions.

**CDRC**

CDRC has received 48 applications for debt restructuring, involving debt of RM22.7 billion. Two restructuring plans have been implemented thus far and 26 Creditor Committees have been formed to oversee the restructuring efforts.

**Mergers**

Eight finance companies have been absorbed/ merged, whilst another 14 finance companies will be absorbed/merged this year. Five small finance companies have been allowed to operate on a stand-alone basis for the time being. Nevertheless, the plan to rationalise these small finance companies remains part of BNM's agenda to further strengthen the finance company industry.

Three merger plans among commercial banks have been announced and expected to be completed by end-1999.

## Conclusion

Following the implementation of selected exchange control measures and the fixing of the exchange rate at US$1=RM3.80, the stable domestic environment has provided an opportunity for the authorities to continue to undertake economic recovery measures as well as accelerate the necessary restructuring and reform in the financial and corporate sectors.

Signs of economic recovery have already emerged in early December, observed from the greater stability in the exchange rate, stock market, employment and in the financial sector. Borrowers now also have greater access to credit, and are less burdened by the high debt servicing cost. The strains on the banking system are expected to lessen as the economy recovers and the restructuring process continues. The restructuring process would strengthen the banking system and thus, place the banking institutions in a position to perform the intermediation function more efficiently and effectively to support the economic recovery process. A stronger banking system would contribute to a stronger and more developed financial system in the longer term, placing the financial system in a better position to meet the challenges of the future.

## *Moving Ahead*

Globalisation and liberalisation of the financial markets will continue to pose great challenges to the banking sector. As the country graduates to become an industrialised nation, a resilient, dynamic, competitive and efficient domestic banking sector becomes highly critical in order to channel resources efficiently and effectively within the economy. The measures introduced thus far essentially serve as a short-term response to current challenges arising from the crisis and to provide the foundation on which to broaden and strengthen the financial infrastructure to enable the financial sector to meet the growing challenges of the future. The lessons that can be drawn from the crisis will help chart the strategic longer term plan for the banking industry. Efforts to further strengthen regulatory and supervisory framework would also continue. Prudential regulations would be continuously reviewed to ensure that best practices are being put to practice. The initiatives for the banking system will continue to be an evolving process to meet short-term challenges without detracting from achieving the long-term objective of a sound and resilient banking system in order to generate increased value-added in the financial services sector to support and contribute towards the overall growth of the real economy.

**Table 4.5**
**Banking System: Unaudited Income and Expenditure**

| | For the calendar year | | | |
|---|---|---|---|---|
| | 1997 | 1998 | Annual change | |
| | RM million | | | % |
| Interest income net of interest-in-suspense | 50,125 | 60,325 | 10,200 | 20.3 |
| *(Interest-in-suspense)* | *520* | *4,899* | *4,380* | *842.5* |
| Less: Interest expense | 33,412 | 45,570 | 12,159 | 36.4 |
| Net interest income | 16,713 | 14,754 | –1,959 | –11.7 |
| Add: Non-interest income | 4,943 | 6,081 | 1,138 | 23.0 |
| Less: Staff Cost | 3,993 | 3,895 | –98 | –2.5 |
| Overheads | 4,383 | 5,150 | 767 | 17.5 |
| Profit before provisions | 13,280 | 11,791 | –1,489 | –11.2 |
| Less: Loan loss provisions | 5,625 | 14,051 | 8,426 | 149.8 |
| Pre-tax profit | 7,655 | –2,260 | –9,914 | –129.5 |
| *(excluding 3 institutions)*[1] | *8,717* | *793* | *–7,925* | *–90.9* |
| Of which: | | | | |
| Commercial banks | 5,717 | 531 | –5,186 | –90.7 |
| Finance companies | 1,274 | –2,150 | –3,424 | –268.7 |
| Merchant banks | 663 | –641 | –1,304 | –196.7 |
| Return on assets | 1.3% | –0.3% | | |
| *(excluding 3 institutions)*[1] | *1.7%* | *0.1%* | | |
| Return on equity | 17.5% | –4.5% | | |
| *(excluding 3 institutions)*[1] | *22.1%* | *1.7%* | | |

[1] Excluding 3 banking institutions that made exceptional loss.

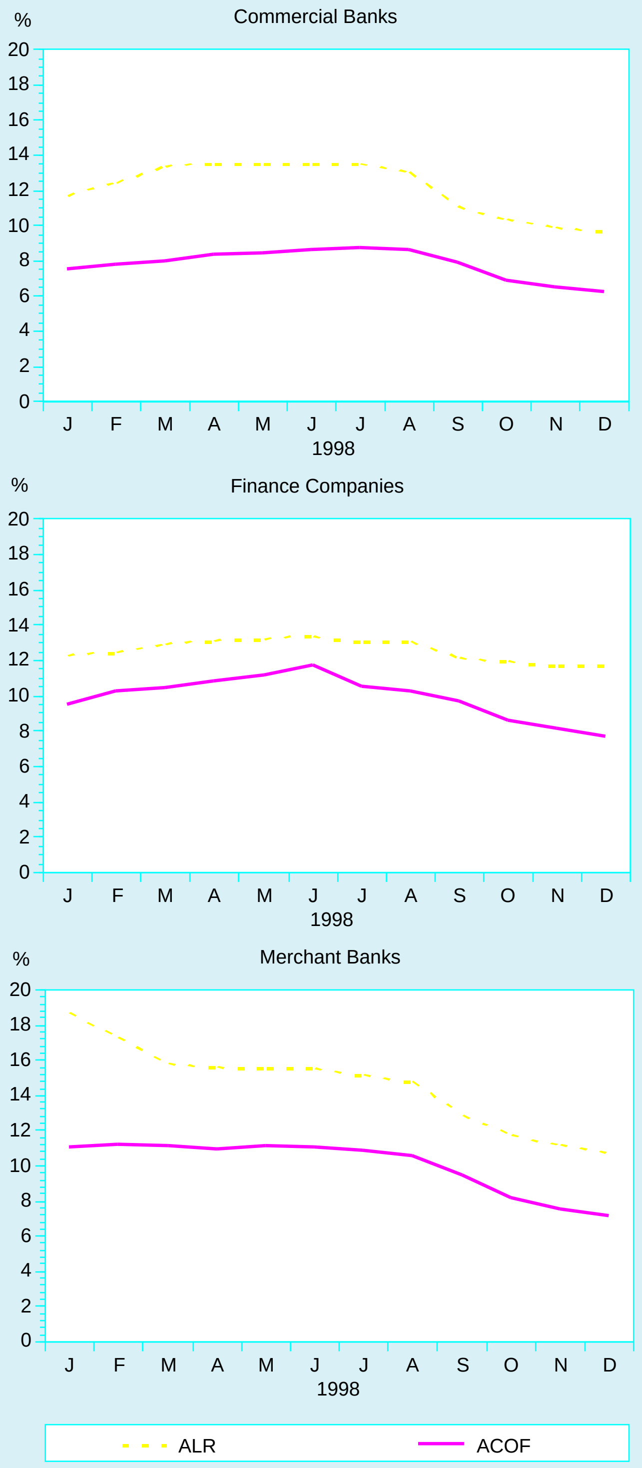
## Performance of Banking System

### *Profitability*

The banking system recorded a pre-tax loss of RM2.3 billion for calendar year 1998 as compared with a pre-tax profit of RM7.7 billion in 1997. This pre-tax loss was due to exceptionally large losses recorded by two commercial banks and one finance company. Excluding the losses registered by these three institutions, the banking system recorded a pre-tax profit of RM793 million which generated a marginal 0.1% return on total assets and 1.7% on total equity. Although the commercial banks as a group (excluding the two commercial banks) recorded a pre-tax profit of RM2.5 billion, this was, however, offset by the pre-tax loss of RM1.1 billion registered by the finance companies (excluding the one finance company) and the loss of RM641 million recorded by the merchant banks.

Losses recorded by the banking system in 1998 were due to the economic contraction which gave rise to negative loan growth, rising NPLs and higher loan loss provisions. Before factoring in the loan loss provisions, the banking system as a whole registered a pre-tax profit of RM11.8 billion, lower than the RM13.3 billion recorded in the previous year. Loan loss provisions and interest-in-suspense charged rose significantly by RM12.8 billion (+208%) to RM19 billion in 1998, mainly as a result of increased net specific provisions charged of RM9.3 billion. Of the total loan loss provisions and interest-in-suspense, RM5.1 billion or 27% was contributed by the three institutions which registered significant losses. The higher loan loss provisions recorded in 1998 was also partly due to the adoption of more stringent provisioning requirements under the revised Guideline on the Suspension of Interest on Non-Performing Loans and Provision for Bad and Doubtful Debts which shortened the period during which banking institutions are required to make loan provisions for doubtful and bad loans.

**Graph 4.1**
**Average Lending Rates and Average Cost of Funds**




The reduction in interest rates and the higher incidence of NPLs saw the banking system earning lower net interest income of RM14.8 billion. Although interest rates in the first seven months of 1998 were high, the rapid downward adjustment in interest rates by BNM in the later part of 1998 saw the overall net interest income declining by 11.7% in 1998. The rapid reduction in the 3-month intervention rate by BNM, to which the computed BLR of the commercial banks and finance companies was pegged, from 10.5% per annum in August 1998 to 7% per annum in September 1998, took its toll on interest margins temporarily as banking institutions' average cost of funds normally lags the policy rate by 3-6 months before falling to the new interest rate level.

The finance companies' profitability was also heavily squeezed during the early part of 1998 when a liquidity shortage in the system drove short-term deposit rates up on the back of fixed rate hire-purchase and term loans offered by the finance companies, causing the interest rate margins to narrow considerably to 1.7 percentage points. In addition, lack of sufficient new hire-purchase loans during the year reduced the ability of the finance companies to earn enough positive returns to compensate for the negative spread incurred on their existing fixed rate loan portfolio. Merchant banks, on the other hand, benefited greatly from the liquidity shortage in terms of interest margins as significant increases in interbank rates in the early part of the year were automatically translated into higher lending rates under their KLIBOR-plus loan pricing.

Non-interest income increased by RM1.1 billion in 1998. The favourable comparison to 1997 was due to an exceptional non-recurring provision for diminution in value of regional investment securities by one commercial bank in 1997 of RM0.9 billion and an increase of RM461 million in net trading income in 1998. Staff cost was contained at RM3.9 billion, while overheads rose by RM0.8 billion to RM5.1 billion in 1998.

## *Loan Growth*

Credit extended by the banking system as a whole declined by RM7.6 billion (–1.8%) in 1998. This was due mainly to the removal of loans by Danaharta in 1998 which amounted to RM13 billion (not including loans sold by the Malaysian banks' overseas branches, which amounted to RM1.4 billion). Taking into account the removal of loans by Danaharta, the banking system as a whole registered a marginal growth of RM5.5 billion or 1.3% in 1998. Higher loan repayments, which increased by 5.5%, and lower turnover in loan disbursements by 26.6% also contributed to the slowdown in growth momentum. Only the

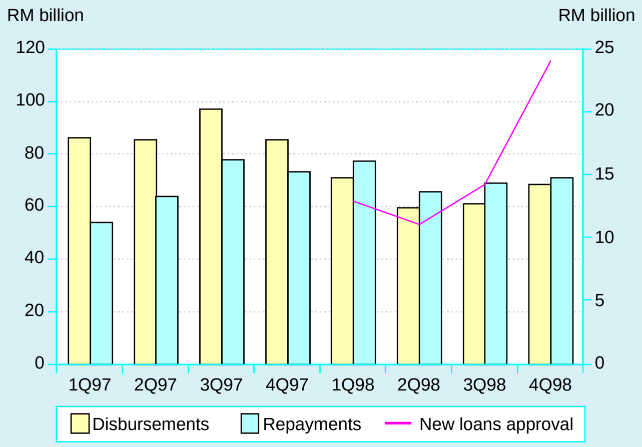
**Table 4.6**
**Banking System: Outstanding Gross Loans**

| | As at end | | | | |
|---|---|---|---|---|---|
| | | 1998 | | | |
| | 1997 | Excluding loans sold to Danaharta | | Including loans sold to Danaharta | |
| | RM million | RM million | Annual change ( % ) | RM million | Annual change ( % ) |
| Commercial banks | 289,756.7 | 299,257.8 | 3.3 | 310,405.2 | 7.1 |
| Finance companies | 108,389.2 | 92,182.1 | –15.0 | 93,072.1 | –14.1 |
| Merchant banks | 23,056.6 | 22,198.3 | –3.7 | 23,200.1 | 0.6 |
| **Banking system** | **421,202.5** | **413,638.1** | **–1.8** | **426,677.3** | **1.3** |

commercial banks as a whole managed to show a positive growth of 3.3% (7.1% if loans removed by Danaharta are taken into account), while both finance companies and merchant banks showed negative growth in 1998. If banks that do not have the capacity to lend due to capital adequacy problems are excluded, the loan growth of the remaining commercial banks was even higher at 8% in 1998. The positive credit growth exhibited by the commercial banks and the negative growth by the finance companies were partly due to the absorption of several finance companies by their respective parent banks.

As the regional financial turmoil became prolonged, banking institutions faced with economic uncertainties became cautious in extending credit during 1998. Tight and uneven distribution of liquidity further heightened the problem.

**Graph 4.2**
**Banking System : Quarterly New Loans Approved, Disbursements and Repayments**



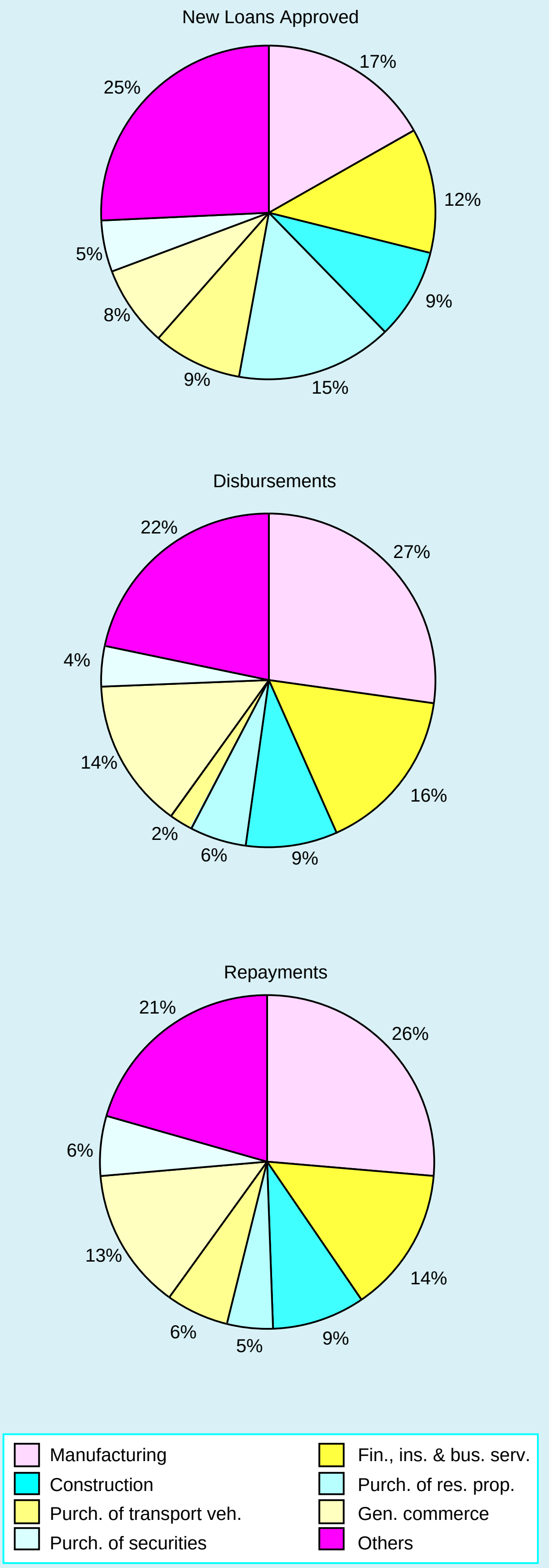

Consequently, only RM38.2 billion of new loans were approved during the first three quarters of 1998, or an average of RM4.2 billion a month. Several measures were introduced to inject greater liquidity, reduce interest rates and remove barriers to the supply of new financing, including the setting up of Danaharta to buy NPLs and the formation of Danamodal to recapitalise banking institutions.

The more conducive business environment brought about by the reduction in interest rates, greater liquidity, the removal of the twin distraction of rising NPLs and erosion of capital as well as rising consumer confidence, resulted in a significant rise in new loans approved during the fourth quarter of 1998. New loans approved amounted to RM24 billion during the last quarter of 1998, or an average of RM8 billion a month, nearly two-fold increase over the preceding nine months. For 1998 as a whole, manufacturing and end-financing for purchase of residential properties were the largest recipients of new loans approved. Loans for the purchase of residential properties costing RM150,000 and below accounted for more than 60% of the new loans approved to the residential property sector.

## *Asset Quality*

The asset quality of the banking system was adversely affected during 1998. In an environment where interest rates were high and economic activities had contracted, the ability of borrowers to service their debt was invariably affected. This was evident in the sharp increase in NPLs in the banking system in 1998.

**Graph 4.3**
**Banking System: New Loans Approved, Disbursements & Repayments by Sector in 1998**




The actual NPLs of the banking system increased by RM34.2 billion or 8.3% of total loans in 1998, whilst on the 3-month classification basis, NPLs grew by RM48.8 billion. On a net basis, the actual NPL ratio of the banking system increased from 4.1% as at end-December 1997 to 9% as at end-December 1998. As at end-December 1998, 57 banking institutions have reverted to the 6-month classification policy for NPL and they account for 54% of total loans of the banking system. Based on the 3-month classification policy, the net NPL ratio of the banking system increased from 4.7% as at end-December 1997 to 13.2% as at end-December 1998. Excluding the NPLs of three banking institutions that were most affected, the net NPL ratio for the industry as a whole was 12.2% as at end-December 1998. For the commercial bank industry, their net NPL ratio remained below 10% as at end-December 1998.

Although NPLs had increased during the year, the rate of increase has in fact moderated during the fourth quarter of 1998. The average monthly increase in NPLs from October to December 1998 slowed down to 6.2% (after taking into account loans sold to Danaharta), as compared with the average monthly increase of 11.3% in the first nine months of 1998. In December 1998 alone, the monthly rate of growth in NPLs moderated to 2.7%. Loan loss coverage ratio of the banking system declined slightly with total provisions (interest-in-suspense, specific provisions and general provisions) set aside by the banking system amounting to 55.7% of NPLs. Including the value of collateral, the total loan loss coverage of the banking system amounted to 143.3% of NPLs as at end-December 1998.

In terms of NPLs by sector, as at end-December 1998, loans to the broad property sector accounted for 35.3% of total loans and gross NPLs to the broad property sector accounted for 35.1% of total NPLs as at end-December 1998. A major proportion of NPLs to the broad property sector came from the construction and real estate sectors, which accounted for 61.6% of total broad property sector NPLs (52% as at end-1997). NPLs for the purchase of residential properties remained relatively low at 11%.

The sharp decline in the stock market has also adversely affected the quality of loans extended for the purchase of securities. The NPL ratio for the purchase of securities increased from 6.5% as at end-1997 to 23.2% as at 31 December 1998. However, given the relatively low exposure of the banking system to share financing at 7.9% as at end-1998, the high levels of NPLs for share financing remained manageable.

**Table 4.7**
**Banking System: Non-performing Loans and Loan Loss Provisions**

| | As at end | | | |
|---|---|---|---|---|
| | 1997 | 1998 | | |
| | Actual[1] | Actual[1] | 3-month Classifi-cation | 6-month Classifi-cation |
| | RM million | | | |
| **Commercial banks** | | | | |
| General provisions | 6,216 | 6,501 | 6,555 | 5,693 |
| Interest-in-suspense | 1,805 | 4,087 | 4,201 | 3,643 |
| Specific provisions | 3,268 | 12,602 | 13,348 | 11,704 |
| Non-performing loans | 14,159 | 37,279 | 44,896 | 32,086 |
| *Net NPL ratio (%)* [2] | *3.2* | *7.3* | *9.7* | *5.9* |
| *Total provisions / NPL (%)* | *79.7* | *62.2* | *53.7* | *65.6* |
| **Finance companies** | | | | |
| General provisions | 1,788 | 1,824 | 1,824 | 1,824 |
| Interest-in-suspense | 990 | 2,193 | 2,640 | 2,237 |
| Specific provisions | 1,923 | 3,601 | 3,822 | 3,551 |
| Non-performing loans | 9,798 | 17,901 | 25,122 | 16,320 |
| *Net NPL ratio (%)* [2] | *6.5* | *14.0* | *21.8* | *12.2* |
| *Total provisions / NPL (%)* | *48.0* | *42.6* | *33.0* | *46.6* |
| **Merchant banks** | | | | |
| General provisions | 443 | 446 | 446 | 446 |
| Interest-in-suspense | 91 | 463 | 624 | 456 |
| Specific provisions | 211 | 1,274 | 1,416 | 1,189 |
| Non-performing loans | 1,096 | 4,083 | 7,197 | 3,888 |
| *Net NPL ratio (%)* [2] | *3.5* | *11.5* | *25.6* | *10.9* |
| *Total provisions / NPL (%)* | *68.0* | *53.5* | *34.5* | *53.8* |
| **Banking system** | | | | |
| General provisions | 8,447 | 8,771 | 8,825 | 7,963 |
| Interest-in-suspense | 2,886 | 6,743 | 7,465 | 6,336 |
| Specific provisions | 5,402 | 17,477 | 18,586 | 16,444 |
| Non-performing loans | 25,053 | 59,263 | 77,215 | 52,294 |
| Exclude 3 banking institutions | 16,967 | 46,203 | 61,278 | 39,539 |
| *Net NPL ratio (%)* [2] | *4.1* | *9.0* | *13.2* | *7.6* |
| *Exclude 3 banking institutions* | *3.2* | *8.3* | *12.2* | *6.7* |
| *Total provisions / NPL (%)* | *66.8* | *55.7* | *45.2* | *58.8* |
| *Exclude 3 banking institutions* | *75.9* | *55.1* | *44.5* | *58.8* |

[1] Loans classified as NPLs based on individual banking institution's NPL classification policy i.e. 3-month or 6-month classification.
[2] Net NPL ratio = (NPL less IIS less SP) / (Gross loans less IIS less SP) x 100%.

**Table 4.8**
**Banking System: Non-performing Loans by Sectors**

| | As at end | | |
|---|---|---|---|
| | 1997 | 1998 | |
| | as % of total loans to sector | | |
| | | Excluding loans sold to Danaharta | Including loans sold to Danaharta |
| Agriculture, hunting, forestry & fishing | 6.4 | 10.6 | 11.7 |
| Mining & quarrying | 11.1 | 15.5 | 16.1 |
| Manufacturing | 5.8 | 14.3 | 16.6 |
| Electricity, gas & water | 0.6 | 0.9 | 1.1 |
| Community, social & personal services | 8.3 | 13.2 | 13.4 |
| Broad property sector | 6.3 | 16.4 | 18.4 |
| *Real estate* | *11.7* | *28.9* | *30.7* |
| *Construction* | *5.7* | *18.6* | *21.7* |
| *Purchase of residential property* | *8.1* | *11.0* | *11.0* |
| *Purchase of non-residential property* | *5.8* | *12.9* | *15.6* |
| Wholesale & retail, restaurants & hotels | 4.4 | 11.2 | 12.6 |
| Transport, storage & communication | 5.2 | 18.2 | 19.4 |
| Finance, insurance & business services | 3.8 | 12.4 | 13.9 |
| Purchase of securities | 6.5 | 23.2 | 34.2 |
| Consumption credit | 6.9 | 14.1 | 14.1 |
| *Personal use* | *6.0* | *15.4* | *15.6* |
| *Credit card* | *10.1* | *17.4* | *17.4* |
| *Purchase of consumer durables* | *13.3* | *18.2* | *19.4* |
| *Purchase of transport vehicles* [1] | *6.7* | *13.0* | *13.0* |
| Others | 7.5 | 12.6 | 13.2 |
| **Total** | **5.9** | **14.3** | **16.8** |

[1] Includes commercial vehicles.

The increase in NPLs was mainly concentrated in the construction, real estate and commercial sectors and for the purchase of shares which together accounted for RM15.5 billion or 45.2% of the total increase in NPLs in 1998. Recognising the vulnerabilities of these sectors, BNM has prohibited banking institutions from extending bridging financing for the development of properties above RM250,000. Although the limit on loans extended for the purchase of shares was increased from 15% to 20% of total loans in September 1998, this was aimed at providing share financing for genuine long-term investment and not for short-term speculative purposes.

**Table 4.9**
**Exposures of Malaysian Banks to East Asian Region**

| Country | Regional exposures as at 31.12.97 | Regional exposures as at 31.12.98 | Annual change (%) |
|---|---|---|---|
| | US$ million | | |
| Indonesia | 492 | 490 | –0.4 |
| Thailand | 276 | 219 | –20.7 |
| Korea | 32 | 32 | – |
| Philippines | 735 | 36 | –95.1 |
| **Total** | **1,535** | **777** | **–49.4** |

## *Exposure to the East Asian Region*

The Malaysian banks' exposure to countries in the East Asian region affected by the severe economic crisis was mainly confined to seven banking institutions through their overseas branches and Labuan offshore units. As at 31 December 1998, the loan exposure of the banking institutions to Indonesia, Thailand, Korea and the Philippines was US$777 million, a reduction of US$758 million from December 1997. The significant reduction was due to the sale of some of these loans to Danaharta, particularly those originating from the Philippines. The loan exposure represented only 1.7% of the total assets of the affected Malaysian banks. Nevertheless, banking institutions have been encouraged to recognise potential problems early and to build up provisions for the regional exposures.

## *Capital Strength*

Corresponding with the losses made by the banking system, total Tier-1 capital of the banking system fell by RM4.3 billion (–9.2%) to RM42 billion as at end-1998. The year also saw a reduction in the paid-up capital of finance companies due to the absorption of five finance companies by their parent banks and a merger of two finance companies. Nevertheless, the decline in Tier-1 capital was offset by a RM4.55 billion injection of Tier-2 capital funds by Danamodal in the form of Exchangeable Subordinated Capital Loan into nine banking institutions. This resulted in a marginal increase in the overall capital base of the banking system by 2.2% or RM1.2 billion to RM55.6 billion.

Total risk-weighted assets of the banking system declined by 8.9% or RM46.1 billion to RM470.9 billion as at end-1998, due mainly to the contraction of credit during the first three quarters of the year, and acquisition and management of loans of RM13 billion by Danaharta. The risk-weighted assets in the 0% and 20% risk-weight category also declined significantly by RM34.2 billion and RM23.6 billion respectively. The reduction in the riskless asset class was mainly due to reduction in the banking system's statutory deposit with BNM of RM41.7 billion following the reduction in the statutory reserve requirement from 13.5% to 4%. The bulk of the reduction was channelled towards repaying the banking system's money market borrowings from BNM which amounted to RM23.7 billion. The reduction in assets in the 20% risk category was due to a significant decline in NIDs held (–RM5 billion), other acceptances discounted (–RM5.7 billion), claims on reverse repos (–RM3.2 billion), and claims on OECD and non-OECD banks (–RM7.9 billion).

Reflecting the injection of capital by Danamodal, the removal of NPLs by Danaharta and the decline

**Table 4.10**
**Banking System: Constituents of Capital**

| | As at end 1997 | As at end 1998 | Annual change | |
|---|---|---|---|---|
| | RM million | | RM million | (%) |
| Tier-1 capital | 46,203 | 41,941 | –4,262 | –9.2 |
| Tier-2 capital | 12,584 | 18,298 | 5,713 | 45.4 |
| Total capital | 58,788 | 60,239 | 1,451 | 2.5 |
| Less: | | | | |
| Investment in subsidiaries and holding in other banking institutions' capital | 4,431 | 4,667 | 236 | 5.3 |
| Capital base | 54,356 | 55,571 | 1,215 | 2.2 |
| Risk assets: | | | | |
| 0% | 122,174 | 87,929 | –34,245 | –28.0 |
| 10% | 31,595 | 26,160 | –5,435 | –17.2 |
| 20% | 133,362 | 109,770 | –23,592 | –17.7 |
| 50% | 61,195 | 62,452 | 1,257 | 2.1 |
| 100% | 456,565 | 415,057 | –41,508 | –9.1 |
| Total risk-weighted assets | 516,995 | 470,853 | –46,142 | –8.9 |
| Risk-weighted capital ratio (%) | | | | |
| **Banking system** | **10.5** | **11.8** | **1.3** | |
| Commercial banks | 10.3 | 11.7 | 1.3 | |
| Finance companies | 10.3 | 11.1 | 0.8 | |
| Merchant banks | 13.3 | 15.2 | 2.0 | |

in total loans, the risk-weighted capital ratio (RWCR) of the banking system showed an increase of 1.3 percentage points to 11.8% as at end-1998 inspite of the pre-tax loss recorded by the banking system as a whole. By type of institution, the RWCR of commercial banks, finance companies and merchant banks showed an improvement from the 1997 position, to 11.7%, 11.1% and 15.2% respectively.

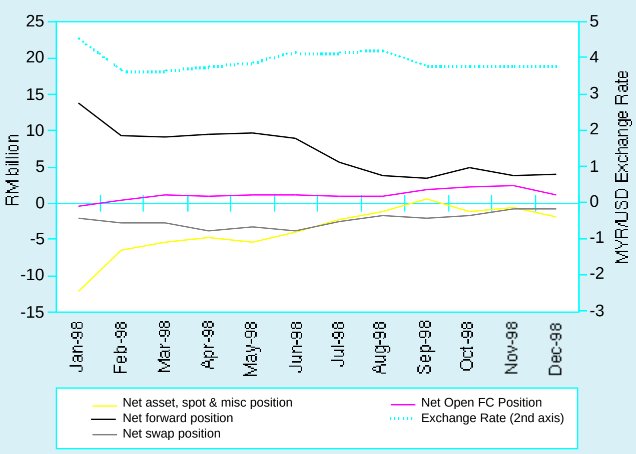
## *Foreign Currency Exposure*

The banking system maintained a relatively small foreign currency position during 1998. Throughout the year, the banking system was net long in forward foreign exchange transactions. This was in line with the net export position recorded during 1998, where overall, there were more parties contracting to sell forward foreign exchange proceeds compared with forward purchases to the banking system. Nevertheless, those positions were essentially matched by the banking system with opposite swap contracts and foreign currency borrowings. There were less forward foreign exchange contracts towards the fourth quarter when capital controls were introduced in September 1998 and concerns over volatile exchange rates diminished.

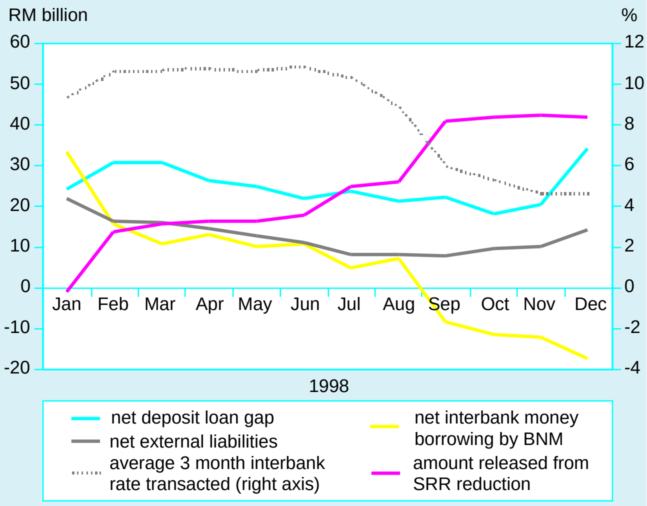
## *Liquidity*

A large number of banking institutions experienced tight liquidity situation in the first half of the year. Tight liquidity during the period was attributed to the continuous fall in total deposits of RM7.7 billion and the decline in the net external liability position of banking system of RM11 billion,

**Graph 4.4**
**Net Open Foreign Currency Position of Banking System**




**Graph 4.5**
**Liquidity of the Banking System**




1. Amount released from SRR reduction is calculated using December 1997 as zero reference base.
2. Increase in deposit-loan gap in December is due to annual seasonal trends

caused by the withdrawal of external funds from the domestic banking system. As a result, banking institutions that had been over-reliant on short-term funding to finance their asset growth, particularly from the interbank money market, encountered funding difficulties. The uneven distribution of liquidity led to a rise in short-term interest rates early in the year. The differences between the highest and the lowest rates transacted among interbank players were as high as 8.8 percentage points for 1-week money and 1.1 percentage points for 1-month money in January. In order to distribute liquidity more evenly among the banking institutions, the statutory reserve requirement of banking institutions was reduced from 13.5% to 10% in February 1998.

Liquidity conditions improved further towards the second half of the year following further reductions in the statutory reserve requirement from 10% to 8% in July and subsequently to 6% and 4% in September. This was accompanied by gradual reductions in the BNM 3-month intervention rate from 10.5% per annum at the beginning of August to 7% per annum in November. These measures contributed to ease the liquidity conditions in the money market as well as to bring down the cost of funds of the banking institutions. As a result, the computed BLR for commercial banks declined from 12.30% per annum in June to 8.08% per annum in December 1998 and for finance companies, from 14.76% per annum to 9.54% per annum. The improvement in the overall liquidity condition was also reflected by the reduction in BNM's money market lending to the banking system.

## Box VII

# *Managing the Y2K Challenges in the Malaysian Banking Industry*

### Introduction

Given the heavy dependence of the nation on information technology and automation, there is grave concern that business operations would be severely disrupted as we move on to the next millennium if computer systems and automated applications fail to be Year 2000 (Y2K) ready. For the financial sector, the Y2K challenges are especially acute, as it relies heavily on automation in almost all aspects of operations. If automated applications fail to function properly, it will be difficult, if not impossible, to conduct business. In view of this, BNM and the industry has adopted a proactive approach to confront the Y2K challenges.

### Impact of the Y2K Challenges

In any economy, the Y2K issue poses significant challenges as businesses and other daily activities are highly dependent on computer technology and integrity of data. Failure to address the problem would result in many automated applications failing to function normally and lead to disruptions in business activities as well as our everyday life. The banking industry faces the greatest challenge, due to its pivotal role in the payment and settlement systems. It is exposed to various risks if it fails to address the Y2K challenges in a proper and timely manner. The payment system may be severely disrupted if the Y2K challenges are not addressed expeditiously. When this happens, the settlement system, both domestically and internationally, will be affected and as a result, customers will not be able to perform their normal banking transactions.

These disruptions could expose banking institutions to a wide array of risks, which include operational risks, credit risks, reputational risks, settlement risks as well as legal risks.

**Operational risks** are the most obvious. Failure to ensure fully operational automated systems can prevent even simple business functions from being transacted because manual or other alternatives may not be feasible, in view of the sizeable volume of transactions or integrity of data. For example, if the Automated Teller Machine (ATM) network, which is highly dependent on automation, fails to comply with Y2K requirements, cardholders will not be able to perform banking transactions through the ATM.

There are other risks associated with the breakdown in the operations as correspondents and clients would be severely affected by the disruption in the operating environment. In the case where the ATM of a banking institution fails to function, there would be a build-up of negative perception on that institution. This may in turn expose the institution to **reputational risks** and consequently to **legal risks.** Customers would resort to legal action against the institution as it would not be able to conduct transactions, resulting in potential damage to the institution's business.

Business customers of banking institutions may also suffer serious disruptions to their businesses if they fail to meet with the Y2K requirements, thus probably affecting their ability to service their loans. This will in turn increase the **credit risks** for the banking institutions. Furthermore, an operational breakdown resulting from the lack of preparation to deal with the Y2K challenges by any one of the financial market participants may affect the integrity and operation of the entire settlement system, which may even lead to the collapse of the entire payment system. For example, a Y2K-induced operational breakdown that results in delayed fund payments may cause significant liquidity pressures for other market participants. These disruptions and interruptions in the banking system could erode the public confidence in the integrity of the banking system.

## Bank Negara Malaysia's Action Plan

BNM is aware and concerned about the challenges posed by the Y2K problem and the potentially serious implications for the financial market and the public at large arising from the lack of readiness. BNM has adopted a proactive approach to confront the Y2K challenges. Amongst the measures implemented by BNM in managing the Y2K challenges include:-

- Establishing targets and benchmarks for institutions to adhere to in addressing the Y2K challenges;
- Developing and communicating the necessºary framework in implementing the Y2K project through the issuance of circulars and guidelines;
- Conducting an industry-wide status assessment through regular reporting by the financial institutions to BNM and the periodic examination of the financial institutions; and
- Placing supervisory pressure on financial institutions to ensure high level of compliance with the Y2K requirements.

A Y2K monitoring system has been implemented to monitor the progress of each banking institution in achieving a fully Y2K-compliant operation. BNM also conducts regular on-site inspections on financial institutions to complement the monitoring process. A special unit, staffed with trained personnel to conduct IT audits, has also been set up to specifically audit the progress of banking institutions in complying with the Y2K requirements.

## Y2K Steering Committee for Banking and Insurance Industries

BNM realises that the Y2K issue, which initially started as a technical problem, is a business survival issue for the banking community as a failure by one institution would have ramifications on the whole system. In this regard, an industry-driven approach with supervisory support and oversight from BNM was adopted. Under this approach, the industry undertook collectively planned and co-ordinated steps spearheaded by an Industry Y2K Steering Committee. The Steering Committee, comprising chief executive officers of financial institutions, plays **a proactive role** to ensure that the financial industry in Malaysia can move confidently and smoothly into the next millennium.

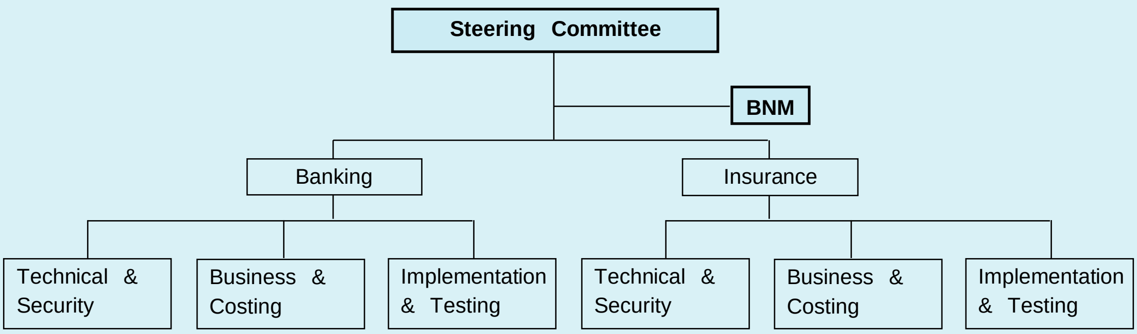
The **terms of reference** of the Y2K Steering Committee are as follows:-

(i) Creating awareness across the industry;

(ii) Creating support from the highest level within an institution;

(iii) Planning and co-ordinating industry-wide action plan;

***Banking and Insurance Industry Y2K Steering Committee***



(iv) Planning and co-ordinating testing and interfacing of various applications;

(v) Managing cost control;

(vi) Co-ordinating issuance of public statements on the state of readiness of the banking and insurance industries in complying with the Y2K issue; and

(vii) Ensuring security and control issues are appropriately addressed.

## Working Committees

The Y2K Steering Committee is supported by two working committees, namely the Banking Sector Working Committee and the Insurance Sector Working Committee. The Banking Sector Working Committee comprises representatives from the commercial banks, merchant banks and finance companies, whilst the members of the Insurance Sector Working Committee are representatives from the insurance companies. Within these two groups, three sub-working committees on each sector were formed to tackle specific issues. The technical and security working committee would address technical and security-related issues, including identifying and listing of inventories to be renovated, while the business and costing working committee would address business and cost-related issues. The responsibility of the business and costing working committee includes co-ordination with vendors to obtain a reasonable cost of renovation as well as ensuring a co-ordinated approach in communicating with the public on Y2K-related issues. The implementation and testing working committee is responsible for co-ordinating testing initiatives within the industry. These sub-committees report to the Y2K Steering Committee on a regular basis in order to keep the Steering Committee abreast with the current progress of the industry's Y2K readiness.

## Implementation Timeframe

As compliance with the Y2K requirements is crucial, the deadline for complying with the Y2K requirements cannot be compromised. In this regard, the timeframe as recommended by the Bank for International Settlements (BIS) in handling the Y2K challenges has been adopted for the Malaysian banking and insurance industries. Under the timeframe, there are four main stages as follows:-

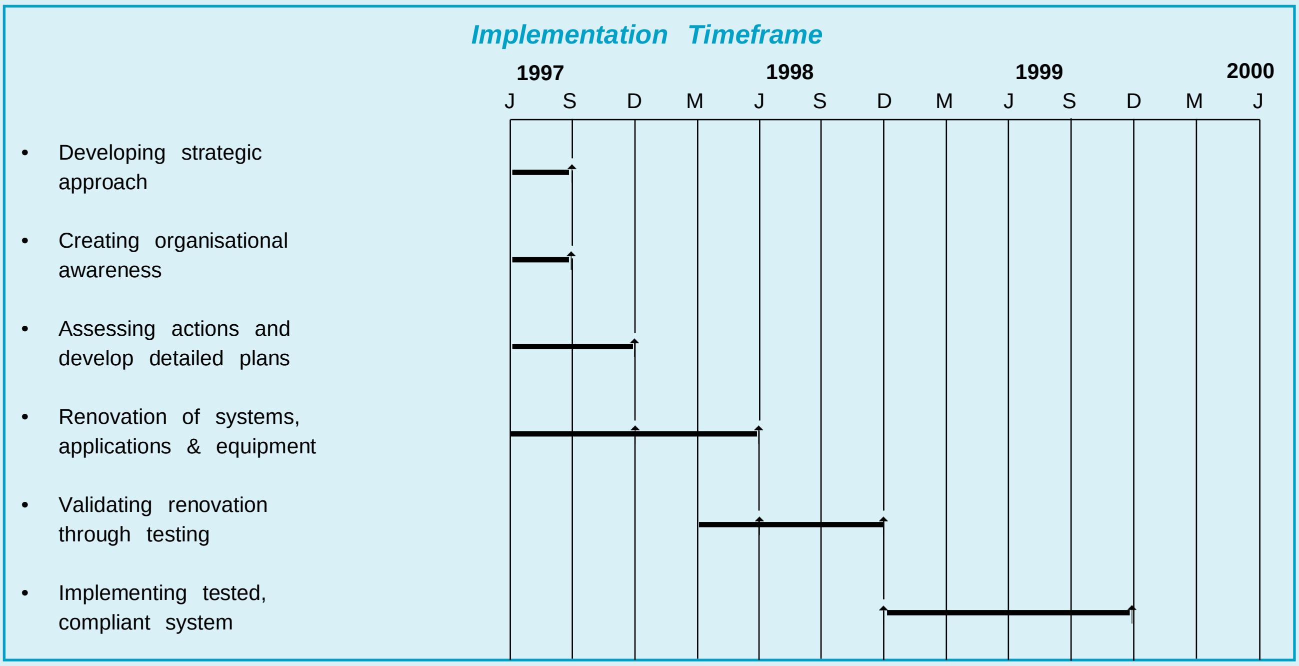
**Assessment stage -** defined as a phase that moves the project from “concept” to “concrete actions”. This stage involves developing detailed inventories of what must be done, the scope of which covers centralised and decentralised hardware, software, and networks, as well as equipment with embedded computer chips and logic. The inventories should include all aspects of business line activities whether internal to the bank or external to it. The risks should be quantified and the priorities should be set based on these risks.

**Renovation stage -** defined as a phase that is primarily technical in nature. During this phase, the necessary fixing of operating systems, applications, hardware and equipment takes place. The development of contingency plans that identify alternative approaches if renovations lag or fail, is an important part of this phase.

**Testing stage -** defined as a phase where detailed test schedules must be developed and co-ordinated with correspondents and customers. Data flows, internally and with third parties, must be thoroughly tested, while both the sender and receiver simulates “Year 2000 conditions”.

**Implementation stage -** defined as a phase that requires careful planning to make sure that inter-related applications are co-ordinated when they are put into production. The implementation phase also requires the monitoring of progress by service providers and vendors.

In accordance with the Y2K implementation timeframe, financial institutions should have completed detailing inventories and renovation work on systems, applications and equipment as well as carried out validation and testing by the end of 1998. This is to provide ample




lead time for banking institutions to conduct testing, including external testing to ensure that the system has undergone rigorous testing and validation before it is deemed as Y2K ready.

Financial institutions have to adhere strictly to this implementation timeframe and to submit reports on a monthly basis to BNM on the progress in complying with the Y2K requirements.

## Progress Made by the Banking Industry

As at **end-February 1999,** 96.1% or 74 out of 77 banking institutions have completed all the three stages of assessment, renovation and testing. The remaining three banking institutions (one commercial bank and two merchant banks) have completed at least 75% of the testing stage and are expected to complete the entire testing by end-March 1999. BNM monitors closely the progress of these institutions and additional supervisory actions have been taken, including conducting regular on-site examinations and meeting with the management of the institutions, to get their full commitment to resolve problems that could impede remedial efforts.

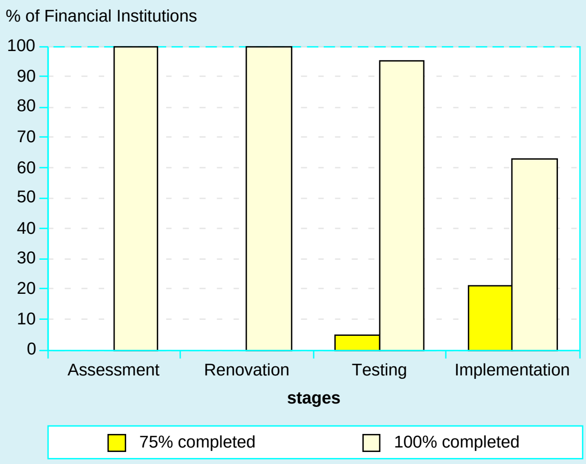
## Other Initiatives

BNM has also initiated a series of measures as follows:-

**Self-Assessment by Institutions**

- Banking institutions have been required to conduct self-assessment exercises on their Y2K compliance process to ensure that they have taken reasonable and prudential steps to address the Y2K challenges and that satisfactory progress is being made to meet the compliance deadline. Banking institutions have been required to report to BNM on the self-assessment.

**Graph VII**
**Financial Institutions: Level of Readiness**
**as at end - February 1999**



**Formal Statement by Chief Executive Officers**

- To ensure the involvement of the highest level of management in handling the Y2K challenges, the chief executive officers of banking institutions have been required to provide formal statements of the Y2K compliance progress on a monthly basis to BNM commencing July 1998. The results so far indicate that the majority of the chief executive officers are satisfied with their institutions' progress.

**Public Disclosures**

- In order to provide accurate and sufficient information on the progress of the banking industry in achieving the Y2K compliance, banking institutions have been required to disclose their level of compliance with the Y2K requirement in their published accounts from the financial year ending 30 June 1998. As it is crucial to instil public confidence, the Business and Costing Working Committee has also been required to co-ordinate the disclosure of Y2K readiness of the Malaysian financial system.

**Business Resumption Plan**

- Banking institutions have also been required to develop business resumption plans and submit their plans to BNM by 30 April 1999. The plan would elaborate clearly the process and steps to be taken by each institution in managing the Y2K challenges. It should cover areas of organisational planning, business impact analysis, identification and documentation of the business resumption plans and its implementation modes, as well as evaluation by an independent audit of the viability and soundness of the business resumption plans.

## The National Y2K Task Force

To ensure a coherent approach in tackling the Y2K initiatives at the national level, BNM also sits as a member on the National Y2K Task Force, which was set up by the Government to co-ordinate the Y2K preparations nation-wide. The National Y2K Task Force is headed by the Minister of Energy, Communications and Multimedia and it co-ordinates the Y2K initiatives of the critical sectors in the economy. The banking and insurance industries have been identified as among the critical sectors with regard to Y2K compliance.

## Progress of the Payment System Y2K Compliance

The payment and settlement system is the key element in facilitating banking transactions. As such, BNM has taken the necessary steps to ensure that all the critical systems will be Y2K compliant by June 1999. The Y2K compliance activities for BNM's internal systems have started since January 1997. As at the end of **February 1999,** about 50% of the critical systems have been tested for Y2K compliance. The other systems are scheduled to be tested in stages until June 1999. The status of the BNM internal critical systems is as follows:-

- The Bond Information Dissemination System (BIDS) and the Fully Automated System for Tendering (FAST) have been tested for Y2K compliance in December 1998.

- The National Imaging Cheque Clearing System (SPICK) was tested for Y2K compliance in February 1999.

- The Real Time Electronic Transfer of Funds and Securities (RENTAS) is now at the advanced stage of development and is scheduled to be implemented as a Y2K ready system in June 1999.

In addition, the Malaysian Electronic Payment System (1997) Sdn. Bhd. (MEPS), the service provider of the largest shared ATM network in Malaysia, has also taken various steps to resolve the Y2K challenges. The focus of MEPS is to ratify the Y2K problem on the existing production system which is the shared ATM network, as well as the development of new application systems such as E-Purse, SET Payment Gateway and Inter Bank Giro. The scope of MEPS Y2K programme covers all critical systems' hardware and software, data centre equipment, network equipment, office equipment and tools, suppliers, service providers, as well as the legal aspect. MEPS has, to date, completed the assessment and renovation on all critical systems, including replacement of hardware, software and modification of systems. The testing of the main hardware and operating system has been successfully conducted to ensure Y2K compliance. The office equipment and other non-critical systems are at the final stage of testing and implementation. The shared ATM switching module is currently at the final stage of testing with selected financial institutions.

## Conclusion

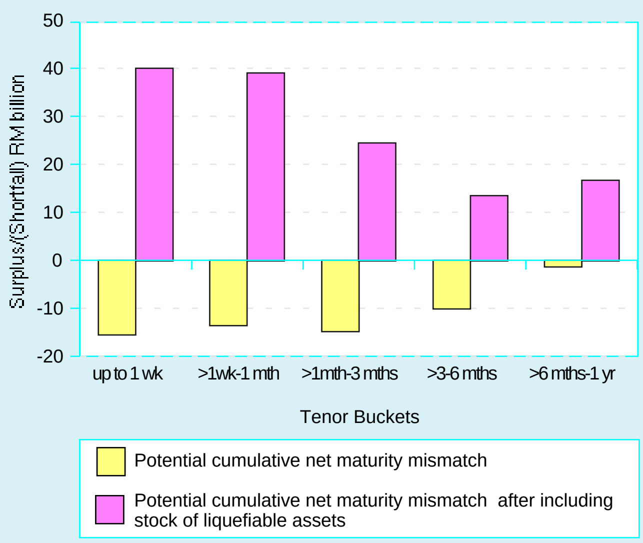
With the year 2000 fast approaching, it is important for everyone to fully realise the challenges and implications of the Y2K issue, and accord the highest priority to ensure compliance with the stipulated timeframe. It is indeed one of the greatest challenges facing mankind today. As a result of a co-ordinated and systematic approach adopted in tackling the Y2K challenges, the banking system is well ahead in preparing for the new millennium. In view of the progress made in complying with the Y2K requirements, we should be able to move on smoothly and confidently into the next millennium. Notwithstanding the measures already in place to ensure readiness, BNM will intensify its supervisory effort and put in place a sound and comprehensive business resumption plan to minimise any potential disruptions.

BNM turned from being a net lender during the initial part of the year to a net borrower from the banking system towards the last quarter of the year.

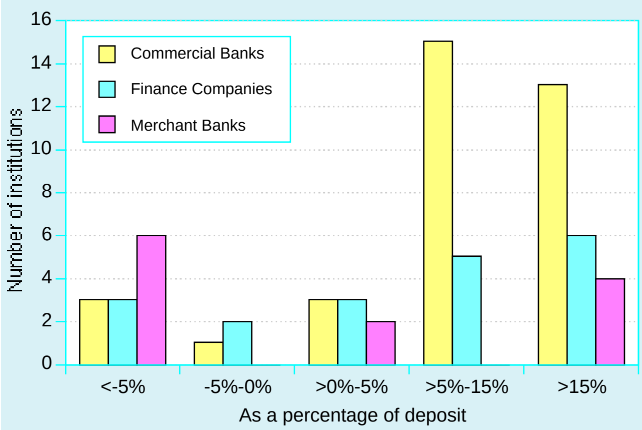
In terms of managing the timing of liquidity to meet obligations, the banking system as a whole maintains sufficient stock of liquefiable assets that can be liquidated to meet any projected potential shortfall that may arise. Taking into account the liquefiable assets as at 31 December 1998, the banking system as a whole had projected a cumulative liquidity surplus of RM20 billion to RM40 billion over the next three months. Approximately 37% of the liquefiable assets held by banking institutions were in the form of Government securities and 22.5% in Danaharta and Danamodal bonds.

The liquidity position by type of institution, however, differs significantly. Finance companies, in general, tend to exhibit higher potential of liquidity shortfall compared with commercial banks, as their deposit base was less stable. Those merchant banks, whose funding structure relied on a small number of large corporate depositors, also faced a higher degree of risk in encountering potential shortfalls. As at 31 December 1998, 77.3% of banking institutions forecasted potential surpluses of liquidity for at least one-month ahead.

**Graph 4.6**
**Aggregate Projected Potential Cumulative Liquidity Surplus/(Shortfall) of Banking Institutions as at 31 December 1998**




**Graph 4.7**
**Profile of Individual Institution's Potential Liquidity Surplus/(Shortfall) Up to One Month Ahead as at 31 December 1998**




## Islamic Banking

Islamic banking continued to record moderate growth in 1998. Total deposits mobilised registered a strong growth of 59.1% to RM16.4 billion during the year. The shareholders' funds of the Islamic bank and the Islamic Banking Fund increased by 23% to RM1.6 billion, while profit before taxation and zakat decreased by 3.3% to RM148 million in 1998. Total assets expanded by 21% to RM21.6 billion due mainly to the increase in holdings of securities (162.4% or RM3.1 billion). Total financing recorded a growth of 1.8% to RM10.9 billion.

Total deposits recorded a strong growth in 1998, particularly in the second half of the year. The increase was partly due to the migration of deposits from conventional banking to Islamic banking in view of the better investment deposit rates. Investment deposits constituted the bulk of deposits (60.5%), which recorded a growth of 108.9% to RM9.9 billion.

The expansion in total financing was small in 1998, due mainly to a decline of 1.4% (RM149 million) in the first half-year, which offset an increase of 3.2% (RM342 million) in the second half of the year. The exposure of Islamic banking to the broad property sector remained significant, at 41.7% of total financing. The high demand for broad property sector financing under Islamic banking was partly attributed to the fixed-rate nature of Islamic financing i.e. Bai' Bithaman Ajil. During the period of rising interest rates in early 1998,

**Table 4.11**
**Islamic Banking: Key Data**

| | As at end of | | Annual change ( % ) | |
|---|---|---|---|---|
| | 1997 | 1998 | 1997 | 1998 |
| Number of financial institutions | 52 | 49 | 4.0 | –5.8 |
| Commercial banks | 24 | 25 | –4.0 | 4.2 |
| Finance companies | 22 | 18 | 4.8 | –18.2 |
| Merchant banks | 5 | 5 | 66.7 | – |
| Islamic bank | 1 | 1 | – | – |
| Total assets (RM million) | 17,881 | 21,632 | 76.5 | 21.0 |
| Commercial banks | 9,078 | 11,835 | 148.5 | 30.4 |
| Finance companies | 2,924 | 3,321 | 57.8 | 13.6 |
| Merchant banks | 677 | 778 | 1.8 | 14.9 |
| Islamic bank | 5,202 | 5,698 | 31.3 | 9.5 |
| Total deposits (RM million) | 10,330 | 16,432 | 42.2 | 59.1 |
| Commercial banks | 5,558 | 9,108 | 108.4 | 63.9 |
| Finance companies | 1,200 | 2,677 | 24.2 | 123.1 |
| Merchant banks | 349 | 607 | 0.3 | 73.9 |
| Islamic bank | 3,223 | 4,040 | –1.8 | 25.3 |
| Total financing (RM million) | 10,750 | 10,943 | 75.0 | 1.8 |
| Commercial banks | 4,706 | 4,764 | 121.5 | 1.2 |
| Finance companies | 2,190 | 2,108 | 78.8 | –3.7 |
| Merchant banks | 503 | 421 | 28.0 | –16.3 |
| Islamic bank | 3,351 | 3,650 | 39.6 | 8.9 |
| Financing-deposits ratio (%) | 104.1 | 66.6 | 24.1 | –37.5 |
| Commercial banks | 84.7 | 52.3 | 11.6 | –32.4 |
| Finance companies | 182.5 | 78.7 | 60.4 | –103.8 |
| Merchant banks | 144.1 | 69.4 | 31.2 | –74.8 |
| Islamic bank | 104.0 | 90.3 | 30.9 | –13.6 |

borrowers took the opportunity to refinance their loans under Bai' Bithaman Ajil to lock in their cost of financing.

The contraction in economic activity in 1998 was also reflected in lower financing activities of the Islamic banking sector. The financing-deposit ratio declined from 104.1% as at end-1997 to 64.9% as at end-1998. The excess deposits were mostly invested in the Islamic money market.

During the year, the Bank introduced the following measures as part of the on-going exercise to strengthen the development of Islamic banking.

- With effect from 1 December 1998, the term "Perbankan Tanpa Faedah (Interest-free Banking)" was replaced by "Perbankan Islam (Islamic Banking)". Banking institutions could use the new term in all their Islamic banking operations, dealings and correspondence.

**Table 4.12**
**Islamic Banking: Deposits by Type & Institutions**

| | Annual change | | | | As at end 1998 |
|---|---|---|---|---|---|
| | 1997 | | 1998 | | |
| | RM million | % | RM million | % | RM million |
| Current deposits | 1,808 | 119.7 | –273 | –8.2 | 3,046 |
| Commercial banks | 1,474 | 215.2 | –134 | –6.2 | 2,025 |
| Islamic bank | 334 | 40.4 | –139 | –12.0 | 1,021 |
| Savings deposits | 398 | 28 | 225 | 12.4 | 2,046 |
| Commercial banks | 223 | 35.4 | 171 | 20.0 | 1,024 |
| Finance companies | 43 | 50 | 47 | 36.4 | 176 |
| Islamic bank | 132 | 18.7 | 7 | 0.8 | 846 |
| Investment deposits | 425 | 9.8 | 5,180 | 108.9 | 9,935 |
| Commercial banks | 789 | 58.4 | 3,217 | 150.3 | 5,358 |
| Finance companies | 161 | 18.3 | 1,439 | 138.2 | 2,480 |
| Merchant banks | 1 | 0.3 | 258 | 73.9 | 607 |
| Islamic bank | –526 | –30.1 | 266 | 21.7 | 1,490 |
| Other deposits | 435 | – | 970 | 223.0 | 1,405 |
| Commercial banks | 405 | – | 296 | 73.1 | 701 |
| Finance companies | 30 | – | –9 | –30.0 | 21 |
| Merchant banks | 0 | – | 0 | 0.0 | 0 |
| Islamic bank | 0 | – | 683 | 0.0 | 683 |

- With effect from 2 January 1999, banking institutions participating in Skim Perbankan Islam were required to upgrade their Islamic Banking Unit (IBU) into an Islamic Banking Division (IBD). The IBD was required to carry out all

**Table 4.13**
**Islamic Banking: Direction of Lending**

| | Annual change | | As at end 1998 |
|---|---|---|---|
| | 1997 | 1998 | |
| | RM million | | |
| Agriculture | 41 | –22 | 172 |
| Mining & quarrying | 68 | –4 | 69 |
| Manufacturing | 358 | 15 | 1,298 |
| Electricity | 10 | –66 | 33 |
| Real estate & construction | 1,177 | –431 | 1,862 |
| Housing | 1,039 | 675 | 2,699 |
| General commerce | 195 | 104 | 628 |
| Transport and storage | 461 | 0 | 720 |
| Finance, insurance & business services | –230 | 151 | 457 |
| Purchase of stocks & shares | 625 | –275 | 853 |
| Consumption credit | 125 | 314 | 947 |
| Others | 738 | –270 | 1,205 |
| **Total** | **4,607** | **194** | **10,943** |

aspects of Islamic banking such as banking services (formulation of policy, processing of applications and full-fledged Islamic banking branch supervision) and administration (product development, training etc.). The IBD should be headed by a senior management officer of the bank, preferably at the level of the Assistant General Manager (AGM).

- With effect from 2 January 1999, the minimum Islamic Banking Fund (IBF) initially set at RM1 million, was revised upwards as follows:-

  (i) Commercial banks - RM5 million, to be gradually increased to RM20 million by 31 December 2000;

  (ii) Finance companies - RM5 million, to be gradually increased to RM10 million by 31 December 2000;

  (iii) Merchant banks - RM3 million, to be gradually increased to RM6 million by 31 December 2000.

- With effect from 12 November 1998, banking institutions participating in Skim Perbankan Islam were allowed to accept funds of less than one-month maturity from non-interbank customers. However, the funds received through the repos were to be utilised solely for Islamic banking purposes. Previously, only principal dealers were granted the privilege to accept funds from repos of less than one-month maturity from non-interbank customers.

- On 8 December 1998, the Bank introduced the Guidelines on Islamic Negotiable Instruments for two new deposit-taking products based on Islamic principles, namely Negotiable Islamic Debt Certificate (NIDC) based on the concept of Bai' Bithaman Ajil and Islamic Negotiable Instruments of Deposit (INID) based on the concept of Al-Mudharabah. The products provided an additional avenue for the Islamic bank and banking institutions participating in Skim Perbankan Islam to mobilise domestic savings from the public, and at the same time, promote the development of the Islamic money market with marketable and liquid instruments.

- With effect from 4 January 1999, discount houses were allowed to participate in the Skim Perbankan Islam. As at end-February 1999, three discount houses had participated in the scheme.

## Other Financial Institutions

### *Discount Houses*

The operations of the discount houses slowed down markedly in 1998. The tight liquidity environment and the high short-term interest rates in late 1997 and the first half of 1998 raised their operational costs and consequently reduced profitability. The situation improved in the second half of 1998 when the liquidity situation eased significantly following the relaxation of monetary policy. Total resources of the industry declined by RM970 million or 4.6% in 1998, compared with an increase of RM3.8 billion or 22% in 1997. The bulk of the decline was due to lower deposits placed by commercial banks with discount houses.

In 1998, total deposits mobilised by discount houses declined by RM1.3 billion or 6.5%. In terms of type of deposits, call money placed with discount houses fell by RM4.8 billion or 63.2% (an increase of RM2 billion or 36.6% in 1997). In the first half of 1998, there was a large withdrawal of call money as financial institutions began to withdraw funds due to the tight liquidity conditions. Meanwhile,

**Table 4.14**
**Discount Houses: Sources and Uses of Funds**

| | Annual change | | At end |
|---|---|---|---|
| | 1997 | 1998 | 1998 |
| | RM million | | |
| Sources: | | | |
| Shareholders' funds | 308 | –31 | 859 |
| Deposits | 3,551 | –1,297 | 18,631 |
| Others | –85 | 358 | 484 |
| **Total** | **3,774** | **–970** | **19,974** |
| Uses: | | | |
| Investment | 2,449 | 185 | 18,640 |
| Treasury bills | 0 | 10 | 10 |
| Government securities | –323 | 643 | 954 |
| Bankers acceptances | –10 | –168 | 4,281 |
| Negotiable instruments of deposit | –236 | 544 | 909 |
| Cagamas papers | –110 | –212 | 247 |
| Private debt securities | 2,725 | 3 | 11,875 |
| Others | 403 | –635 | 364 |
| Loans to licensed institutions | 1,395 | –1,354 | 832 |
| Others | –70 | 199 | 502 |

interbank borrowings by discount houses increased by RM3 billion, most of which was in borrowings from commercial banks. Fixed deposits recorded a smaller increase of RM660 million in 1998 (RM1.2 billion in 1997).

Despite the decrease in total resources, total investments by the discount houses continued to increase, albeit at a very moderate level. Total investment increased by RM185 million (an increase of RM2.4 billion in 1997). The bulk of the investments were in Malaysian Government Securities (MGS) as well as negotiable instruments of deposit. Investments in MGS by discount houses picked up due to the large issuance of MGS in 1998 as well as the shift into the New Liquidity Framework. These developments have reduced the liquid asset premium and increased the effective yield placed on these papers.

During the year, the fee-based activities of the discount houses slowed down significantly. The industry arranged, lead-managed and co-managed RM360 million (RM434 million in 1997) of Private Debt Securities, while the total amount underwritten by the discount houses fell to RM510 million (RM1.5 billion in 1997). As in the previous year, there were only three discount houses appointed as principal dealers in 1998.

## *National Savings Bank*

Total resources of the National Savings Bank (NSB) increased more moderately in 1998 by RM463 million or 6.1% to RM8 billion (RM616 million or 8.9% in 1997). The increase was due mainly to higher deposits, in tandem with the increase in the number of active account holders which rose to 8.7 million at the end of 1998 from 8.5 million at the end of 1997. Fixed deposits rose by 38.1% and deposits in Sistem Perbankan Islam (SPI) products rose significantly by 147.9%, while other types of deposits declined. The higher fixed deposits mobilised during the year was due to extensive savings promotions by NSB for their corporate clients. Although deposits mobilised through the GIRO scheme declined by 3.6%, it continued to be the most popular deposit scheme, accounting for 38.5% of total deposits. The number of Premium Savings Certificates sold during the year declined by 11.9% to 515,003 certificates amounting to RM536 million.

**Table 4.15**
**National Savings Bank**

| | Annual change | | As at end 1998*p* |
|---|---|---|---|
| | 1997 | 1998*p* | |
| | RM million | | |
| Deposits [1] | 489 | 441 | 6,380 |
| Savings | –96 | –171 | 1,415 |
| Fixed | 588 | 667 | 2,419 |
| Save-As-You-Earn | –1 | –6 | 16 |
| GIRO | –10 | –93 | 2,458 |
| Others | 8 | 44 | 72 |
| Premium Savings Certificate | 115 | –48 | 536 |
| Investments (book value) | –300 | –132 | 3,940 |
| Malaysian Government Securities | –572 | –209 | 1,177 |
| Other investments | 272 | 77 | 2,763 |
| Total loans | 535 | 203 | 2,225 |
| Total loans (after provision for doubtful debts) | 511 | 173 | 2,132 |
| Number of NSB branches [2] | –7 | –20 | 448 |
| Number of post offices with NSB facilities | 6 | 3 | 645 |
| Number of account holders (' 000) | –681 | 197 | 8,667 |

[1] Includes interest credited.
[2] Includes mini-branches and sub-branches.
*p* Preliminary

During the year, NSB invested about 49.2% of its total resources in various types of investment certificates. As in previous years, in line with the statutory requirement, the bulk of the resources was invested in MGS, which accounted for 29.9% of the total investment as at end-1998. Other investments were in the form of trustee stocks (RM1 billion), unquoted shares (RM487 million), Government guaranteed bonds (RM333 million), non-trustee stocks (RM312 million) and Government promissory notes (RM307 million).

Reflecting the contraction in economic activities, lending operations of NSB slowed down in 1998. Total loans outstanding increased by 10.1% (36% in 1997) to RM2.2 billion as at end-1998. The bulk of the outstanding loans continued to be extended to individuals, accounting for RM1.9 billion or 87.6% of total loans outstanding. Of the total loans outstanding, RM1 billion or 45.4% was granted for the purchase of houses and RM0.7 billion or 33.2% was utilised for hire-purchase financing. While corporate loans declined by RM6.5 million or 6% (+RM0.8 million or 0.8% in 1997), subordinate loans increased by RM125 million. During the year, NSB allocated about 4.2% of its total loans outstanding for doubtful debts. At the end of 1998, non-performing loans accounted for 9.4% of its gross loans.

In 1998, several branches of NSB were merged, reducing the total number of branches and sub-branches to 448 from 468 at the end of 1997. In addition, savings account facilities were also provided in 624 permanent and 21 mobile post offices. During the year, 13 automated teller machines (ATMs) were closed, bringing the total number of ATMs to 583 by the end of 1998.

## *Provident and Pension Funds*

The provident and pension funds (PPFs), the largest source of long-term finance among the non-bank financial intermediaries, continued to expand their activities during the year. Total resources mobilised by the 14 provident and pension funds surveyed by BNM increased by 12.2% to RM172.8 billion at the end of 1998, against a growth of 13.5% to RM154.1 billion at the end of 1997. Most of the resources were derived from accumulated contributions in contributors' accounts (89.7% or RM155 billion), with the balance held in the form of reserves and other liabilities. Contributions placed with the Employees Provident Fund (EPF) have traditionally dominated, representing 94.1% of accumulated contributions. On an annual basis, accumulated contributions of the PPFs grew at a slower pace, at 11.4% (14.4% in 1997), due mainly to lower net contributions as well as the moderation in the growth of the number of members. Total membership rose by 2.4% to 17.2 million persons at the end of 1998 compared with an expansion of 5.4% in 1997.

**Table 4.16**
**Provident and Pension Funds: Selected Indicators**

| | 1996 | 1997 | 1998*p* |
|---|---|---|---|
| | RM million | | |
| **As at end** | | | |
| Number of Contributors ('000) | 15,931 | 16,788 | 17,196 |
| Accumulated Contributions | 121,668 | 139,246 | 155,067 |
| Assets | 135,724 | 154,080 | 172,819 |
| *Of which: Investments in* | | | |
| *Malaysian Government Securities* | *40,952* | *40,021* | *46,756* |
| **During the year** | | | |
| Contributions | 14,515 | 16,524 | 16,707 |
| Withdrawals | 4,107 | 6,392 | 9,042 |
| Net Contributions | 10,408 | 10,133 | 7,665 |
| Dividends Credited | 8,196 | 8,163 | 9,043 |
| Income | 9,637 | 10,233 | 11,510 |

*p* Preliminary

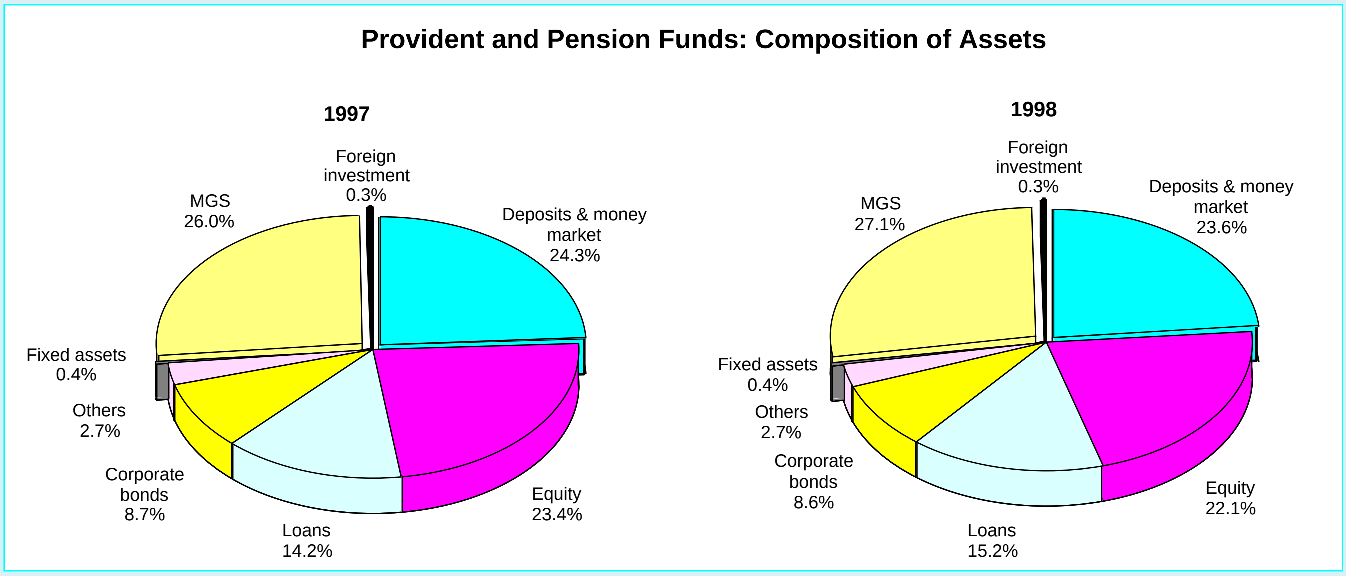
Source: Employees Provident Fund, Pensions Trust Fund, Social Security Organisation, Armed Forces Fund, Malaysian Estates Staff Provident Fund, Teachers Provident Fund and eight other private provident and pension funds.

Net contributions of the PPFs were lower in 1998, for the second consecutive year, amounting to RM7.7 billion (RM10.1 billion in 1997). The lower amount of net contributions was due to the marginally higher gross contributions (RM16.7 billion; RM16.5 billion in 1997), while withdrawals were higher, at RM9 billion (RM6.4 billion in 1997). Nine of the PPFs surveyed, in fact, experienced net withdrawals during the year, with the largest net withdrawal registered by the Armed Forces Fund consequent to the lower increase in new recruits compared with the number of retirees. Meanwhile, net contributions were also smaller for the rest of the PPFs except for the Pension Trust Fund. Similarly, net contributions as a percentage of gross national savings was lower at 7.1% (9.9% in 1997).

In the case of the EPF, gross contributions were only slightly higher (RM14.8 billion; RM14.6 billion in 1997). This was attributed to the slower growth in average wages as a result of the reduction in salaries, although the number of active contributors expanded by 2.8% (3% in 1997). In contrast, withdrawals were higher, at RM8.4 billion (RM5.7 billion in 1997), reflecting the cumulative effects of the liberalisation of the EPF's withdrawal schemes. Of the total, RM3.5 billion (or 42.3%) was withdrawn under the Age 55 Withdrawals Scheme, and RM2.4 billion (or 28.1%) for the purchase of houses. Since the introduction of the Member's Savings Investment Scheme in November 1996, which allowed withdrawals to invest in approved fund management institutions, such withdrawals doubled to RM1.2 billion, to account for 14.4% of total withdrawals from the EPF in 1998.

In terms of investments, total new investments by PPFs continued to expand by 12.2% or RM18.7 billion (13.5% or RM18.4 billion in 1997). However, there was a significant shift in the investment strategy of PPFs in 1998. Contrary to the trend which had emerged since 1995, whereby the focus of investment was on private financial instruments, investment in Government papers absorbed the bulk (35.9%) of new investments in 1998. Investments in Government papers expanded by 16.8% or RM6.7 billion (decline of 2.3% or RM931.1 million in 1997) to RM46.8 billion, representing 27.1% of the total assets of PPFs. This was made possible by new issues of Malaysian Government Securities

Graph 4.8




(MGS) in line with the deficit in the Government's fiscal position.

Investments of the PPFs in fixed deposits and money market papers were also higher, encouraged by the high interest rate environment during the first half of the year and hence, higher returns. These investments constituted 18.4% of total new investments. Investments in these instruments rose by RM3.4 billion or 9.2% (–RM722.5 million or –1.9% in 1997), to reach RM40.8 billion or 23.6% of total investments at end-1998.

The economic downturn and the fall in the equity market during most of the year had directly affected the investment of the PPFs in equities. As a result, the growth in the holdings of equities slowed markedly to 6.1% or RM2.2 billion, against an increase of 27.3% or RM7.7 billion in 1997. In addition, investments in equities accounted for a smaller share (11.7%) of the total new investments (42.2% in 1997), although the share of total assets of the PPFs at end-1998 remained relatively unchanged (22.1%).

Similarly, investments in corporate bonds by PPFs were also lower (10.1% or RM1.4 billion; 38.5% or RM3.7 billion in 1997), due to the fewer new issues of private debt securities in the capital market. Of the total new investments of PPFs, 7.2% was invested in corporate bonds, compared with a higher share of 20.4% in the previous year. Loans extended by the PPFs slowed to grow at an annual rate of 19.5% (or RM4.3 billion) from 50.2% (or RM7.3 billion) in 1997.

A similar trend was observed in the asset structure of the EPF given its dominance among the PPFs. Holdings of Government papers by EPF increased by RM6.9 billion or by 18.1% to RM45 billion. Investments in Government papers accounted for 44.2% of total new investments of EPF, with the investment effected through private placement, tender and purchases in the secondary market. In addition, EPF continued to extend Government or bank guaranteed loans to finance Government projects although these loans increased at a slower pace of 20.1% (48.3% in 1997), contributing to 27.1% of total new investments of EPF. Meanwhile, investment in equities increased by RM781.4 million or 3.1% (RM6.4 billion or 33.9% in 1997), while investments in deposits and money market instruments rose by RM1.5 billion or 4.7% (–RM1.9 billion or –5.6% in 1997).

## *Pilgrims Fund Board*

The activities of the Pilgrims Fund Board continued to expand, albeit at a slower pace in 1998. Total resources mobilised by the Board amounted to RM7.3 billion at the end of 1998, representing an increase of RM1.1 billion or 18.7% (RM1.4 billion or 30.4% in 1997). The increase in resources reflected mainly an expansion of its operations which included the number of depositors increasing by 8.5% to 3,477,562 at the end of 1998 compared with 3,205,885 in the previous year. At the same time, the number of Muslims registered with the Board to perform the pilgrimage was higher at 27,341 (23,886 in 1997).

Total balances held by depositors, including bonuses credited, rose by RM1 billion or 18.3% (RM1.4 billion or 33.4% in 1997), accounting for 92.7% of the total resources mobilised at the end of 1998 (93% at the end of 1997). During the year, deposits placed with the Board increased by 36.7% to RM2.9 billion. With withdrawals of deposits rising by 103.1% to RM2.4 billion in the same period (1997: RM1.2 billion), there was a net increase in deposits of RM580 million. Although the bonus rate was lower at 8% per annum in 1998 (9.5% per annum in 1997), the amount of bonuses credited to depositors' accounts was higher at RM461 million (1997: RM440 million).

The Board invested the bulk of its investible funds in corporate securities. Investments in corporate securities rose by RM518 million or 17.4% (RM1 billion or 54.2% in 1997) to RM3.5 billion, accounting for 48.1% of total assets in 1998. Of these investments, 71.5% was in quoted shares, mainly in the industrial and property sectors, and 28.5% in unquoted shares. Investments in short-term instruments continued to decline by RM193 million or 9.6% (–RM174 million or –8% in 1997) to RM1.8 billion in 1998. Consequently, their share of total assets was also lower at 25.1%. As a result of higher investments in corporate securities, gross dividends received by the Board increased by 37.6% to RM245 million in 1998. Income earned from other investments also increased to RM508 million in 1998 (RM482 million in 1997).

## *Industrial Finance Institutions*

The industrial finance institutions recorded a strong increase in their assets of 43% in 1998 (22.3% in 1997). The increase in assets was attributed mainly to the higher investments in terms of deposits with financial institutions and loans which accounted for 40.9% and 34.5% respectively of the increase. The increase was funded mainly by 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.

Borrowings by the industrial finance institutions increased significantly from RM6,655.4 million (25.5%) in 1997 to RM10,463.8 million (57.2%) in 1998, to account for 83.9% of the increase in the total liabilities. The increase in borrowings was mainly by Export-Import Bank of Malaysia Berhad (RM1,782.9 million) and Bank

**Table 4.17**
**Industrial Finance Institutions: Changes in Direction of Lending**

| Sector | Year | | | | | |
|---|---|---|---|---|---|---|
| | 1996/95 | | 1997/96 | | 1998/97 | |
| | RM million | % | RM million | % | RM million | % |
| Manufacturing | 115.51 | 10.48 | 214.29 | 19.44 | 1,334.22 | 85.29 |
| Transport & storage | 0.11 | 0.01 | –25.96 | –2.36 | 125.77 | 8.04 |
| Real estate & construction | 683.47 | 62.01 | 568.80 | 51.61 | 61.83 | 3.95 |
| General commerce | 104.70 | 9.50 | 19.00 | 1.72 | 29.06 | 1.86 |
| Mining & quarrying | –2.91 | –0.26 | 7.73 | 0.70 | 3.82 | 0.24 |
| Agriculture | 17.77 | 1.61 | 22.75 | 2.07 | –32.33 | –2.07 |
| Other | 183.55 | 16.65 | 295.56 | 26.82 | 42.06 | 2.69 |
| **Total** | **1,102.20** | **100.00** | **1,102.17** | **100.00** | **1,564.43** | **100.00** |

Industri Malaysia Berhad (RM1,577.2 million). The increase in total borrowings of Export-Import Bank of Malaysia Berhad, was to finance the Export Credit Refinancing Scheme, a portfolio which was transferred from Bank Negara Malaysia since January 1998. Bank Industri Malaysia Berhad sourced its funds mainly through deposits placed by the Government agencies following the Government's approval for the bank to accept such deposits to ease its liquidity position.

The other major source of funding for the industrial finance institutions in 1998 was capital funds. However, capital funds declined in 1998 by RM47.6 million due mainly to the losses amounting to RM193.4 million incurred by the industrial finance institutions (in 1997, the capital funds accounted for 28.7% of the total increase in the liabilities of the industrial finance institutions). In 1998, two institutions, namely the Export-Import Bank of Malaysia Berhad and the Malaysian Industrial Estates Berhad (MIEL) had increased their paid-up capital, by RM100 million each.

Loans extended by the industrial finance institutions increased by 25.7% in 1998 (22.1% in 1997). The increase reflected the active participation of these institutions in utilising the various funds established by the Government for lending to priority sectors. Loans to the manufacturing sector accounted for the largest share (85.3%) of the increase in loans, amounting to RM1.3 billion compared with RM214.3 million (19.4%) in the previous year. Loans to the transport and storage sector increased by RM125.8 million, after registering a decrease of RM26 million in 1997. However, loans to the real estate and construction sector declined by RM507 million to RM61.8 million in 1998.

The sharp increase in loans to the manufacturing sector resulted in the exposure to this sector to increase to 44.7% of the total loans outstanding at the end of 1998 (1997: 34.2%). Despite the decline in loans to the real estate and construction sector, the exposure to this sector continued to remain high at 28.9%. Notwithstanding the sharp increase in loans to the transport and storage sector, the industrial finance institutions' exposure to this sector was only 4.5% of the total loans outstanding.

## Financial Markets

Reflecting external developments and prevailing domestic economic conditions, activity in the financial markets was generally slower in 1998. A turnaround in the capital and foreign exchange markets was, however, observed consequent to the imposition of the selective exchange controls in September. While the prices and trading volume of stocks improved significantly, offshore trading in the ringgit ceased after September. Market development efforts, nevertheless, continued unhindered.

Recourse to the capital market was influenced by the slowdown in corporate activity, contraction in private sector investment and economic activity, the higher interest rate environment in the first half-year as well as the weak sentiment in the equity market for most of the year. As a result, net funds raised were significantly lower at RM17.3 billion, amounting to half of the peak level of RM33.5 billion in 1997, attributed to the substantially lower amount of net funds sourced by the private sector. The public sector, meanwhile, was more active in tapping funds, for the first time since 1988, as it undertook the lead role in promoting economic recovery.

In the equity market, the benchmark Kuala Lumpur Composite Index (KLCI) ended the year 1.4% lower than the level at the end of 1997, while the total trading volume on the Kuala Lumpur Stock Exchange (KLSE) was lower by 19.9% at 58.3 billion units. After commencing the year on a pessimistic note, the KLCI rose significantly between mid-January and end-February. This was, however, followed by consecutive price declines until the KLCI reached 262.70 points on 1 September, the lowest level in ten years. Improved investor sentiment following the more stable conditions with the introduction of the selective exchange control measures resulted in a turnaround in September, as reflected by the KLCI which increased strongly by 123% to 586.13 points by year-end. Given the lower stock prices for most of the year and the lower trading volume, the value of transactions fell by 71.8% to RM115.2 billion for the year. The market capitalisation of the KLSE which declined marginally to RM374.5 billion at the end of 1998, maintained its seventh rank in the Asia-Pacific region and second rank in the ASEAN region.

As in the equity market, the Kuala Lumpur foreign exchange market also experienced a decline in transactions during the year. In the first eight months of the year, ringgit trading activity was intensive, with the monthly volume averaging RM73.8 billion. The volatility of the market conditions, however, moderated consequent to the introduction of the selective exchange control measures and fixing of the ringgit exchange rate against the United States dollar in September. As a result, the monthly average volume of transactions fell to RM28.4 billion, less than half of that transacted during January-August. For the year as a whole, the average daily volume, therefore, decreased by 32.1% to RM3.7 billion in 1998.

The volume of funds traded in the money market, similarly, declined by 2% to RM1,822.6 billion. Trading in interbank deposits declined, reflecting reduced dependence on the money market as a source of funding and improved liquidity flows in the system. Transactions were focused on the shorter tenures in an environment of uncertainty over the future direction of interest rates. As with interbank deposits, money market papers were traded on a smaller scale. The tight liquidity situation limited the primary issuance and secondary trading of negotiable instruments of deposit and bankers acceptances, while there was no issuance of Bank Negara Bills, although there was a larger volume of trading in Malaysian Government Securities.

Efforts continued to be focused on developing the financial markets. Measures in the money market were intended to enhance the efficiency of liquidity management. Among the measures were the introduction of a new money market operations procedure, widening of the daily variation band for compliance with the statutory reserve requirement, the introduction of a new liquidity framework, and changes to the privileges granted to the principal dealers in the money market. In the capital market, measures were directed towards strengthening the regulatory framework. Towards this end, disclosure and transparency, investor protection and enforcement capabilities of the regulatory authorities were enhanced, corporate governance practices improved, and financial standing of domestic stockbroking companies strengthened. Equally significant was the move towards consolidating the exchanges in the capital market, in line with global trends. Such consolidation would lead to economies of scale by enhancing the efficient utilisation of resources, improving operational efficiency and enhancing the availability of financial products offered. This in turn would contribute to enhance investor confidence in the Malaysian financial markets. Meanwhile, enhancement of the financial infrastructure, product development and education of members, companies and investors were the priorities of the Malaysian Exchange of Securities Dealing and Automated Quotation.

## *Money Market*

Following a robust expansion of 61% in 1997, the volume of funds traded in the money market fell marginally by 2.1% to RM1,822.3 billion in 1998, reflecting a contraction in both the volume of trading in interbank deposits (–1.4%) as well as money market papers (–8.2%). The decline in the volume of interbank deposits reflected the improvement of liquidity flows in the system and reduced reliance on the money market to meet funding requirements given the slowdown in loan growth. Transactions also became more concentrated at the shorter-end of the market. Transactions in tenures of one month and above declined while shorter tenures registered increases. A similar trend was evident in 1997, although the shift in 1998 was less pronounced. The higher number of transactions in the shorter tenure deposits in 1997 and 1998 was associated with the volatility of interest rates. Given the uncertainty about the future direction of interest rates, market

**Table 4.18**
**Money Market**

| | 1997 | | 1998 | |
|---|---|---|---|---|
| | Volume (RM billion) | Annual change (%) | Volume (RM billion) | Annual change (%) |
| Total Money Market Transactions | 1,860.6 | +61.0 | 1,822.3 | –2.1 |
| **Interbank Deposits** | **1,673.6** | **+71.9** | **1,650.7** | **–1.4** |
| **Money Market Papers** | **187.0** | **+2.6** | **171.6** | **–8.2** |
| Bankers Acceptances (BAs) | 85.2 | +5.1 | 79.3 | –6.9 |
| Negotiable Instrument of Deposits (NIDs) | 56.4 | +3.0 | 43.1 | –23.5 |
| Malaysian Government Securities | 12.4 | –51.3 | 27.3 | +121.0 |
| Treasury Bills | 4.3 | +52.0 | 6.7 | +54.6 |
| Bank Negara Bills | 12.4 | –12.1 | 0.0 | –100.0 |
| Cagamas Bonds | 3.7 | +51.5 | 2.4 | –36.9 |
| Cagamas Notes | 12.6 | +634.4 | 12.8 | +2.0 |

**Table 4.19**
**Islamic Interbank Money Market (IIMM)**

| | 1997 | | 1998 | |
|---|---|---|---|---|
| | Volume (RM billion) | Annual change (%) | Volume (RM billion) | Annual change (%) |
| Total IIMM Transactions | 134.1 | +175.5 | 115.4 | –13.9 |
| **Mudharabah Interbank Investment (MII)** | **92.3** | **+221.0** | **77.9** | **–15.5** |
| **Islamic Interbank Cheque Clearing System (IICCS)** | **25.5** | **+627.1** | **23.0** | **–9.9** |
| **Islamic Papers** | **16.3** | **–0.9** | **14.4** | **–11.3** |
| Green Bankers Acceptances (Green BAs) | 13.7 | +5.3 | 12.7 | –7.4 |
| Islamic Acceptance Bills (IABs) | 2.6 | –24.3 | 1.8 | –31.9 |

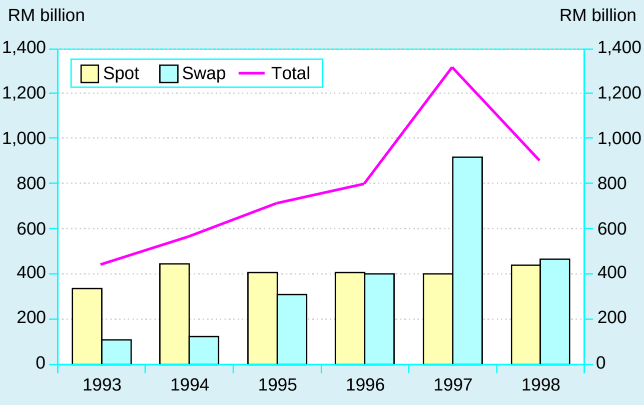
players avoided being locked-in as lenders or borrowers of longer-term funds. The volatility in interest rates since 1997 was primarily associated with the speculative pressure on the ringgit; the outflows of short-term speculative funds and the consequent tightening of domestic liquidity; inefficiencies in the financial intermediation process; as well as shifts in the stance of monetary policy. Meanwhile, the decline in the volume of money market papers traded reflected reduced trading of Negotiable Instruments of Deposit (NIDs), which more than offset the increased trading of Malaysian Government Securities (MGS). The decline in the trading volume of NIDs and Bankers Acceptances (BAs) was due to the tight liquidity situation, especially in the first half of 1998, which limited the primary issuance and secondary trading of these papers. There was also no trading of Bank Negara Bills in 1998, in the absence of new issues by Bank Negara Malaysia (BNM) since October 1997 when the last outstanding Bank Negara Bills matured. Meanwhile, Cagamas Bonds also recorded lower trading volumes due to a net redemption of the paper in 1998 (–RM1.7 billion; net issue of RM3.5 billion in 1997). In contrast, the increase in the trading of MGS was attributed to the larger primary issues of the paper to meet the funding needs of the government in the second half of 1998.

Similarly, the total volume of transactions in the **Islamic interbank money market** (IIMM) declined by RM18.7 billion (-13.9%) to RM115.4 billion, compared with a significant increase of RM85.4 billion in 1997. The contraction in volume reflected declines in all types of transactions, namely Mudharabah interbank investment (MII), the Islamic interbank cheque clearing system (IICCS) and interbank trading of Islamic papers. As a result, the relative size of the IIMM compared to the conventional money market was smaller. The trading volume of the IIMM fell to 6.3% of the conventional money market volume in 1998 (7.2% in 1997).

A number of **measures to improve the efficiency of liquidity management** in the banking system were introduced in 1998. Firstly, a new money market operations procedure was introduced on 30 April. The new system enabled market participants to better assess the liquidity surplus or deficit in the system via BNM's forecasted cash flow of the financial system provided at regular intervals during the day. In addition, transparency was enhanced with all BNM operations being conducted via tender under the new procedure, with the exception of overnight lending/borrowing and the small liquidity support operations for institutions facing exceptionally tight liquidity. A second measure to improve liquidity management was the widening of the daily variation band for the statutory reserve requirement (SRR) compliance. Effective 1 May 1998, this band for the permissible daily variation in the average balances that are required to meet the SRR was widened to ±2% of the prescribed SRR rate from the previous band of ±0.5%. This accorded financial institutions greater flexibility in managing their daily liquidity operations. Thirdly, a new liquidity framework was introduced in July 1998, featuring active monitoring and forecasting of the liquidity position of financial institutions based on the maturity profile of assets and liabilities, as well as diversity of funding sources.

Several measures were also taken during the year to further promote a more active money market. These included increasing the number of principal dealers (PDs) to 16 in 1999, with the appointment of another PD on 1 January 1999. To promote trading in the money market, changes were also introduced to the privileges given to PDs. For the purpose of the calculation of the SRR, PDs were previously allowed to net off from their eligible liabilities (EL) base an amount equivalent to 15% of the higher of either sales or

Graph 4.9
**Volume of Interbank Transaction in the Kuala Lumpur Foreign Exchange Market**




purchases of specified liquid asset instruments in the secondary market, subject to the amount deducted being less than 1% of EL. Effective 1 January 1999, the amount deductible was raised from 15% to 50% of the volume of liquid assets traded. In addition, the deduction limit (1% of EL) was abolished.

## *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 declined by 32.1% during the year, from RM5.4 billion in 1997 to RM3.7 billion in 1998. The decline was largely attributable to the moderation in the volatility of the currency market conditions, following the imposition of the selective exchange control measures and the fixing of the ringgit exchange rate against the United States dollar in September. The volatility of the ringgit as measured by the standard deviation moderated to 0.22 in 1998 compared with a standard deviation of 0.44 in 1997. The higher volume of transactions in 1997 was on account of the increased number of transactions as well as higher value for each transaction in the wake of the currency turbulence in the region. The activities in the foreign exchange market in 1998 continued to be dominated by the transactions of the United States dollar against the ringgit. These transactions, however, declined to RM703 billion (1997: RM1,215 billion) to account for 77.9% of total transactions (1997: 92.1%). The continued dominance of transactions of the United States dollar against the ringgit was in view of the "safe-haven" status of the currency during the period of economic crisis. Demand for the United States dollar also reflected outflows of foreign funds from the domestic stock market. Transactions in the United States dollar for the Deutsche Mark and Japanese yen accounted for 17.1% and 3.3% respectively.

Activity in the foreign exchange market peaked in January 1998 as speculative activity intensified following adverse market reaction to developments in Indonesia. The monthly volume of total transactions (spot and swap) of the United States dollar against the ringgit averaged RM73.8 billion during the period January-August, which was well above the monthly average of RM58.6 billion for the whole of 1998. However, ringgit trading activity declined significantly in the last four months of 1998 following the imposition of the selective exchange control measures in September. During this period, the monthly average volume of foreign exchange transactions amounted to only RM28.4 billion (RM115.8 billion in the same period in 1997). The exchange control measures effectively restricted the trading activity of ringgit in non-trade transactions. Hence, during this period, the foreign exchange transactions originated mainly from trade-related transactions.

As in the previous year, the offshore financial institutions were the major buyers of the United States dollar for the ringgit, both in the spot and swap markets. Transactions by offshore financial institutions were attributed mainly to speculative activities on expectations of ringgit depreciation as well as outflows of short-term portfolio investments of non-residents. Swap market transactions accounted for 66% of total transactions in the Kuala Lumpur interbank foreign exchange market in 1998 (1997: 75.5%), with a large proportion being transacted during the period January-August. The monthly volume of swap transactions of the United States dollar against the ringgit during this period averaged RM47.8 billion compared with an average of RM38.7 billion for 1998 as a whole. As a consequence of the reduced volatility in the foreign exchange market, the monthly volume of swap transactions declined markedly to an average of RM20.7 billion in the last four months of the year.

## *Funds Raised in the Capital Market*

Funds raised in 1998 were significantly lower, amounting to RM17.8 billion compared with the peak recorded in 1997 (RM33.5 billion). During the year, net funds raised on a monthly basis were generally moderate, except in October. In the months of January, March, July, August, September and November, there were in fact net redemptions. This situation last occurred in April 1995. Despite the lower net funds raised, the capital market was a more important source of financing in 1998 compared with the banking system. The ratio of net funds raised in the capital market to loans extended by the banking system rose to 3.17 in 1998 (0.41 in 1997). This reflected caution on the part of banks in their lending activities, the slowdown in the demand for loans as well as the increase in the volume of debt securities issued by the Federal Government and Danamodal Nasional Berhad (Danamodal).

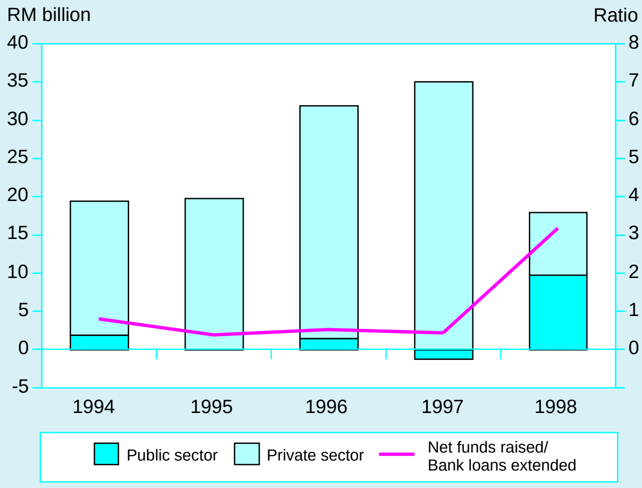
The lower net funds raised during the year was due solely to the significantly smaller amount of net funds raised by the **private sector** of RM8 billion (RM34.9 billion in 1997) from both the equity and debt markets. Danamodal and Syarikat Perumahan Negara accounted for more than half (61.5%) of the new funds tapped through debt issues. However, higher net funds were raised by the **public sector** in 1998. This was a significant development, reflecting the lead role by the Government in reviving economic activities, for the first time since 1988. The public sector raised RM9.8 billion in 1998 (a net redemption of RM1.4 billion in the previous year), accounting for 55% of the net funds raised during the year.

**Table 4.20**
**Funds Raised in the Capital Market**

| | 1997 | 1998 *p* |
|---|---|---|
| | RM million | |
| **By Public Sector** | | |
| Government Securities (gross) | 3,000 | 14,950 |
| *Less* Redemptions | 3,648 | 6,200 |
| *Less* Government Holdings | –1 | 0 |
| *Equals* Net Federal Receipts | –647 | 8,750 |
| Khazanah Bonds | 794 | 2,732 |
| Govt. Investment Issues (net) | –1,400 | –750 |
| Malaysia Savings Bond (net) | –155 | –928 |
| **Net Funds Raised** | **–1,408** | **9,804** |
| **By Private Sector** | | |
| Shares | 18,359 | 1,788 |
| Debt Securities[1] | 19,597 | 14,152 |
| *Less* Redemptions | 3,009 | 7,916 |
| *Equals* Net Issues | 16,588 | 6,235 |
| **Net Funds Raised** | **34,947** | **8,023** |
| **Total Net Funds Raised** | **33,540** | **17,827** |
| Short-term Papers and Notes (net)[2] | 4,946 | –155 |
| **Total** | 38,486 | 17,672 |

[1] Excludes debt securities issued by banking institutions.
[2] Refers to commercial papers and Cagamas Notes only.
*p* Preliminary

**Graph 4.10**
**Net Funds Raised in the Capital Market**
**By the Public and Private Sectors**




Recourse to the capital market was affected by investor concerns over the financial health of corporations, the weak sentiment in the stock and bond markets as well as uncertainties over the impact of the global financial market turmoil. Issuers were also affected by the contraction in private sector investment and economic activity, the higher interest rate environment and the freeze on new submissions for capital-raising exercises in the first half-year.

In terms of debt instruments issued by the public sector, **Malaysian Government Securities (MGS)** accounted for the bulk (84.5%) of the gross issuance in 1998. There were six new issues of MGS in 1998 totalling RM14.95 billion (1997: two issues totalling RM3 billion), with yields and maturities ranging between 7.005%-9.03% and 3-20 years respectively. The MGS were issued to offset the redemptions of MGS (RM6.2 billion) and Government Investment Issues (RM750 million) in order to meet market demand as well as to finance the Budget deficit. As a result of the higher number of new issues, total outstanding MGS rose by 13.2% (1997: –1%) to RM75 billion at the end of 1998. Meanwhile, Khazanah Nasional Berhad (KNB), the investment arm of the Ministry of Finance, continued with its programme to issue a series of bonds aimed at providing a benchmark yield curve for the ringgit bond market. KNB made four new issues of

**Khazanah *Murabahah* zero-coupon government-guaranteed bonds** in 1998, with nominal values of RM3.85 billion (1997: one issue with nominal value of RM1 billion), raising RM2.7 billion (1997: RM794 million). The yields on the bonds ranged between 6.797%-11.23%. The new issues increased the outstanding KNB bonds to RM4.85 billion at the end of 1998. The year also saw the maturity of the discounted 5-year Malaysia Savings Bonds that was issued by BNM in February 1993 as part of the measures to promote savings.

Developments in the equity market reflected the slowdown in corporate activity and private sector investment as well as the weak sentiment on the KLSE in the first three quarters of the year. As a result, funds raised from new equity issues were substantially lower, by 90.3% (1997: +15.3%) and amounted to only RM1.8 billion. The bulk of the funds were raised through rights issues (40.4%) and initial public offers (38.3%). A large portion of the funds raised from the equity market (72.8% of total) was raised in the first half-year, from issues submitted before the general freeze on submissions for capital- raising exercises that was imposed on 5 December 1997 and subsequently lifted on 30 June 1998. The heightened risk aversion of investors and the bearish investor sentiment that prevailed throughout most of 1998 was reflected in the higher percentage of initial public offers (IPOs) that closed at a discount to their offer prices as well as the higher percentage of IPOs that were undersubscribed. Of the 28 IPOs in 1998, 10 IPOs or 35.7% (1997: 17%) closed at a discount to their offer prices on their listing date. In addition, 13 were oversubscribed while the balance of 15 was undersubscribed.

**Table 4.21**
**New Issue of Private Debt Securities by Sector**

| | 1997 | 1998*p* |
|---|---|---|
| | RM million | |
| Agriculture, hunting, forestry & fishing | 214.1 | – |
| Mining & quarrying | – | – |
| Manufacturing | 3,587.1 | 125.0 |
| Electricity, gas & water supply | 2,829.5 | 529.0 |
| Wholesale & retail trade, restaurants & hotels | – | – |
| Construction | 177.1 | – |
| Purchase of residential property | – | 1,000 |
| Purchase of non-residential property | 7.8 | – |
| Real estate | 302.9 | 370.0 |
| Transport, storage and communications | 3,438.4 | 1,103.3 |
| Finance, insurance & business services | 8,362.5 | 16,921.4 |
| Purchase of securities | 837.5 | – |
| Others | 24.0 | – |
| **Total** | **19,781.4** | **20,048.7** |

*p* Preliminary

In the longer-term corporate debt securities market, the smaller amount of gross funds sourced through the new issuance of bonds, amounting to RM14.2 billion compared with RM19.6 billion in 1997, and increased redemptions of RM7.9 billion compared with RM3 billion caused net funds tapped from the market to be sharply lower, by 62.4% at RM6.2 billion (1997: RM16.6 billion). Syarikat Perumahan Negara Berhad and Danamodal played a key role, accounting for more than half (61.5%) of the new funds raised, while the higher redemptions were due in part to four early redemptions totalling RM745 million. On a monthly basis, there were net repayments every month, except for four months (i.e. February, April, May and October), with no new debt securities being issued in the month of November.

The lower amount of funds raised reflected mainly investors' aversion to investments in corporate bonds and the lower demand for funds by bond issuers. The cautious attitude of the investors can be attributed to several factors, among others, the tight liquidity environment in the first seven months of the year and the high number of rating downgrades that reflected the weakening credit standing of issuers and the increased risk of corporate defaults. Apart from the weak investor sentiment, the low issuing activity in the primary market for private bonds was on account of the relatively higher cost of borrowing and the lower demand for funds for investments by issuers.

In terms of utilisation, 84.4% of the funds raised was channelled to the finance, insurance, and business services sector and 5.5% to the transport, storage and communication sector. By instrument, straight bonds accounted for 72.3% of the gross issuance of debt securities (21.5% in 1997) while the share of asset-backed bonds declined from 26.4% in 1997 to 23.5%. Of the funds raised through the issuance of straight bonds, three-quarters (RM7.7 billion) were in the form of 5-year zero-coupon bonds with a nominal value of RM11 billion, issued by Danamodal for the recapitalisation and strengthening of the banking institutions. In the case of long-term asset-backed bonds issued by Cagamas Berhad, there was a net redemption of

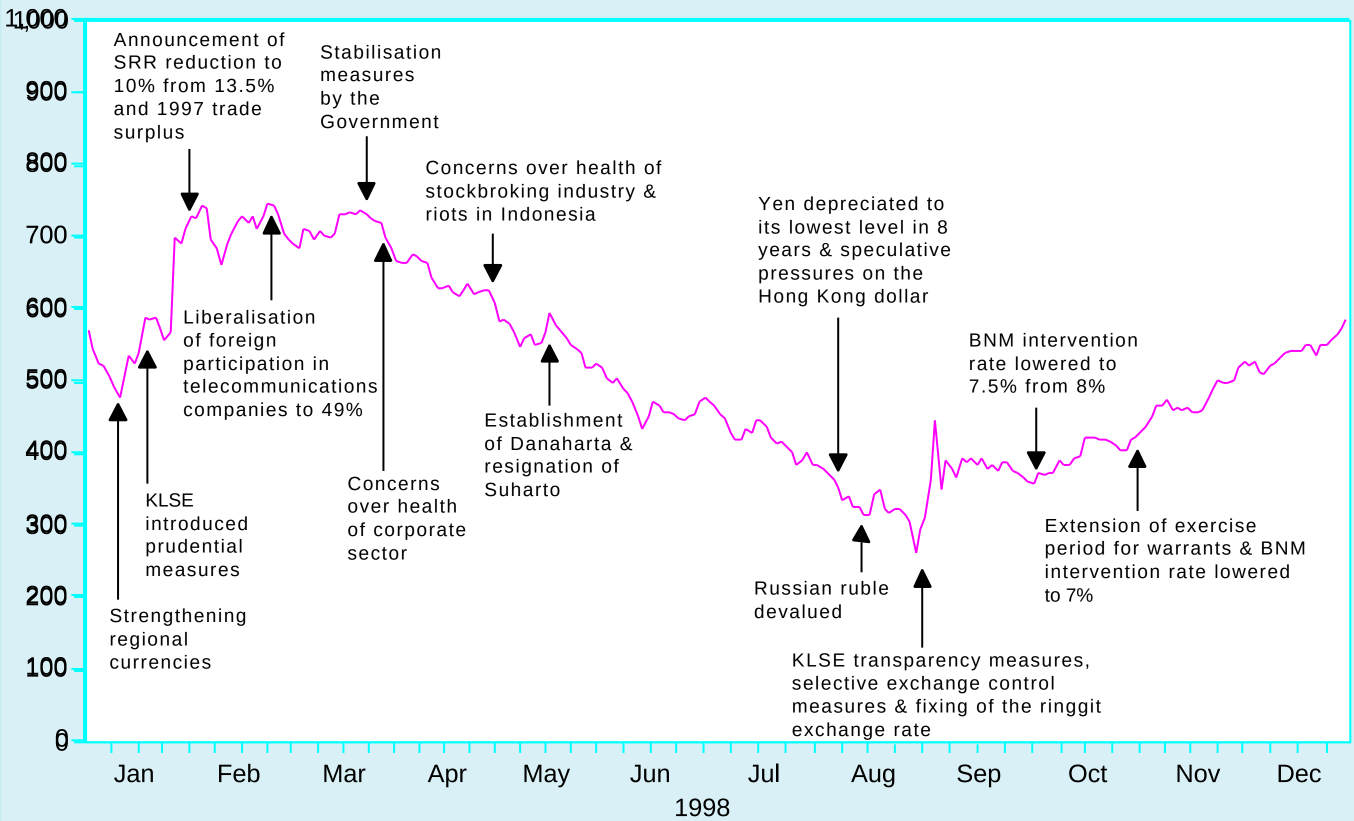
RM1.7 billion (1997: +RM3.5 billion) resulting from the smaller amount of bonds issued (RM3.3 billion) and the higher amount of redemptions (RM5 billion). A significant development in the private bond market in 1998 was the issuance of two Government-guaranteed zero coupon bonds by Pengurusan Danaharta Nasional Berhad (Danaharta), with a total nominal value of RM2.6 billion. These bonds were unique in that they did not raise any funds from the market but were instead issued to the banking institutions as consideration for non-performing loans purchased by Danaharta. This, together with the increase in the net issues of bonds, contributed to the growth of 19.1% in the total outstanding long-term private debt securities (1997: 35.5%) to RM75.5 billion at the end of 1998.

## *Equity Market*

The performance of the **Kuala Lumpur Stock Exchange (KLSE)** during 1998 was mixed, influenced by a combination of domestic and external factors. The benchmark Kuala Lumpur Composite Index (KLCI) experienced three discernible phases, namely the mini-rally phase, downward trend phase and a recovery phase. The year began on a pessimistic note, continuing the downward trend that had prevailed since April 1997. This trend was short-lived as the KLCI increased significantly between mid-January and end-February. During January-February, the KLCI rose by 56% from 477.57 points on 12 January to peak at 745.36 points at the end of February. This was, however, followed by a period of six months of continuous price declines. Between March and early September, the index declined by 64.8% to its lowest level in 10 years of 262.70 points on 1 September. The KLCI subsequently made a significant turnaround, from September to the end of the year, rising strongly by 123% to end the year at 586.13 points. Despite the strong recovery, the KLCI was still 1.4% lower than the level at the end of 1997, reflecting mainly the contraction in corporate activity, private investment and economic activity in general.

The performance of the other indices on the KLSE generally followed the movements in the KLCI. In the first two months of the year, all the indices were on an uptrend, with the best

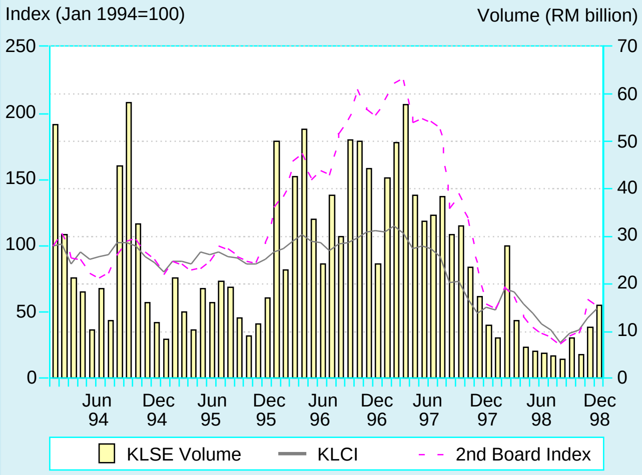
**Graph 4.11**
**Performance of the KLCI in 1998**



performing indices being the Mining (+68.6%) and Finance (+39.3%) Indices. During the bearish phase from the end of February to end-August, the decline was led by the Mining, Construction, Finance and Second Board Indices, which declined by 70.4%, 69.1%, 62.8% and 61.8% respectively. The significant decrease in the Mining Index reflected a correction following a rise of 68.6% in the index during the mini-rally in the first two months of the year, while the decline in the Construction Index reflected the considerable contraction in construction activities (decline of 24.5% in 1998). Investor concerns over the health of the banking institutions and stockbroking companies contributed to the decline in the Finance Index. The fall in the Second Board Index reflected concerns over the health of Second Board companies, following the move by a number of Second Board companies for court protection under Section 176 of the Companies Act 1965. The index that registered the lowest decline was the Plantation Index, since plantation stocks were viewed by investors to have benefited most from the exchange rate depreciation. The Mining, Finance, Construction and Second Board Indices rebounded strongly by 186.6%, 116.4%, 116.3% and 106.1% respectively, as investor sentiment improved following the introduction of the selective exchange control measures on 1 September, and the more accommodative monetary conditions with ample liquidity and declining interest rates.

The KLSE started off weaker in 1998, as the regional currency crisis continued. Sentiment, however, reversed in mid-January, with the KLCI bolstered by the strengthening ringgit, a preliminary

**Graph 4.12**
**Kuala Lumpur Composite Index, Second Board Index and KLSE Trading Volume**




Source: Kuala Lumpur Stock Exchange

announcement of a trade surplus for 1997, the reduction in the statutory reserve requirement (SRR) of the banking institutions from 13.5% to 10% in February and announcements to allow an increase in foreign equity participation in telecommunications companies. These developments were reflected in the 30.9% increase in share prices and 214.4% increase in turnover in February, the highest monthly increase for the entire year, pushing the KLCI to 745.36 points and the turnover to 12 billion units.

The brief rally was abruptly interrupted in early March as concerns over the health of the financial sector emerged for the first time since the early 1990s, amidst rising non-performing loans and financial problems of the corporate sector. Announcements of companies seeking court protection under Section 176 of the Companies Act 1965 and companies being placed under receivership dampened the incentive to invest in equities. In May, news of the cessation of trading of a domestic stockbroking company and the escalation of widespread social unrest in Indonesia as well as the fall in regional stock markets further dampened sentiment. The bearish sentiment, particularly on the financial sector and Second Board companies, were reflected in the decrease in the Finance and Second Board Indices.

The downtrend, however, reversed on 21 May, prompted by the announcement of the establishment of Pengurusan Danaharta Nasional Berhad to acquire and manage the non-performing loans of the financial institutions. The political succession in Indonesia also restored some regional confidence that contributed positively to the KLSE. This optimism was, however, not sustained. From early June, investors became concerned over the performance of the domestic economy following the announcement of a contraction in the first quarter GDP. Market sentiment continued to deteriorate in subsequent months due to the interaction of both domestic and external factors. Domestic factors included uncertainty over the outlook for the economy for 1998, downgrades of Malaysia's credit rating by two international credit rating agencies and poor corporate earnings. The most significant external factors were the weakening Japanese yen and speculative pressures on the Hong Kong dollar and the Chinese renminbi which dampened regional stock markets. By the end of August, the KLCI had declined sharply by 43.7% from the level at the end of May, while the Mining and Construction Indices fell the most, by 54.8% and 50.2% respectively.

The KLCI staged a turnaround in September on the introduction of selective exchange control measures, although the initial reaction was a 13.3% drop in the KLCI to 262.70 points on 1 September, its lowest level in 1998. This decline also reflected the response to the huge 512-point collapse of the Dow Jones Industrial Average on 31 August. Prices, however, recovered in heavy trading volume as the KLCI surged for four consecutive trading days from 2 September to record a gain of 69% to 445.06 points on 7 September. During this period, on 4 September, the Stock Exchange of Singapore announced the discontinuation of trading in Malaysian shares on CLOB International. Measures to support the economic recovery process such as the fixing of the ringgit exchange rate, easier liquidity conditions and reductions in interest rates contributed to the improved investor sentiment. Within one month, the KLCI had increased by 23.3% to 373.52 points, while turnover was notably higher by 128.6% at six billion units. The best performing index in September was the Construction Index, which rose by 60.1%.

Buying interest continued to be sustained in the fourth quarter of the year, supported by expectations of an expansionary Budget announcement, considerable progress achieved in bank restructuring and recapitalisation, the introduction of a scheme to resolve the problems of troubled stockbroking

**Graph 4.13**
**Performance of Selected Regional & Emerging Stock Market Indices (% change from 1997 to 1998)**

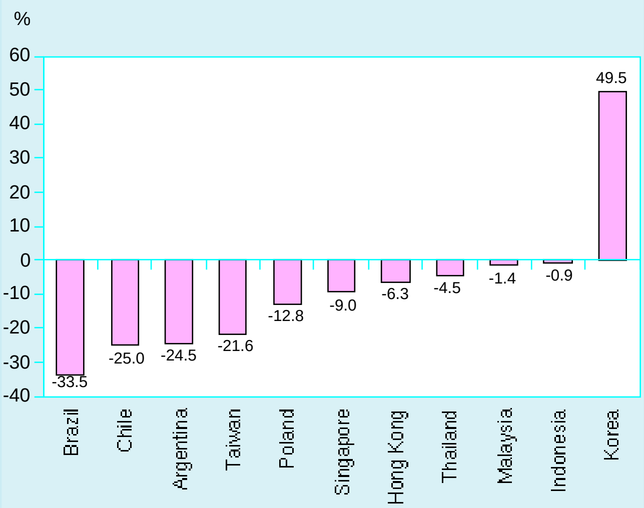



**Table 4.22**
**Kuala Lumpur Stock Exchange: Selected Indicators**

| | 1997 | 1998 |
|---|---|---|
| Price Indices | | |
| Composite | 594.44 | 586.13 |
| EMAS | 151.21 | 146.94 |
| Second Board | 162.93 | 158.37 |
| Total Turnover | | |
| Volume (billion units) | 72.8 | 58.3 |
| Value (RM billion) | 408.6 | 115.2 |
| Average Daily Turnover | | |
| Volume (million units) | 293.5 | 236.9 |
| Value (RM million) | 1,647.4 | 468.2 |
| Market Capitalisation (RM billion) | 375.8 | 374.5 |
| Market Capitalisation/GDP (%) | 136.5 | 134.4 |
| Total No. of Companies Listed | 708 | 736 |
| Main Board | 444 | 454 |
| Second Board | 264 | 282 |
| Market Liquidity: | | |
| Turnover Value/Market Capitalisation (%) | 108.7 | 30.8 |
| Turnover Volume/Number of Listed Securities (%) | 47.4 | 37.1 |
| Market Concentration: | | |
| 10 Most Highly Capitalised Stocks/ Market Capitalisation (%) | 35.9 | 35.5 |
| Average Paid-Up Capital of Stockbroking Firms (RM million) | 72.0 | 86.1 |

Source: Kuala Lumpur Stock Exchange

companies and the extension of the exercise period for some listed warrants, in an environment of ample liquidity and lower interest rates. Gains experienced in regional markets further reinforced the positive sentiment. With some stocks continuing to be involved in window-dressing, the KLCI continued to climb to end the year at 586.13 points. This, however, represented a loss of 8.31 points or 1.4% from the level at the end of 1997.

Compared with the performance of the other stock markets in the region, the fall in the KLCI was smaller than the declines in the Taiwan Weighted Index (–21.6%), the Tokyo Nikkei-225 Index (–9.3%), Singapore ST Index (–9%), the Hong Kong Hang Seng Index (–6.3%) and the Thailand SET Index (–4.5%). However, the performance of the KLCI was poorer when compared against the Korea Composite Index, which recorded a 49.5% gain, and the Philippines Composite Index (5.3%).

Reflecting the marginally lower share prices and slower corporate activity, the market valuation of the securities listed on the KLSE decreased marginally by 0.35% to RM374.5 billion at the end of 1998 (end-1997: RM375.8 billion), equivalent to 134.4% of the nation's GDP (1997: 136.5% of GDP). At its highest point, the capitalisation was 323.6% of GDP on 25 February 1997. The KLSE maintained its 1997 ranking of seventh in the Asia-Pacific region and second in the ASEAN region.

Trading volume on the KLSE was lower by 19.9% in 1998, amounting to 58.3 billion units or an average daily volume of 237 million units (72.8 billion and 293.5 million units respectively in 1997). Reflecting the lower stock prices for the greater part of 1998 and the lower trading volume, the total transacted value was markedly lower by 71.8% at RM115.2 billion. The bulk of the trading volume was concentrated in the first and fourth quarters of the year (accounting for 68% of total trading volume) when share prices were generally rising. In terms of sectors, greater interest continued to be centered on the trading/services (23.3%), finance (16.7%) and property (11.5%) sectors on the Main Board, while the share of the Second Board was reduced to 10.6% (1997: 14.4%). Reflecting the lower trading volume, market liquidity (measured by the ratio of trading volume to number of securities listed) fell to 37.1% in 1998 from 47.4% in 1997. Similarly, the ratio of trading value to market capitalisation, declined to 30.8% in 1998 from 108.7% in 1997.

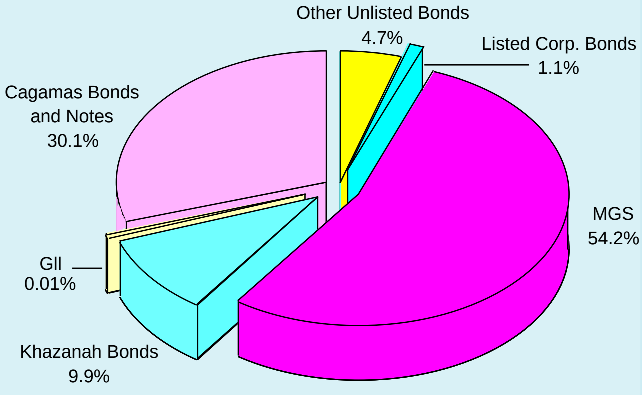
Economic and financial conditions during the year similarly affected developments on the **Malaysian Exchange of Securities Dealing and Automated Quotation** (MESDAQ). In October 1997, the Government set up MESDAQ as an over-the-counter market where high-technology and small companies with good growth potential could raise capital. In 1998, three companies, of which two were in software development and one in the electronics and information technology hardware business, had applied for listing. Another two companies delayed the submission of their applications due to the significant changes in the business environment during the year. As at the end of 1998, the exchange had 18 members, of which eight were market makers. Trading on the exchange is expected to commence in 1999.

In the meantime, MESDAQ focused efforts on enhancing the infrastructure and undertaking product development, as well as educating members, companies and investors. During the year, the MESDAQ Quotation System (MQS) was developed for the trading of MESDAQ stocks. The MQS is an electronic, quote-driven system that supports competitive market-making through the use of Bloomberg software and hardware and represents the first step towards the full deployment of MESDAQ's open architecture. In addition, MESDAQ organised various roadshows and presentations to potential issuers, investors, MESDAQ members, analysts, media and the general public. MESDAQ is also planning to launch the Malaysian Enterprise Network soon. The network represents one of the first electronic networks within the Asian region that utilises the Internet as a medium to showcase companies, thereby enabling them to reach out to investors and strategic partners.

## *Bond Market*

Trading activity on the secondary market for bonds was mixed in 1998. Trading continued to be focused on the unlisted segment of the market (98.9%), particularly on MGS. Trading of MGS was significantly higher at RM27.3 billion, more than double the amount traded in 1997 (RM12.4 billion), while the trading volume of Cagamas bonds and notes was 6.9% lower, at RM15.2 billion (1997: RM16.3 billion). Trading of Khazanah bonds (RM5 billion), Government Investment Issues (RM3 million) and the other unlisted bonds (RM2.4 billion) were on a smaller scale (data for these bonds were

**Graph 4.14**
**Trading of Domestic Debt Securities in 1998**




Source: BNM page on Reuters, Bond Information & Dissemination System (BIDS) & Kuala Lumpur Stock Exchange (KLSE) only available since the launch of the Bond Information and Dissemination System (BIDS) in October 1997). In contrast, trading of listed corporate bonds on the KLSE was considerably lower, amounting to RM536 million or 79.5% lower than the volume traded in 1997. The high trading volume of MGS and the low turnover of corporate bonds can be attributed to increased issues of MGS in 1998. There were six new issues totalling RM14.95 billion in 1998, of which two issues amounting to RM6 billion were privately placed with the EPF. At the same time, due to uncertainties in the economic and financial environment, investors had a preference for the risk-free MGS. Investors were also concerned over the weakening credit risk profiles of corporates, resulting, to some extent, in a "flight to quality".

In terms of composition, MGS accounted for more than half (54.2%) of the total volume of bonds traded in 1998, while Cagamas bonds and notes and Khazanah bonds accounted for 30.1% and 9.9% respectively. The dominance of MGS emerged in the second half of the year, with trading of other bonds being more active in the first half-year. In January, February, March and May, Cagamas bonds and notes accounted for most of the trades, while trading in June was concentrated on Khazanah bonds.

Trading was more active in the second half of the year, with 81.9% of the total trades being transacted during this period. The increase in bond prices on the back of declining interest rates led investors to accumulate debt securities in anticipation of the continued softening of interest rates. Another contributory factor was the increase in liquidity arising from the three reductions in the SRR (one in July and two in September). The large number of MGS issued also contributed to the higher trading volume during this period. Three out of the four non-privately placed MGS involving RM6.95 billion issued in 1998 were in the second half of the year.

In 1998, the number of new issue ratings (including commercial papers) conducted by Rating Agency Malaysia Berhad (RAM) and Malaysia Rating Corporation Berhad (MARC) was sharply lower. This reflected the reduced issuance of private debt securities in an environment of a slowdown in economic activities and high interest rates during the first half-year. During the year, RAM completed seven rating exercises valued at RM1.4 billion (51 exercises totalling RM13.5 billion in 1997). The bonds issued were by corporations in the financial services, property and consumer products industries. Similarly for MARC, new issue ratings numbered seven compared with 22 issues in the preceding year, while the total value of debt rated was RM2.5 billion (RM11.2 billion in 1997). The bonds rated were from the property, industrial products, transportation, utility and infrastructure sectors. In terms of the maturity profile of the bonds rated, there was a preference for short- and medium-term papers (nine short- and medium-term papers compared with five long-term papers), as the market anticipated an easing in interest rates.

**Table 4.23**
**Unit Trust Industry: Selected Indicators**

| | As at end | | | | | |
|---|---|---|---|---|---|---|
| | 1997 | | | 1998 | | |
| | Government Sponsored Funds | Private Funds | Total | Government Sponsored Funds | Private Funds | Total |
| No. of Unit Trust Mgt. Cos. | 10 | 21 | 31 | 10 | 22 | 32 |
| No. of Unit Trust Funds * | 27 | 53 | 80 | 28 | 61 | 89 |
| Units in Circulation (billion) | 35.9 | 9.3 | 45.2 | 35.5 | 11.0 | 46.5 |
| No. of Accounts (million) | 7.5 | 0.8 | 8.3 | 7.7 | 0.8 | 8.6 |
| Net Asset Value (NAV) (RM billion) | 28.6 | 5.0 | 33.6 | 32.3 | 6.4 | 38.7 |
| % of NAV to KLSE Market Capitalisation | 7.6 | 1.3 | 8.9 | 8.6 | 1.7 | 10.3 |

* Refers to funds already launched.

Source: Securities Commission Malaysia

# Key Capital Market Measures in 1998

Capital market measures implemented in 1998 were aimed mainly at strengthening the regulatory framework. Among others, the measures were intended to enhance disclosure and transparency, investor protection and the enforcement capabilities of the regulatory authorities as well as improve corporate governance practices, ensure an orderly and fair market in the trading of securities and futures contracts on the Malaysian exchanges and strengthen the financial standing of domestic stockbroking companies. The key measures were as follows:

## Rules on Gearing Ratio, Exposures to Single Client and Single Security and Margin Financing

With effect from **19 January 1998**, the Kuala Lumpur Stock Exchange (KLSE) announced new rules on gearing, and improvements to existing rules on margin financing and exposure to single client and single security to instill a greater sense of financial discipline and to enhance the financial standing of stockbroking companies (SBCs).

**Gearing ratio on borrowing exposures**

- Under this new rule, SBCs were required to maintain a gearing ratio on the approved limit of not more than three times the adjusted capital and on the utilised level of not more than two and a half times the adjusted capital of the SBCs, by 31 December 1998. Prior to this, there were no prudential rules on the SBCs' borrowing exposures.

**Exposures to a single client and a single security**

- In these new rules, there was a clear distinction between the exposure for margin financing clients and trading clients.
  - ***For exposure to a single client***
    The limits on margin financing exposure were 30% of the SBC's adjusted capital, and for **trading exposure**, 100%. (Previously, the total combined limit on margin financing and trading exposure was 300% of the SBC's last audited shareholders' funds, provided that the exposure for margin financing did not exceed 30%).
  - ***For exposure to a single security***
    The limit on margin-financing exposure was 20% of the SBC's adjusted capital. The limit on trading exposure for SBCs with adjusted capital of less than RM200 million was 100% of the adjusted capital and the limit for SBCs with adjusted capital exceeding RM200 million was 200% of its adjusted capital. (Previously, the total combined limit on margin financing and trading exposure was 500% of the SBC's last audited shareholders' funds).

**Margin financing**

- The maximum exposure to a margin client was limited to 30% of the SBC's adjusted capital (30% of the SBC's shareholders' funds in the old rule), and the total exposure to all margin clients was 100% (12.5 times the shareholders' funds previously).

## Rules on the Placement of Clients' Funds in Trust Accounts

The KLSE announced a new rule provisioning for the placement of clients' funds in trust accounts to enhance investor protection, **effective 4 March 1998**.

## Practice Notes to Enhance Disclosure

On **29 May 1998**, the KLSE in its efforts towards **enhancing corporate disclosure and transparency amongst public listed companies**, embarked on the issuance of Practice Notes. With effect from 1 June 1998, two Practice Notes were issued on disclosure of information **on the Year 2000 (Y2K) Compliance and on Default in Payment**. The Practice Notes served to promote better disclosure by public listed companies regarding their Y2K compliance/readiness and their defaults in payments of interest and/or principal in respect of loan stocks, bonds, debentures or credit facilities.

## Removal of Restrictions on Corporate Exercises

On **30 June 1998**, the Securities Commission (SC) announced the lifting of most of the restrictions on submissions for new listings, capital raising exercises and restructuring schemes that were announced on 5 December 1997, to provide companies with the needed avenues to raise funds to support their core businesses. Nonetheless, the SC would continue to exercise close scrutiny over all applications, especially with regard to listing on the Second Board of the KLSE. This was to consolidate and strengthen listed companies in those sectors where there were already a significant number of companies.

## Changes to Rules on Related-Party and Interested-Party Transactions

With effect from **2 July 1998**, the rules on related-party and interested-party transactions were revised by the SC to enhance the overall framework for corporate governance in listed companies. The new rules, *inter alia:*

– widened the scope of the application of the rules beyond directors and substantial shareholders to include persons connected with them;

– required details of such transactions to be announced and included in circulars to shareholders;

– required shareholder approval for the transaction while preventing persons interested in the transaction from voting on the resolution approving the transaction;

– required the appointment of corporate advisers to ensure that the transaction was carried out on fair and reasonable terms; and

– required the board of directors to state that the transaction was in the best interests of the company.

## Measures to Enhance Transparency in the Stock Market

On **31 August 1998**, the KLSE as part of its efforts to further enhance transparency in the stock market, announced new measures effective 1 September 1998, to ensure an orderly and fair market in the trading of Malaysian securities and to improve overall market transparency in the Malaysian capital market. Among the many benefits that the measures sought to bring about were enhanced transparency in share trading, enhanced investor protection, cost efficiency and overall greater efficiency in the trading system. Key features of the measures were:-

**Trading of listed securities**

- All dealings in securities listed on the KLSE were to be effected only through the KLSE or through a stock exchange recognised by the KLSE.

- Except as otherwise permitted, all dealings in KLSE securities were to be effected only through the KLSE trading system.

- SBCs should not deal in securities on behalf of a client if they had reason to believe that the transaction was intended to facilitate the dealing in securities on a stock exchange not recognised by the KLSE.

**New disclosure requirements**

- A client, in dealing in securities listed on the KLSE on another person's behalf, would have to disclose the identity of that person to the SBCs.

- For all new and existing nominee accounts, the name and other particulars of the beneficiary would have to be stated in full.

- Each Central Depository System (CDS) account operated by a nominee could have only one beneficiary. For nominee accounts which were presently shared by more than one beneficiary, new accounts would have to be opened to comply with the new requirements.

**Off-market business and its clearing and settlement**

- SBCs were permitted to engage in off-market dealing only in the form of direct business (i.e. crossings and married deals).

- All direct business was to be cleared and settled through the Securities Clearing Automated Network Services Sdn. Bhd.

**New issues of securities**

- Public listed companies were not permitted to issue certificates to the securities holders in respect of any new issues of securities as all new issues were to be made by way of crediting the securities into the CDS accounts of the securities holders.

**Mandatory deposit**

- Shareholders of companies which had been approved for listing or were currently listed on the KLSE would have to deposit their share certificates with Malaysian Central Depository Sdn. Bhd. (MCD).

**Withdrawal**

- All withdrawals of securities would be prohibited, except for the circumstances allowed in the notice issued by the KLSE (for example, to facilitate share buyback; conversion of debt securities; the process of company restructuring).

## Amendments to Securities Laws

The Securities Industry Act 1983 (SIA) and Securities Industry (Central Depositories) Act 1991 (SICDA) were amended twice. The first set of amendments was passed during the October 1997 session of Parliament and came into force on **1 April 1998**. The second set of amendments was made during an emergency Parliamentary sitting held from 28-30 September 1998 and came into force on **1 November 1998**. At the same time, amendments were also made to the Securities Commission Act 1993 (SCA) and to the Futures Industry Act 1993 (FIA).

**April 1998 Amendments**

The SIA amendments broadened the definition of insider trading; increased the range of sanctions, including civil sanctions, to deter insider trading and market manipulation; required additional disclosure from directors and chief executive officers (CEOs); and increased the power of the SC over directors and CEOs. Amendments to the SICDA included the amendment to the definition of “securities” to include “unit trust schemes”.

**November 1998 Amendments**

Key amendments to the Acts were as follows:

**SICDA**

- It was mandatory for securities to be deposited into the CDS within one month of the coming into force of the Amendment Act. Failure to do so would result in the securities being transferred to the account maintained under the name of the Minister of Finance.

- Every securities account with the MCD was to be in the name of the beneficial owner of the deposited securities or in the name of the authorised nominees.

- Off-market deals that were not transacted through a recognised stock exchange and cleared through a recognised clearing house were prohibited.

**SIA**

- The enforcement powers of the exchange and clearing house in relation to any person failing to comply with their rules or the exchange’s listing requirements were enhanced. Among others, the power relating to the compliance with the rules and listing requirements of the exchange and clearing house have been extended to apply to a person to whom the rules or listing requirements are directed and advisers.

**SCA**

- The powers of investigations of an Investigating Officer (IO) of the SC to enforce securities laws were extensively increased. For example, an IO may arrest without warrant, any person he reasonably suspects to have committed an offence under the securities laws.

- The Amendment Act empowered the SC to conduct an examination without prior notice on licensed persons.

**FIA**

- The Amendment Act prohibits the setting up of a futures market for the trading in futures contracts unless such futures markets were recognised.
- The provisions that protect the money and property of a client of a futures fund manager were tightened.

## New Capital Adequacy Requirements for the Stockbroking Industry

On **31 December 1998**, the SC approved the Capital Adequacy Requirements for SBCs to refine the prudential benchmark for maintaining market integrity. The new requirements would replace the existing Minimum Liquid Fund rules once they were implemented through the KLSE's business rules in 1999. The new risk-based capital adequacy framework would enable both the KLSE and SBCs to identify more clearly the capital available to cover the risks of running a securities business and would encourage market intermediaries to adopt a more relevant approach to risk management.

## *Unit Trust Industry*

The unit trust industry expanded in 1998, with the launching of nine unit trust funds compared with six in the preceding year and the establishment of one unit trust management company, the same number as in 1997 (see Table 4.23). Units in circulation rose marginally by 1.3 billion units to 46.5 billion units, compared with an increase of 6.2 billion units in 1997. As at the end of 1998, there were 32 management companies and 89 unit trust funds. The increase in the number of funds launched and units in circulation as well as the strong performance of the KLSE in the last four months of the year contributed to a 15.3% growth (1997: –44%) in the net asset value (NAV) of the unit trust industry. The NAV of the industry amounted to RM38.7 billion at the end of 1998 (1997: RM33.6 billion). Consequently, the ratio of the industry's NAV to the total market capitalisation of the KLSE improved from 8.9% in 1997 to 10.3% in 1998.

## *Futures Market*

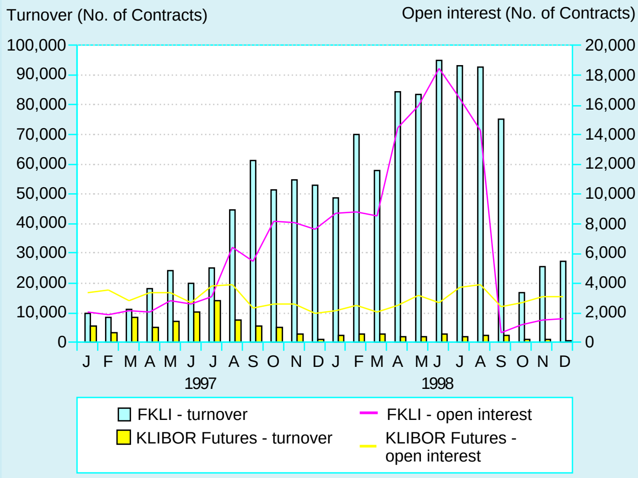
The **Kuala Lumpur Stock Exchange Composite Index Futures (FKLI)**, remained the only product offered by the Kuala Lumpur Options and Financial Futures Exchange (KLOFFE) since it was first launched in December 1995. The FKLI contract performed remarkably well for the larger part of the year, continuing the trend from the previous year. This reflected the increased maturity of the market as well as greater investor awareness of the efficacy of the product, leading to increased utilisation for both income enhancement as well as for hedging investors' portfolio exposure in the underlying stock market. Nevertheless, following the implementation of the selective exchange control measures in September, the lack of depth in the market and the withdrawal of foreign participants caused a substantial drop in activities. Activities, however, stabilised towards the end of the year.

During the first eight months of the year, the FKLI recorded a marked improvement in performance. The average daily turnover climbed progressively, from 2,869 contracts in January 1998 to peak at 4,646 contracts in August 1998. The average daily open interest also rose from 8,787 contracts to reach a record high of 18,442 contracts at the end of June and 14,293 contracts at the end of August. The improvement was equally evident when compared with the same period in 1997. In this regard, the average daily turnover for the first eight months expanded by 289% to 3,888 contracts, while the average daily open interest was significantly higher by 514% to 18,965 contracts. The total turnover during the period increased by 284% to 625,919 contracts. The Derivative Liquidity Ratio (DLR), which measures the value of futures contracts traded against the total value of the 100 underlying component stocks, rose from 55.1% in January to exceed 100% in April and in subsequent months, indicating that investor exposure in the underlying market was fully covered by similar investments in the futures market. This development indicates signs of growing maturity in the futures market.

The trend, however, reversed subsequently following the imposition of the selective exchange control measures in September. The withdrawal of foreign participation, coupled with the lack of domestic participation, contributed to significantly lower trading activities. As foreign players began to close their open positions, the share of foreign institutions decreased, from 54% of total turnover in August to 28% in September. Consequent to these developments, the average daily volume fell from 4,646 contracts in August to 3,588 contracts in September, accompanied by a more drastic decline in the average daily open interest from 14,293 contracts to only 681 contracts. The DLR also declined from 104% to 48%. To ensure that trading activities were not hindered by the rules restricting the transfer of funds held in external accounts by foreign participants, on 14 September, non-resident clearing members of the Malaysian Derivatives Clearing House (MDCH) were allowed to open designated external accounts for trading purposes in KLOFFE, Malaysia Monetary Exchange and Kuala Lumpur Commodity Exchange. With this, the restrictions on external accounts were relaxed for funds maintained in these accounts for purposes of derivatives trading.

Trading activities stabilised somewhat towards the last two months of the year. Nevertheless, for the period September-December, activities slowed when compared with the corresponding period in 1997, as total turnover declined to 145,325 contracts (1997: 220,082 contracts), while the average daily turnover and average daily open interest also decreased to 1,710 contracts and 4,353 contracts respectively (1997: 2,589 contracts and 9,446 contracts). In comparison with the period January-August, both the average monthly turnover and average daily turnover fell by 56% and 77% respectively. This situation reflected the lack of foreign participation in the market. The dominance of foreign participants declined significantly to account for only 5% to 9% of total turnover in the last three months of 1998. Despite this downturn, for the year as a whole, the considerable improvement over the larger part of the year saw total turnover and average daily open interest improve to 771,244 contracts and 13,916 contracts respectively, from 382,974 contracts and 5,267 contracts respectively in 1997.

**Graph 4.15**
**FKLI & KLIBOR Futures: Turnover and Open Interest**




Source: KLOFFE and COMMEX

Recognising the need to ensure greater domestic participation, the Futures Industry Act 1993 was amended during the year to allow the participation of asset managers and unit trusts in the futures industry. Parallel to this, the Securities Commission also issued guidelines for the licensing of futures fund managers and futures fund managers' representatives. In addition, unit trust companies, as provided in the Securities Commission's Guidelines on Unit Trust Funds, have since been exempted from the licensing requirement under the Act to trade in futures contracts.

Another important development that took place in January 1999 was the acquisition of KLOFFE Capital Sdn. Bhd., the holding company of KLOFFE Bhd. by the KLSE. The merger would pave the way for greater consolidation between the two exchanges particularly in the areas of business development and system requirements. Such consolidation, which is in line with global trends, would further enhance investor confidence in Malaysian financial markets. At the end of 1998, KLOFFE had 40 trading members, 49 local members and 563 futures broker representatives.

In 1998, the 3-month **Kuala Lumpur Interbank Offered Rate (KLIBOR)** futures contract continued to be the only product traded in the Malaysia Monetary Exchange (MME), which was later renamed Commodity and Monetary Exchange of Malaysia (COMMEX) after the merger between MME and the Kuala Lumpur Commodity Exchange

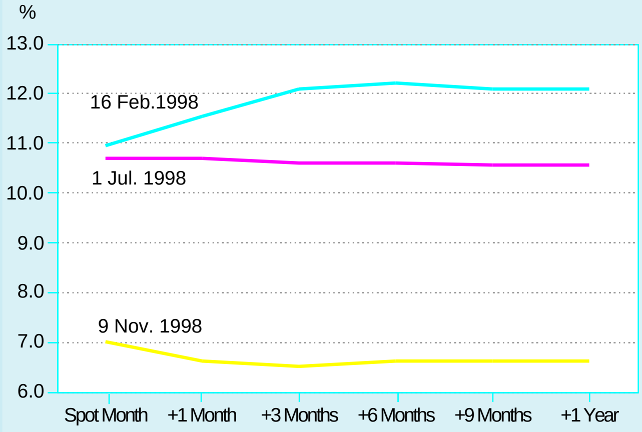
(KLCE). Trading of the product declined significantly in 1998 compared with 1997 as trading activities slowed although the year-end open position added 1,896 contracts to 3,092 contracts.

As the total volume for the year decreased by 67.6% to 24,738 contracts, the average daily volume also fell by 67.3% to 101 contracts. The lower trading volume was attributable to several factors. First, there was a divergence between the 3-month KLIBOR and the rates of related money market instruments, notably the 3-month negotiable instruments of deposit and bankers acceptances. The divergence was particularly noticeable in early 1998 when the shorter-term interbank rates were aggressively bidded up by some smaller banking institutions. To rationalise the term structure of interest rates as well as to improve liquidity flows in the system, in February 1998, BNM officially announced the 3-month intervention rate as its policy rate and reduced the SRR. Second, the preoccupation of the banking institutions with managing their non-performing loans as well as loan recovery reduced their participation in the KLIBOR futures market. This was significant as the domestic banking institutions were major players in the market, accounting for 72.8% of total turnover during July-December 1998. Third, the introduction of selective exchange control measures in September also reduced the activities of the foreign players. During the period August to September, their share of total turnover averaged 23%, but declined to an average of 4.3% in the remaining months of the year.

The low trading volume contributed to reduced trading by market-makers, worsening the lack of liquidity in the market. This was reflected in the wide bid-ask spread averaging 40 ticks (1 tick = 0.01%) in 1998 (average of 3.5 ticks from the period May 1996-June 1997, when the product was first launched to just before the crisis). In fact, the bid-ask spread widened to 200 ticks in the first week of September following the introduction of the selective exchange control measures, indicating the severe lack of liquidity in the market. As the environment remained unconducive, the market-making scheme was terminated on 7 July.

An encouraging development, however, was the relatively stable open-interest position at the end of the year which stood at 3,092 contracts (1,196 contracts in 1997), attributed to the increased use

**Graph 4.16**
**Selected 3 - Month KLIBOR Futures Implied Yield in 1998**




Source: COMMEX

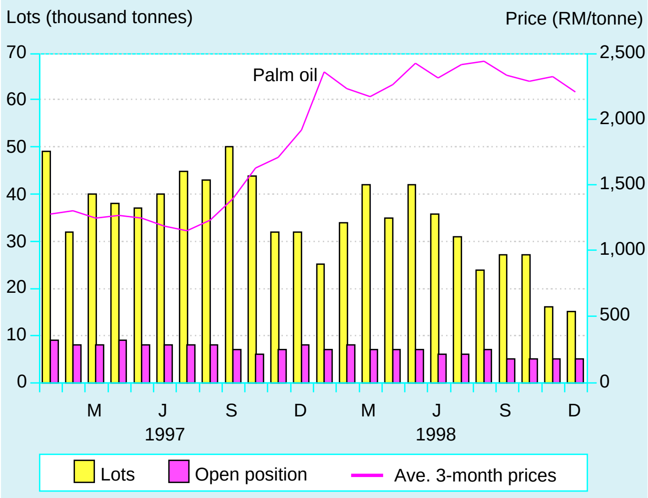
of strip trading among participants. The strip order, introduced in April, essentially involved using three or more consecutive quarterly KLIBOR futures contracts at one single price. The trade was initiated when it was determined that the trader could lock in a higher return or a lower borrowing cost for the spectrum of the 3-year yield curve than was otherwise available in the cash-only money market transaction. In terms of type of trades, outright trades remained most popular, representing 70.3% (93.2% in 1997) of total turnover followed by cross trades (13.8%, 5.3% in 1997), strip trades (12.5%, none in 1997), spread trades (2.4%, 1.2% in 1997) and All-or-None trades (1%, 0.3% in 1997).

The term structure of the 3-month KLIBOR futures implied yield during the year generally reflected that of the underlying interest rates. Hence, movements in the futures implied yield curve during the year could be divided into three distinct periods, similar to the developments in the cash rates. In January and February 1998, implied yields were high, as indicated by the spot month yield of 10.95% on 16 February, depicting the prevailing high interest rates associated with the progressive tightening of liquidity conditions that had commenced in September 1997. Market expectations during this period were for interest rates to increase further in the near term. Subsequently, the implied yield curve shifted slightly downward on 1 July with the spot month yield of 10.70%, while cash rates were stable amidst the tight liquidity in the system due to continued pressure on the ringgit. The flatness of the implied yield curve indicated that the interest rates were to remain high in the near future. In the third period from August to December, the implied yield curve shifted significantly downward on 9 November when the spot monthly yield declined further to 7% following successive reductions of the intervention rate and SRR of the banking institutions as part of the measures to support the economic recovery process. However, the implied yield curve became inverted, implying market expectation for further reductions in interest rates in the future.

An important development during the year was the merger between MME and KLCE to establish COMMEX on 7 December. The merger would benefit the industry through economies of scale in enhancing the efficient utilisation of resources as well as improving operational efficiency. In addition, it would enable the exchange to offer multi-financial and commodity derivative products to their clients. At the end of the year, there were 28 companies (18 Broker Members and 10 Non-Broker Members) and 49 individuals (Locals) who had been awarded membership in COMMEX.

In 1998, trading of **crude palm oil (CPO) futures** contracts on the Kuala Lumpur Commodity Exchange (KLCE) declined by 27% to 353,539 lots or equivalent to 8.8 million tonnes of CPO (1997: -2.8% or 484,323 lots or equivalent to 12.3 million tonnes). However, prices have recorded a continuous upward trend since mid-1997. Prices rose above the psychological support level of RM2,000 per tonne at the beginning of 1998 and remained above this level throughout the year. The higher prices reflected primarily the sustained demand for palm oil and its products worldwide as well as lower supplies. Crude palm oil production declined in Malaysia, and supplies were also lower from Indonesia, the world's second largest producer. The Indonesian Government, for most of 1998, had imposed very high export duties (up to 60%) on palm oil exports in its efforts to contain rising prices in Indonesia. During 1998, the price range for CPO futures was, however, slightly narrower at RM500 compared with RM800 in 1997. The highest price recorded was for the third month contract at RM2,562 per tonne.

**Graph 4.17**
**Futures Trading on the KLCE**




The price volatility resulted in several sessions of limit-up and limit-down in the KLCE, thereby impeding market participation. Consequently, the KLCE expanded the daily price limits, effective 9 February 1998, allowing the palm oil industry to continue to undertake hedging activity. Meanwhile, the average daily turnover for the first nine months was 1,615 lots before falling to 928 lots per day in the last quarter. The decline in trading volume during the final quarter reflected mainly subdued foreign interest following the imposition of selective exchange control measures on 1 September 1998 as well as market uncertainties regarding the price prospect for crude palm oil, in view of its high premium over competing oils and expectations of changes to export duties on palm oil in some producing countries. For the year as a whole, the average daily volume was lower at 1,443 lots, compared with the daily average of 1,961 lots in 1997, while the total open positions declined from 6,899 lots in January to 4,597 lots in December. Overall, the decline in activity on the CPO futures market was due primarily to the lower production of crude palm oil in Malaysia and the high price volatility.