The Financial Sector

Sources and Uses of Funds of the Financial System

The higher economic activity in 2000 was reflected in the growth of the total assets of the financial system, which increased by RM70.7 billion or 6% to RM1,243 billion at the end of 2000 (an increase of RM76.6 billion or 7% in 1999). This was attributable to the increase in the assets of both the non-bank financial intermediaries (NBFIs) and the banking system. Growth in banking system assets was moderate, rising by 3.2%. Given the higher growth of the assets of the NBFIs (+12.2%), the share of the banking system to the total assets of the Malaysian financial system declined slightly from 68.6% at the end of 1999, to 66.8% at the end of 2000.

Within the banking system, the bulk of the increase in assets was due to the increase in the assets of the commercial banks (including Islamic banks), which more than offset the decline in the assets of the finance companies and merchant banks. The assets of the commercial banks registered an increase of 6.4% (+5.1% in 1999), reflecting mainly the increase in loans and advances and the increase in deposit placements with other financial institutions.

For the NBFIs, total assets rose by 12.2% (+11.9% in 1999). As a result, their share of total financial system assets increased from 31.4% at the end of 1999 to 33.2% at the end of 2000. The higher growth was driven principally by an expansion in the assets of the provident, pension and insurance funds (+RM28.3 billion), which accounted for 63.2% of the increase in the assets of the NBFIs.

During the year, the bulk of new resources was contributed by contributions to the provident, pension and insurance funds and deposits placed with financial institutions. Deposits mobilised by the financial institutions grew by 4.6% (+10.8% in 1999). The slower growth in deposits reflected mainly the lower rate of increase in deposits mobilised by the banking system (see Chapter on Monetary and Fiscal Developments). Nevertheless, deposits continued to account for the largest share (47.1%) of the total sources of funds at the end of 2000 (47.8% in 1999). Similarly, the banking institutions (comprising commercial banks, finance companies, merchant banks and discount houses) continued to be the largest mobiliser of deposits, accounting for 82.7% of total deposits of the financial system (83.2% in 1999).

Graph 4.1
Assets of the Financial System as at end 2000*p* (% share)

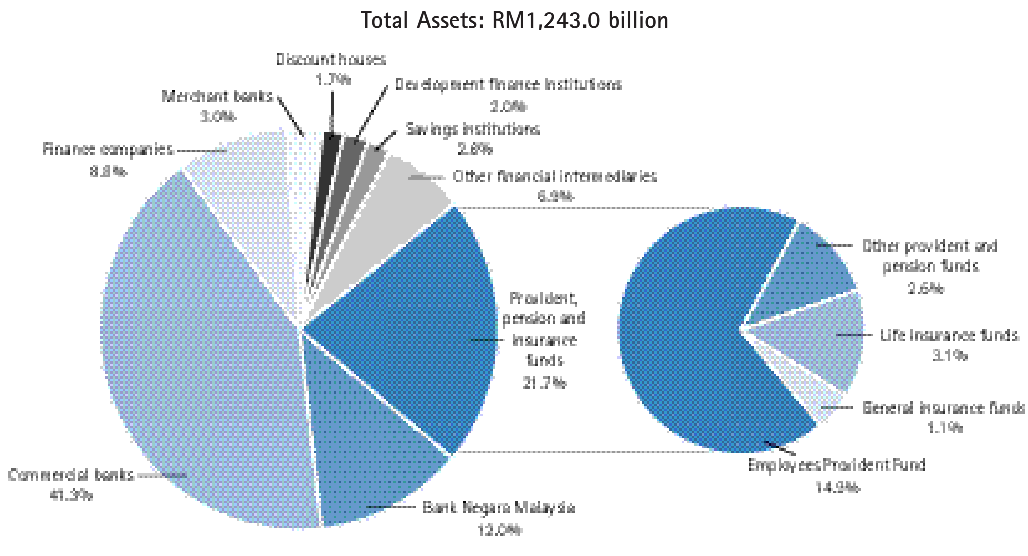

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Table 4.1
Assets of the Financial System

	Annual change 1999	Annual change 2000*p*	As at end 2000*p*
	RM billion		
Banking system	**37.3**	**25.9**	**829.9**
Bank Negara Malaysia	22.3	1.9	148.9
Commercial banks[1]	23.5	30.8	513.6
Finance companies	–7.2	–7.0	109.4
Merchant banks	0.0	–2.3	36.9
Discount houses	–1.4	2.6	21.1
Non-bank financial intermediaries	**39.3**	**44.8**	**413.1**
Provident, pension and insurance funds	27.9	28.3	269.8
Employees Provident Fund	*18.5*	*18.7*	*185.8*
Other provident and pension funds	*3.6*	*3.2*	*31.8*
Life insurance funds	*5.4*	*5.9*	*38.1*
General insurance funds	*0.4*	*0.5*	*14.1*
Development finance institutions[2]	2.0	3.4	25.1
Savings institutions[3]	6.1	7.1	32.3
Other financial intermediaries[4]	3.3	6.0	85.9
Total	**76.6**	**70.7**	**1,243.0**

[1] Includes Bank Islam Malaysia Berhad and Bank Muamalat Malaysia Berhad (since 1999).
[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 dan Infrastruktur Malaysia Berhad and Bank Industri dan Teknologi Malaysia Berhad.
[3] Includes National Savings Bank, Bank Kerjasama Rakyat and co-operative societies.
[4] Includes unit trust (ASN, ASB, ASW2020, ASN2, ASM (Malaysia) and ASM Mara), building societies, Pilgrims Fund Board, Credit Guarantee Corporation, Cagamas Berhad, leasing companies, factoring companies and venture capital companies.
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In terms of holders, the deposits were held mainly by the non-financial private sector (comprising individuals and business enterprises), accounting for 65.1% of the outstanding deposits at the end of 2000 (62.5% in 1999). The deposits of this group grew by 9% in 2000 (+5.1% in 1999) in line with the general rise in income and business profits during the year. As in previous years, fixed deposits continued to account for the bulk of the increase in deposits placed by the non-financial private sector (+RM14.6 billion). By maturity, fixed deposits continued to be concentrated at the shorter-end.

Contractual savings with provident and pension funds as well as contributions to insurance funds continued to be major sources of funds for the financial system, expanding by 12.5% (13.9% in 1999), to account for 19.4% of the total funds mobilised by the financial system at the end of 2000. Meanwhile, the capital and reserves of the financial system increased by 6.9% (+11.6% in 1999), reflecting mainly the strengthened capital position of the banking institutions.

Table 4.2
Sources and Uses of Funds of the Financial System

	Annual change 1999	Annual change 2000*p*	As at end 2000*p*
	RM billion		
Sources:			
Capital and reserves	12.0	8.0	123.3
Currency	9.9	–3.8	26.7
Deposits[1]	54.6	25.6	585.6
Borrowings	–0.8	–0.3	7.6
Funds from other financial institutions[1]	0.7	–2.7	69.0
Insurance and provident funds	26.2	26.8	240.7
Other liabilities	–26.0	17.0	190.2
Total	**76.6**	**70.7**	**1243.0**
Uses:			
Currency	5.9	–2.6	6.6
Deposits with other financial institutions	27.2	7.4	186.4
Bills	6.1	0.1	16.5
Treasury	*–0.1*	*0.6*	*4.2*
Commercial	*6.2*	*–0.4*	*12.3*
Loans and advances[2]	–11.7	23.8	496.4
Securities	14.1	33.5	272.2
Malaysian government	*3.3*	*10.6*	*85.4*
Foreign	*0.3*	*0.3*	*1.8*
Corporate	*12.3*	*20.8*	*178.1*
Others	*–1.8*	*1.9*	*6.9*
Gold and foreign exchange reserves	17.5	–3.9	109.8
Other assets	17.5	12.4	155.0

[1] Effective 1998, the statutory reserves of banking institutions have been reclassified as "Funds from other financial institutions" rather than "Deposits". In this regard, data from prior years have also been revised accordingly.
[2] Excludes loans sold to Danaharta and Cagamas. Including loans sold to Danaharta and Cagamas, the annual change of loans and advances of the financial system would amount to RM5 billion in 1999 and RM32.7 billion in 2000, while the amount outstanding at the end of 2000 would be RM553.8 bilion.
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Graph 4.2
Sources and Uses of Funds of the Financial System as at end 2000*p* (% share)

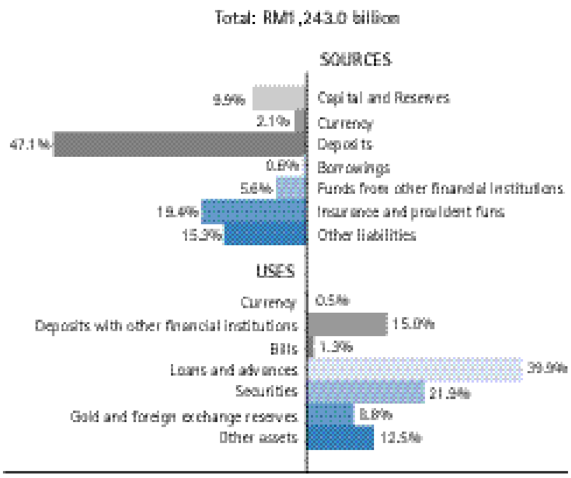

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Table 4.3
Non-Financial Private Sector Deposits[1] with the Financial System[2]

	Annual change		As at end 2000*p*
	1999	2000*p*	
	RM billion		
Deposits[3] with:			
Commercial banks	21.4	19.7	269.7
Finance companies	–7.3	–1.2	57.8
Merchant banks	–0.4	2.8	13.6
Discount houses	0.2	1.3	5.3
National Savings Bank	0.0	3.8	10.8
Others	3.2	5.0	24.3
Total	**17.1**	**31.3**	**381.5**
Demand deposits	9.1	7.2	48.5
Fixed deposits	16.1	14.6	252.6
Savings deposits	8.9	9.4	61.8
NIDs[4]	–15.5	-0.1	2.8
Repos[5]	–1.5	0.3	15.8
Fixed deposits			
of which:			
Up to 1 year	*17.8*	*12.4*	*232.1*
More than 1 year	*–1.7*	*2.2*	*20.4*

[1] Refers to deposits of the business enterprises (excluding NFPEs) and individuals.
[2] Excludes provident, pension and insurance funds, and other financial intermediaries.
[3] Refers to demand, savings and fixed deposits, negotiable instruments of deposits and repos.
[4] Refers to negotiable instruments of deposit.
[5] Refers to repurchase agreements.
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The increase in the total resources of the financial system in 2000 was mainly invested in securities and loans and advances. In line with the stronger economic growth, financing extended by the financial system recovered during the year. Total loans and advances increased by RM23.8 billion or 5% in 2000 (-RM11.7 billion or -2.4% in 1999). The bulk of the increase was extended for the purchase of residential property, the purchase

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

	Annual change		As at end 2000*p*
	1999	2000*p*	
	RM billion		
Loans and advances	**–6.5**	**14.9**	**455.4**
Agriculture	1.7	2.6	13.3
Mining and quarrying	–0.3	0.0	1.4
Manufacturing	–2.2	1.7	57.0
Housing	5.6	12.1	83.1
Construction[2]	–7.3	–3.3	82.2
Business services	11.4	–0.9	20.4
General commerce	0.3	1.2	19.0
Transport & storage	0.2	–0.1	14.1
Purchase of shares	–5.6	–0.1	22.9
Consumption credit	–1.3	5.9	55.8
Others	–9.0	–4.2	86.2
Investments in corporate securities	**12.3**	**20.8**	**178.1**
Total	**5.8**	**35.6**	**633.4**

[1] Excludes credit to non-financial public enterprises.
[2] Includes loans for real estate.
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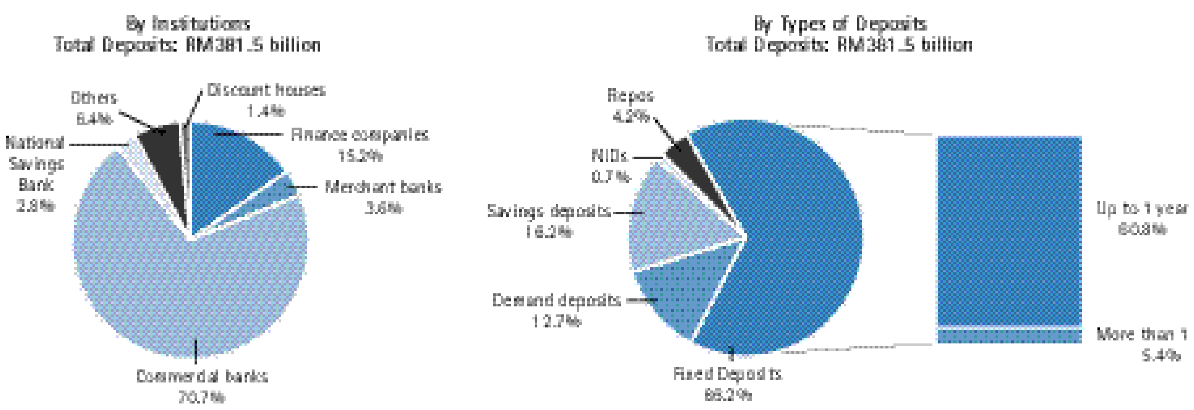
of passenger cars and to the agriculture and manufacturing sectors.

Concomitant with the expansion in the PDS market, investment in securities by the financial system recorded a stronger increase of 14% in 2000 (+6.3% in 1999). In particular, there were marked increases in investments in corporate (+RM20.8 billion) and government securities (+RM10.6 billion). Provident and pension funds continued to be the main investors in securities, accounting for 64.5% of the increase in investments in securities. Gross holdings of gold and foreign exchange reserves declined

Graph 4.3
Non-Financial Private Sector Deposits with the Financial System as at end 2000*p* (% share)



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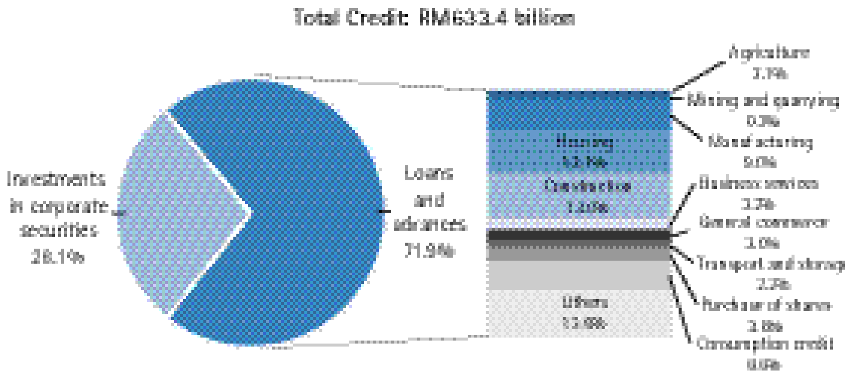
Graph 4.4
Direction of Credit to the Non-Financial Private Sector as at end 2000*p* (% share)



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marginally by RM3.9 billion in 2000 (+RM17.5 billion in 1999) on account of services payments, repayment of external loans, overseas investment, portfolio outflows and foreign exchange revaluation losses.

Management of the Banking Sector

The momentum set in the year 1999 towards strengthening the banking sector continued with vigor in the year 2000. The institutional arrangements and policy responses to mitigate the impact of the financial crisis on the banking system have succeeded in restoring financial stability and resumption in the growth process. In the year 2000, these stabilisation and recovery measures were complemented with longer term measures, aimed towards building a domestic banking sector that is resilient and competitive, whilst enhancing efficiency and promoting greater competition amongst players in the banking sector. BNM took the opportunity available to be forward looking, to build the necessary foundations so that the financial sector becomes more resilient in facing future challenges and continues to play its important role in the economy.

Following the strong economic growth as well as the successful restructuring efforts, the banking sector has emerged in a much stronger position in the year 2000. Loan activities have now resumed and are increasing steadily. Substantial progress continued to be achieved by the various restructuring vehicles, namely Danaharta, Danamodal and the Corporate Debt Restructuring Committee (CDRC) in strengthening the banking sector. The focus of these agencies throughout 2000 was to maximise recovery value of the assets held/managed via various exit mechanisms. In addition, recognising the role of the small and medium sized enterprises (SMEs) in contributing towards the overall development of the economy, efforts were also channeled towards accelerating the recovery of the SMEs and placing them on a stronger footing to support the economic growth process.

The main focus during the year was the consolidation programme for domestic banking institutions. Efforts were directed at ensuring that the merger negotiations that began in 1999 were successfully concluded by the end of 2000. In this regard, BNM acted as a facilitator, particularly when there were disputes or disagreements in the negotiations between the parties involved. To encourage banking institutions to accelerate the conclusion of their merger negotiations, various tax incentives were granted by the Government, namely exemption from stamp duty and real property gains tax and recognition of losses of the acquiree institutions for tax purposes. These incentives were available for banking groups that executed their Conditional Sales and Purchase Agreements by 31 August 2000. The merger negotiations which were based on market driven principles were mostly concluded before or by 30 August 2000, aided to a large extent by the presence of goodwill and commitment from the parties involved.

Banking Measures Introduced in 2000

The regulatory framework was further strengthened in 2000 with the introduction of several new measures as well as refinement to existing prudential regulations.

Investment in Shares and Interest-in-Shares

BNM streamlined the prudential limits on investment in shares and interest-in-shares by banking institutions. The revision streamlines the permissible investment limit to 5% of the investee corporation's paid-up capital or 5% of the banking institution's paid-up capital and published reserves, whichever is lower, in any corporations (trustee or non-trustee) that are listed on the Main Board of the Kuala Lumpur Stock Exchange (KLSE). In addition, banking institutions have also been allowed to participate in initial public offerings subject to the same limit. The banking institution's aggregate exposure in equity and quasi equity investments remains at 25% of the banking institution's paid-up capital and published reserves.

Previously, the banking institutions' investments in trustee shares and interest-in-trustee shares were capped at 10% of the investee corporation's paid-up capital or 5% of the banking institution's paid-up capital and published reserves, whichever is lower. Meanwhile, holdings of non-trustee shares and interest-in-non-trustee shares were limited to not more than 5% of the of investee corporation's paid-up capital or 5% of the banking institution's paid-up capital and published reserves, whichever is lower. Differences in the limits were the result of progressive liberalisation of the scope of permissible equity investments over the years. As the relative risk associated with investments in shares and interest-in-shares of trustee companies is no different from investment in non-trustee companies, differentiation in investment limits was deemed no longer relevant.

Minimum Guidelines on the Provision of Internet Banking Services

With effect from 1 June 2000, domestic banking institutions were allowed to offer a full range of banking products and services over the internet. Consistent with the no-branching rule imposed on the locally-incorporated foreign banks and the definition of branches that includes electronic terminals, the locally-incorporated foreign banks on the other hand, were allowed to set up communicative websites with effect from 1 January 2001 and transactional websites from 1 January 2002.

To govern the provision of banking products and services over the internet, BNM issued the "Minimum Guidelines on the Provision of Internet Banking Services by Licensed Banking Institutions". Under the guidelines, the board of directors and senior management of the banking institutions are entrusted with the primary responsibility of ensuring the feasibility, safety and integrity of the Internet banking activities that would not pose risk of serious loss to depositors. These include putting in place the following:

- an effective and comprehensive risk management framework to enable identification, quantification, monitoring and management of all associated risks. The risk management framework must also be flexible and sophisticated to accommodate for changes in the electronic environment and advancements in technology;
- Internet banking security policies including security requirements to be implemented for the Internet banking systems, contingency and business resumption plans, objective review and audit requirements;
- safeguards and administrative requirements for outsourcing, advertisements, web link arrangements, strategic alliances/partnerships;
- human resource requirements including training programmes to ensure availability and adequacy of experts and skilled personnel to run and support the Internet banking system; and
- proactive consumer protection programmes to educate consumers on the risks involved in

Internet banking and their rights and responsibilities including the formulation of Client Charter on Internet Banking. The Client Charter should stipulate, amongst others, commitments to customer information privacy, product and service transparency and services reliability and quality.

Client Charter on Granting of Loans to Small- and Medium-Sized Industries by Banking Institutions

Beginning the year 2000, banking institutions were required to publish a Client Charter which clearly stipulates the various documents and information that are needed by banking institutions to process a loan application of small- and medium-sized industries (SMIs). These include the eligibility criteria for obtaining loans, definition of project viability as well as duration taken by the banking institutions in processing a loan application. The Client Charter must be prominently displayed or made readily available at all branch premises of banking institutions.

One of the most cited reasons for delays in processing loan applications is the incomplete submission of essential documents and information by applicants. With the Client Charter, the borrowers will be better informed on the various requirements needed by the banking institutions and will be more adept at providing the necessary information. In addition, banking institutions are also required to convey all rejections in writing by specifying the relevant aspects or criteria that the borrowers had not met. In totality, the improved disclosure aims to create greater awareness among the SMIs and hence, help to expedite and facilitate the processing of loan applications by banking institutions. This culture will help to inculcate a more informed community among the SMIs as well as contribute towards the orderly development of the SMI industry in the longer run.

Resolution of Non-Performing Loans of Small- and Medium-Sized Enterprises – The Enterprise Programme

The Enterprise Programme was introduced on 9 June 2000 to expedite the resolution of NPL problems afflicting the small- and medium-sized enterprises (SMEs) as a result of the financial crisis. This is complementary to the other measures that have earlier been instituted to resolve problem loans in the SME industry, with special emphasis on borrowers having credit facilities with multiple banking institutions.

The broad principles underlying the formulation of the Programme include standardised and simplified loan restructuring guidelines, streamlined processes and standard funding support for on-going operations as well as systematic and structured training programme.

Given that the larger NPLs are being addressed by Danaharta and the CDRC, this Programme focuses on the smaller NPLs ranging between RM500,000 and RM5 million. As the overriding objective of the Programme is to provide financial assistance to viable SMEs which were affected by the financial crisis, only loans which turned non-performing between 1 January 1998 and 30 April 2000 are eligible for assistance under the Programme. The end-April 2000 deadline was imposed to reduce the risk of moral hazard where performing loans are intentionally left unserviced to be classified as non-performing in order to be eligible to participate in the Programme. The NPL problem of the affected SMEs have restricted their access to new financing. To enable these SMEs to carry on with their operations and participate in the economic recovery, it is critical that the SMEs continue to have access to new financing. As such, a key feature of the Programme is the provision of new financing to the affected SMEs, not exceeding 30% of their existing NPLs. A risk-sharing mechanism is adopted for the new financing granted whereby losses arising from the new financing are borne by the Government and the banking institutions in the ratio of 70:30. The portion borne by the Government is extended in the form of a guarantee through the Credit Guarantee Corporation. Repayments received from the SMEs under this Programme are on a last-in-first-out (LIFO) basis where the new loans are repaid in priority to the banking institution's existing indebtness.

The SME industry is an important component of the economy. Therefore, it is vital that the SME industry develops in an orderly and systematic manner for it to make more effective and meaningful contribution to the economy. Therefore, an added feature of the Programme is the compulsory training and awareness programmes that the SMEs must attend. The programmes include structured courses in business management, skill enhancement and training on financial cash flow management, computerised accounting as well as trade and financing tools.

Increase in Minimum Capital Funds

On 15 November 2000, BNM announced the increase in the minimum amount of capital funds unimpaired by losses for banking institutions which will take effect from 31 December 2001. The new minimum capital funds requirement was raised to RM2 billion for domestic banking groups (comprising commercial banks, merchant banks and finance companies) and RM300 million for the locally-incorporated foreign banks.

The larger and stronger capital base will strengthen the resilience and capital position of the banking institution, in rising to the challenges of the more global and liberal environment and in absorbing further shocks. At the same time, the increase will enable the banking institutions to enhance their operational efficiency by making the necessary investments in strategic areas as well as information technology.

Liberalisation Measures in 2000

A number of liberalisation measures were also implemented during the course of the year aimed at enhancing the efficiency levels and intensifying competition in the banking sector.

Outsourcing of Banking Operations

With effect from 14 April 2000, banking institutions were granted blanket approval to outsource non-core functions to third party resident service providers. These include those that do not involve decision making function or impair the image, integrity and credibility of the banking institutions. Banking institutions are also required to observe various safeguards before executing any outsourcing arrangements. These safeguards include due diligence reviews, proper reporting and monitoring mechanisms, regular testing and review of the work conducted by the outsourcing vendor and a contingent plan should the arrangement with the outsourcing vendor be suddenly terminated.

As the market becomes more liberal and competitive, the need for banking institutions to restrategise and reengineer their work processes and operational functions in order to achieve higher efficiency levels and competitive edge becomes more pronounced. Engaging the services of third party service providers with a ready infrastructure will allow banking institutions to leverage on the availability of skills and expertise as well as relieves the banking institution from developing the internal infrastructure, thus reducing the financial burden. The risk of investing in obsolete technology is minimised, reduces the need for frequent upgrades and enhances customer responsiveness. The more focused approach would therefore enable the banking institutions to concentrate on their core functions more effectively. It will also allow banking institutions to focus on formulating appropriate business strategies that will improve their competitive advantage and ultimately their overall efficiency levels.

Lifting of RM150,000 Limit on Sale of Housing Loans with Recourse to Cagamas

For the period between 17 April 2000 and end-March 2001, banking institutions have been allowed to sell loans extended for the purchase of houses priced above RM150,000 to Cagamas Berhad.

Development of the securitisation market, pioneered by Cagamas Berhad, since late 1990s through the purchase of loans with recourse basis, provides a significant window for banking institutions to source cheaper funding. Prior to the liberalisation, residential mortgages that can be securitised are restricted to those extended for the purchase of houses priced below RM150,000. The restriction complements other lending restrictions placed on banking institutions to curb speculative activities that led to escalation in the price of high-end residential properties. As volume in the securitisation market increased significantly, the pool of eligible housing loans that can be securitised was significantly reduced. At the same time, Cagamas Berhad has also embarked on its purchase without recourse schemes to widen the scope of securitisation activities. The temporary relaxation would enable banking institutions to widen their funding sources whilst at the same time, assist in the smooth and continued functioning of securitisation activities.

Upliftment of Wage Moratorium for Banking Institutions

With effect from 18 April 2000, the moratorium on wage increases imposed since January 1987 was uplifted. Following the liberalisation, banking institutions now have the flexibility to determine the remuneration, allowances and bonuses of their employees (excluding CEOs and Directors) based on their respective productivity and efficiency levels. The Board of Directors is responsible in ensuring that remuneration packages awarded to employees are not overly excessive but instead commensurate with their productivity and efficiency levels. Banking institutions are also encouraged to form a Compensation Committee that provides oversight of the remuneration package of senior management and key personnel and to ensure that the remuneration package is aligned with the objectives and strategy of the banking institution.

The wage moratorium was first imposed in January 1987 during the recession, in line with the Government's call for restraint in wage increases so as to ensure that the increase in wages commensurate with the level of productivity, especially when there is a limited number of professionals, skilled and experienced bankers in the country. Over the years, the restriction has been progressively liberalised and modified in line with developments in the labour market as well as the economy.

The significance of skilled and agile workforce in developing an efficient and effective banking sector will continue to be emphasised. In an environment characterised by rapid evolution and increasing competitiveness, banking institutions must have the ability to attract and retain best talents and skilled personnel within their organisations in order to remain successful. In particular, professionals that have acquired experience and expertise in the more developed financial markets and are apt in key areas such as risk management, systems development and alliance building where locals are lacking should be employed. A more flexible remuneration model would facilitate this process.

Rationalisation of Operational Structure of Banking Institutions – Cross-Selling Activities and Pooling of Internal Operations

As of 5 June 2000, banking institutions are permitted to conduct cross-selling activities through agency arrangements and to pool their common internal operations at a centrally chosen location. All cross-selling activities will be performed under a principal-agent relationship and must be contracted with the principal institutions. These activities must also be reflected in the books of the principal institutions. Banking institutions are also permitted to cross-sell financial products and services belonging to their subsidiaries or subsidiaries of the immediate bank holding company or appoint these subsidiaries as their agents to cross-sell their financial products and services.

Any rationalised business units and internal operations affecting customers of banking institutions must be contained within one of the licensed institutions to ensure banking secrecy provisions continue to be observed. Banking institutions are also required to have the necessary systems and internal controls in place, as well as a business resumption plan.

As competition among banking institutions intensifies, operational efficiency becomes a key element in ensuring the success and hence, continued existence of the institution in the long run. This can be achieved by allowing banking institutions to coalesce common operations and functions, thus avoiding duplication in activities and infrastructure. This would enable banking institutions to realise greater cost savings via economies of scale as well as allowing banking institutions to maximise group synergy which would lead to more competitively-priced products and services.

Repurchase Agreements by Non-Licensed Institutions

With effect from 1 July 2000, pursuant to the "Banking and Financial Institutions (Amendment of Definition of Deposit) Order 2000", non-licensed institutions are permitted to enter into repurchase agreement (repo) transactions with principal dealers for a maturity period of less than one month.

In the past, non-banking institutions were prohibited from transacting in repo as funds obtained from such transactions are defined as deposit-taking under the Banking and Financial Institutions Act 1989. This prohibition impedes active trading of debt papers in the secondary market, thus hindering the development of an active secondary debt market. The liberalisation will help to unlock the captive holdings of debt securities by non-banking institutions and enable position taking by all market players. More importantly, this liberalisation would contribute towards deepening liquidity in the securities market and the overall development of the bond market.

Recognition of Audited Half-Year Profits in Computation of Risk-Weighted Capital Ratio

With effect from 7 November 2000, banking institutions are allowed to recognise half-year audited pre-tax profits as capital base for purposes of computing the risk-weighted capital ratio, single customer credit limit, and limit on the issuance of negotiable instruments of deposit.

The rapid pace in loan expansion precipitated by a period of buoyant economic performance prompted Bank Negara Malaysia in 1996 to introduce measures to slow down the increase in capital base. In addition to shortening the maturity period of subordinated-loans to 3 years, banking institutions were also not allowed to include half-year profits in their respective capital base since January 1997. As concerns over aggressive balance sheet expansion had diminished, the relaxation to allow the inclusion of half-year audited profits in computing the capital base would assist the banking institutions in rebuilding and strengthening their balance sheets.

As at 31 December 2000, the merger programme was successfully implemented, with 50 out of 54 domestic banking institutions consolidated into 10 banking groups and 94% of the total assets of the domestic banking sector rationalised and consolidated. One of the banking institutions completed its merger process on 1 March 2001. The remaining three institutions were given approval to commence negotiations with other anchor banking groups. To further strengthen the capital base of the banking groups formed under the merger, the minimum capital funds unimpaired by losses for domestic banking groups were increased to RM2 billion while foreign banking institutions were required to increase their minimum capital funds to RM300 million by 31 December 2001. By the first quarter of 2001, only 1 domestic banking group and 5 foreign banking institutions have yet to comply with the new minimum capital funds requirement.

To complement the consolidation and rationalisation efforts, BNM continued to implement various regulatory and supervisory reforms. In line with this objective, a number of measures were introduced to enhance the strength and capacity of banking institutions.

Measures to Strengthen the Resilience of the Banking Sector

During the recent financial crisis, it was evident that poor asset quality was the main concern for banking institutions. The absence of a sound and effective credit risk management process in some institutions led to poor administration and management of loans, which in turn could threaten the solvency position of the institutions. Moving forward, effective credit risk management is critical to ensure that the credit activities of banking institutions are conducted in a prudent manner, thereby minimising the risk of potential bank failures. In this regard, BNM issued guidelines on credit risk management, denoting specific requirements that had to be complied with by banking institutions as well as best practices which banking institutions ought to adopt. The main principles of the guidelines were to ensure appropriate overview by the Board of Directors and management, adequate infrastructure for effective credit risk management and comprehensive internal controls and audit procedures to administer credit risk. In addition, the limit on credit facilities to a single customer was tightened from 30% to 25% of capital funds to be in line with international best practices and to minimise the banking institutions' over-exposure to a single customer. A consultative paper was also issued, proposing further amendments to the scope and definition of credit facilities and single customer, stipulated in the Guidelines on Credit Limit to a Single Customer (GP5). Banking institutions would be required to observe the lending limit to a single customer on a consolidated as well as on an entity basis, thereby mitigating the possibility of one institution in the group having excessive exposure to a single customer, whilst the consolidated single customer exposure of the entire group still falls within the permissible limit. The limit on large loans would also be reduced to 10% of capital base of banking institutions, instead of the previous limit of 15% of capital funds.

One of the main weaknesses of the credit risk management process is the lack of competent credit personnel who have complete understanding of the risks associated with lending activities. In the past, individual banking institutions provided in-house training for their credit personnel but the syllabus and quality of such training programme varied from one institution to another. Given the crucial importance of developing competent personnel to manage and control credit risk within banking institutions, an accreditation programme has been introduced, whereby personnel involved in credit appraisal, approvals and credit review would need to undergo a common training programme conducted by the Institut Bank-Bank Malaysia (IBBM) and pass a common test as well as receive certification before being eligible to sign off or approve a credit proposal. This programme encompasses the critical areas of sound credit risk management practices such as fundamental principles of good lending, financial and cash flow statement analysis, techniques on qualitative risk analysis and remedies for credit deterioration. The programme also sets the benchmark for in-house training programmes that may be conducted by individual banking institutions. The common test covers questions that require application of concepts, principles and regulation, as well as a case study designed to test the analytical capability of the credit officers in assessing the viability of the loan application. This programme is aimed at ensuring all credit personnel have a complete understanding of the risks associated with lending activities, which in turn would help to enhance the credit culture and credit standards of the banking institutions.

BNM supervisors also continued to upgrade their supervisory techniques, with emphasis on strengthening their on-site examinations and off-site surveillance systems to detect possible areas of vulnerabilities. Regular stress tests have also been conducted. This is vital to ensure that problems are detected early and pre-emptive measures are taken to deal with these problems. In addition, a consultative paper on prompt corrective measures (PCM) was issued in 2000 that recommended a set of regulatory actions that would be automatically instituted on banking institutions found to be operating in a manner detrimental to depositors' interest. The automatic set of actions addresses deterioration in capital

To complement the consolidation efforts, BNM continued to implement regulatory and supervisory changes to enhance resilience and improve the level of competitiveness and efficiency of the banking institutions.

adequacy as well as liquidity problems. These measures would help to limit supervisory forbearance, delay or failure to take appropriate action against troubled banking institutions.

Despite various efforts undertaken since 1998 to expedite the resolution of non-performing loans (NPLs) of the small and medium scale enterprises (SMEs), the progress remained relatively slow given the large number of accounts. Banking institutions were also reluctant to extend new financing to these borrowers in view of their poor credit standing. This inevitably affected the recovery process of viable SMEs. As long as these SMEs continued to be plagued by NPL problems, they would not be in a position to sustain their operations to support economic growth. In order to maximise efficiency and hasten the speed of resolving the SME loans, BNM launched the Enterprise Programme to support the viable businesses. The main principles of the programme entailed the usage of standard loan restructuring guidelines with business friendly terms and the provision of funding support to such viable SMEs. New loans extended under the programme were partly guaranteed by the Government through the Credit Guarantee Corporation Malaysia Berhad, which bears 70% of the credit risk, whilst the remaining 30% would be borne by the lending institutions. Moving forward, the capabilities and capacities of the SMEs need to be nurtured and strengthened to ensure that this sector grows into a vibrant industry and becomes an important backbone to the economy. In view of this, an important element of this programme was the mandatory training conducted by IBBM for borrowers participating in the programme. Therefore, this programme was not only aimed at restructuring and rehabilitating the NPLs but also helped towards creating greater awareness and educating the SMEs on key areas of business and financial management to improve their competitiveness and resilience in the long run.

Measures to Enhance Efficiency and Promote Competition

A banking sector that is poised to embrace future challenges needs to be focussed, resilient and competitive. Against this backdrop, a number of measures were introduced in 2000 to enhance the level of competitiveness of banking institutions. In the past, banking institutions were not allowed to extensively outsource their operational functions to third party service providers due to concerns over secrecy provisions and the ability of these service providers to preserve the quality of services. Banking institutions had to invest significant human and financial resources to manage their non-core operational activities which provided insufficient value add to the business as a whole. Substantial amount of time and money had to be allocated to recruit and train personnel on such functions. Given the rapid pace of technological advancements, it has become imperative for banking institutions to respond more swiftly to customer demands and challenges posed by the more competitive environment, thereby necessitating institutions to build up their skills and competencies in niche areas and specialise in core banking functions. Recognising this, with effect from April 2000, BNM granted blanket approval for banking institutions to outsource their non-core operational functions to third party service providers. Non-core operational functions are those that are not crucial to the strategic positioning of banking institutions such as payroll functions and data entry processes. This would relieve banking institutions from having to invest a substantial amount of time and funds to undertake such functions, thereby allowing them to maximise returns by concentrating their resources on developing competencies in their core areas of businesses. However, the Board of Directors of banking institutions would be responsible for monitoring and putting in place control mechanisms to ensure that the integrity and quality of work conducted by the outsourcing vendor is maintained to ensure that it would not affect the provision of services to consumers.

The ability of banking institutions to offer a broad range of financial services through different distribution channels has become increasingly important to maintain their competitive edge in the new global environment. Large global players are beginning to create one stop financial centres to meet the demands of customers more effectively and efficiently. In line with the restructuring process undertaken by banking groups during the merger exercises, greater flexibility was accorded for banking institutions within the group to conduct cross-selling activities and rationalise their internal operations to maximise group synergy and economies of scale.

Banking institutions were allowed to freely cross-sell financial products and services of entities within the same group, including those belonging to their related non-bank financial institutions, provided the interests of the minority shareholders were not compromised. Smaller banking institutions would then be able to tap a larger pool of customers via wider marketing channels, enjoy greater cost savings and tap on the expertise of their larger related banking institutions. The centralisation of internal operations would also result in the operations being carried out more efficiently and effectively and prevent the duplication of similar operational functions.

The strength of manpower capabilities, expertise and degree of innovation defines the competitive advantage of banking institutions. Recognising this, proactive strategies should be implemented not only to retain the experienced and high quality pool of bankers who are already in the industry, but also to attract the best talents into the industry to spearhead the developmental process. One of the main drivers is the remuneration packages offered by banking institutions. In the past, the remuneration schemes for personnel of banking institutions have been relatively less competitive due to concerns that such schemes would not commensurate with the productivity levels. This has, to a certain extent, hindered the ability of banking institutions to retain some of the best quality professionals in the industry. To enable banking institutions to retain as well as attract a substantial pool of highly skilled and innovative manpower that would contribute towards the development of an efficient and effective banking sector, BNM has abolished the Guideline on Wage Moratorium thereby according greater autonomy to banking institutions to determine the salaries, allowances and bonuses of their employees based on their productivity and efficiency levels. To monitor the remuneration packages of senior management and key personnel, banking institutions were encouraged to form Compensation Committees to ensure that the remuneration packages are not overly excessive. The abolishment of this guideline signifies a move towards according greater flexibility in rewarding employees based on performance and productivity.

The objective of the merger programme for domestic banking institutions was primarily to create a core of resilient, competitive and forward looking domestic banking institutions that would be able to face the challenges arising from liberalisation and globalisation. During the course of consolidation, banking institutions would be able to reap greater benefits from economies of scale through greater investment in technology and a more substantive pool of skilled staff to maintain efficiency and competitiveness. Some form of rationalisation in terms of branches and staff strength would be inevitable in order to minimise duplication of resources and maximise consolidation benefits. Of the 10 domestic banking groups, 4 groups have confirmed that there would not be any staff rationalisation in the next few years given that the existing staff strength would be needed to sustain their expanded operations. In the remaining 6 banking groups, although there would be some staff rationalisation, the number of staff involved is expected to be manageable, not more than 10,000 staff. For those staff that would leave the industry, re-skilling initiatives are being put in place to facilitate the smooth transition of these workforce into other industries in the economy. A comprehensive re-skilling programme has been developed in consultation with the major players in the industry and IBBM to assist these affected workers during the transition period. The programme will be conducted through a combined effort at IBBM in addition to those provided by individual banking institutions. The programme comprises 5 modules, entailing programmes on increasing personal effectiveness during challenging times, managing the process of a career change, personal financial management, building own business and enhancing information technology skills. Financial subsidies will also be provided through the Staff Training Fund to minimise the financial burden on banking institutions as well as the participants. In addition, to provide further support to the affected workers, a website will be set up, dedicated to allow these workers to indicate their availability for job

> Re-skilling initiatives are being put in place to facilitate the smooth transition of the workforce into other industries. A web-site will be set up to allow workers to register their availability for job appointments and provide linkages to on-line classified advertisements web-sites.

appointments and to provide linkages to on-line classified advertisements websites.

In the international financial landscape, advances in information technology is rapidly changing the way business is being conducted. The widespread transformation of players in the market, the needs of the players and the volume of activities clearly highlights the point that banking institutions need to enhance their competitiveness and efficiency. Moving forward, information technology would be an important enabler in improving internal efficiency as well as effectiveness in reaching out to customers through alternative delivery channels. As part of this process, domestic banking institutions were given a headstart to offer a full range of banking products and services over the internet with effect from 1 June 2000. Locally incorporated foreign banks will be allowed to offer communicative internet banking services with effect from 1 January 2001, and transactional internet banking services starting 1 January 2002. The lead time given to domestic banking institutions was to allow time for the banking institutions to build up their capacity and capability in this new area of business before foreign banking institutions are brought into the playing field. This is necessary to ensure that there would be fair competition between the domestic and foreign banking institutions once the internet banking policy is liberalised to allow the same level of participation for all players in the banking sector. The definitive timeframe also demonstrates the commitment to progressively liberalise the restrictions imposed on the operations of foreign banking institutions in Malaysia.

While the internet provides important benefits to banking institutions and their customers, banking institutions should also be mindful of the risks involved and the controls that must be put in place to manage such risks. In this regard, BNM issued "Minimum Guidelines for the Provision of Internet Banking Services by Licensed Banking Institutions", stipulating specific requirements that banking institutions should observe in providing internet banking. The main areas covered in the guidelines include the role and responsibilities of the Board of Directors and management in maintaining active oversight on the provision of internet banking services, the risk management processes to deal with risks, the security requirements to maintain the integrity of internet banking and consumer education. The ultimate objective is to ensure that the associated risks involved in the provision of internet banking services are adequately managed to protect the interests of consumers, whilst preserving the integrity of banking institutions.

In addition to the measures to enhance the level of efficiency in the banking sector, efforts were also channeled towards minimising distortions arising from certain practices adopted by banking institutions. One of the major policies announced was the abolishment of the commissions paid by finance companies to car dealers for forwarding hire-purchase financing cases to them. In the past, these commissions were determined based on the amount and tenure of the hire-purchase loan. This, translated into higher costs for the consumers, as the rates charged by the finance companies on the hire-purchase loans were relatively higher. To remove such practices, the payment of commissions was prohibited. Instead, finance companies were permitted to pay a handling fee of up to RM600 for each hire-purchase financing case forwarded by the car dealers. This standard handling fee would serve as payment for certain specified services provided by the car dealers such as assisting the consumer to complete the necessary loan application documents and providing information on hire-purchase loans to the consumers. This cost would be borne entirely by the finance companies, without burdening the consumers. As a result, there were greater cost savings to the consumers, whilst ensuring that the car dealers were compensated for the services provided.

Conclusion

The financial landscape in the future would be very much influenced by the changes in the structure of the economy in line with Vision 2020. In an emerging economy like Malaysia, the financial sector would play a pivotal role in facilitating and supporting the growth process of the economy. Therefore, financial institutions would need to be dynamic and proactive in providing services to support the economic transformation process. Changes in the financial sector would be required as the economy develops towards achieving a more diversified economic structure and sustainable and balanced growth with price stability. Given the critical role played by the Malaysian financial sector in achieving these objectives, the Financial Sector Masterplan (FSMP) has been developed to chart the future direction of the financial sector for the next 10 years. (The FSMP is discussed in greater detail in Chapter 5)

Banking Sector Restructuring

Danaharta, Danamodal and CDRC continued to record significant progress in their operations during the year 2000. As at 31 December 2000, Danaharta had acquired and is managing NPLs with loan rights amounting to RM47.5 billion (2,835 accounts), of which RM39.3 billion loan rights were acquired from the banking system. The book value of the loans removed from the banking system was RM37.5 billion, representing 44% of the NPLs in the banking system. The removal of NPLs by Danaharta succeeded in reducing the residual NPLs in the banking system to manageable levels. As at 31 December 2000, the net NPL ratio of the banking system has moderated to 6.3% based on the 6-month classification, from its peak of 9% as at end-November 1998. The weighted average discount rate for the acquired NPLs by Danaharta remained relatively constant, at 55% as at end-December 2000 compared to 56% in the preceding year. During the year 2000, Danaharta issued three tranches of zero-coupon bonds as consideration for the NPLs acquired, bringing the total nominal value of bonds issued to RM11.1 billion (with a present value of RM8.2 billion) as at end-December 2000.

Table 4.5
Danaharta: Recovery Methods

	Loan outstanding[1] RM billion	Expected recovery RM billion	Expected recovery rate %
Performing loans	2.57	2.57	100
Plain loan restructuring	7.06	6.54	93
Settlement	6.34	4.86	77
Scheme of arrangement	6.08	5.07	83
Special Administrators			
- Scheme approved	2.50	1.54	62
Foreclosure	7.63	2.12	28
Others	2.02	1.10	55
Legal action	1.63	-	-
Total	35.83	23.80	66

[1] Inclusive accrued interest of RM0.789 billion

Danaharta, Danamodal and CDRC continued to record significant progress in their operations during the year 2000.

For the year 2000, Danaharta concentrated on its loan and asset management process. Various resolution techniques were applied on its loans and assets, such as active restructuring and rescheduling for viable loans; foreclosure, appointment of Special Administrators and Schemes of Arrangement for non-viable loans. As at 31 December 2000, Danaharta has successfully restructured RM35.8 billion of loans (representing approximately 74% of loans under its portfolio), with expected recoveries of RM23.8 billion. This translates into a 66% recovery rate over the outstanding loans. Danaharta expects to resolve the remaining NPLs of RM12.4 billion (in gross value terms) by the end of 2001. Table 4.5 gives a breakdown on the recovery methods employed by Danaharta.

Danaharta's method of recovery does not focus on foreclosure and sale of collateral. Danaharta, being an asset management company, has focused on the management of the assets and has chosen the recovery measure that maximises the recovery value of the assets. The preference is to restructure the loans wherever possible, and only resort to foreclosure and sale of collateral as a last resort. Loan restructuring has shown to give a higher recovery rate than outright foreclosure, as shown in the above table.

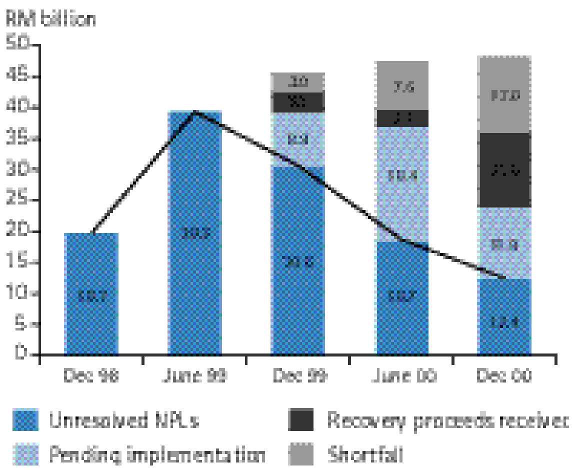
As at 31 December 2000, as a result of the recovery measures initiated, Danaharta has received recovery proceeds of RM12 billion, comprising cash of RM6.4 billion and the remainder in the form of performing loans, securities and properties. A further RM11.8 billion of expected recoveries would be received over time, partly through repayments from performing loans.

Given the encouraging recovery rates achieved by Danaharta, it has distributed RM4.4 billion of net recoveries obtained from the management of loans of Bank Bumiputra Malaysia Berhad Group and Sime Bank Group. For the acquired loans, RM200.3 million of net recoveries have been redistributed back to 12 financial institutions. This is based on the arrangement between Danaharta and the selling institution, whereby Danaharta would share any surplus recovery (after deducting recovery and holding cost) from the sale of the loans/assets with the selling institution on a 80 (selling institution):20 (Danaharta) basis.

With regard to the property tenders conducted by Danaharta, 4 tenders have been conducted by the end of December 2000, offering a total of 449 properties (excluding hotels and leisure properties) with indicative value of RM985.9 million. Properties that were not sold during the tenders have been transferred to Danaharta Hartanah Sdn Bhd, and would be re-offered to the market for secondary sales. As at 31 December 2000, Danaharta has sold 325 properties, garnering proceeds of RM535 million. Danaharta also completed the sale of the businesses of four wood-based companies under the administration of Special Administrators. The successful bids garnered RM44 million, representing a premium of 7% above the indicative value of the assets. As for the remaining businesses that have been left unsold, other viable options are being considered to maximise recovery values. In addition, Danaharta also launched a hotel and leisure property tender in 2000. Three foreclosed hotels and the businesses/assets of 8 hotels under Special Administrators were offered during the tender. The sale of businesses by the Special Administrators represented part of the workout proposals for the resolution of NPLs of the borrower companies. Danaharta received a total of 15 bids, of which only three were successfully concluded. As for the remaining 8 hotels, other viable options to maximise its recovery values would be considered such as re-tender, negotiations with investors who have indicated interests, liquidation or joint ventures.

The composition of Danaharta's assets would change over time from unresolved NPLs to various asset groups and ultimately into cash. As Danaharta moved from its establishment phase to management phase, its composition of NPLs also changed from being unresolved to NPLs that have been processed where recovery proceeds have been received or pending implementation. This trend is reflected in Graph 4.5.

Graph 4.5
Asset Movements



As at 31 December 1999, Danaharta had initiated recovery on approximately RM15 billion of its portfolio. This amount increased to RM35.8 billion as at 31 December 2000, with RM12.4 billion of loans yet to be resolved. Based on the current pace of resolution, Danaharta is on track to achieve its targeted unwinding by 2005.

Danamodal has made no additional capital injection during the year 2000. Following the improved economic environment and in tandem with the merger programme for domestic banking institutions, 8 banking institutions have repaid their loans to Danamodal amounting to RM3.4 billion, bringing the outstanding amount of capital injection to RM3.7 billion as at 31 January 2001. During the course of consolidation, Danamodal has played an active role in spearheading the merger negotiations for those banking institutions where Danamodal was the major shareholder. As a result of the merger process, 2 banking institutions repaid their loans to Danamodal. Where Danamodal continues to hold stakes in banking institutions, Danamodal would assess all viable options in order to maximise recoveries from the capital investments and give financial flexibility for Danamodal to redeem its bonds amounting to RM11 billion when they mature in the year 2003. Due consideration would however be accorded to ensure that the financial strength of the banking institutions or bank holding companies would not be unduly weakened by the capital repayment.

With respect to the corporate debt restructuring exercise, the CDRC has successfully resolved debts of 42 companies amounting to RM27.3 billion as at 31 December 2000. During the course of debt restructuring, various techniques were applied such as debt to equity conversion, debt to private debt securities conversion, participation of white knights and reduction in the paid-up capital of the borrowers. CDRC has also withdrawn or rejected 21 cases with debts of RM7.8 billion. Therefore, as at 31 December 2000, CDRC has 12 outstanding cases to be resolved with total debts of RM12.1 billion. The progress of corporate debt restructuring under

Box III

The Central Credit Bureau and the Central Credit Reference Information System

Introduction

Few people outside the banking system have heard of, much less know, there is a Central Credit Bureau (CCB) in Malaysia. Bank Negara Malaysia (BNM) has been operating the credit bureau since 1982. What is a credit bureau? Basically, a credit bureau is a repository of the credit histories of borrowers, both past and present. Closely associated with the credit bureau is the centralized database system that houses the credit information on the borrowers. The existence of such a database on borrowers, including individuals and corporations, inevitably raises concerns particularly on the confidentiality of the information. This article discusses the role of the CCB within the financial system and the various issues relating to the confidentiality of the information. The article also provides information on the new database system that is being developed by BNM, known as the Central Credit Reference Information System (CCRIS).

Role of the Central Credit Bureau

The CCB was established under section 30(1)(mmm) of the Central Bank of Malaysia Act 1958 to carry out the following functions:

- collect credit information on the customers of banking institutions, comprising commercial banks, Islamic banks, finance companies, merchant banks, and other financial institutions such as development finance institutions; and
- furnish the credit information so collected to these institutions.

In performing the above functions, the CCB plays an important role in the areas of credit risk management and the promotion of a sound credit culture in the financial system. When financial institutions grant loans, they face the risk of borrowers defaulting on their debts, due to a variety of reasons, including fraudulent applications. Therefore, as a prudent practice, financial institutions conduct background checks on prospective borrowers prior to making lending decisions. These background checks include checking the credit history of the borrowers from various sources, including a search with the CCB. The information obtained from the database of the CCB would include the total credit exposure of the borrower from the financial system and financial conduct of existing credit facilities. The background checks on borrowers are part of the credit risk management of the individual financial institutions as such check provides indications on the level of indebtedness of the borrowers. Proper credit risk management controls are needed to ensure the quality of the asset portfolio. Widespread poor credit risk management could impair financial stability. In the wake of the Asian financial crisis in 1997-1998, the need for better credit risk management in financial institutions in the region became very apparent, given the collapse of several institutions in some of the affected countries.

In addition to providing the financial institutions a useful decision-support tool to facilitate their credit risk assessment of potential or current borrowers, the database of the CCB is also of critical importance to BNM, particularly in monitoring the financial institutions under its supervision and keeping watch on the potential sources of systemic risk in the banking system. The database of the CCB assist banking supervisors in evaluating the level of credit risks in individual financial institutions, and serves as an early warning system to detect potential signs of distress in the banking system. The early detection of potential problems in a financial institution would prompt BNM to instruct the institution concerned to implement prompt remedial action to maintain its solvency, thereby ensuring financial stability.

The important role played by a credit bureau is recognized globally. Indeed, there are already credit bureaus operating in many advanced and developing countries. Some are commercial bureaus, which are operated as businesses that collect and sell the information on borrowers. This is more prevalent in the developed economies, such as in the United States, United Kingdom and Australia. There are also a number of central banks in the world that manage national credit bureaus, that are typically non-profit oriented, a case more prevalent in the developing economies.

Confidentiality of Information

The CCB processes highly confidential information as the data that it collects and disseminates to the financial institutions relate to specific borrowers of such institutions. Being the custodian of such important information, BNM has already gazetted legislations to protect customers' confidentiality and to uphold banking secrecy provisions.

The banking institutions are required to observe banking secrecy under the Banking and Financial Institutions Act 1989 (BAFIA), and the Islamic Banking Act 1983 (IBA) in the case of Islamic banks. These laws essentially prohibit the banking institutions from divulging the affairs of their customers except in legally permitted circumstances, one of which is the reporting of information to the CCB, under section 43(2) of the BAFIA and section 19(1) of the IBA. The provisions restrict the use of the information to the purposes of the credit bureau, which as mentioned above, is largely to facilitate the credit risk assessment of borrowers. Thus, the credit bureau does not collect any information on the deposits of customers.

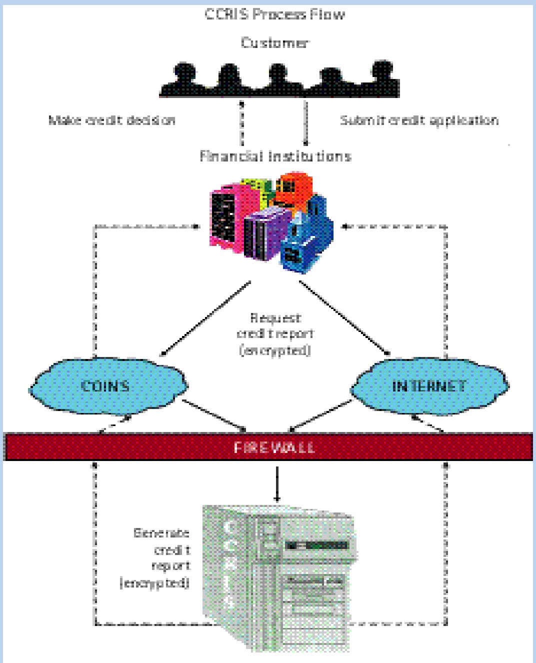
The provisions in the BAFIA and IBA are consistent with section 30 (1) (mmm) of the Central Bank of Malaysia Act. The latter provision establishes the CCB. At the same time, the provisions also imposes restrictions on the disclosure of information by the CCB. Specifically, the CCB is permitted to disclose information to only those financial institutions that report their loan customers to the CCB and such information disclosed shall be confidential between BNM and the financial institutions. Further to this, BNM, as a matter of policy, has established that the financial institutions can only access the information for legitimate credit evaluation purposes. The information is thus not freely available. It is also clear from the law that the credit bureau is not permitted to disclose information to any other third party.

The Central Credit Reference Information System (CCRIS)

BNM started a centralised credit database system in the late 1980s. The early systems were, admittedly, not technically efficient or user friendly and thus was limited in its usefulness to the financial institutions. Over the years, the system has undergone several upgrades to improve the quality and timeliness of the data as well as provide easier access to the users. The CCB currently maintains a database system known as the Credit Information System, or 'CRIS'. This system will be replaced by a more sophisticated and comprehensive system, known as the Central Credit Reference Information System (CCRIS) which will be implemented in July 2001.

The new system will enhance the capabilities of the CCB in terms of coverage of information and delivery of its services to financial institutions. CCRIS will capture and store credit information on all borrowers of the financial institutions as needed for the purposes of the credit bureau. This would include private individuals, businesses, corporations and the Government and its agencies. Information on new borrowers of the financial institutions will be captured at the loan application stage. The financial institutions are required to update the information regularly so that the integrity and accuracy of the data are assured. The information on customers captured in CCRIS would include the necessary identification references such as names, identity numbers, dates of birth or registration, and data on credit facilities taken by the customers, including information on the financial conduct of the facilities.

To improve the delivery of credit information to the financial institutions, accessibility to CCRIS by the financial institutions will be made available on an on-line basis. In this regard, the financial institutions may use the Internet or the private wide-area network between BNM and the financial institutions via the COINS (Corporate Information Superhighway). The salient features of CCRIS are given in the schematic diagram below:



Given that the financial institutions will be able to access the CCRIS database through the Internet, there will obviously be concerns on the security of the system. To ensure that the system will not be compromised by unauthorized access, a number of highly effective precautionary security measures have been taken. In this regard, the latest available smart card, data encryption and firewall technologies are being employed. All authorized users from the financial institutions will have to be registered with BNM. To deter abuse of access privileges, the system will contain extensive audit trails that will be closely monitored for potential breaches of confidentiality.

Conclusion

The role of the CCB will be significantly enhanced by the enlarged scope of the new database in the CCRIS, when it is completed. Credit information that is required by the financial institutions for effective evaluation of the credit risk of all potential and existing customers will be more comprehensive and efficiently delivered to these institutions. From a broader perspective, the CCB and CCRIS will help to develop a sound credit culture in the financial system. The country as a whole will benefit from such a development as credit should be rightfully channeled to the more credit-worthy sectors of the economy, thus reducing the risk to financial institutions and ultimately ensuring the stability of the financial system. While pursuing this objective is highly desirable, the concerns for confidentiality of information and the privacy of individuals should not be compromised. BNM in its management of the credit bureau and the legal framework in establishing the boundaries of the credit bureau have ensured the balance between the two competing needs.

the purview of CDRC has been relatively slower given the following factors:-

(i) Larger number of creditors involved in the debt restructuring exercises;

(ii) The need to obtain 100% consensus from the parties involved; and

(iii)The lacklustre performance of the capital markets in recent months, resulting in difficulties for some borrowers to implement their debt restructuring schemes.

To benefit and strengthen the economy in the long run, CDRC also played a pivotal role in driving the restructuring of the public transportation industry. The debt restructuring scheme for the public transportation industry has been finalised and will be implemented in the near term. CDRC has also completed its study on the restructuring of the steel and telecommunication industries and the options to address the various issues concerning the industries are being considered.

Performance of the Banking System

Profitability

Reflecting the strong economic performance in 2000 and higher lending activities, the banking system recorded a significant increase of 107.5% in pre-tax profit to RM9.7 billion for the calendar year 2000, from the RM4.7 billion recorded for the year 1999. This surpassed the level of pre-tax profit recorded in 1997 of RM7.7 billion, providing further testimony that the banking system has recovered fully from the Asian crisis. Consequently, the return on average assets and equity increased significantly to 1.5% and 20.4% respectively.

Notably, finance companies and merchant banks have turned around from the loss making position last year to record pre-tax profits of RM1.9 billion (+306.7%) and RM0.6 billion (+441.8%) respectively. The pre-tax profits of the commercial banks rose further by 23.5% to RM7.1 billion. The lower growth rate reflected the high extraordinary gains made by a commercial bank in 1999, which was later merged in 2000.

The higher level of profitability is primarily due to higher net interest income (+RM3.7 billion or +24.7%) and lower provisioning levels (-27.4%). The net interest income rose in 2000 as interest expense experienced a larger decline (-18.5%) compared to the

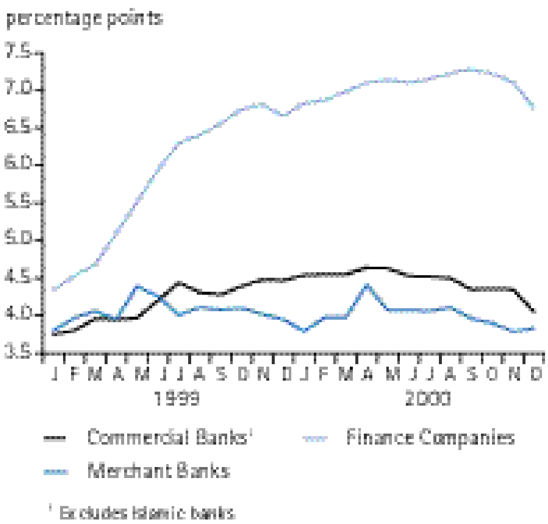
Table 4.6
Banking System[1]: Income and Expenditure

	For the calender year			
	1999	2000*p*	Annual change	
	RM million			%
Interest income net of interest-in-suspense	39,883	38,944	–939	–2.4
(interest in suspense)	*5,249*	*4,977*	*–272*	*–5.2*
Less: Interest expense	25,010	20,394	–4,616	–18.5
Net interest income	14,873	18,550	3,676	24.7
Add: Non-interest income	6,079	6,721	643	10.6
Less: Staff Costs	3,663	4,620	957	26.1
Overheads	4,178	4,849	671	16.1
Profit before provisions	13,111	15,802	2,691	20.5
Less: Loan loss provisions	8,451	6,133	–2,318	–27.4
Pre-tax profit	4,660	9,669	5,009	107.5
of which:				
Commercial banks	5,775	7,133	1,358	23.5
Finance companies	–943	1,949	2,892	306.7
Merchant banks	–172	587	759	441.8
Return on assets (%)	0.7	1.5		
Return on equity (%)	9.8	20.4		

[1] Excludes Islamic banks.
p Preliminary

decline in gross interest income (-2.4%). The RM4.6 billion decline in interest expense was mainly attributable to lower interest paid on deposits (-RM3.4 billion or -18.4%) in spite of the 25 basis points increase in deposit rates in August 2000 and increase in total deposits

Graph 4.6
Net Interest Rate Margins

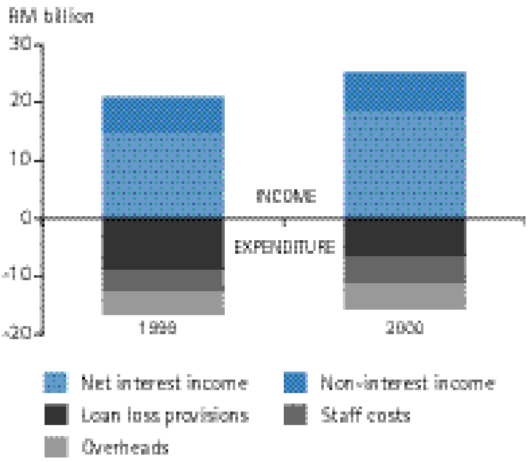


(+RM15.9 billion or +3.5%). However, the increase in deposits was concentrated in short-term fixed deposits with original maturities of less than one year (+RM10.8 billion or +5.9%) while deposits with maturities of one year or more declined by RM4.4 billion. The decline of RM1.2 billion in gross interest income was wholly due to lower income received from loans extended (-RM1.2 billion), partly offset by an increase of RM0.4 billion in interest income from holdings of debt securities. Although lending activities have improved during the year, the lower interest income was attributed to a general decline in lending rates. The finance companies benefited from the increase in the new fixed rate hire purchase financing which generates higher interest margin during the first few years of the loan tenure.

The non-interest income of the banking system increased by RM0.6 billion or 10.6% in 2000 to RM6.7 billion. This was mainly due to fee income that increased by RM0.5 billion or 17.8% in year 2000 to RM3 billion. As the trend towards greater disintermediation will intensify, banking institutions are expected to focus more on the provision of value added fee-based services to complement traditional fund-based income.

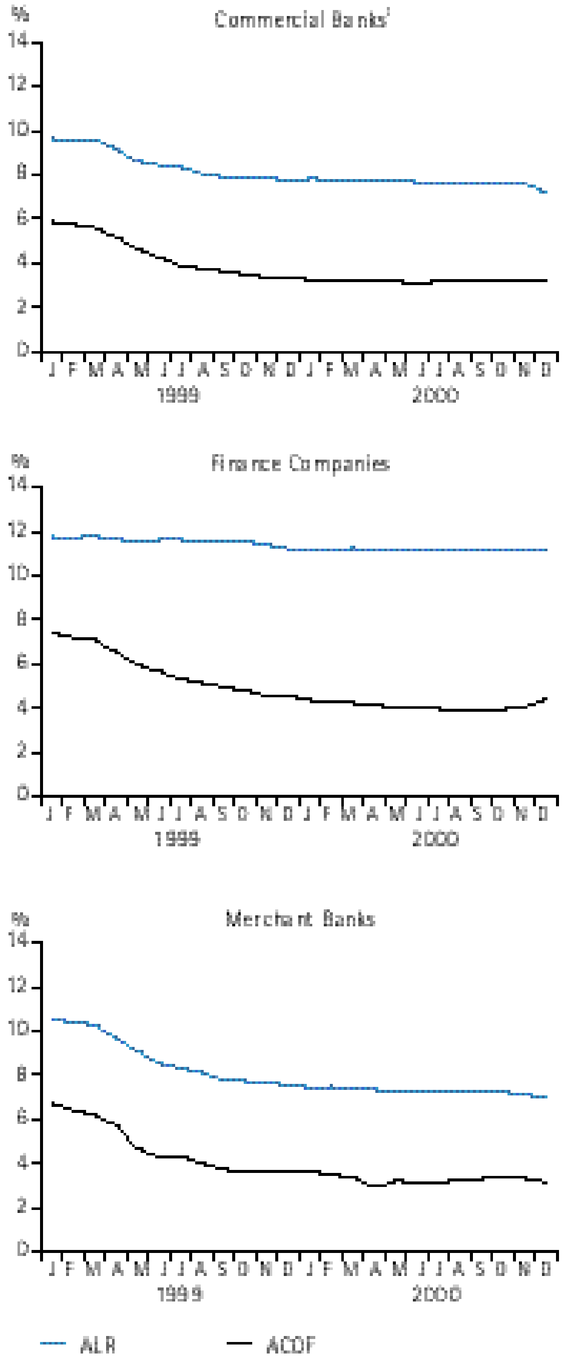
The reduction of loan loss provisions during the year also contributed to the increase in profitability. Only RM6.1 billion was charged in year 2000, which was 27.4% or RM2.3 billion less than the amount provided in the previous

Graph 4.7
Banking System[1]: Profitability



[1] Excludes Islamic banks

Graph 4.8
Average Lending Rates and Average Costs of Funds



[1] Excludes Islamic banks

Note: ALR includes interest which have been suspended and penalty interest on NPLs.
ACOF excludes the costs of overheads, statutory reserves and liquid asset requirements.

year. The lower provisioning was mainly due to reductions to specific provisions as the NPL level stabilised at around RM50 billion during the year and the inflow of new NPLs moderated significantly. The improved profitability also allowed the banking institutions to build up general provisions. General provisions charged rose by RM365 million or 144.8% to RM617 million in year 2000.

Staff costs increased by 26.1% in 2000 to RM4.6 billion following the upliftment of the wage moratorium. Concurrently, overheads rose by 16.1% to RM4.8 billion partly due to merger related costs.

Productivity levels also improved in tandem with the higher profits earned. Pre-tax profit per employee increased from RM49,500 in 1999 to RM104,400 in 2000. The cost to income ratio has also improved significantly from 59.2% in 1999 to 36.8% in 2000.

Loan Activity

As the pace of economic growth gained greater momentum during 2000, demand for financing continued to register an upward trend, resulting in higher rates of loan approvals and disbursements during the year. New loans approved by the banking system rose during the year by 26.7% to RM131.7 billion, while disbursements of approved credit facilities rose by 12.6% to RM357.3 billion in 2000.

During the early stages of the economic recovery in 1999, most of the financing was

Table 4.7
Banking System[1]: Financing Activities

	For the year		Annual Growth
	1999	2000	
	RM billion		%
Loan approvals	104.0	131.7	26.7
Loan disbursements	317.4	357.3	12.6
Loan repayments	331.9	345.0	4.0
	As at end		Annual Growth
	1999	2000	
	RM billion		%
Outstanding loans[2]	424.5	446.3	5.1
Adjusted outstanding loans[3]	424.5	453.4	6.8
Adjusted total financing for the economy[4]	502.9	554.2	10.2

[1] Excludes Islamic banks.
[2] Includes loans sold to Cagamas and Danaharta.
[3] Outstanding gross loans, adjusted for loans sold to Cagamas and Danaharta as well as loans written-off and conversions.
[4] Outstanding gross loans, adjusted for loans sold to Cagamas and Danaharta, loans written-off and conversions, and outstanding private debt securities.

extended to finance trade activities, which were mainly short-term in nature. This resulted in a higher rate of turnover and flat or even negative growth in outstanding loans. As the excess capacity in certain industries began to diminish in 2000, longer-term loans extended to finance investments for capacity enhancement began to pick up during the year. As a result, loan repayments registered only a marginal increase of 4% totaling RM345 billion in 2000 compared with RM331.9 billion in 1999. Consequently, outstanding loans of the banking system, including loans sold to Cagamas and Danaharta, rose by 5.1% to RM446.3 billion as at end-2000. Including loans written-off and loan conversion into equity, total outstanding loans increased by an annual rate of 6.8%.

No minimum loan growth target was set for the year 2000 by Bank Negara Malaysia. To encourage banking institutions to extend loans to further strengthen the economic recovery, the Government accorded tax incentives for those banking institutions that registered an annual loan growth of 10% or more for the calendar year 2000. For these institutions, net interest income from loans and business income derived from Islamic financing activities in excess of 8% would be exempted from taxable income. Approximately 25 banking institutions (including two Islamic banks) were eligible for the tax incentives.

As in the previous year, a significant amount of funds were approved to finance the purchase of residential properties (18.7% of total approvals in 2000). Loans approved for this purpose rose by 20.8% over the amount approved in 1999. Of the total loans approved for the purchase of residential properties, 72.6% was approved for the purchase of residential properties priced RM250,000 and below. New loans approved to the manufacturing sector increased by 47.3% to RM20.8 billion accounting for 15.8% of total loans approved in 2000. The low interest rate regime amidst improved consumer and investor sentiments stimulated greater demand for hire purchase financing as reflected in higher car sales. New financing extended to finance purchase of transport vehicles rose by 47.5% to RM17.9 billion or 13.6% of total new loans approved during 2000.

The increase in loan disbursements during the year was mainly attributed to the large drawdowns by the manufacturing sector, which accounted for 26% (RM93 billion) of total disbursements. Another 17.5% (RM62.7 billion) was disbursed to the wholesale, retail, restaurant and hotel sector. Disbursements to the broad property sector accounted for 18% (RM64.4 billion) of total disbursements in 2000, the bulk of which (75.8% or RM48.8 billion) were channeled for the purchase of residential properties and to the construction sector. Analysis of the repayment pattern by sector also revealed that the highest repayments (26.3%) were received from the manufacturing sector as cash flows improved in tandem with buoyant economic activities and strong export performance. Another 17.7% (RM60.9 billion) were repayments by the wholesale, retail, restaurant and hotel sector.

Funds raised through the bond market rose markedly in 2000 as issuers took advantage of the prevailing low interest rates to raise long-term funds and lock-in the low interest cost. During the year, a total of RM26.9 billion of new private debt securities (PDS) were issued. As a result, outstanding PDS expanded by 28.8% in 2000 to RM100.8 billion as at end-2000. Taken together, total outstanding loans (adjusted for loans written-off and loan conversions) and outstanding PDS registered an annual growth of 10.2% to RM554.2 billion at end-2000.

The loan portfolio of the banking system, generally remained well diversified. Mortgage lending for residential properties and to the manufacturing industry accounted for 17.5% and 15.0% of total outstanding loans as at end-2000 respectively. Given that residential mortgages are secured against properties and historically have exhibited low incidence of NPLs, the exposure to residential properties is manageable and would not pose substantial risk to the banking system. Similarly, the high exposure to the manufacturing sector is well diversified within the various sub-segments and industries within the manufacturing sector itself.

In 2001, with the more modest economic outlook projected for the year, loan growth is expected to moderate slightly. The challenge would be to sustain private sector demand for new financing and ensure that SMEs continue to have access to financing.

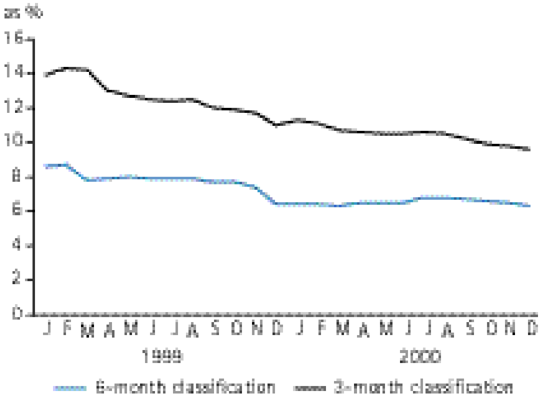
Asset Quality

The banking system experienced a lower level of NPLs in 2000 compared with the level experienced in 1999. The net NPLs ratio on a 6-month classification basis remained relatively stable throughout 2000, moving within a narrow band of 0.5 percentage points (fluctuating between 6.3% – 6.8%) before settling at 6.3% as at end-December 2000. This was 10 basis points lower than the level of 6.4% recorded as at end-December 1999. Although gross NPLs rose by 3.5%, interest-in-suspense rose by 21.5% to RM8 billion. Excluding interest-in-suspense, the principal NPLs increased marginally by RM0.2 billion or 0.5% to RM39.8 billion as at end-December 2000.

Based on the 3-month classification policy, the gross outstanding NPLs declined by 3.5% to RM62.5 billion as at end-December 2000. Similarly, excluding interest-in-suspense, NPLs on a 3-month basis declined by a wider margin of 6.4% to RM53.9 billion. NPLs excluding specific provisions and interest-in-suspense, declined by 8.6% to RM36.7 billion. Consequently, net NPL ratio improved significantly during the same period from 11% to 9.6% as at the end of 2000.

Total outstanding loans in arrears are also on a declining trend, especially those in the 2 to less than 3 months and between 3 to less than 6 months buckets. Loans which are between 3 to less than 6 months in arrears have declined significantly by 22.7% from RM16.8 billion as at end-December 1999 to RM13 billion as at end-December 2000. Loans which are between 2 to

Graph 4.9
Banking System[1]: Net Non-performing Loans Ratio



[1] Excludes Islamic banks

Table 4.8
Banking System[1]: Non-performing Loans and Loan Loss Provisions

	As at end					
	1999			2000		
	Actual[2]	Classification		Actual[2]	Classification	
		3-month	6-month		3-month	6-month
	RM million					
Commercial banks						
General provisions	6,306.5	6,311.8	5,203.6	6,366.9	6,338.8	5,216.6
Interest-in-suspense	4,591.9	4,737.6	4,181.7	5,597.7	5,697.3	5,281.4
Specific provisions	11,070.6	11,399.1	10,085.6	11,268.2	11,436.1	10,437.7
Non-performing loans	33,451.4	40,267.1	29,182.6	35,441.9	40,640.9	31,329.5
Net NPL ratio (%)[3]	*6.5*	*8.8*	*5.4*	*6.4*	*8.1*	*5.3*
Total provisions / NPL (%)	*65.7*	*55.7*	*66.7*	*65.6*	*57.8*	*66.8*
Finance companies						
General provisions	1,441.6	1,211.0	1,258.8	1,670.6	1,664.2	1,680.5
Interest-in-suspense	1,989.5	2,098.9	1,985.3	2,343.3	2,475.5	2,225.6
Specific provisions	5,270.2	4,975.6	5,275.1	4,765.1	4,929.5	4,439.0
Non-performing loans	14,415.2	19,073.4	13,570.5	14,255.4	17,725.3	13,481.5
Net NPL ratio (%)[3]	*9.7*	*16.3*	*8.6*	*9.3*	*13.4*	*8.8*
Total provisions / NPL (%)	*60.4*	*43.4*	*62.8*	*61.6*	*51.2*	*61.9*
Merchant banks						
General provisions	415.4	406.7	407.6	396.0	355.3	355.8
Interest-in-suspense	481.2	520.8	441.0	505.6	566.3	520.9
Specific provisions	1,086.5	1,003.7	882.8	819.2	810.4	780.5
Non-performing loans	3,764.5	5,589.9	3,487.5	3,018.4	4,289.7	3,059.6
Net NPL ratio (%)[3]	*12.7*	*23.4*	*12.3*	*10.5*	*18.2*	*10.9*
Total provisions / NPL (%)	*52.7*	*34.5*	*49.6*	*57.0*	*40.4*	*54.2*
Banking system						
General provisions	8,163.5	7,929.5	6,870.0	8,433.5	8,358.2	7,252.9
Interest-in-suspense	7,062.6	7,357.3	6,608.0	8,446.7	8,739.1	8,027.9
Specific provisions	17,427.2	17,378.3	16,243.6	16,852.5	17,176.1	15,657.2
Non-performing loans	51,631.1	64,930.3	46,240.6	52,715.7	62,655.8	47,870.7
Net NPL ratio (%)[3]	*7.4*	*11.0*	*6.4*	*7.1*	*9.6*	*6.3*
Total provisions / NPL (%)	*63.2*	*50.3*	*64.3*	*64.0*	*54.7*	*64.6*

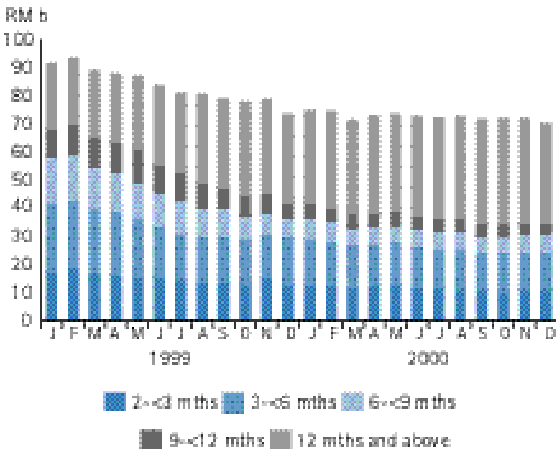
[1] Excludes Islamic banks.
[2] Loans classified as NPL based on individual banking institution's NPL classification policy i.e. 3-month or 6-month classification.
[3] Net NPL ratio = (NPL less IIS less SP) / (Gross loans less IIS less SP) x 100%.

less than 3 months in arrears declined by 14.8% from RM13.3 billion as at end-December 1999 to RM11.3 billion as at end-December 2000. In aggregate, loans which are 2 to less than 6 months in arrears accounted for only 5.9% of total outstanding gross loans as at end-December 2000.

Further analysis shows that in aggregate, loans which are 2 or more months in arrears (net of interest-in-suspense and specific provisions) as a percentage of net loans have declined from 13.8% of total loans as at end-December 1999 to 12% as at end-December 2000. In addition, past due loans have also exhibited a declining trend, suggesting that there are fewer new incidences of loans becoming non-current.

The periodic stress tests conducted on banking institutions indicated that under the most stringent assumptions and worst case scenario, the risk-weighted capital ratio of the banking sector would not fall below 10%. Total outstanding loan loss provisions of banking system rose by 4.1% during the year, which has further improved the loan loss coverage of the banking system marginally from 64.3% as at end-December 1999 to 64.6% as at end-December 2000. Including the value of collateral, the level of loan loss coverage would be 149%. In addition, NPL indulgence granted as an incentive to accelerate the debt restructuring process under the Corporate Debt Restructuring Committee, amounted to only 1.2% of total loans. Therefore, the expiry of the indulgence beginning 2001 will not cause the NPLs levels to increase significantly. Furthermore, most banking institutions have adopted a conservative stance on these loans by suspending interest income on such loans and

Graph 4.10
Banking System[1]: Ageing Profile of Loans in Arrears



[1] Excludes Islamic banks

progressively setting aside specific provisions against them.

With the economy expected to grow at a slower pace in 2001, any potential increase in NPLs can be absorbed by the banking institutions and will not threaten the stability of the banking system. Stress tests are conducted on a regular basis to ensure that any potential or emerging problem will be addressed promptly so as to ensure that financial stability is maintained and the intermediation process continues to function effectively.

In terms of economic sector, the bulk of the banking system's NPLs remained concentrated in the manufacturing sector. NPLs in the manufacturing sector grew by 5.6% in 2000. However, the level of NPLs in the manufacturing sector remained manageable, accounting for 14.1% of loans to the sector. The NPLs in the sector were mainly concentrated on loans granted to the SMEs. A number of measures have therefore been introduced to assist the SME borrowers, such as the Enterprise Programme for SMEs, the Rehabilitation Fund for Small and Medium Industries and the Bumiputera Entrepreneur Project Fund (see Monetary Measures in Chapter 2). The Credit Guarantee Corporation

Table 4.9
Banking System[1]: Non-performing Loans by Sector

	As at end				
	NPL by sector		Change	As percentage of total loans to sector	
	1999	2000	1999/2000	1999	2000
	RM million		%		
Agriculture, hunting, forestry and fishing	690.6	702.5	1.7	7.8	6.4
Mining and quarrying	230.5	210.3	–8.8	16.2	14.7
Manufacturing	8,273.0	8,733.0	5.6	13.8	14.1
Electricity, gas and water supply	102.1	252.9	147.8	1.4	3.3
Wholesale and retail, restaurants and hotels	4,272.7	4,678.5	9.5	12.3	13.1
Wholesale trade	*1,960.1*	*2,007.6*	*2.4*	*10.7*	*10.3*
Retail trade	*1,276.1*	*1,300.5*	*1.9*	*12.0*	*11.9*
Restaurants and hotels	*1,036.5*	*1,370.4*	*32.2*	*17.4*	*26.4*
Broad property sector	18,949.7	20,666.5	9.1	13.5	14.0
Construction	*8,027.0*	*7,925.1*	*–1.3*	*21.4*	*22.8*
Purchase of residential property	*4,436.1*	*5,055.3*	*14.0*	*7.3*	*7.1*
Purchase of non-residential property	*3,447.5*	*4,132.4*	*19.9*	*12.6*	*15.5*
Real estate	*3,039.2*	*3,553.7*	*16.9*	*20.3*	*24.0*
Transport, storage and communication	2,082.0	1,917.6	–7.9	15.0	16.8
Finance, insurance and business services	4,192.7	3,029.6	-27.7	13.5	9.6
Consumption credit	6,508.0	6,260.7	–3.8	12.5	10.4
Personal uses	*1,619.2*	*1,885.2*	*16.4*	*12.5*	*14.6*
Credit cards	*275.2*	*377.8*	*37.3*	*5.1*	*5.1*
Purchase of consumer durable goods	*189.5*	*80.3*	*-57.6*	*20.8*	*10.1*
Purchase of transport vehicle [2]	*4,424.1*	*3,917.4*	*–11.5*	*13.4*	*10.0*
Purchase of securities	4,746.0	4,580.6	–3.5	19.1	18.8
Community, social and personal services	751.0	754.5	0.5	10.8	12.4
Others	832.8	928.9	11.5	9.3	8.2
Total	**51,631.1**	**52,715.7**	**2.1**		

[1] Excludes Islamic banks.
[2] Includes commercial vehicles.

has also been restructured to enable it to play a more effective role in supporting and developing the SMEs.

The NPLs of the construction sector declined by RM101.9 million and accounted for 15% of total NPLs in the banking sector or 22.8% of total loans to this sector. Although the NPL ratio of the construction sector increased to 22.8% as at end-December 2000 from 21.4% as at end-December 1999, this was mainly due to the contraction in outstanding loans to this sector. As at end-December 2000, loans to the construction sector declined by 7.2%, as against the decline in NPLs to this sector of 1.3%. With the construction sector as a whole still projected to register a positive growth in year 2001, NPLs to this sector is expected to improve further.

As a result of the strong growth in the residential property sector, loans for the purchase of residential properties grew by 17.7% during the year 2000. NPLs to this sector, however, only increased by 14%, from RM4.4 billion as at end-1999 to RM5.1 billion as at end-2000. Consequently, the NPL ratio to this sector remained low at 7.1% of loans to this sector.

Despite the lacklustre performance of the stock market during the year, the gross NPLs for the purchase of securities recorded a decline of 3.5%. The NPL ratio of loans for the purchase of securities also declined from 19.1% of loans for the purchase of securities as at end-1999 to 18.8% as at end-2000. The improvement in asset quality for this sector could be attributed to investors holding the securities as long-term investments rather than for short-term speculative purposes.

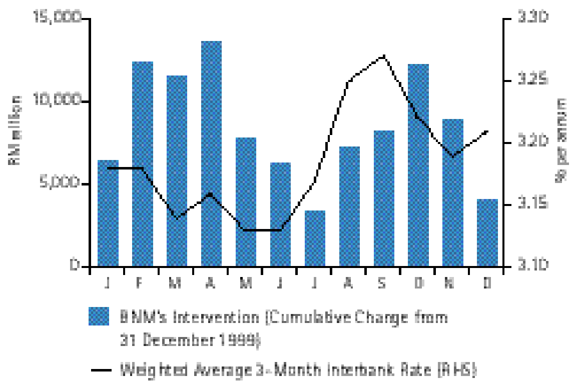
The country exposure of the banking institutions remained small and manageable, accounting for RM36 billion or only 5.6% of total assets of the banking system. Of these exposures, non-government guaranteed loans granted by overseas branches and subsidiaries of banking institutions accounted for RM16.9 billion or approximately 50% of total exposure. In addition, banking institutions' off-balance sheet exposure in terms of commitments extended and derivatives amounted to only RM13 billion. These assets comprise mainly letters of credit (RM6.9 billion) arising from trading transactions with Singapore, USA, Japan, Hong Kong, Taiwan, United Kingdom and the EU.

Liquidity Management

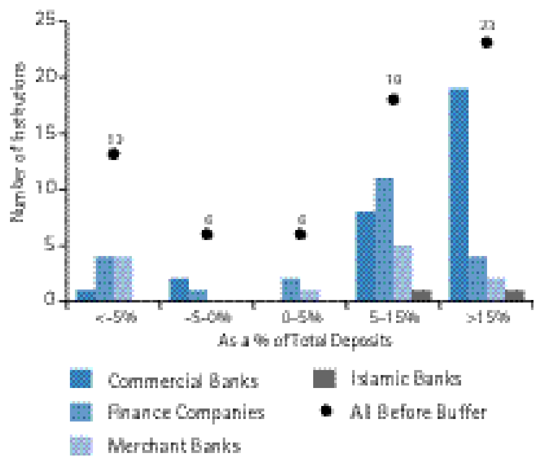
Liquidity in the banking system remained ample throughout the year 2000, driven mainly by the strong export performance that led to high trade surpluses. As a result, BNM intervened in the interbank market, allowing interest rates to settle at levels conducive to the domestic economic environment. The outstanding amount of BNM's intervention, in the form of interbank borrowings and issuance of Bank Negara Bills, increased from RM46.1 billion as at end-December 1999 to RM50.2 billion as at end-December 2000. As a result of the active liquidity management, interest rates were relatively stable throughout the year, with the 3-month weighted average interbank rate fluctuating within a tight range of 14 basis points, ending the year at 3.21% p.a. The average Base Lending Rate (BLR) for both commercial banks and finance companies also remained unchanged at 6.78% p.a. and 7.95% p.a. respectively.

The new Liquidity Framework, which became effective from 1 January 2001, encourages and nurtures best practices in liquidity management. This new framework gives recognition to an institution's strengths and weaknesses in managing liquidity. Throughout the year 2000, the banking system as a whole projected sufficient liquidity to meet any unexpected withdrawals for a period of up to one month. As at 31 December 2000, the banks had a cumulative liquidity surplus of RM8.6 billion to meet estimated liquidity demands of up to one week and a surplus of RM28.1 billion to meet demands of up to one month. The banking system as a whole had sufficient capacity to absorb shocks arising from volatility in deposits of up to

Graph 4.11
Liquidity in the Banking System in 2000



Graph 4.12
Banking System: Profile of Potential Liquidity Surplus/Shortfall up to One Month Ahead as at 31 December 2000



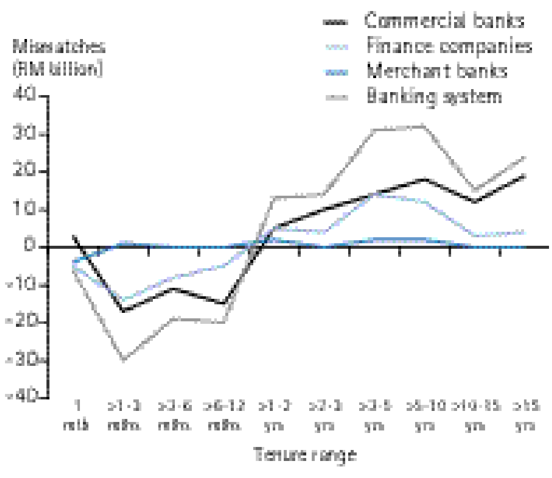
12% and 15% of total deposits in the one-week and one-month buckets respectively.

Interest Rate Risk

Reflective of the nature of banking activities and the lack of long-term hedging instruments in the market, the interest rate exposure of banking institutions continued to exhibit a negative gap position for the shorter-term maturities not exceeding one year, denoting a net liability position. In contrast, the medium and longer-term tenures of one year and more portrayed a positive gap position.

The negative gap position in the shorter-term maturity bucket arises from the maturity mismatch in the asset and funding profile of the banking institutions. Typically, a significant proportion of the asset portfolio of a banking institution comprises loans, which have medium to long-term maturities exceeding one year, which are mainly funded by shorter-term deposits, not exceeding six months maturity. The positive gap in the medium to longer-term maturities is typically driven by holdings of debt securities in their investment portfolio as well as for liquidity purposes. The negative gap position in the shorter-term maturity bucket, therefore, may result in losses, should interest rates swing upwards.

Graph 4.13
Banking System[1] : Net Interest Rate Position Mismatches as at 31 December 2000



[1] Excludes Islamic banks

While efforts have been focused at extending the funding base of banking institutions especially for the medium to longer-term tenure, the market for long-term instruments remains relatively underdeveloped in terms of liquidity and depth. Other than sourcing from Cagamas, the lack of sufficient funding instruments for the longer tenures restricts the ability of banking institutions to hedge their positions.

To quantify the potential amount of loss arising from movement in interest rates across all maturity spectrums, the duration concept can be employed. Specifically, the duration-weighted net position measures the potential estimated loss in the economic value of the banking institution's positions, both on- and off-balance sheets, resulting from a one percentage point shift in interest rate. Given the maturity profile, the primary source of interest rate risk can be expected in the 3 to 10 years maturity bucket, which exhibited the highest duration-weighted net position of RM2.7 billion, representing 43% of the approximated total duration-weighted net position of the banking system. The commercial banks registered the highest exposure of RM1.5

Table 4.10
Banking System[1]: Impact of 1% Rise in Interest Rate on Profitability and Balance Sheet

	Duration-weighted net position		
		As a percentage of	
	RM million	Capital base (%)	Balance sheet size (%)
Commercial banks[1]	–4,250.8	–10.3	–0.9
Finance companies	–1,787.6	–20.1	–1.6
Merchant banks	–248.6	–5.6	–0.7

[1] Excludes Islamic banks.

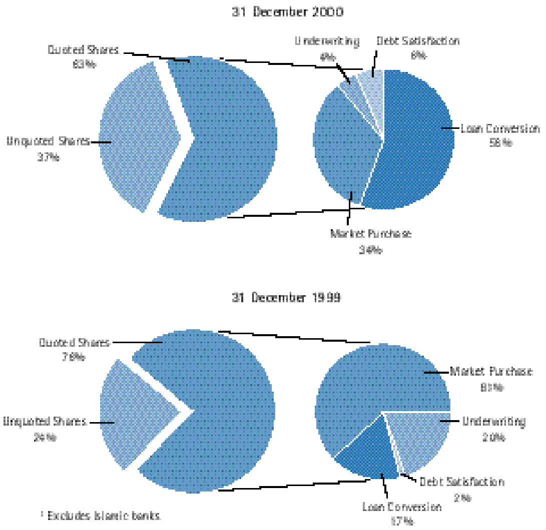
billion, followed by RM1.1 billion for the finance companies and RM0.2 billion for the merchant banks. The large exposure of the finance companies is by virtue of its medium-term fixed rate hire purchase financing totaling RM36.5 billion, which accounts for 43% of its total loan portfolio. Meanwhile, the exposure of the commercial banks and merchant banks in the 3 to 10 years tenure is attributed to holdings of fixed-rate debt securities amounting to RM15.1 billion or 25% of total holdings of fixed-rate debt securities. In terms of currency, almost the entire exposure involves ringgit positions, whilst exposure in foreign currencies is negligible.

Interest rate risk, aside from credit risk, is the other major source of risk, which can potentially have an adverse impact on the profitability and balance sheets of banking institutions. The resilience of banking institutions against movements in interest rate can be measured against the size of the approximated aggregate duration-weighted position to the capital base and total assets, respectively. Within the banking sector, the finance companies as a group has the largest exposure to interest rate risk, in view of the nature of finance company business. A one percentage point increase in the interest rate can erode the capital base of finance companies by 20.1%. This exposure is much higher than that recorded as at end-December 1999 of 12.9%, due to the double-digit growth (23.9%) in its hire purchase financing. In tandem with the expansion in outstanding loans, the impact of interest rate mismatch on capital base for the commercial banks and merchant banks also increased to 10.3% and 5.6% respectively as at end-2000. In terms of balance sheet sensitivity to interest rate movements, a one percentage point shift in interest rate will change the balance sheet value by 0.9% for the commercial banks, 1.6% for the finance companies and 0.7% for the merchant banks.

Equity Risk

Investments in quoted shares of the banking system increased by RM883 million or 130.4% during the year to RM1.6 billion at the end of December 2000. Other than equity investments in the form of direct acquisition from the market (34%), a significant part of the shares held were as a result of loan conversions and debt satisfaction (62%). Consequently, 86.5%

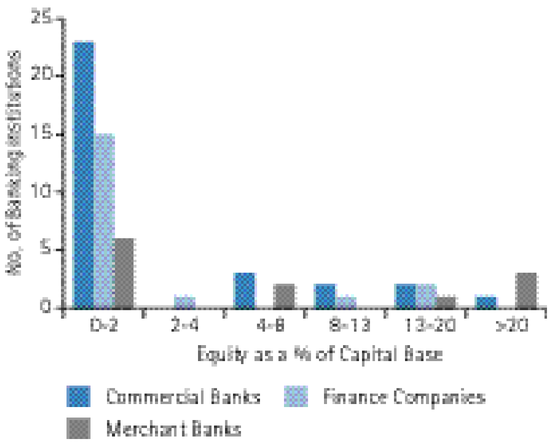
Graph 4.14
Banking System[1]: Composition of Equity Investments



[1] Excludes Islamic banks

(+RM763 million) of the increase was attributed to debt conversions, which mostly took place during the first half of the year. The proportion of shares held as a result of underwriting commitments, on the other hand, declined substantially from 20% at the end of 1999 to 4% of quoted shares held, as most of the shares held were disposed during the year. The upward trend of the Kuala Lumpur Composite Index (KLCI) during the first two months (the KLCI peaked at 1,013 points in February 2000) and with the KLCI settling at above the 800 level, direct equity acquisitions by banking institutions during the first half of the year increased significantly by 49%. The growth rate however,

Graph 4.15
Banking System[1]: Distribution by Equity as a Percentage of Capital Base as at 31 December 2000



[1] Excludes Islamic banks

Table 4.11
Banking System[1]: Equity Exposure

	Equity[2] position (RM million)		Equity[2]/Capital base (%)		Potential equity[2] loss/Capital base (%)	
	1999	2000	1999	2000	1999	2000
Commercial banks	259.1	836.9	0.6	1.9	0.1	0.2
Finance companies	174.0	417.3	2.1	4.6	0.4	0.5
Merchant banks	244.1	305.8	6.1	6.9	1.2	0.7
Banking system[1]	677.2	1,560.0	1.2	2.8	0.2	0.3

[1] Excludes Islamic banks.
[2] Refers to investments in quoted shares only.

moderated to 25.6% for the whole of the year 2000 in view of the downward pressure on the KLCI during the latter half of the year. Although total equity investments had increased substantially during the year, the outstanding equity holdings of the banking system remained insignificant, representing only 0.2% of total assets of the banking system. Similarly, although holdings of unquoted shares by the banking system soared by 333% during the year, the amount held of RM905 million is quite negligible as it accounted for only 0.1% of total assets of the banking system.

In terms of type of institutions, quoted shares held by the commercial banks recorded the highest growth rate of 223% (+RM578 million), while such investments by the finance companies and merchant banks rose by 140% and 25% respectively. The merchant banks had the highest exposure as their holdings of quoted shares accounted for 6.9% of their capital base, whilst equity exposures of commercial banks and finance companies accounted for 1.9% and 4.6% of their respective capital base. The equity exposure of the merchant banks increased marginally despite the lesser number of underwriting activities during the year as equity holdings from debt conversions rose. Holdings of equity arising from underwriting activities declined from 56% of total equity investment of the merchant banks as at end-1999 to 21% as at end-2000. In terms of individual banking institutions, four institutions had equity exposure exceeding 20% of their capital base.

Reflective of the less volatile market, the estimated potential decline in equity value based on a 10-day volatility of the KLCI during the year was only 10%. Given this volatility, the potential loss of the banking system resulting from the decline in KLCI has been estimated to be only 0.3% of the capital base despite the increase in total equity investments of the banking sector. Merchant banks had the highest equity risk of 0.7% given the small size of their capital base.

This is, however, much lower compared to the level of 1.2% recorded in 1999. On the other hand, the equity risk of commercial banks and that of the finance companies increased by 10 basis points to 0.2% and 0.5% respectively for the year 2000.

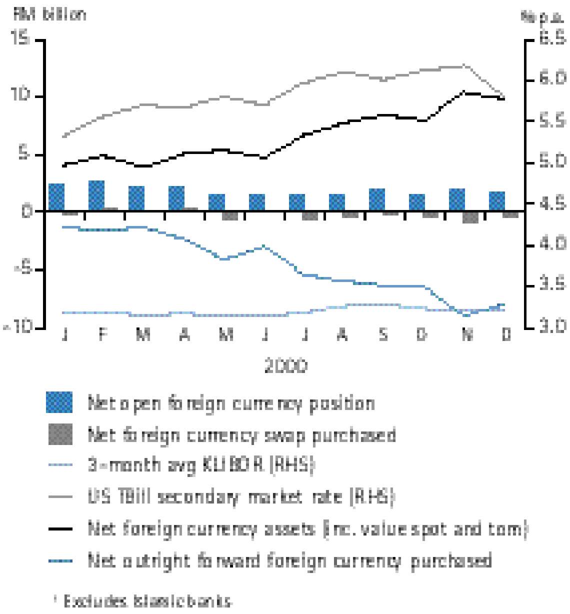
As the amount of equity investments by the banking institutions is small and is subject to prudential limits prescribed by BNM, movements in equity prices are not likely to adversely reduce the value of their equity holdings to an extent that can significantly impact the capital position of the banking system.

Foreign Exchange Risk

The banking system observed a declining trend in the net open foreign currency position, with an overall long position throughout the year. Net open foreign currency position declined by RM1.2 billion or -40% to RM1.8 billion as at end-2000.

Total holdings of foreign currency assets by banking institutions registered a strong increase of 17.7%, to take advantage of the higher USD interest rates, while the foreign currency liabilities remained stable. This resulted in a growth in net foreign currency assets of RM5.8 billion to RM10.5 billion as at end-2000. However, the rise

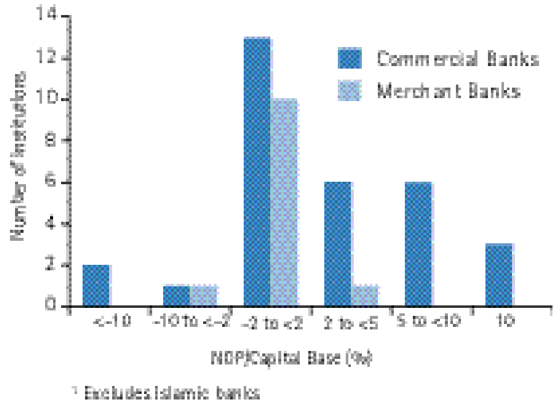
Graph 4.16
Banking System[1]: Foreign Currency Exposure



[1] Excludes Islamic banks

in net foreign currency assets was offset by a decline in forward contracts. Throughout the year, banking institutions were net sellers of foreign currency forwards. From the initial short position of RM0.8 billion as at end-1999, the net sale position of the banking institutions increased steadily to RM8.2 billion. The surge in demand for FX forwards is mainly driven by importers capitalising on the interest rate differential between the USD and Ringgit, by buying forward contracts for their foreign currency obligations and taking advantage of the forward discount. Meanwhile, banking institutions increased their foreign currency interbank placements, which

Graph 4.17
Banking System[1]: Distribution of Net Open Foreign Currency Position as at 31 December 2000



[1] Excludes Islamic banks

Table 4.12
Foreign Currency Mismatch as at 31 December 2000 (RM million)

	<1wk	1wk-<1m	1-<3m	3-<6m	6m-<1y	≥ 1y
Mismatch position	–3,644.6	–775.9	2,110.3	869.1	–888.1	1,867

rose by RM7.5 billion to RM22 billion as at end-2000, mostly for maturities of less than 3 months. The magnitude of the increase was more significant during the second half of the year in view of the widening interest rate differential between the domestic rates and US interest rates, following the increase in US Fed Rate during the year (February, March and May), totalling 100 basis points to 6.50% per annum.

Nevertheless, the net exposure to foreign currency risks of the banking institutions remained within prudential levels. As at end-2000, the net open foreign currency position of the commercial banks and merchant banks as a percentage of capital base stood at 4.2% and 0.4% respectively, as opposed to 6.8% and 2.3% as at end-1999. Eleven banking institutions out of 43 commercial banks and merchant banks had net open position to capital base in excess of 5%, of which five had a net exposure beyond 10%. The high foreign exchange exposures of the foreign-owned banks arose largely from back-to-back transactions with their overseas parents.

In terms of currency exposure, banking institutions are mainly exposed to the USD and SGD, reflective of large trade settlements in these currencies. In terms of foreign currency liquidity profile, there was preference towards maintaining negative mismatch position for a period of less than one month, while covering the mismatch with assets having maturities of between one to six months. With the shift towards an easing bias in monetary policy stance in the US and other countries, the spread between the domestic and interest rates abroad is expected to narrow, while the negative short-term mismatch position is expected to moderate.

Capital Strength

The improved profitability and domestic economic conditions further strengthened the capital position of the banking system with the risk-weighted capital ratio (RWCR) remaining above 12% during the calendar year against the

Table 4.13
Banking System[1]: Constituents of Capital

	As at end		Annual change	
	1999	2000		
	RM million		RM million	%
Tier-1 capital	44,954.8	48,889.0	3,934.1	8.8
Tier-2 capital	14,980.8	14,927.7	–53.1	–0.4
Total capital	59,935.6	63,816.7	3,881.1	6.5
Less: Investment in subsidiaries and holdings of other banking institutions' capital	5,521.0	7,647.2	2,126.2	38.5
Capital base	54,414.6	56,169.5	1,754.9	3.2
Risk assets:				
0%	121,707.4	118,145.9	–3,561.5	–2.9
10%	21,754.8	17,591.7	–4,163.0	–19.1
20%	103,923.0	101,363.3	–2,559.8	–2.5
50%	67,848.2	78,878.9	11,030.7	16.3
100%	381,651.6	395,552.7	13,901.1	3.6
Total risk-weighted assets	438,535.8	457,024.0	18,488.2	4.2
Risk-weighted capital ratio (%)				
Banking system[1]	**12.4**	**12.3**	**–0.1**	
Commercial banks	12.6	12.1	–0.5	
Finance companies	10.8	11.6	0.8	
Merchant banks	14.5	16.6	2.1	

[1] Excludes Islamic banks.

minimum requirement of 8%. The core capital ratio was equally strong throughout the year, never falling below 10.5%, far exceeding the internationally prescribed ratio of 4%.

Total tier-1 capital of the banking system increased by RM3.9 billion (8.8%) to RM48.9 billion as at end-2000. The increase was due to the higher level of profitability recorded by the banking system. Despite the repayment of Danamodal's capital injection amounting to RM810 million by 3 banking institutions, total tier-2 capital recorded only a marginal decline of RM53.1 million as it was offset by general provisions which rose by RM0.8 billion in 2000. Overall, total capital base increased by 3.2% or RM1.8 billion to RM56.2 billion.

Arising from stronger loan growth in the year 2000, total risk-weighted assets of the banking system increased by 4.2% or RM18.5 billion to RM457.0 billion as at end-2000. The expansion in risk-weighted assets came mainly from the 100% risk-weight category which rose by RM13.9 billion or 3.6% and the 50% risk-weight category (+RM11.0 billion or 16.3%) due to the continued expansion in mortgage financing.

By type of institution, the RWCR of the finance companies and merchant banks improved significantly during the year, from 10.8% as at end-December 1999 to 11.6% as at end-December 2000 and from 14.5% to 16.6% respectively. Overall, the banking system showed a declining RWCR from September until December 2000 due to losses recorded by several banking institutions which have an immediate impact on their capital position while profits recorded by other banking institutions are allowed to be included as part of capital only after they have been audited and approved by BNM. If such interim profits are included, the RWCR would increase from the reported 12.3% to 13.2%. The decline in the RWCR from 12.8% as at end-November 2000 to 12.3% as at end-December 2000 was also due to the completion of several merger transactions. The mergers resulted in a decline in the capital base of the banking system in December 2000 as the capital base of the acquired institutions are excluded while their risk-weighted assets are aggregated with their respective anchor banking institutions. The mergers also resulted in a significant increase in investment in subsidiaries which rose by RM2.13 billion or 38.5% in 2000 to RM7.65 billion. This partially offset the 8.8% increase in tier-1 capital during the year.

In line with the overall objective to strengthen the resilience of banking institutions and enhance the level of capitalisation of the banking system, the minimum capital funds unimpaired by losses for the domestic banking groups (comprising the commercial bank, finance company and merchant bank) was increased to RM2 billion. For the foreign-owned banking institutions, the minimum capital fund requirement was increased to RM300 million. All banking institutions have until 31 December 2001 to comply with the new capital requirement.

Islamic Banking

The Islamic banking sector registered a strong performance in tandem with the continued improvement in the Malaysian economy. The market share of Islamic banking assets in the banking system increased to 6.9% during the year from 5.5% in 1999, whilst Islamic banking deposits and financing constituted 7.4% and

Box IV

Banking Supervision

Introduction

Banking supervision plays a pivotal role in safeguarding the soundness and stability of the financial system. The primary objective of banking supervision is to promote a strong and stable financial system that is internally robust and able to cope with both internal and external shocks. The new millennium brings numerous challenges for banking supervisors. With the rapid development of financial and technological innovations, the very nature of banking functions, delivery and payment channels and their associated risks have altered dramatically.

The consolidation of the Malaysian banking industry with the emergence of larger financial conglomerates will also increase the scale, scope, span and general complexity of operations. The integration of markets and increasing globalization will further melt down borders and eventually lead to a more open economy which would intensify market competition. In the wake of this evolving landscape, banking supervisors need to be more innovative and forward looking in their supervisory strategies and processes.

Risk-based Supervision

BNM has continuously upgraded its supervisory techniques in tandem with these changes to better evaluate the increasingly complex risks assumed by the banking institutions. Snapshots of banking institutions are no longer adequate for supervisory evaluation as balance sheet positions change rapidly within a short period of time. The solution lies in ensuring that appropriate controls are in place and that risks are adequately managed to minimize repercussions.

This concept is encapsulated in the risk-based approach that emphasizes the need to assess the adequacy of risk management systems and controls and to identify weaknesses before they impact the financial performance and soundness of the banking institutions. Supervisory resources are thus, mainly allocated to evaluate the way banking institutions manage and control their risks as well as to ascertain whether the management fully understand and actively monitor these risks. To guide the banking institutions in developing their risk management processes, minimum guidelines have been issued on credit risk management, internet banking and derivatives, amongst others.

The risk-based supervisory approach encompasses the following :-

- Dynamic off-site surveillance for early detection of problems in banking institutions;
- Effective planning to customize on-site examinations in relation to the size and activities of banking institutions; and
- Concentration of supervisory resources on areas that expose banking institutions to high degree of risks.

Off-site surveillance focuses on analysis of financial data, ratios and trends covering the important areas of capital adequacy, asset quality, management, earnings performance and liquidity position of banking institutions. A key objective of risk-based supervision is to identify problems at an early stage. Towards this objective, BNM has put in place a more dynamic off-site surveillance system. This surveillance system provides rigorous financial and non-financial analysis of banking institutions for early detection of problematic institutions.

On-site examination processes have also been realigned to allow greater focus on assessing the type and extent of risks, banking institutions are exposed to. The emphasis is on the assessment of credit, market, liquidity and operational risk. This is performed through the employment of state of the art techniques which includes benchmarking of the systems in banking institutions against best practices. On-site examination under the risk-based approach is not confined to a fixed set of routine procedures. The procedures to be performed are adjusted depending on the circumstances of the institution being evaluated. Banking institutions with higher degree of risk are continuously monitored and subject to more regular and intense on-site examination.

Corporate Governance

The risk-based approach also provides a framework for improved assessment of the banking institutions' corporate governance. In carrying out this assessment, the following elements are reviewed:

- Adequacy of board and management oversight;
- Adequacy of policies and procedures;
- Adequacy of risk identification, measurement, monitoring and control process; and
- Comprehensiveness of internal audits and internal control system.

As part of improving the banking institutions' corporate governance process, BNM has issued the Guideline on Duties and Responsibilities of Directors and Appointment of Chief Executives. The objective of this guideline is to ensure that there is an effective Board of Directors to assume full responsibility for the overall management of the banking institution. It is also envisaged that as the internal audit function of banking institutions become more effective, greater reliance can be placed on the internal control system in promoting effective operations, financial and regulatory reporting, and helps to ensure compliance with laws, regulations and internal policies and procedures. In this regard, BNM has issued the Guideline on Minimum Audit Standards for internal auditors of banking institutions.

Impact of Macroeconomic Conditions on the Banking System

Even with sound prudential regulations in place, systemic instability may arise from changes in macroeconomic conditions. This includes adverse macroeconomic conditions, financial market volatility and external shocks such as the currency crisis in 1997. Banking institutions may also collectively misjudge the performance of certain sectors resulting in over concentration of exposure or excessive extension of credit.

With this in mind, mechanisms to monitor, inter alia, trends, concentrations and new risk areas in the banking system have been put in place so that appropriate preventive/remedial prudential action is taken to mitigate any possible negative impact on the financial system. An important mechanism put in place is the **stress testing of banking institutions** by the supervisors and the banking institutions themselves. This is done by factoring potential changes in macroeconomic conditions, financial markets and external developments to test the resilience of the banking system. Stress testing is invaluable for revealing the magnitude of portfolio at risk posed by more challenging macroeconomic conditions. As capital adequacy for the banking institutions is dependent on the underlying collateral values of the loan portfolios, any distortion of the collateral value can significantly affect the financial soundness of the banking institutions. The stress tests would therefore highlight the potential vulnerabilities of the banking system. This forward looking information is useful in the formulation of policies and implementation of pre-emptive actions to address potential problems both at the institutional and system level well before the problems become pronounced and thereby ensure the stability of the system.

On-Going Challenges Facing Banking Supervision

E- Banking

Although it is recognized that the basic types of risks associated with e-banking are not new, the specific way these risks arise as well as the potential magnitude and speed of impact on banks will be a new challenge for banking supervisors. The rapid change of technological innovations supporting e-banking, the increased degree of systems outsourcing and the reliance on the use of open networks such as the internet, will also require banking supervisors to further intensify the need for a rigorous and ongoing risk management process. To meet this challenge, enhanced technical training of existing supervisory staff, complemented by engaging outside expertise, will be a high priority to ensure the banking supervisors keep abreast with increasingly complex technology and market developments.

Consolidated Supervision

The consolidation of the banking industry and the emergence of more complex group structures require the development of an enhanced framework for consolidated supervision. The framework has to take into account financial conglomerates with component entities that have varying capital requirements and risk factors. Banking supervisors have to ensure that the health of the financial conglomerate can be assessed at a group-wide basis and not just at the institutional level. There is also a need to balance between allowing group synergies and efficiency and ensuring that the activities of the financial conglomerates do not introduce excessive systemic risks. A pre-requiste of the consolidated supervision framework is to ensure efficient sharing of information among the different regulatory bodies.

New Capital Accord

The implementation of the New Capital Accord currently being finalized will pose several challenges. The capital accord requires banks to develop their internal credit rating systems which will enable loan portfolios to be classified into risk classes of fine gradation and to use this classification for internal capital allocation, loan pricing and determination of loan loss reserves. The supervisors have the dual tasks of ensuring that banking institutions develop this rating system as well as equip themselves to be able to evaluate the adequacy and efficacy of the system. This is an on-going exercise and many of the banking institutions are already in the process of developing the rating system.

Cross-border Initiatives and Co-operation

Greater consultation and co-operation among supervisors of the various regulatory bodies and their international counterparts must be established, especially in areas involving cross-border supervisory issues and the formulation of regional best practices in banking supervision. BNM actively participates in international working groups, such as those established at the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP), South-East Asian Central Banks (SEACEN), South East Asia, New Zealand and Australia Central Banks (SEANZA) and Asia-Pacific Economic Co-operation (APEC) meetings. These groupings facilitate the sharing of experience, knowledge and most importantly, best practices among banking supervisors.

Conclusion

Banking supervision will remain vigilant in its efforts to proactively gear itself to deal with the challenges ahead and promote banking system stability. The focus will be on risk-based supervision, pre-emptive measures and closer cooperation with international and regional supervisory and regulatory agencies to promote sharing of experience, knowledge and best practices. Effective banking supervision is highly critical in upholding the well-being of a country's economic core and will serve to ensure that BNM's twin goals of financial and monetary stability are attained for the long-term prosperity and wealth of the nation. However, while banking supervision will provide the broad framework to ensure financial stability, the primary responsibility for the safety and soundness of individual banking institutions is with the board and management of each institution.

Table 4.14
Islamic Banking: Key Data

	As at end		Change (%)	
	1999	2000	1999	2000
Number of financial institutions	**52**	**49**	**6.1**	**-5.8**
Commercial banks	22	21	-12.0	-4.5
Finance companies	16	14	-11.1	-12.5
Merchant banks	5	5	–	–
Islamic banks	2	2	100.0	–
Discount houses	7	7	–	–
Total assets (RM million)	**36,136**	**47,068**	**65.3**	**30.3**
Commercial banks	15,589	20,094	33.6	28.9
Finance companies	4,806	7,150	41.6	48.8
Merchant banks	1,439	1,507	80.8	4.7
Islamic banks	11,724	14,029	97.5	19.7
Discount houses	2,578	4,288	–	66.3
Total deposits (RM million)	**24,804**	**35,923**	**50.6**	**44.8**
Commercial banks	10,576	16,091	13.8	52.1
Finance companies	3,033	5,393	-1.3	77.8
Merchant banks	401	867	49.8	116.2
Islamic banks	9,685	11,304	140.4	16.7
Discount houses	1,109	2,268	–	104.5
Total financing (RM millon)	**13,724**	**20,891**	**28.0**	**52.2**
Commercial banks	4,920	8,606	9.2	74.9
Finance companies	2,996	5,090	42.1	69.9
Merchant banks	778	769	84.8	-1.2
Islamic banks	5,030	6,426	37.8	27.8
Discount houses	–	–	–	–
Financing-deposits ratio (%)	**55.3**	**58.2**	**-15.0**	**2.8**
Commercial banks	46.5	53.5	-4.0	7.0
Finance companies	98.8	94.4	44.0	-4.4
Merchant banks	194.0	88.7	23.4	-105.3
Islamic banks	51.9	56.8	-42.7	4.9
Discount houses	–	–	–	–
Number of branches	**128**	**131**	**2.4**	**2.3**
Commercial banks	6	7	-14.3	16.7
Finance companies	2	2	-33.3	–
Islamic banks	120	122	50.0	1.7
Number of counters	**2,095**	**2,087**	**-21.5**	**-0.4**
Commercial banks	1,370	1,338	-15.4	-2.3
Finance companies	719	745	-6.1	3.6
Merchant banks	6	4	–	-33.3

5.3%, respectively. As at end-December 2000, the Islamic banking system had 49 players, comprising two Islamic banks and 47 conventional banking institutions participating in the Islamic Banking Scheme (IBS banking institutions). The IBS banking institutions consisted of 21 commercial banks, 14 finance companies, five merchant banks and seven discount houses. Upon completion of the merger exercise among the domestic banking institutions, the number of players will be 35, consisting of two Islamic banks and 33 IBS banking institutions (13 commercial banks, eight finance companies, five merchant banks and seven discount houses).

In year 2000 and early 2001, BNM took concerted steps towards ensuring that Islamic banking will not only play a more important role in the development of the Malaysian financial system, but also that its development addresses the consumer needs in Malaysia and the region. A significant milestone in the future development of Islamic banking was the launching of the financial sector master plan in March 2001, which incorporated the 10-year master plan for Islamic banking and takaful. The overall objective of the master plan for Islamic banking and takaful is to create an efficient, progressive and comprehensive Islamic financial system and to promote Malaysia as a regional financial centre for Islamic banking and finance. In this regard, the policy focus would be to enhance the capabilities of Islamic banking institutions (comprising the Islamic banks and the IBS banking institutions) to compete effectively and to increase significantly their market share in the financial system. The target is that Islamic banking would capture at least 20% of the banking market share by 2010. In addition, specific measures will be taken to develop the financial infrastructure and regulatory framework to support the expansion of the Islamic banking industry. A well developed financial infrastructure as well as an effective legal and Syariah framework will enhance Malaysia's position to become a leader in Islamic banking and finance in the Far East region. Within BNM, a specialised department, the Islamic Banking and Takaful Department, was established with the responsibility of formulating strategies and policies as well as regulating Islamic banking activities. The department will also be undertaking further measures to implement the recommendations outlined in the master plan for Islamic banking and takaful.

During the year, continuous efforts were made to support the expansion of the Islamic banking system. The measures and revisions made in the year 2000 were as follows:

(i) Islamic banking institutions were allowed to offer Islamic floating-rate financing products subject to approval by BNM. This is to enable the Islamic banking institutions to mitigate risks arising from asset and liability mismatches more effectively as well as to stimulate product innovation in the industry;

(ii) Amendments were made to the Guidelines on Islamic Negotiable Instruments (INI) in terms of pricing, issuance specification, maturity structure and standardization of market practices. These amendments would accord flexibility to Islamic banking institutions to structure the INI to meet their funding requirements as well as to fulfil diverse customer needs more effectively. It will also increase the supply of longer maturity Islamic financial instruments in the Islamic interbank money market (IIMM) and instill confidence among the players by promoting standard market practices; and

(iii) IBS commercial banks were allowed to offer Islamic leasing facility under the concept of Al-Ijarah Thumma Al-Bai, subject to the condition that the leasing facility is for financing industrial and heavy machinery equipment costing more than RM200,000.

A target set by BNM for each IBS banking institutions was the attainment of at least 5% of Islamic banking business in terms of assets, deposits and financing relative to total banking business of each IBS banking institutions by the end of year 2000. As at end-December 2000, five commercial banks, six finance companies and two merchant banks achieved the target for all the three specified components.

National Syariah Advisory Council

The National Syariah Advisory Council for Islamic Banking and Takaful (the Council) held five meetings during the year 2000. The total number of Council members increased to seven following the appointment of an additional member by BNM in October 2000. During the year, the Council deliberated on more than 20 Syariah issues in relation to the operations of Islamic banking and takaful. Their deliberations resulted in decisions on some major issues, including the following:

(i) Islamic banking institutions are allowed to incorporate the ibra' (rebate) clause in the financing agreement, provided that the clause is not treated as a condition for the transaction. The issue of gharar (uncertainty) in the transaction does not exist if the clause is documented clearly and specifically in the agreement;

(ii) Islamic banking institutions are not allowed to charge commitment fee for facilities such as Islamic overdraft and revolving credit facilities as it contravenes the principle of sale and purchase; and

(iii) Issuer banks are allowed to repurchase their own negotiable Islamic debt certificate (NIDC) prior to the maturity date. The repurchase price of the NIDC may be determined on a willing buyer willing seller basis.

Sources and Uses of Funds

The total assets of the Islamic banking sector increased by RM10.9 billion or 30% to RM47.1 billion as at end-2000 supported by the strong economic activity. A significant share of the

Table 4.15
Islamic Banking: Sources and Uses of Funds

	As at end			
	1999		2000	
	RM million	% share	RM million	% share
Sources:				
Capital and reserves*	2,026	5.6	2,526	5.4
Debentures and notes	–	...	–	...
Deposits [1]	24,804	68.6	35,923	76.3
of which:				
NIDs issued	*80*	*0.2*	*500*	*1.1*
Repos	*384*	*1.1*	*431*	*0.9*
Amount due to financial institutions	6,282	17.4	4,796	10.2
Domestic	*6,281*	*17.4*	*4,796*	*10.2*
Foreign	*1*	*...*	*–*	*...*
Bankers acceptances	198	0.5	597	1.3
Others	2,826	7.8	3,227	6.9
Total	**36,136**	**100.0**	**47,069**	**100.0**
Uses:				
Cash [2]	254	0.7	348	0.7
Reserve with BNM	482	1.3	724	1.5
Amount due from financial institutions	8,823	24.4	8,743	18.6
Domestic	*8,823*	*24.4*	*8,743*	*18.6*
Foreign	*–*	*...*	*–*	*...*
Investments	1,572	4.4	3,135	6.7
of which:				
Stocks and shares	*54*	*0.1*	*82*	*0.2*
Debentures	*1,335*	*3.7*	*2,808*	*6.0*
Fixed Assets	*173*	*0.5*	*245*	*0.5*
Foreign Investments	*–*	*...*	*–*	*...*
Placement with discount houses	1	...	–	...
Marketable securities	9,998	27.7	12,877	27.4
of which:				
Treasury bills	*–*	*...*	*–*	*...*
MGS	*124*	*0.3*	*357*	*0.8*
NIDs held	*50*	*0.1*	*212*	*0.5*
Cagamas bonds	*109*	*0.3*	*134*	*0.3*
Loans [3] (incl. trade bills)	13,724	38.0	20,891	44.4
Others	1,282	3.5	351	0.7
Total	**36,136**	**100.0**	**47,069**	**100.0**

[1] Includes NIDs issued and repos.
[2] Includes balances with BNM.
[3] Excludes house financing sold to Cagamas Berhad.
* Includes current unaudited unadjusted profit.

increase in assets amounting to RM7.2 billion or 66.1% reflected the financing extended by the Islamic banking institutions. Within the Islamic banking sector, the total assets of the IBS discount houses recorded a sharp increase of 66.3% in year 2000 due to a significant increase in the holding of Islamic debt securities of RM1.7 billion. The IBS finance companies also registered a sharp increase in assets growth of 48.8% in year 2000, owing to growth in financing, particularly in Islamic hire purchase. In terms of the overall Islamic banking market share, the IBS commercial banks remained the largest segment of the market with a market share of 42.7%, followed by Islamic banks (29.8%) and finance companies (15.2%).

Concomitant with the improved economic activity during the year, a major portion of funds in the Islamic banking sector continued to be sourced from deposits, which accounted for 76.3% of total resources. Total deposits recorded a strong growth of 44.8% (RM11.1 billion) to reach RM35.9 billion as at end-2000. The IBS commercial banks and the Islamic banks accounted for the major share of 76.3% of the total deposits in the Islamic banking sector (81.7% in 1999). Among the Islamic banking players, the IBS merchant banks recorded the highest growth rate in deposits of 116.2%, followed by the IBS discount houses with 104.5%. The rapid growth in deposits reflected the increasing confidence and acceptance by the public of Islamic banking as well as the competitiveness of Islamic banking in terms of rates of return to its customers and investors.

In terms of types of customers, the deposits were mainly sourced from the domestic non-financial private sector, comprising business enterprises, government and individuals, which accounted for 73.5% of the total deposits. Investment deposits continued to capture the bulk of deposits placed in Islamic banking, accounting for 84.6% of the increase in total deposits. During the year, current and savings deposits recorded growth rates of 22.1% and 32.5% respectively. In terms of the maturity profile of the investment deposits, 65.3% of the deposits were concentrated at the shorter end of the yield curve with one to three months maturity. The average rates of return for the investment deposits were in the range of 2.9% to 3.4% for placement of less than three months maturity and 3.5% to 4.7% for placement with maturity of one year and above. The lack of interest for longer tenure placements was attributable to the unattractive incremental return relative to the long-term risks.

Table 4.16
Islamic Banking: Deposits by Type and Institutions

	Annual change				As at end 2000
	1999		2000		
	RM million	%	RM million	%	RM million
Current deposits	**2,328**	**76.4**	**1,190**	**22.1**	**6,564**
Commercial banks	1,181	58.3	580	18.1	3,786
Islamic banks	1,147	112.3	610	28.1	2,778
Savings deposits	**464**	**22.7**	**817**	**32.5**	**3,327**
Commercial banks	–11	–1.1	567	56.0	1,580
Finance companies	110	62.5	145	50.7	431
Islamic banks	365	43.1	105	8.7	1,316
Investment deposits	**5,124**	**51.6**	**9,405**	**62.5**	**24,464**
Commercial banks	527	9.8	3,917	66.6	9,802
Finance companies	55	2.2	2,214	87.3	4,749
Merchant banks	–206	–33.9	129	32.2	530
Islamic banks	4,748	318.7	877	14.1	7,115
Discount houses	1,109	–	1,159	104.5	2,268
Other deposits	**–651**	**–46.3**	**814**	**108.0**	**1,568**
Commercial banks	–229	–32.7	451	95.6	923
Finance companies	191	909.5	–	–	212
Merchant banks	1	–	337	–	338
Islamic banks	–614	–89.9	26	37.7	95
Discount houses	–	–	–	–	–

The shareholders' fund of the Islamic banks and the Islamic banking capital fund of the IBS banking institutions improved significantly by RM500 million to RM2.5 billion as at end-2000. The increase was contributed mainly by the higher retained profits during the year. The profitability of the Islamic banking sector recorded an impressive growth, with total pre-tax profit reaching RM534.5 million during the year (RM355.3 million in 1999).

Total financing extended by the Islamic banking sector expanded by RM7.2 billion or 52.2% (RM3.1 billion or 28% in 1999). The financing-deposits ratio of the Islamic banking sector improved to 58.2% at end-2000 from 55.3% at end-1999. As in previous years, financing to the broad property sector remained significant at 54.7% of the total Islamic financing, followed by consumption credit (29.5%). The high demand for property sector financing was attributed to the rapid growth in financing for residential properties which constituted 29% of the total financing. Financing to agriculture and

Table 4.17
Islamic Banking: Direction of Lending

	As at end			
	1999		2000	
	RM million	% share	RM million	% share
Agriculture, hunting, forestry and fishing	497.7	3.6	1,577.7	11.5
Mining and quarrying	74.2	0.5	78.5	0.6
Manufacturing	1,216.9	8.9	2,044.3	14.9
Electricity, gas and water	213.8	1.6	855.6	6.2
Community, social and personal services	128.4	0.9	292.7	2.1
Broad property sector	6,164.0	44.9	7,506.3	54.7
Real estate	*521.0*	*3.8*	*363.1*	*2.6*
Construction	*1,367.2*	*10.0*	*1,572.0*	*11.5*
Purchase of residential property	*2,881.7*	*21.0*	*3,974.4*	*29.0*
Purchase of non-residential property	*1,394.1*	*10.2*	*1,596.8*	*11.6*
Wholesale, retail, restaurants and hotels	740.2	5.4	854.7	6.2
Transport, storage and communications	759.8	5.5	787.9	5.7
Finance, insurance and business services	632.8	4.6	595.7	4.3
Purchase of securities	747.1	5.4	705.0	5.1
Consumption credit	2,058.1	15.0	4,043.1	29.5
Credit cards	*1.7*	*...*	*1.4*	*...*
Personal uses	*211.8*	*1.5*	*340.2*	*2.5*
Purchase of consumer durables	*129.8*	*0.9*	*43.1*	*0.3*
Purchase of transport vehicles	*1,714.8*	*12.5*	*3,658.4*	*26.7*
Others	490.7	3.6	1,549.7	11.3
Total	**13,723.7**	**100.0**	**20,891.2**	**152.2**

electricity sectors recorded a sharp increase of 217% (RM1.1 billion) and 300.2% (RM641 million) respectively. The sharp increase was mainly due to the disbursement of several corporate financing to plantation and electricity-based companies.

Profitability

The Islamic banking sector recorded a pre-tax profit of RM534.5 million for calendar year 2000 as compared to RM355.3 million in 1999. Improved profitability enabled the sector to continue generating a positive rate of return on assets of 1.1% (1.0% in 1999) and a return on equity of 21.2% (17.5% in 1999) for the year. In line with the strong growth in total financing, the Islamic banking sector recorded an increase in net financing income of RM550 million at the operating level. The non-financing income of the Islamic banking sector increased by RM32 million or 18.7%.

Asset Quality

The asset quality of Islamic financing continued to improve during the year 2000. The non-performing financing (NPF) ratio declined to

Table 4.18
Islamic Banking: Non-performing Financing and Financing Loss Provision

	As at end	
	1999	2000
	RM million	
Islamic Banking		
General provisions	238	314
Income-in-suspense	110	163
Specific provisions	373	535
Non-performing financing (NPF)	**1,585**	**2,119**
Net NPF ratio (%)	8.15	7.04
Total provisions/NPF (%)	45.49	47.76

7.0% from 8.2% in 1999. The decline in the NPF ratio was attributed to the significant increase in the total financing during the year, which more than offset the increase in NPF absolute amount of RM534 million. With the increase in total financing and NPF, the total provision set aside in 2000 increased slightly to 47.8% of NPF, compared with 45.5% of NPF in 1999.

The broad property sector continued to account for the largest share of NPF, at 50.2% of the total NPF (49.0% in 1999). The high NPF in the broad property sector emanated mainly from residential and non-residential property financing, which accounted for 28.6% of the NPF in this sector (39.7% in 1999).

Islamic Interbank Money Market (IIMM)

In year 2000, the volume of funds traded in the Islamic interbank money market (IIMM) declined by 30.7% to RM301.9 billion. The lower trading volume resulted mainly from the decline in Mudharabah interbank investments by RM138.3 billion. The

Table 4.19
Islamic Interbank Money Market (IIMM)[1]

	1999		2000	
	Volume (RM billion)	Annual change (%)	Volume (RM billion)	Annual change (%)
Total IIMM transactions	**435.7**	**175.6**	**301.9**	**-30.7**
Mudharabah interbank investments	**421.9**	**197.1**	**283.6**	**-32.8**
Green Bankers Acceptances	12.6	29.9	13.6	7.9
Islamic Accepted Bills	1.2	-81.3	4.7	291.7

[1] Volume transacted through brokers.

Table 4.20
Islamic Interbank Money Market (IIMM) – Maturity Profile

	1999 Volume (RM billion)	2000 Volume (RM billion)	Change (%)
Overnight and weekends	**388.3**	**223.8**	**–42.4**
1 week	**10.2**	**66.3**[1]	**550.0**
1 month	**6.7**	**13.4**[1]	**100.0**

[1] Volume transacted through brokers and Mudharabah money market tender.

concentration of BNM's liquidity operations on longer tenure investments led to the decline in the supply of funds in the interbank market, resulting in a lower volume of transactions in the Mudharabah interbank investments. The outstanding amount of liquidity absorbed from the IIMM by BNM as at end-2000 stood at RM3.9 billion. As part of the efforts to manage the liquidity situation and to further develop the IIMM, BNM introduced a new monetary policy instrument in the IIMM known as Bank Negara Negotiable Notes (BNNN) which were issued based on the concept of Bai' Al-Inah. As at end-2000, a total of RM250 million of BNNN papers were issued. BNM also appointed the two Islamic banks, namely Bank Islam Malaysia Berhad (BIMB) and Bank Muamalat Malaysia Berhad (BMMB), as the agent banks in its liquidity operations. Previously, BNM relied on existing principal dealers which participated in the IBS for its liquidity operations in the IIMM.

The trading activities in the short-term Islamic money market instruments expanded to record a total trading volume of RM18.3 billion as compared to RM13.8 billion in 1999. The trading of green bankers acceptance recorded a slow growth of 7.9% in 2000 as compared to 29.9% in 1999. Meanwhile, the Islamic accepted bills (IAB) made a sharp turnaround in 2000 with trading volume of RM4.7 billion (RM1.2 billion in 1999).

Other Financial Institutions

Discount Houses

The discount houses recorded a rebound in 2000. Total resources rose by RM2.6 billion or 13.8% to RM21.1 billion at end-2000 (-RM1.4 billion or -7.1% in 1999) on the back of active

Table 4.21
Discount Houses: Sources and Uses of Funds

	Annual change		At end
	1999	2000	2000
	RM million		
Sources:			
Approved capital funds	558	188	1,785
Deposits	933	3,858	13,953
Interbank borrowings	–2,873	–1,670	4,926
Others	–33	186	458
Total	**–1,415**	**2,563**	**21,122**
Uses:			
Investment in securities:	–2,379	2,508	18,559
Goverment debt securities	*–333*	*46*	*677*
MGS held	*–363*	*–122*	*469*
Khazanah bonds	*269*	*163*	*433*
BNM bills	*0*	*709*	*709*
Private debt securities	*–1,506*	*342*	*10,704*
Bankers acceptances	*–1,092*	*990*	*4,175*
Negotiable instruments of deposit	*38*	*–603*	*344*
Cagamas debt securities	*206*	*858*	*1,310*
Others	*40*	*2*	*206*
Interbank placements	828	313	2,133
Others	135	–258	431
	1998	**1999**	**2000**
Number of discount houses	7	7	7

participation in Islamic banking. SPI deposits contributed significantly to the increase in total resources as Islamic banking services were made available at all discount houses. With aggressive marketing activities, the discount houses were able to mobilise a significant amount of very short-term Islamic deposits. These deposits were attractive to customers due to their highly liquid nature which enabled depositors to make deposits and subsequent withdrawals within a very short span of time. With the increase in deposits, there was less reliance on the interbank market as a source of funds, hence the decline in interbank borrowing during the year.

The increase in total resources was invested mainly in securities, which expanded by RM2.5 billion or 15.6% in 2000 (-RM2.4 billion or -12.9% in 1999). The increase was mainly in investments in bankers' acceptances, which were attractive due to their short-term and tradable nature, and Cagamas debt securities. There was also investment in BNM bills. In contrast to 1999, there was a turnaround in the holdings of private debt securities (PDS), in line with the rise in PDS issues during the year, particularly in the Islamic bond market. NIDs held by the discount houses, however, were lower as there was less incentive for banking institutions to issue NIDs due to the ample liquidity in the banking system.

During the year, discount houses also expanded their fee-based activities. The industry arranged, lead-managed and co-managed the issuance of PDS worth RM3.3 billion (RM1.6 billion in 1999). The total amount underwritten by the discount houses, therefore, rose to RM2.8 billion (RM0.8 billion in 1999), with a total of 55 PDS issues (18 issues in 1999). In 2000, there were only two discount houses appointed as principal dealers (three in 1999).

National Savings Bank

Total resources of the National Savings Bank (NSB) increased significantly by RM3.7 billion or 46.6% to RM11.6 billion at end-2000 (RM0.6 million or 0.7% in 1999). The increase was due mainly to higher placement of deposits as the number of active account holders increased. The main source of the increase in deposits was fixed deposits, reflecting mainly an increase in placements by corporates (from RM1.2 billion to RM4.7 billion). Fixed deposits by individuals declined slightly (from RM1.4 billion to RM1.3 billion). The rise in placements by corporates was due to NSB's aggressive marketing and sales activities as well as a large deposit placement by a pension fund. As a result, fixed deposits remained the most popular deposit scheme, accounting for 58.2% of total deposits outstanding at the end of 2000, followed by GIRO deposits with a share of 27.5%.

The increase in total resources was invested mainly in deposits with financial institutions, which expanded by RM3.2 billion. The higher placements with financial institutions was in short-term fixed deposits (with maturities of less than one year) which rose by RM3.5 billion, while longer-term fixed deposits decreased marginally by RM358 million. Lending operations of the NSB also expanded in 2000, with loans outstanding increasing by RM261 million, mainly due to an increase in hire-purchase loans. As in the previous years, the bulk of the loans continued to be extended to individuals, who accounted for 92.1% of total loans outstanding. At the end of 2000, NSB's non-performing loans (NPLs) remained at 8% of its gross loans outstanding. As at the end of 2000, NSB's resources were invested mainly in securities (36.6%) and deposits with financial institutions (34.8%).

Table 4.22
National Savings Bank

	Annual change		At end
	1999	2000*p*	2000*p*
	RM million		
Deposits [1]	108	3,621	10,386
Savings	-66	-67	1,316
Fixed	-23	3,424	6,049
Save-As-You-Earn	-2	0	15
GIRO	28	371	2,860
Islamic Banking System (SPI)	171	-107	146
Premium Savings Certificates	20	37	600
Investments (book value)	-461	1,128	4,259
Malaysian Government Securities	-281	117	1,029
Other investments	-181	1,011	3,230
Deposits with financial institutions	-357	3,152	4,045
Gross loans	-153	260	2,321
Net loans (less provision for doubtful debts, bad debts, and interest in suspense)	-192	261	2,187
Number of NSB branches [2]	-9	-3	436
Number of post offices with NSB facilities [3]	0	-18	623
Number of account holders ('000)	-156	387	8,905
Number of Automated Teller Machines	10	13	610

[1] Includes interest credited.
[2] Includes mini-branches and sub-branches.
[3] Includes permanent and mobile offices.
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Provident and Pension Funds

Total resources of the 14 provident and pension funds (PPF) surveyed by Bank Negara Malaysia continued to expand in 2000. The

Table 4.23
Provident and Pension Funds: Selected Indicators

	1998	1999	2000*p*
	RM million		
As at end			
Number of contributors ('000)	17,833	18,382	18,752
of which: EPF	*9,158*	*9,544*	*9,748*
SOCSO	*8,429*	*8,598*	*8,772*
Accumulated contributions	155,034	174,011	186,132
Assets	173,597	195,709	217,871
of which: Investments in MGS	*47,481*	*53,822*	*63,630*
During the year			
Gross contributions	17,096	17,532	20,187
Withdrawals	9,103	7,780	10,686
Net contributions	7,993	9,752	9,501
Dividends credited	9,119	10,483	9,748
Investment income	11,131	12,163	12,024

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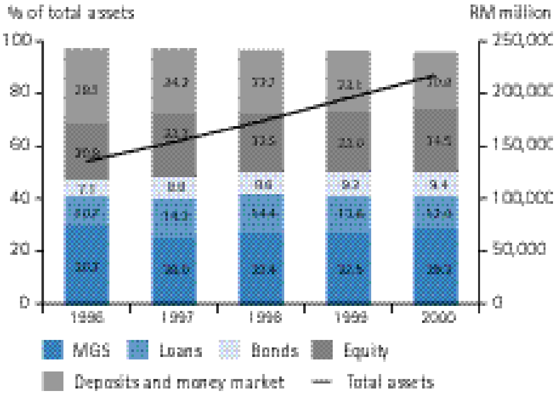
Source: Employees Provident Fund, Pension Trust Fund, Social Security Organisation, Armed Forces Fund, Malaysian Estates Staff Provident Fund, Teachers Provident Fund and eight other private provident and pension funds

Graph 4.18
Provident and Pension Funds: Major Asset Composition



funds' total resources grew by 11.2% to RM217.6 billion (1999: +12.7% to RM195.7 billion), of which 85.4% were the resources of the Employees Provident Fund (EPF). The growth in the resources of the PPF was largely attributable to the growth of accumulated contributions in contributors' accounts. Accumulated contributions, however, grew at a slower rate of 7% or RM12.1 billion during the year (1999: +12.2%); reflecting mainly the lower net contributions and dividends credited during the year.

During the year, net contributions of PPF declined by 2.6%, reflecting higher withdrawals. Withdrawals rose by 37.4% after a decline of 14.5% in 1999. EPF introduced four new withdrawal schemes for purchase of computers, education, pensionable staff and annuity schemes for retirees to supplement 10 existing withdrawal schemes. In addition, the higher withdrawals were also due to improvement in processing time for withdrawal applications by EPF. Nevertheless, gross contribution of PPF continued to grow by 15.1% (1999: 2.6%) with the increase in the number of contributors and higher income levels of the contributors. The total number of contributors increased by 2% to 18.7 million persons as at the end of 2000. The decline in defaults among employers had also contributed to the higher contribution level. The bearish performance of the equity market in 2000 had only a slight impact on investment activities of PPF. As a result, a marginal decline of 1.1% was recorded for investment income during the year.

In terms of the composition of assets of the PPF, there was a shift from the holdings of deposits and money market papers to Malaysian Government Securities (MGS) and corporate bonds. The share of deposits and money market papers declined to 20.8% (23.1% in 1999), while the share of MGS and corporate bonds increased to 29.2% and 9.4%, respectively (27.5% and 9.2% in 1999, respectively). The shift reflected the preference for assets with higher returns and the larger issuance of MGS and corporate bonds in 2000. Meanwhile, investment in equities recorded a higher share of 24.5%, while the share of loans declined to 12%, reflecting some shift in the investment strategy of PPF during the year.

Several measures were announced in the 2001 Budget, which affected the PPF industry. All EPF contributors were allowed to buy computers for their own use. To enhance efforts on house ownership, the Government allowed EPF contributors to make withdrawals for the purpose of buying a second house on condition that they sell the first house. In addition, under the enhanced education scheme, EPF contributors were allowed to make further withdrawals for payment of tuition fees for their children pursuing diploma courses, apart from degree courses. Under the withdrawal benefits for pensionable staff, the scheme has been opened to all retired civil servants, including staff who have opted out, but are still contributing to the EPF in their new private sector jobs, or if they are self-employed or are employees who work in Government agencies. These measures were implemented on 2 January 2001.

Pilgrims Fund Board

The total resources of the Pilgrims Fund Board continued to expand in 2000. Total resources mobilised by the Board amounted to RM10.2 billion at the end of 2000, representing an increase of RM1.6 billion or 19% (+RM1.3 billion or 17.8% in 1999). The expansion in resources arose from the increase in deposits placed by an increased number of depositors.

The increase in total resources was invested mainly in short-term investments and corporate securities, which expanded by RM801 million (+35%) and RM322 million (+8.3%) respectively in 2000. As at the end of 2000, the bulk of the Board's resources continued to be invested in corporate securities (41% of total assets) and short-term investments (30.2% of total assets).

Table 4.24
Pilgrims Fund Board: Selected Indicators

	Annual Change 1999	Annual Change 2000*p*	At end 2000*p*
	RM million		
Liabilities:	**1,293.9**	**1,628.7**	**10,208.8**
Depositors' balances	1,233.6	1,455.0	9,441.7
Total reserves	–88.1	312.8	716.7
Deposits received from tenants, etc	1.2	1.0	5.6
Other liabilities	147.2	–140.1	44.8
Assets:	**1,293.9**	**1,628.7**	**10,208.8**
Net fixed assets	127.9	224.2	1,009.5
Corporate securities	383.3	321.7	4,183.5
Short - term investments	462.7	800.5	3,079.1
Current assets	319.9	282.2	1,936.6
Other Statistics:			
Number of depositors ('000)	307.2	355.1	4,370.7
Number of pilgrims registered ('000)	5.5	4.5	39.5

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Industrial Finance Institutions

Total assets of the industrial finance institutions increased at a slower pace in 2000 (14.2%) compared with the previous year (16.7%). The bulk of the increase was due to the higher loans outstanding and total deposits placed with financial institutions which accounted for 60.6% and 57.1% respectively of the increase in total resources.

Industrial finance institutions have traditionally relied heavily on borrowings to fund asset growth as they are not licensed to mobilise deposits from the public. Established primarily to promote development programmes in the agricultural, industrial and international trade and export sectors, these institutions have access to resources at concessionary rates from the Government and foreign and international institutions such as the Japan Bank for International Co-operation and the Islamic Development Bank, Jeddah.

Total borrowings of industrial finance institutions increased significantly by 23.8% (+RM2.8 billion) in 2000 (10.8% or +RM1.1 billion in 1999) to RM14.4 billion, mainly by Bank Pembangunan dan Infrastruktur Malaysia Berhad (+RM3.1 billion) which raised funds through its Notes issuance programme amounting to RM1.0 billion. The funds were raised to minimise its interest rate and liquidity risk to better match the long gestation period of infrastructure projects financed by the bank, in line with its role as an infrastructure bank. Bank Pembangunan dan Infrastruktur Malaysia Berhad also increased its sources of financing in the form of soft loans from the Ministry of Finance and borrowings from statutory authorities and foreign and international institutions.

Generally, the other industrial finance institutions reduced their borrowings. Borrowings by the industrial finance institutions from the Government increased significantly by 65.6% to RM4.6 billion in 2000 after a decline in such borrowings in the previous year. Borrowings from the non-Government entities accounted for 68% of total borrowings.

Loans extended by the industrial finance institutions increased by 16.3% (+RM1.5 billion) in 2000, compared with 20.8% in 1999. The increase was attributed mainly to Bank Pembangunan dan Infrastruktur Malaysia Berhad, through build up of its infrastructure loan portfolio. Excluding Bank Pembangunan dan Infrastruktur Malaysia Berhad, loans extended by the industrial finance institutions declined by

Table 4.25
Industrial Finance Institutions: Changes in the Direction of Lending

Sector	Annual growth 1998 RM million	1998 % Comp.	1999 RM million	1999 % Comp.	2000 RM million	2000 % Comp.
Transport and storage	125.77	8.04	995.29	62.37	1,612.74	106.78
Agriculture	–32.33	–2.07	–13.43	–0.84	38.31	2.54
Mining and quarrying	3.82	0.24	9.69	0.61	–0.53	–0.04
Manufacturing	1,334.22	85.28	–0.77	–0.05	–96.80	–6.41
General commerce	29.06	1.86	–24.76	–1.55	–212.87	–14.09
Real estate and construction	61.83	3.95	838.17	52.53	–372.71	–24.68
Others	42.06	2.69	–208.47	–13.06	542.21	35.90
Total	**1,564.43**	**100.00**	**1,595.72**	**100.00**	**1,510.35**	**100.00**

RM202.6 million in 2000. The decline resulted mainly from reduction in loans extended by Bank Industri dan Teknologi Malaysia Berhad to its subsidiary, BI Credit and Leasing Berhad which ceased operations since November 2000.

The transportation and storage sector accounted for the largest share of the increase in loans in 2000. In contrast, loans to the real estate and construction sector decreased significantly by 24.7% (-RM372.7 million) in 2000 after continuous expansion for the past seven years. Outstanding loans to the manufacturing sector decreased further by 6.4% or RM96.8 million in 2000. Despite the decline in loans to the manufacturing sector, the exposure of the industrial finance institutions to this sector remained high at 31% of the total loans outstanding as at end-December 2000.

Deposits placed by industrial finance institutions with the financial institutions increased significantly by 46.4% (+RM1.4 billion) in 2000, compared with 3.1% (+RM93.1 million in 1999).

Venture Capital

The venture capital (VC) industry continued to expand in 2000, with total resources increasing by 18.1% to RM1.7 billion at end-2000. With VC financing gaining increasing recognition as an alternative source of funds, the number of VC companies (VCCs) rose to 33 at end-2000. Similarly, the number of investee companies backed by VC investments rose to 221, from 194 in the previous year.

During the year, the VCCs expanded their investment activities and invested a total of RM117.1 million in 64 investee companies (RM104.1 million in 56 investee companies in 1999). There was a significant shift in the investment preference of the VCCs, with more VCCs investing in the information communication and technology (ICT) sector (58.1% of total investments, compared with only 13.4% in 1999).

VCCs continue to provide financing to investee companies at various stages. While their share of investment in the seed, start-up and other early stages had increased to 36% in 2000 (18% in 1999), the bulk of the investment was for second stage financing.

Table 4.26
Venture Capital Funds/Companies

	As at end	
	1999	2000*p*
Number of venture capital companies	30	33
Number of investee companies	194	221
	RM million	
Sources		
Shareholders' funds	703.6	1,037.0
Liabilities	703.3	624.8
Total	**1,406.9**	**1,661.8**
Uses		
Investments in investee companies	637.3	727.9
Other assets	769.6	933.9
Total	**1,406.9**	**1,661.8**

p Preliminary

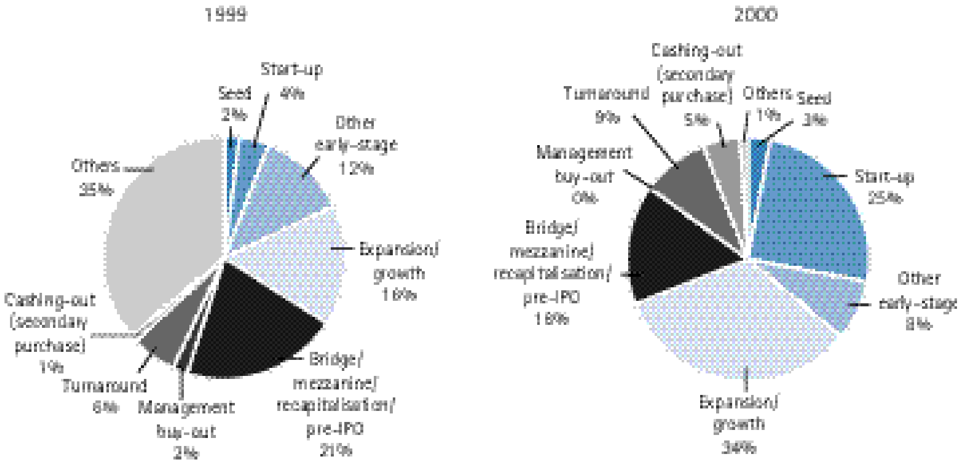
While progress has been made in developing the VC industry, further development is required to support the growth of knowledge-intensive and technology-intensive companies in the country. Recognising the importance of VC as an alternative form of financing, the Government has over the years been very supportive of the industry. In 2000, several measures and initiatives were introduced by the Government to further promote the VC industry. During the year, two VC funds for high-tech projects of RM150 million each were launched. In addition to these two funds, a RM500 million VC Fund was being set up by the Government to increase the availability of VC financing in the economy and in the process, stimulate more new ventures, particularly the ICT industry. Additional tax incentive in the form of tax deductions

Table 4.27
Venture Capital Funds/Companies: Investments during the year

	1999	2000*p*
Number of investee companies	56	64
	RM million	
Investments during the year	**104.1**	**117.1**
By sector		
Manufacturing	31.9	17.9
of which:		
IT based products	*–0.1*	*3.3*
Electrical and electronic products	*5.2*	*8.4*
Advance electronics technology	*12.5*	*5.3*
Information communication technology	14.0	68.0
Life sciences	6.4	5.2
Others	51.8	26.0

p Preliminary

Graph 4.19
Venture Capital Companies: Investments by Stages



equivalent to the amount of investments made in approved venture companies at start-up, seed capital and early stage financing was accorded to the industry. Recognising the need to ensure that there is accountability in promoting the VC industry and to ensure that the development of the VC industry is given priority and is well coordinated, the Government announced the establishment of a 'one-stop' VC centre. The 'one-stop' VC centre will chart the strategic direction for the VC industry and act as a single reference point for all Government initiatives and incentives. In addition, the Government announced that the more restrictive MESDAQ's listing requirements (eg. the ruling that 70% of MESDAQ IPO proceeds must be utilised in Malaysia) would be liberalised. The objective is to make the exit mechanism for VCCs more attractive.

To complement the Government's efforts, the private sector had also shown initiative in the development of the VC industry. The first business plan competition, Venture 2001, was launched in November with the objectives of converting potential ideas into actual businesses, attracting venture capital companies and fostering an entrepreneurial environment in Malaysia.

In addition, the Financial Sector Masterplan and the Capital Market Masterplan launched in first quarter of 2001, outlined recommendations for the future direction of the industry. The overall objective is for the VC industry to play an effective role in ensuring that Malaysia achieves its vision of becoming a knowledge-based economy. In developing a vibrant VC industry, a holistic approach was recommended. The recommendations outlined included the establishment of Islamic VC funds; matching services; VC trusts; more business angel clubs and networks; and technology appraisal centres in promoted high technology sectors.

Financial Markets

Overview of the Financial Markets

The performance of the financial markets was mixed in 2000. Trading volumes in the money, bond and futures markets were higher while trading in the foreign exchange market was marginally lower. The bearish sentiments in the equity market resulted in significantly lower trading volume. Nevertheless, the financial markets remained effective in their role as financial intermediaries for the mobilisation and allocation of funds. The financial markets continued to be supported by a facilitative regulatory framework that was further enhanced by efforts aimed at improving transparency and efficiency.

The total trading volume in the money market increased marginally by 0.7% to RM1,425 billion in 2000. The increase was attributed to the higher volume of transactions of money market papers which more than offset the decline in the trading of interbank deposits. Trading of interbank deposits continued to decline during the year mainly because of the ample liquidity environment coupled with moderate loan growth in the banking system, which reduced the need for interbank funding.

Trading of money market papers increased across most instruments. This increase reflected mainly demand for institutional investments. In an environment of a gradual increase in loan activities and ample liquidity, banking institutions actively sought money market instruments for investment of excess funds.

Activity in the domestic interbank foreign exchange market remained relatively stable during the year, with the average daily volume of interbank foreign exchange transactions effected through the eight foreign exchange brokers declining slightly by 0.1% compared to 1999. Transactions in the foreign exchange market continued to be dominated by transactions in the United States (US) dollar against the ringgit reflecting the significance of the US dollar as a vehicle currency in the interbank foreign exchange market and the high concentration of US dollars in the settlement of trade and other capital account transactions.

Funds raised in the capital market were significantly higher in 2000 amounting to RM40.4 billion (1999: RM26.2 billion). This reflected a greater amount of funds raised by the private sector as funds raised by the public sector were marginally lower. The main source of private sector funding was the private debt securities (PDS) market. The low interest rate environment encouraged greater recourse to the PDS market to finance longer-term projects as well as to meet the financing requirements for the ongoing corporate debt restructuring activities. The equity market remained an important source of financing for the private sector in 2000. Funds raised were largely made through rights issues and initial public offerings.

Table 4.28
Funds Raised in the Capital Market

	1999	2000*p*
	RM million	
By Public Sector		
Government Securities, gross	10,000	16,413
Less Redemptions	6,676	5,286
Less Government holdings	0	0
Equals Net Federal receipts	3,324	11,128
Khazanah Bonds (net)	2,598	551
Govt. Investment Issues (net)	0	2,000
Malaysia Savings Bond (net)	375	–19
Net funds raised by public sector	**6,297**	**13,659**
By Private Sector		
Shares	6,096	6,004
Debt securities[1]	26,558	31,097
Less Redemptions	12,750	10,331
Equals Net issues	13,808	20,766
Net funds raised by private sector	**19,904**	**26,770**
Total Net Funds Raised	**26,202**	**40,429**
Short-term papers and notes (net)[2]	–720	–1,626
Total	**25,481**	**38,803**

[1] Excludes debt securities issued by banking institutions.
[2] Refers to Commercial Papers and Cagamas Notes only.
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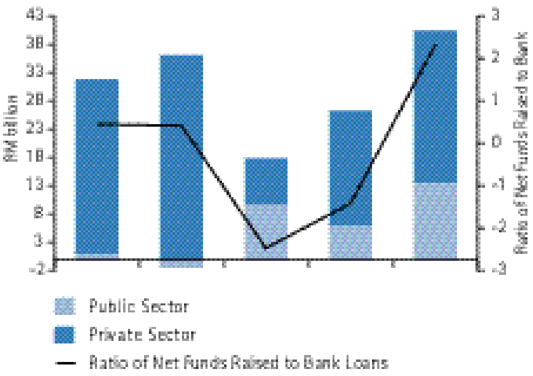
Graph 4.20
Net Funds Raised in the Capital Market by the Public and the Private Sectors



The public sector raised a total amount of RM13.6 billion from the capital markets in 2000, mainly by issuing more Malaysian Government Securities (MGS). The higher issuance of MGS reflected the higher financing needs of the Government as well as its commitment towards establishing a benchmark yield for the bond market through regular issues of papers.

The equity market was generally bearish in 2000 with the Kuala Lumpur Stock Exchange (KLSE)'s main index, the KLSE Composite Index (KLSE CI), declining by 16.3% to end the year at 679.64 points. Total market capitalisation and trading volume (in terms of units) were much lower at 19.6% and 16.4% respectively. The relatively poor performance of the KLSE despite the strong economic performance was mainly a result of contagion effects from major regional and US markets, shifts in international capital flows and concerns over developments in the local corporate sector. Despite declines in stock prices, the equity market remained an important avenue for the private sector to raise funds in 2000. Since the Asian financial crisis, the ringgit bond market has expanded strongly. During the year, a total amount of RM34.4 billion was raised in the market, accounting for 85.1% of the total net funds raised in the capital market. In terms of size, the value of bonds outstanding in the market expanded by 19.4% from RM202.5 billion at end-1999 to RM241.7 billion at the end of 2000. The higher issuance of both public and private sector debt securities arose from a combination of factors. These were the low interest rate environment, the increasing needs to finance economic activities as economic growth improved, the acceleration in the implementation of corporate debt restructuring schemes and the higher fiscal deficit.

With higher issues in 2000, the PDS market expanded to account for 58% of total bonds outstanding. This expansion contributed to developing a deeper and more liquid PDS market. Trading activities in the secondary market rose significantly during the year, amounting to RM253.8 billion or an increase of 62.8% from the previous year. Consequently, market liquidity improved from 77% to 105%. In line with the low and stable interest rate environment, bond yields were lower and moved within a narrow band. The economic growth and the recovery of corporate credit quality during the year had also resulted in the narrowing of yield spreads for various rated bonds against the risk-free MGS.

During the year, several measures were taken to further develop the bond market. In developing benchmark yield curves, the Government, for the first time, announced an auction calendar on the issuing of Government securities and re-opened its existing MGS issues to a larger value. In addition, the Securities Commission was appointed as the single regulatory body for the PDS market.

In the derivatives market, a significant development was noted in terms of further broadening of the market and the development of a nascent market. The Kuala Lumpur Options and Financial Futures Exchange (KLOFFE) launched the first financial option product, the KLSE CI Options, in December 2000. Meanwhile, trading activities on the KLSE CI Futures were thin during the course of 2000. Turnover volume declined by 15%, due mainly to the absence of foreign participation. On the other hand, trading in KLIBOR futures was active, recording a 54.6% improvement from the previous year. Higher trading was driven by the ample liquidity in the interbank cash market, as well as the increased activities in the local bond and interest-rate swap markets.

On the development aspects, further development of financial markets focussed mainly on regulatory issues targeted at improving and strengthening market efficiency and competitiveness. In particular, additional measures were directed at improving corporate governance and instilling greater transparency for minority shareholder protection. Measures were also introduced to strengthen the local stockbroking industry through consolidation of stockbroking companies, improving market procedures and transparency to enhance competitiveness. The development of the bond market was further promoted with the rationalisation of the regulatory structure in order to achieve a more effective market mechanism.

The Capital Market Masterplan was launched in February 2001 with the objective of setting the strategic position and future direction for the Malaysian capital market. The Masterplan seeks to ensure that the capital market is well positioned to play its part in supporting national economic growth needs and aspirations, meeting the challenges of regional competition and increasing globalisation, as well as tapping value-added opportunities in areas of comparative and competitive advantage.

The Masterplan has six key objectives, which will be achieved through 24 strategic initiatives and 152 recommendations. The six key objectives are to develop Malaysia as the preferred fund-raising centre for Malaysian companies, to promote an effective investment management industry and a more conducive environment for investors, to enhance the competitive position and efficiency of market institutions, to develop a strong and competitive environment for intermediation

Financial markets in 2000 remained stable and continued to effectively mobilise funds to support economic growth. Markets developments were enhanced through greater efforts to improve transparency and governance.

services, to ensure a stronger and more facilitative regulatory regime, and to establish Malaysia as an international Islamic capital market centre.

The Masterplan will be implemented in three phases. In Phase 1 (2001 to 2003), the focus will be to strengthen domestic capacity and develop strategic and nascent sectors. In Phase 2 (2004 and 2005), efforts will concentrate more on strengthening key sectors and gradually liberalising market access where necessary. Finally, in Phase 3 (2006 onwards), the Masterplan will focus on the further expansion and strengthening of market processes and infrastructure in order to achieve a fully developed capital market. It will also focus on enhancing the market's international positioning in areas of comparative and competitive advantage.

Table 4.29
Money Market [1]

	1999		2000	
	Volume (RM billion)	Annual change (%)	Volume (RM billion)	Annual change (%)
Total money market transactions	**1,415.2**	**-23.1**	**1,425.4**	**0.7**
Interbank deposits	**1,189.3**	**-28.0**	**1,091.7**	**-8.2**
Money market papers	**225.9**	**19.1**	**333.7**	**47.7**
Bankers Acceptances (BAs)	67.9	-14.4	63.6	-6.3
Negotiable instrument of deposits (NIDs)	27.2	-36.9	21.0	-22.8
Malaysian Government Securities (MGS)	63.8	92.7	88.6	38.9
Khazanah bonds	16.1	222.0	15.5	-3.7
Treasury bills	11.5	22.3	15.0	30.4
Bank Negara Bills	–	–	50.9	–
Cagamas nonds	12.9	186.7	29.3	127.1
Cagamas notes	26.5	73.2	49.8	87.9

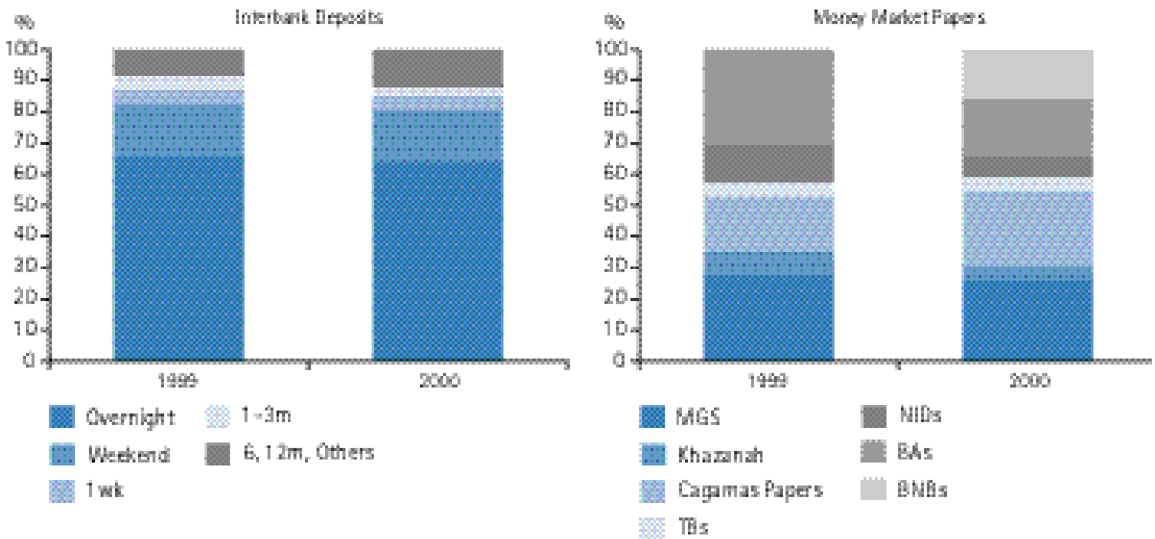
[1] All data are sourced from the Bond Information and Dissemination System, except BAs and NIDs which are sourced from money market brokers.

Money Market

The total trading volume in the money market increased marginally by 0.7% in 2000 to RM1,425 billion (Table 4.22). The increase was attributed to the higher volume of transactions of money market papers (+47.7%) which more than offset the decline in the trading of interbank deposits (-8.2%). Trading of interbank deposits continued to decline during the year mainly because of the ample liquidity environment coupled with a moderate loan growth which reduced the need for interbank funding. The decline in trading was across all tenures, except those with longer tenures of 6-month and above which recorded higher trading volumes. Nonetheless, the bulk of the trading was still concentrated at the shorter tenures of overnight and weekend deposits (64.5% and 16.7% of the total volume of interbank trading respectively). This concentration of trading at the shorter-tenures typifies activities in an interbank market where transactions are usually carried out for short-term settlement and liquidity purposes.

Trading volume in the money market papers continued to increase in 2000 by 47.7% to

Graph 4.21
Share of Total Volume Traded

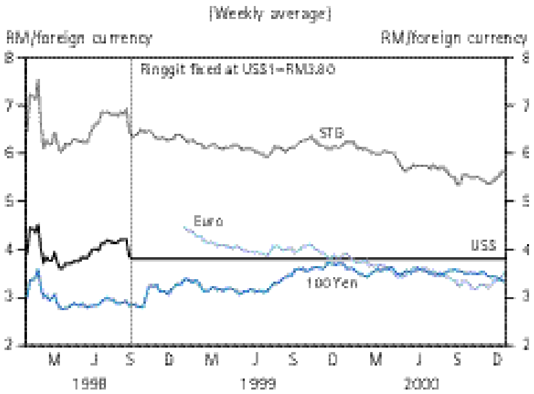


RM333.7 billion. As in the previous year, increases were recorded across all instruments, except negotiable instruments of deposits (NIDs) and bankers acceptances (BAs). The decline of these two instruments was largely the result of market participants' natural behaviour in an environment of ample liquidity and moderate loan growth. In such circumstances, banking institutions would not aggressively seek funds either from the interbank market or the retail market. Hence, there was a significant decline in NIDs issued from RM27.4 million at end-1999 to RM21 million at end-2000, resulting in a lower secondary trading volume of the papers. Similarly, although BAs issued had increased in tandem with the increase in economic activity, there was a decline in the trading volume of the papers as banking institutions preferred to hold the papers until maturity. On the other hand, other papers recorded higher trading volumes as participants actively sought these securities for investments from their available pool of ample funds. In addition, both the Malaysian Government Securities (MGS) and Cagamas Bonds recorded significantly higher transactions during the year compared with the previous year, due to higher primary issuance of RM16 billion of MGS and RM8.5 billion of Cagamas Bonds (RM10 billion and RM4.4 billion respectively in 1999). The rise in the trading of Bank Negara Bills (BNBs) was a result of the re-issuance of the papers since February 2000.

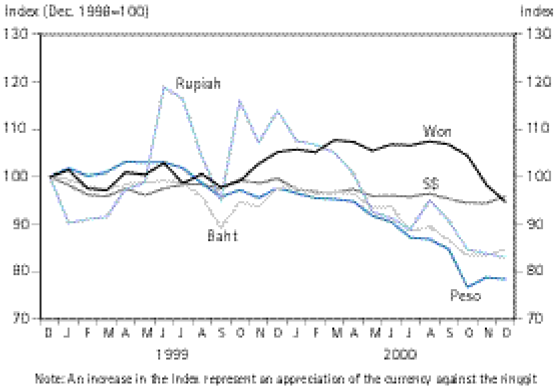
The Foreign Exchange Market and Ringgit Exchange Rate

The **ringgit exchange rate** remained pegged to the US dollar at the rate of RM3.80 per US dollar in 2000 - an arrangement that has been effective since 2 September 1998. Under this

Graph 4.22
Exchange Rate of the Malaysian Ringgit against Major Currencies (1998-2000)



Graph 4.23
Performance of the Malaysian Ringgit against Selected Regional Currencies



arrangement, bilateral exchange rates with other currencies are determined through cross-rates based on the movements of the US dollar against these currencies in the international foreign exchange markets.

In terms of its trade-weighted nominal effective exchange rate, the ringgit appreciated by 6.8% during the year in line with the appreciation of the US dollar. Higher expected returns on US$-denominated assets, especially during the first half of the year when estimates of GDP growth prospects in the United States increased significantly relative to other countries, provided support for the appreciation of the US dollar against the other currencies in Malaysia's trade-weighted basket.

On a bilateral basis, **the ringgit appreciated against the Japanese yen (12.1%), the euro (8.5%) and the pound sterling (8.3%)** in tandem with the movements of the US$ against these currencies in the international foreign exchange markets. The euro depreciated against the US dollar during the first ten months of the year due mainly to the outflows of foreign direct investment, equity and bond capital from the euro area, in particular to the United States. Concern over the significant depreciation in the euro led the G7 countries to intervene in the foreign exchange markets to support the euro on 22 September 2000. The European Central Bank also intervened unilaterally on a number of subsequent occasions. Meanwhile, the pound sterling also depreciated against the US dollar during the year in line with the weak euro. The depreciation of the pound sterling reflected market perception that the monetary tightening bias by the UK authorities had ended. Technical

Table 4.30
Movement of the Ringgit

	RM to one unit of foreign currency [1]				Annual change (%)		Change (%)	
	1997	1998	1999	2000	1999	2000	End-June '97-Dec.2000	2 Sept. '98-Dec.2000
	End-June	Sept.2 [2]	End-Dec.					
Composite	102.47	72.11	68.64	70.86	-1.3	3.2	-30.8	-1.7
SDR	3.5030	5.1177	5.2096	4.9511	2.7	5.2	-29.2	3.4
US$	2.5235	3.8000	3.8000	3.8000	0.0	0.0	-33.6	0.0
S$	1.7647	2.1998	2.2809	2.1946	0.3	3.9	-19.6	0.2
100 Yen	2.2088	2.7742	3.7115	3.3121	-10.7	12.1	-33.3	-16.2
Pound Sterling	4.1989	6.3708	6.1389	5.6662	3.1	8.3	-25.9	12.4
Deutsche Mark	1.4522	2.1743	1.9599	1.8064	15.5	8.5	-19.6	20.4
Swiss franc	1.7368	2.6450	2.3836	2.3234	15.4	2.6	-25.2	13.8
Euro [3]	–	–	3.8333	3.5331	17.5	8.5	–	–
100 Thai baht	9.7470	9.3713	10.1199	8.7790	2.4	15.3	11.0	6.7
100 Indonesian rupiah	0.1038	0.0354	0.0542	0.0395	-12.2	37.2	162.8	-10.4
100 Korean won	0.2842	0.2827	0.3355	0.3022	-4.9	11.0	-6.0	-6.5
100 Philippine peso	9.5878	8.8302	9.4823	7.6053	2.4	24.7	26.1	16.1

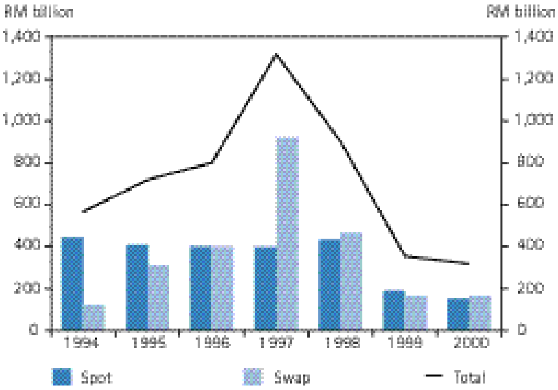
[1] US$ rates are the average of buying and selling rates at noon in the Kuala Lumpur Interbank Foreign Exchange Market. Rates for foreign currencies other than US$ are cross rates derived from rates of these currencies against the US$ and the RM/US$.
[2] Ringgit was fixed to US$1 = RM3.8000 on 2 September 1998.
[3] The Euro began to be traded on 4 January 1999 (EUR 1= RM4.5050). The annual change for 1999 is calculated against the value as at 4 January 1999.

factors, such as momentum trading and mergers and acquisitions related flows also influenced the exchange rate movements.

Towards the end of 2000, the trend for the dollar reversed slightly and depreciated against both the euro and the pound sterling as increasing signs of slower growth in the US led traders to believe that further increases in interest rates by the Federal Reserve were not likely. The Japanese yen, however, remained under downward pressure in the last quarter of 2000 due to concerns over the slow progress in the Japanese economic recovery.

During the year, the **ringgit appreciated against all regional currencies.** Investors' concern over the impact of slowing US growth and high oil prices on the region's growth prospects placed downward pressure on most

Graph 4.24
Volume of Interbank Transactions in the Kuala Lumpur Foreign Exchange Market

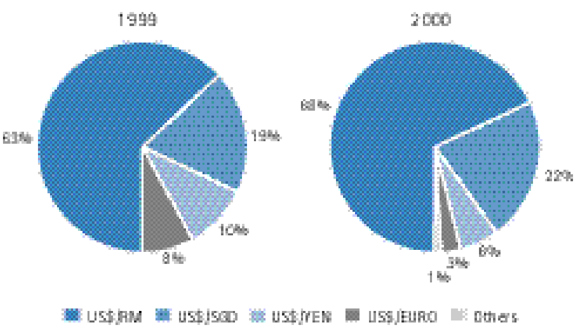


regional currencies vis-a-vis the dollar. Political events in Indonesia and the Philippines further exacerbated the depreciation of the rupiah and the peso. The Korean won remained strong for the first three quarters of the year, supported by strong portfolio inflows. However, the won depreciated significantly in the last quarter due to concerns over the health of the Korean corporate sector as well as the weak performance of the Korean stock market.

The pegged exchange rate regime continued to accord stability to Malaysian financial markets in an environment of volatile foreign exchange markets. Despite the depreciation of regional currencies, the peg remained well supported by the strong economic fundamentals. Inflation remained low and the current account of the balance of payments continued to be in surplus. In addition, the level of international reserves remained strong while short-term foreign borrowings were low, accounting for only 15.7% of reserves. Macroeconomic policy continued to be directed towards sustaining these underlying fundamentals.

Activity in the KL interbank foreign exchange market remained relatively stable during the year. The average daily volume of interbank foreign exchange transactions (spot and swap transactions) effected through the eight foreign exchange brokers declined slightly by 0.1% compared to the volume traded in 1999. Since the introduction of the selective exchange controls, ringgit trading activities in the KL interbank foreign exchange market arise mainly

Graph 4.25
Interbank Transactions in the Kuala Lumpur Foreign Exchange Market by Currency



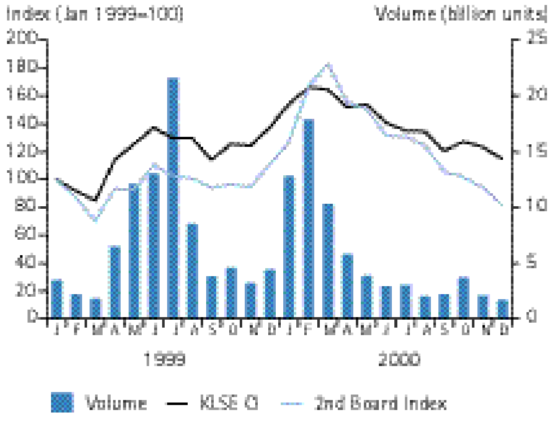
from trade-related transactions, which generate more stable flows and are supported by real economic activity. Position-taking activities on the ringgit have been contained through the elimination of the offshore ringgit market as well as through guidelines governing the operating framework of banking institutions. As a result of these measures, the volume of transactions conducted has declined significantly compared to previous years.

By currency, transactions in the Kuala Lumpur foreign exchange market continued to be dominated by transactions in the United States dollar against the ringgit, with the share of such transactions increasing from 63% of the total transactions in 1999 to 68% in 2000. The continued dominance of US$/RM trades reflects the significance of the US$ in the KL interbank foreign exchange market as well as the high usage of US dollars used in settlement of trade and other capital account transactions.

Equity Market

The year 2000 commenced on a strong note for the Kuala Lumpur Stock Exchange (KLSE). Along with the smooth transition over the Y2K bug, buying interest returned to the stock market early in the year with solid evidence that the Malaysian economy remained on a recovery track. The return of foreign portfolio investment to Malaysia was evident ahead of Malaysia's re-instatement into the MSCI Indices and hence, provided ample liquidity for the local bourse. In the first half of the year, the global technology, media and telecommunications boom experienced in most major stock markets continued to fuel interests in similar counters in the KLSE. Technology-related stocks experienced higher prices and enhanced valuations during this period. The KLSE launched

Graph 4.26
Kuala Lumpur Stock Exchange Composite Index, Second Board Index and KLSE Trading Volume



Source: Kuala Lumpur Stock Exchange

a Technology Sector and a corresponding Technology Index in May to assist investors to identify technologically innovative companies listed on the KLSE while encouraging other similar companies to seek listing on the exchange.

Table 4.31
Kuala Lumpur Stock Exchange: Selected Indicators

	1999	2000*p*
Price indices		
Composite	812.33	679.64
EMAS	206.39	159.77
Second Board	180.57	132.98
Total turnover		
Volume (billion units)	90.1	75.4
Value (RM billion)	199.6	244.1
Average daily turnover		
Volume (million units)	363.5	309.1
Value (RM million)	805.0	1000.2
Market capitalisation (RM billion)	552.7	444.4
Market capitalisation / GDP (%)	184.0	130.9
Total number of companies listed	757	795
Main Board	474	499
Second Board	283	296
Market liquidity:		
Turnover value / Average market capitalisation (%)	43.5	42.3
Turnover volume / Number of listed securities (%)	52.3	39.5
Market concentration:		
10 most highly capitalised stocks/Market capitalisation (%)	33.9	38.9
Average paid-up capital of stockbroking firms (RM million)	103.2	129.6

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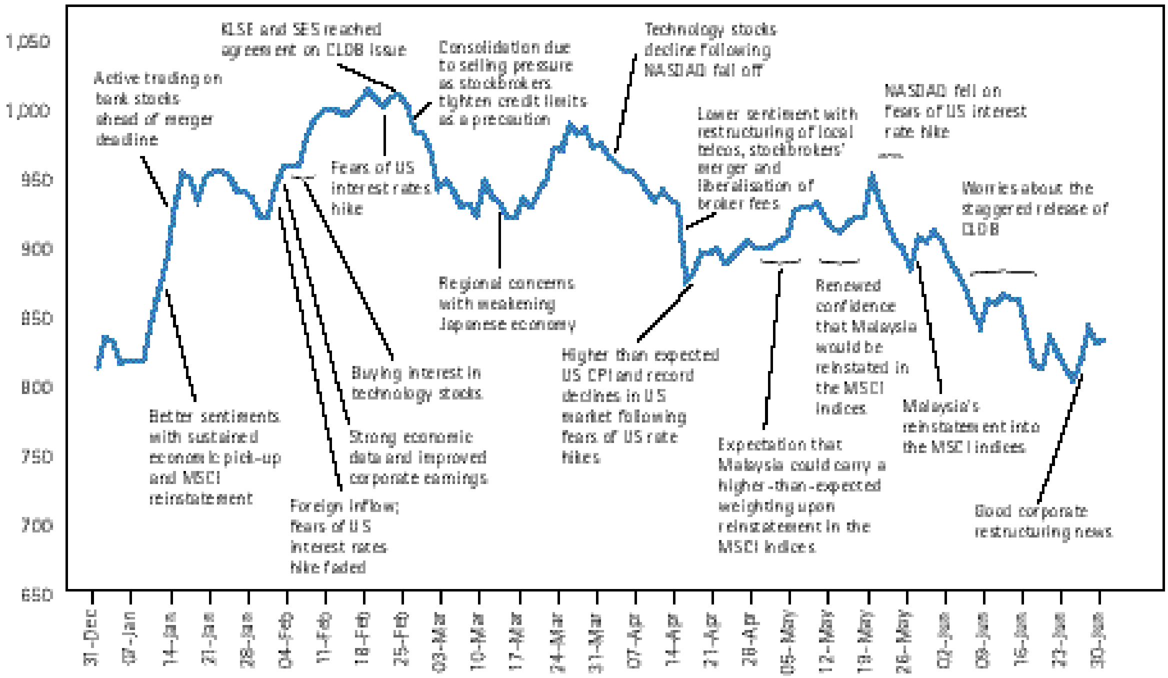
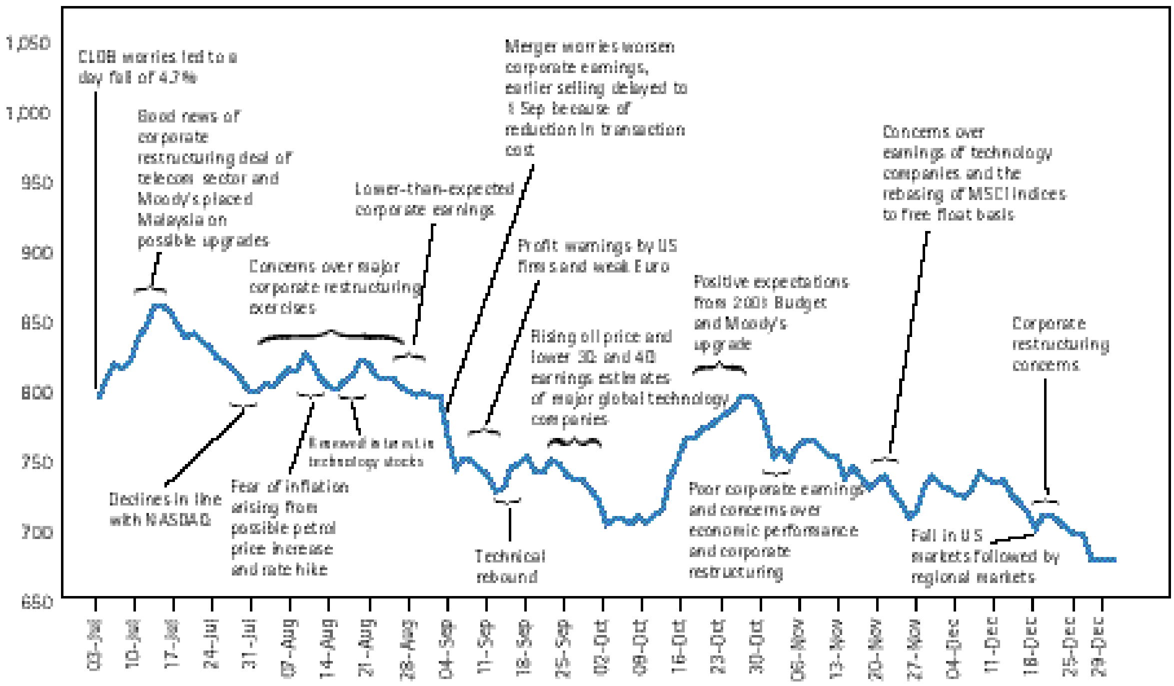
Source: Kuala Lumpur Stock Exchange

Graph 4.27
Performance of the KLSE CI (31 Dec 99 – 30 Jun 2000)



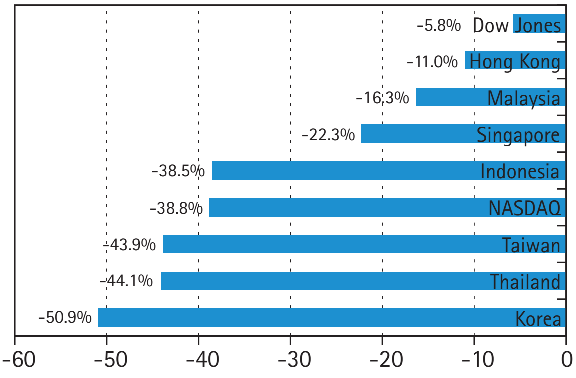
Graph 4.28
Performance of the KLSE CI (1 July – 30 December 2000)



Despite the strengthened economic fundamentals as well as the ample liquidity situation and low inflation and interest rate environment, the KLSE's performance weakened in the second half of 2000. This development was mainly a result of contagion effects from major regional and US stock markets and shifts in international capital flows, along with concerns over developments in the local corporate sector. The factors influencing the performance in the local bourse during the course of 2000 are explained in the charts below.

The benchmark, KLSE Composite Index (KLSE CI) ended lower by 16.3% to close at 679.64 points at end-2000 while the market capitalisation declined by 19.6% to RM444.35 billion. The overall trading volume was lower by 16.4% while trading value

Graph 4.29
Performance of the Stock Market Indices (change from 1999 to 2000)



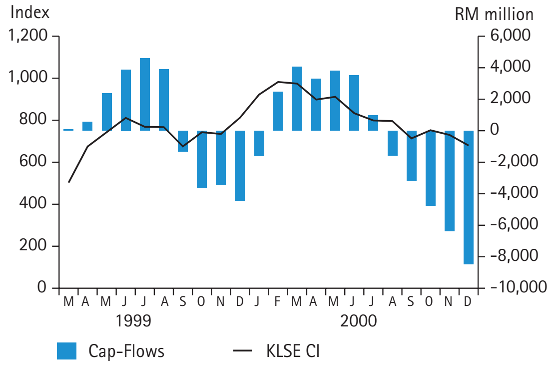
Source: Datastream

increased by 22.3% compared to the previous year. Sector indices in the KLSE also exhibited similar trends. On an annual basis, the declines of most of the indices across the board ranged between 20 to 40%. The only sectors recording higher trading volumes were infrastructure (68.7%), plantations (42.4%) and mining (10.9%). Nevertheless, the KLSE CI performance did better, compared to other regional bourses.

The accumulation of stocks by institutional investors ahead of Malaysia's reinstatement in the MSCI indices at end-May, helped push the market to its year high (KLSE CI: 1,013) on 18 February. In the space of seven weeks, from 3 January to 18 February, the KLCI had risen a phenomenal 21.5%, far outperforming many other bourses in the region. In the first five months of 2000, a total of RM8.3 billion (US$2.2 billion) of portfolio capital inflows was recorded through the External and Special External Accounts. However, between end-June to year-end, there was a net outflow of RM12.3 billion (US$3.2 billion). For the year as a whole, net outflow of portfolio funds totalled RM4 billion (US$1.1 billion). Outflows of foreign portfolio capital affected the liquidity in the local bourse and both price and turnover remained depressed in the second half of the year.

The equity market remained an important source of financing for the private sector in 2000, accounting for 22.4% of net funds raised by the private sector in the capital market (30.6% in 1999). About 65% of new financing raised in the equity market was made through rights issues while initial public offerings (IPOs) accounted for 16.6%. In 2000, there was a total of 38 IPOs, of which 12 were listed on the main board.

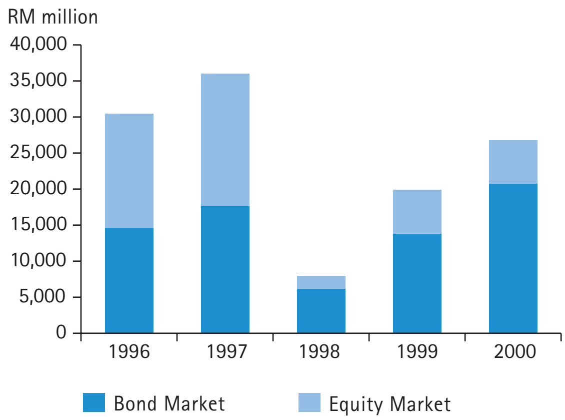
Graph 4.30
KLSE CI vs Net Cumulative Flows through External Accounts (Mar. 1999 – Dec. 2000)



Companies involved in the production of industrial and consumer products formed the bulk of new listings. IPOs, in terms of number, more than doubled for the year and a total of 425.9 million new units were introduced. This development was in line with stronger economic activities, which led to an improvement in the earnings prospects of the corporate sector. In terms of market development, there was a greater number of units traded as well as diversity in terms of different types of counters in the local bourse in 2000. This provided a wider range for equity investment selection. However, to some extent, the poor performance of the KLSE in the second half of the year did affect listing prospects, evident by the fact that almost 80% of new listings were undertaken between January and June.

Several measures were introduced during the year to develop the capital market. The key measures are contained in the box, "Key Capital Market Measures in 2000". The year 2000 also saw the

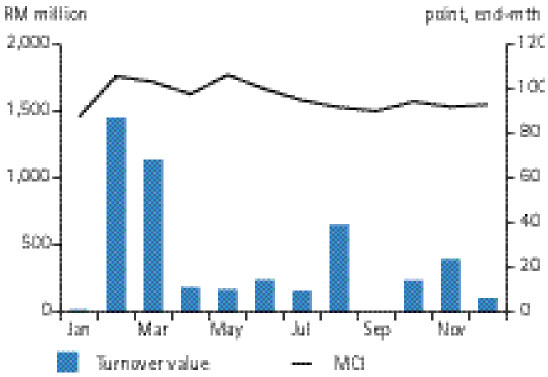
Graph 4.31
Funds Raised by the Private Sector in the Capital Market



continued implementation of new corporate governance measures as well as their enforcement. Measures taken were aimed at improving accountability of public-listed companies in order to promote strength and resilience of these companies. These measures continued to implement credible and effective corporate governance practices for the benefit of investors and the market as well as the promotion of business efficiency and entrepreneurship. Public-listed companies made progress in the implementation of corporate governance practices. As at end-2000, the submission of quarterly reporting of financial statements of public-listed companies achieved a 99% compliance rate, indicating greater disclosure, transparency and accountability by market participants. At the same time, a total of 143 actions was taken against public-listed companies for failure to comply with listing requirements.

In the Malaysian Exchange of Securities Dealing & Automated Quotation (MESDAQ), the MESDAQ composite index (MCI) increased by 3.5% to close at 93.1 points at end-2000. Trading volume on MESDAQ was valued at RM4.7 million. The bulk of the trading was concentrated in the months of February and March, which was consistent with the KLSE's upbeat performance during the period. Market capitalisation increased to RM141.4 million (end-1999: RM55.7 million). Two more counters were listed on MESDAQ last year. As at end-2000, there had been six applications for listing on MESDAQ. Trading on MESDAQ counters was affected by adverse market sentiments which resulted in MESDAQ stocks experiencing thin trading volumes. As at end-2000, MESDAQ's total membership rose to 19,

Graph 4.32
Malaysian Exchange of Securities Dealing and Automated Quatation: Trading and MESDAQ Composite Index (MCI)



of which 15 are stockbroking companies and four are merchant banks. Seven of these members are market makers.

MESDAQ's new internet-based trading system, MORE! (MESDAQ Order Routing and Execution System) was launched on 28 July 2000. The new system replaced the Bloomberg-based quote driven system. A significant event for MESDAQ was the approval by the Securities Commission to allow Multimedia Super Corridor companies to dual list on both MESDAQ and NASDAQ by issuing up to 30% of the paid-up capital of the company in NASDAQ through American Depository Receipts. This move will enable companies to raise more funds by tapping two equity markets and leverage on the branding, liquidity and valuation that NASDAQ has to offer.

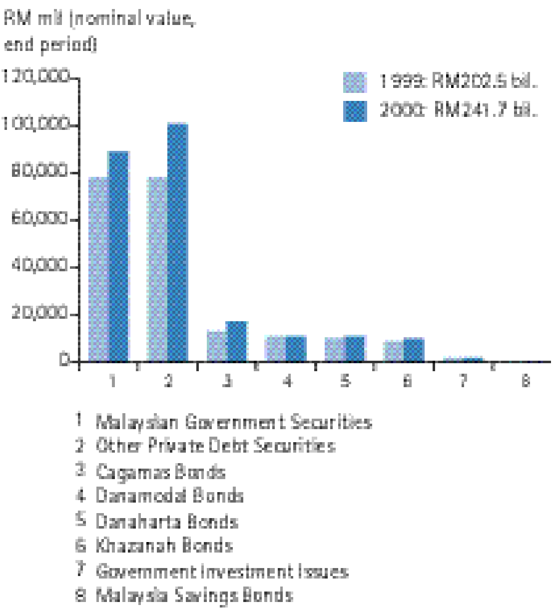
One of the objectives of the recently launched Capital Market Masterplan is to enhance the competitive position and efficiency of market institutions. To achieve this, the Masterplan recommends, among other things, that market institutions consolidate and adopt a more commercial-focus in their activities. A single Malaysian exchange would be established through the merger of all existing exchanges. The consolidated exchange would be demutualised and operate as a profit-earning entity to ensure that it has an appropriate governance framework to drive the future development of the exchange. It was also proposed that the demutualised entity be listed on the stock market. Market institutions would continue to meet international best practices and offer globally competitive cost-structures.

Bond Market

In 2000, the ringgit bond market expanded strongly, and contributed significantly to providing an alternative source of financing to borrowers. The growth of the bond market was attributed to the low interest rate, higher demand for longer-term financing as economic activities expanded, as well as the financing needs under the on-going corporate debt restructuring schemes. In addition, the Government continued to issue Malaysian Government Securities (MGS) to finance the fiscal deficit.

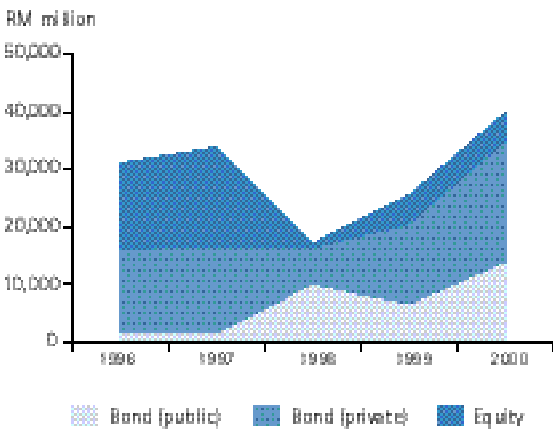
The growing significance of the bond market was seen in the marked expansion in the value of the outstanding ringgit bonds, comprising

Graph 4.33
Size of the Ringgit Bond Markets: Amount Outstanding



public sector securities[1] and private debt securities[2] (PDS), by 19.4% in 2000 to RM241.7 billion (RM202.5 billion in 1999). Outstanding PDS was larger at 58% of the total amount at the end of 2000, compared with outstanding public sector securities of 42%. The ratio of the bond market to GDP also rose to 71.2%, while that of the PDS market stood at 41.3%. This growth in the PDS market is significant. In 1990, the market size of PDS was 5.3% of GDP and after the crisis in 1999, this ratio stood at 37.6%. It is expected that the PDS market would continue to expand to assume a greater share of financing the economy. Currently, the banking sector still accounts for a larger share with its total loans outstanding (excluding loans

Graph 4.34
Funds Raised in the Bond Market (1996-2000)



sold to Cagamas and Danaharta) at 116.9% of GDP at the end of 2000.

In terms of net funds raised, the bond market (both public and private sector) raised RM34.4 billion, accounting for 85.1% of the total net funds raised in the capital market.

The net funds raised by the public sector amounted to RM13.7 billion, mainly from the issuance of MGS. During the year, the Government floated five issues of MGS amounting to RM16.4 billion, with maturities of 3, 5 and 10 years. After adjusting for redemptions, net funds raised through MGS was RM11.1 billion (1999: RM3.3 billion). The higher issuance of MGS was attributed to both the higher financing needs of the Government as well as the Government's objective of ensuring regular issues as part of the measures to develop the ringgit bond market.

Gross funds raised in the PDS market was higher in 2000, amounting to RM31.1 billion (1999:

Table 4.32
Funds Raised in the Bond Market

	1999	2000*p*
	RM million	
By Public Sector		
Government Securities, gross	10,000	16,413
Less Redemptions	6,676	5,286
Equals Net Federal receipts	3,324	11,128
Khazanah bonds (net)	2,598	551
Govt. Investment Issues (net)	0	2,000
Malaysia Savings Bond (net)	375	–19
Net funds raised by the public sector	6,297	13,659
By Private Sector		
Private debt securities[1], gross	26,557	31,097
Straight bonds	18,182	12,940
Bonds with warrants	947	0
Convertible bonds	1,269	1,944
Islamic bonds	1,734	7,666
Cagamas bonds	4,425	8,547
Less Redemptions	12,750	10,331
Private debt securities	6,280	6,077
Cagamas bonds	6,470	4,254
Net funds raised by the private sector	13,807	20,766
Net funds raised in the bond market	**20,104**	**34,425**
Net issues of short-term securities [2]	–720	–1,626
Total	**19,384**	**32,799**

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

[1]Public debt securities refer to Malaysian Government Securities Government Investment issues, Khazanah bonds and Malaysia Savings Bonds.
[2] Private debt securities refer to Cagamas bonds, Danamodal bonds, Danaharta bonds and other PDS.

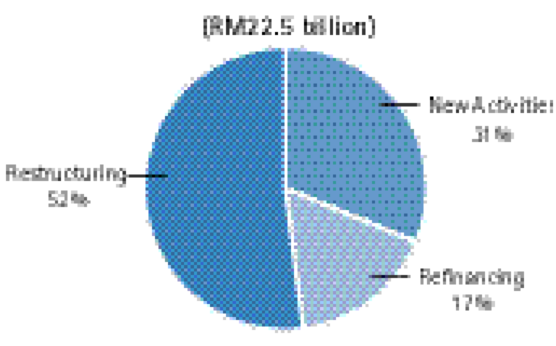
Table 4.33
New Issues of Private Debt Securities by Sector[1]

Sector	1999		2000*p*	
	RM mil.	% share	RM mil.	% share
Agriculture, hunting, forestry and fishing	0.0	0.0	42.5	0.2
Mining and quarrying	0.0	0.0	0.0	0.0
Manufacturing	1,506.9	6.8	1,354.6	6.0
Electricity, gas and water supply	63.8	0.3	4,564.1	20.2
Wholesale and retail trade, restaurants and hotels	660.0	3.0	1,853.9	8.2
Construction	5,002.2	22.6	2,006.3	8.9
Transport, storage and communication	8,331.2	37.6	7,320.3	32.5
Financing, insurance, real estate and business services	6,568.4	29.7	5,108.3	22.7
Others	0.0	0.0	300.0	1.3
Total	**22,132.5**	**100.0**	**22,550.0**	**100.0**

[1] Excluding Cagamas Bonds.
p Preliminary

RM26.6 billion). In terms of types of issuance, straight bonds accounted for 41.6% (1999: 68.5%) of the gross funds raised, asset-backed Cagamas bonds, 27.5% (1999: 16.7%), followed by Islamic bonds, 24.7% (1999: 6.5%). After accounting for redemptions of RM10.3 billion, the net funds raised in the PDS market remained high at RM20.8 billion (1999: RM13.8 billion). The higher issuance of PDS was due to several factors, such as the low interest rate environment and the ample liquidity conditions for corporates to raise funds, as well as the increased long-term capital financing requirements and the ongoing corporate debt restructuring activities. The growth of the PDS market was also attributed to investors' demand for alternative forms of investment which would yield higher returns than bank deposits.

Graph 4.35
Utilisation of Proceeds in 2000[1]

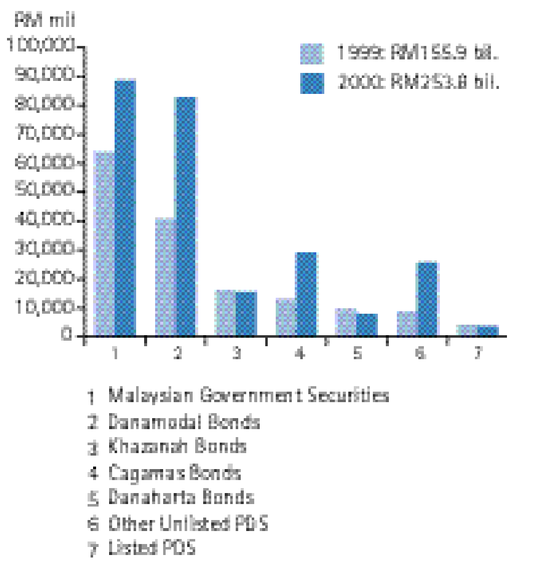


[1] Excluding Cagamas

The issuers of the PDS were broad-based. In the primary issuance market, new issues were mainly from the infrastructure (transport, storage and communication), utilities (electricity, gas and water supply) and financial services sectors. In terms of utilisation of proceeds, 52% of the PDS issued was for implementation of corporate debt restructuring schemes, followed by new activities (31.2%) and refinancing (16.8%) purposes.

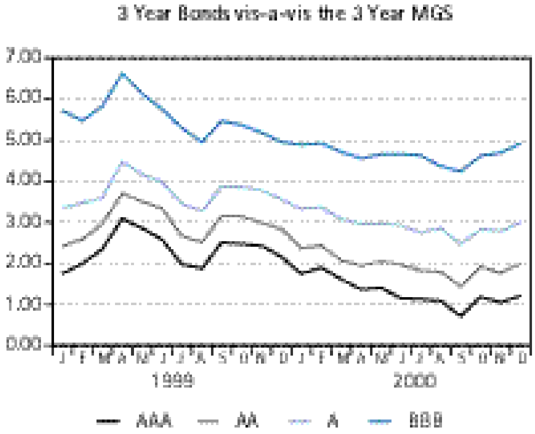
Trading activities in the secondary market increased significantly during the year. An active and liquid secondary market is a key indicator of sustained investor demand and market maturity. Trading activities in the secondary market amounting to RM253.8 billion (1999: RM155.9 billion) rose by 62.8% in 2000. The higher volume of trading activities was driven by the larger issuance in the primary market coupled with the favorable environment such as ample liquidity in the banking system, lower yields as well as improved economic conditions. Liquidity in the bond market, as measured by the ratio of trading volume to amount outstanding, had also risen to 105% (1999: 77%). Of significance was the increase in corporate bond transactions by 128%, from RM13 billion to RM29.6 billion. In terms of share of total ringgit bonds trading, corporate bonds rose from 8.3% to 11.7%. This is an encouraging trend, as increased liquidity in the secondary market is indicative of the growing depth of the corporate bond market in Malaysia.

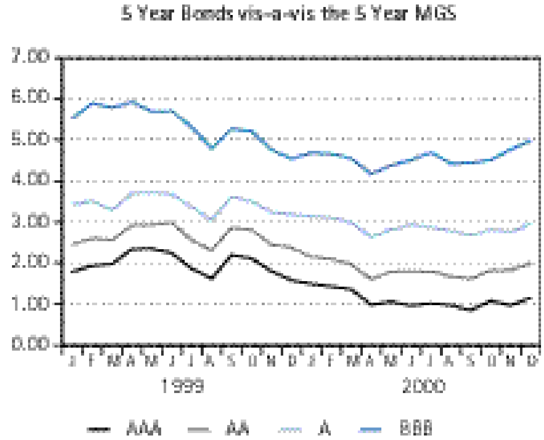
Graph 4.36
Trading of Ringgit Bonds



Source: Bond Information and Dissemination System

Graph 4.37
Yield Differentials





With low and stable interest rates, the bond yields were lower in 2000. The strong economic growth and the consequent recovery of corporate credit quality during the year had also resulted in narrower yield spreads for various rated bonds against the risk-free MGS.

The growing size of the PDS market and the greater preference of companies sourcing alternative financing from the debt market resulted in the need for more rating exercises. This was reflected in the increased number of new ratings completed by both the Rating Agency Malaysia Berhad (RAM) and the Malaysian Rating Corporation Berhad (MARC). Rating exercises are vital to issuing companies and investors alike as they reflect the risk profile of the bond issues and creditworthiness of the issuing companies. They also enhance transparency and instill higher confidence and credibility in market activities. RAM completed 85 new rating exercises valued at RM32.6 billion in 2000, compared with 49 rating exercises valued at RM35.3 billion in 1999. Meanwhile, new rating activities by MARC increased to 41 valued at RM17.7 billion in 2000, compared with 22 valued at RM8.3 billion in the previous year.

In 2000, rating reviews of the existing debt securities conducted by RAM and MARC amounted to 153 and 15 respectively. Of the 153 rating reviews conducted by RAM, 15 were upgrades and 114 were reaffirmations, which accounted for 84.3% of the total reviews in 2000. Rating review by MARC showed a similar trend. Of the total 15 rating reviews conducted, five were upgrades and nine were reaffirmations, which accounted for 93.3% of the total reviews during the year. The number of downgrades by both rating agencies was low at 17 (11.1% of the total reviews) and one (6.7% of the total reviews) respectively. The high portion of rating upgrades and reaffirmations reflected the positive corporate profiles, as well as the stable economic conditions during the year which reduces risks of defaults.

A more active bond market in 2000 complemented the banking system as an alternative source of financing. The debt market provided for the higher financing needs of the economy, especially for longer-term projects.

During the year, several measures were introduced to further develop the bond market. These included developing the benchmark yield curve through regular MGS issues. In 2000, the Government announced an auction calendar for the issue of Government securities. This is to enhance transparency and facilitate the formulation of investors' strategies. In addition, the Government has also reopened four of its existing MGS issues to a larger value to generate more active trading in the secondary market.

Another significant development was the amendments made to the Securities Commission (SC) Act 1993, BAFIA 1989 and the Companies Act 1965 to place the SC as the single regulatory

Table 4.34
Unit Trust Industry – Selected Indicators

	1999			2000			1999	2000
	Govt. sponsored funds	Private funds	Total	Govt. sponsored funds	Private funds	Total	Growth (%)	
Number of unit trust management companies	10	23	33	10	24	34	3.1	3.0
Number of unit trust funds[1]	29	72	101	30	89	119	13.5	17.8
Units in circulation (billion)	37.1	15.5	52.6	40.2	23.6	63.8	13.1	21.3
Number of accounts (million)	7.9	1.0	8.9	8.4	1.2	9.6	4.7	7.9
Net asset value (NAV) (RM billion)	32.0	11.1	43.1	30.5	12.8	43.3	11.4	0.5
Ratio of NAV to KLSE market capitalisation (%)	5.8	2.0	7.8	6.9	2.9	9.8		

[1] Refers to funds already launched.

Source: Securities Commission Malaysia

body for the PDS market. The objective is to rationalise and streamline the regulatory structure as well as to speed up the approval of PDS issues. The SC has introduced a new facilitative approval scheme in relation to straight bonds under the new PDS guidelines, implemented a shelf-registration scheme and liberalised the issuing requirements to allow greater flexibility in bond issuance.

In February 2001, the Capital Market Master Plan (CMP) which contained comprehensive recommendations to further promote the Malaysian bond market was launched. The key priority for the development of the bond market is to establish a deeper, broader and more efficient corporate bond market that provides a competitive source of financing across a wide range of tenure. Among others, in fostering greater market liquidity, the CMP recommended greater market access to the bond trading infrastructure and processes. At the same time, the CMP also emphasized the development of other essential components of the overall bond market such as the yield curve, asset securitisation as well as the promotion of bond derivatives and bond funds.

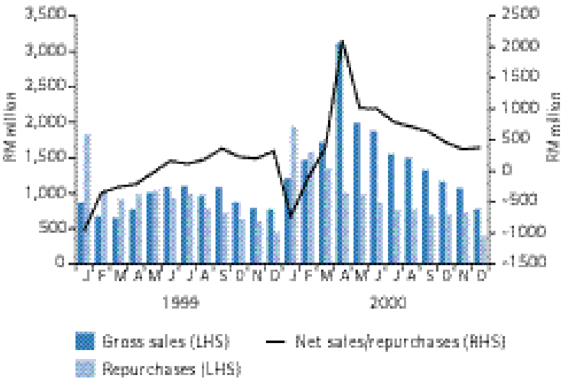
Unit Trust Industry

In 2000, the unit trust industry expanded further in terms of number of unit trust funds, units in circulation and number of accounts. Gross sales recorded by unit trust funds also exceeded repurchases during the year resulting in net sales of approximately RM7 billion. The growth of the industry was mainly due to increased market demand for unit trusts as investors sought to reduce the price volatility of their equity investments, and increased marketing efforts by the industry following the relaxation of guidelines governing the marketing of unit trusts by the SC and BNM. In addition, the continued availability of the EPF Member's Investment Scheme contributed to the growth of the unit trust industry. This scheme allows members to invest a portion of their EPF savings in fund management companies, including unit trust management companies, approved by the Ministry of Finance.

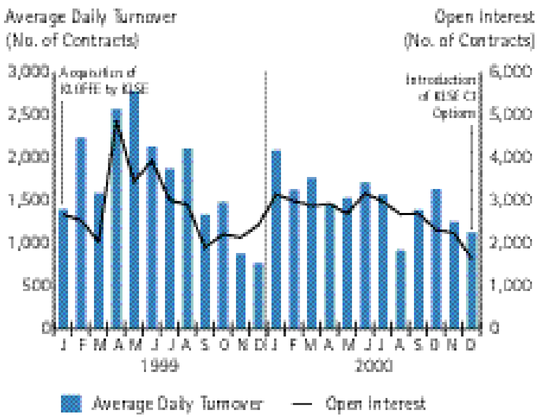
However, the weak performance of the KLSE during the year affected the net asset value (NAV) of the unit trust industry resulting in only a marginal growth of 0.5% in the latter. Nonetheless, the KLSE's weak performance, as reflected in the contraction of its market capitalisation by 19.6% in 2000 (growth of 47.6% in 1999), resulted in an increase in the industry's ratio of NAV to KLSE market capitalisation.

The Capital Market Masterplan made several recommendations regarding investment

Graph 4.38
Unit Trust Industry – Gross Sales, Repurchases and Net Sales

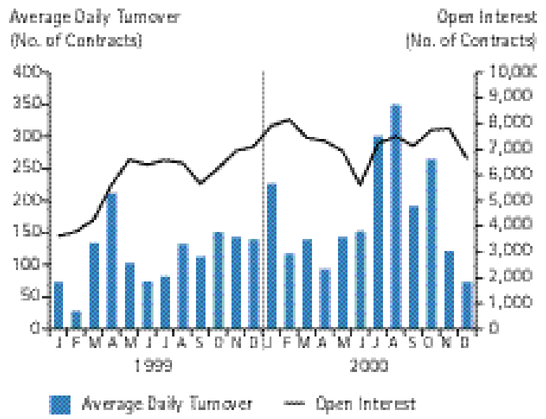


Graph 4.39
Kuala Lumpur Options and Financial Futures Exchange: Average Daily Turnover and Open Interest



Source: Kuala Lumpur Options and Financial Futures Exchange

KLIBOR Futures: Average Daily Turnover and Open Interest



Source: Commodity and Monetary Exchange of Malaysia

Graph 4.40
Futures Trading on the COMMEX

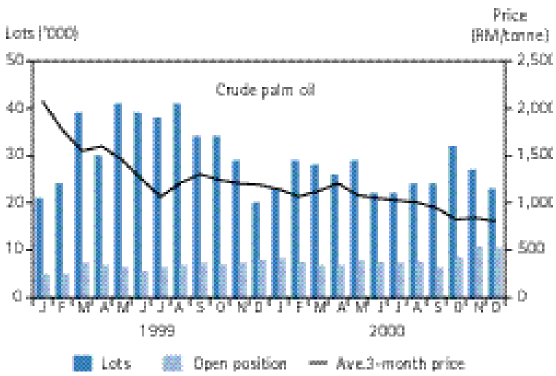


Table 4.35
KLOFFE and COMMEX
Turnover: Number of Contracts

	1999	2000	% change
KLOFFE			
KLSE CI Futures	436,678	366,942	–16.0
KLSE CI Options		349	n.a.
COMMEX			
KLIBOR Futures	28,994	44,812	54.6
CPO Futures	388,933	308,622	–20.6

Source: Kuala Lumpur Options and Financial Futures
Commodity and Monetary Exchange of Malaysia

management that would facilitate the development of the unit trust industry. These measures included the liberalisation of foreign ownership requirements, whereby foreign majority ownership of unit trust management companies would be allowed from 2003.

Exchange Traded Derivatives Markets

Performance of products traded over Malaysia's derivatives market exchanges was mixed in the year 2000. Trading activities in the KLSE CI Futures were weak with trading volume of the KLSE CI Futures declining by 16%. The month-end open interest, which is the number of unsettled positions, declined from 3,152 contracts in January 2000 to 1,644 contracts at the end of the year. These declines reflected the generally weak market sentiment as well as the lack of interest from foreign institutions. The lower trading activities were reflected in the low Derivaties Liquidity Ratio (DLR), which remained below the 100 mark throughout the year, implying that investors' exposure in the underlying market was not fully covered by their futures contracts. The DLR represents the ratio between the turnover value of futures against the turnover value of the component stocks.

In December 2000, KLOFFE launched its second product, the KLSE CI Options contract. With this contract, activities on KLOFFE expanded as it was able to offer investors an additional instrument for hedging and risk management of their stock market trades. This new product on KLOFFE recorded a better-than-expected performance. Turnover volume of 105 contracts was recorded on its first day of trading, while the open interests stood at 80 positions. The daily average trading volume for the first trading month was 21 contracts.

Key Capital Market Measures in 2000

Capital market measures introduced in 2000 were designed to enhance the on-going efforts to ensure a more efficient, transparent, innovative and competitive capital market. At the same time, several additional measures were introduced to improve corporate governance and minority shareholder protection. The key measures were as follows:

Strengthening the Stockbroking Industry

- On 21 April, the Securities Commission (SC) released a policy framework on the consolidation of the stockbroking industry. Guidelines were announced on issues of firewalls, involvement of stockbroking groups in the property or construction business, Universal Broker and the establishment and location of a branch office by a Universal Broker and a non-Universal Broker. A task force has been set up to monitor and review the progress of the consolidation of the stockbroking industry.
- In an effort to reduce transaction costs, commission rates were liberalised. In the first phase, which took effect on 1 September, commission rates for all trades above RM100,000 became fully negotiable while those for trades below RM100,000 were subject to a fixed rate of 0.75%. In the second phase, which would be implemented in 2001, commission rates would be made fully negotiable for all trades, but subject to a cap of 0.70%. In addition, transaction fees such as the SCANS clearing fee, the SCORES fee and the SC levy were also reduced.

Promotion of the Bond Market

- Effective 1 July, SC became the single regulator for all fund raising activities. This move will facilitate the rationalisation of the regulatory structure, as well as create a facilitative and transparent approval scheme for private debt securities (PDS).
- The SC announced new guidelines, regulations and practice notes, which took effect on 1 July, in the area of offering of PDS, prospectus contents for debentures, Shelf Registration Scheme for debentures and minimum content requirement for trust deeds. These measures were aimed at ensuring an efficient issuance process.
- On 23 October, the restrictions on the use of proceeds from issuance of PDS were relaxed. Proceeds from PDS issues can now be used to finance the development of residential properties and shop houses valued above RM250,000 per unit, provided that the excess price is due to additional land area (such as corner or end units). Corporations can also issue PDS for development of residential properties, shop houses, commercial buildings, shopping complexes and hotels in Putrajaya, Cyberjaya and Kulim Technology Park.

Enhancing Market Mechanism and Competitiveness

- The KLSE strengthened the disclosure of Internet and E-Commerce activities by public-listed companies (PLCs). On 1 April, PLCs were required to publicise the details of the E-Commerce business acquired such as the business model, details of the development stage, description of risks and rewards and technical capability and competence. The PLCs are also required to announce the progress of their businesses on a quarterly basis. This measure was to ensure that investors have timely, adequate and accurate information.
- KLSE launched a new technology index and introduced a technology sector on 15 May. The technology index represented all shares of technology companies from both the Main and Second Boards. This new index was introduced to assist investors to track their technology stock investments and identify technologically innovative companies.
- Effective 13 June, the SC liberalised the requirements for chain listing and par value of ordinary shares for primary listing. The subsidiaries / associated companies of listed holding companies are allowed to be listed on KLSE or the MESDAQ, without the need for their already-listed holding companies to meet the requirements for listing. In addition, the restriction that a company would not be allowed to be listed on the KLSE if it contributed more than 50% of the already-listed holding company's consolidated after-tax profits and/or

net tangible assets, was removed. Companies seeking listing on KLSE were also no longer required to fix the par value of their ordinary shares at RM1.00 each.

- On 1 July, the SC introduced new guidelines on prospectuses for equity and equity-linked issues. SC was made the approving and registering authority for all equity and equity-linked issues (other than the issue, offer or invitation of shares or debentures by an unlisted recreational club).
- The Labuan International Financial Exchange (LFX) was launched on 23 November. It is a global exchange that provides listing and trading facilities for a wide range of financial and non-financial products (as well as Islamic products), including mutual funds, bonds derivatives, insurance-linked products and intellectual properties.
- A shorter settlement period (T+3) was implemented for all trades on the KLSE and MESDAQ on 20 December. The shorter settlement cycle was aimed at reducing the settlement risk, increasing efficiency, and instilling greater confidence in the safety and soundness of the securities clearance and settlement system.
- The Kuala Lumpur Stock Exchange (KLSE) and Commodity and Monetary Exchange of Malaysia (COMMEX) signed a merger agreement on 22 December. The agreement set out the mechanism for COMMEX to join the KLSE Group. This move would maximise utilisation of resources, achieve economies of scale and promote cost efficiency.

Improving Corporate Governance and Minority Shareholder Protection

- On 11 May, the KLSE established a Taskforce on Internal Control to formulate a guide to assist directors of listed companies to meet their disclosure obligation. This was to maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.
- On 25 May, the SC introduced a Code of Conduct for Market Institutions. The code principally requires the market institutions to ensure a clear, consistent, fair, equitable and transparent regulatory process within each institution. It provides the best practices of governance by the market institutions to ensure accountability of these institutions. The Code was introduced in response to the increasing attention and scrutiny given to corporate governance issues, and the recognition that market institutions such as exchanges, clearing houses and central depositories must act in the public interest and observe the highest standards of governance in conducting their affairs. The Code of Conduct will form the basis for each market institution to establish detailed policies, procedures and decision-making structures at all levels within each institution.
- Effective 1 October, the listing requirements of the Main and the Second Boards were amended to comply with the approved principles of the Malaysian Accounting Standards Board (MASB).

Promotion of Fund Management Industry

- Effective 1 February, all Institutional Unit Trust Agents (IUTAs) must be registered with the Federation of Malaysian Unit Trust Managers (FMUTM). All IUTAs and their representatives who wish to market, or, are already marketing unit trust products of third parties must obtain approval from the FMUTM.
- Revisions to the Guidelines on the Establishment of Foreign Fund Management Companies (FFMC) were made effective on 1 July. The SC has restructured and reformatted the FFMC guidelines, and clarified certain clauses for easy reference to reflect policy changes and recent developments in the financial markets. (The FFMC guidelines were introduced in August 1995 to promote and develop the fund management industry to ensure that the pace of liberalisation is properly managed).
- On 1 July, the SC announced several measures for unit trust schemes. These measures include Minimum Covenant Requirements and Procedures for Registration and Lodgement of Deeds of Unit Trust Funds, Prospectus Guidelines for Unit Trust Funds, Guidelines on Unit Trust Advertisements and Promotional Materials and Amendments to the Guidelines on Unit

Trust.

- On 7 September, the SC announced the issuance of a practice note on the Policy on Distribution of Returns to ensure uniform practices by unit trust funds. The "Best Practice Policy Framework" of the note serves as a guide for fund management companies to determine the amount of distribution to be paid by the unit trust schemes under their management. The objective of this note is to ensure sufficient and adequate disclosure in respect of the performance results of unit trust funds, enhance transparency, create awareness among unit holders, especially on the total returns of the fund, and establish a consistent distribution pattern in the unit trust industry.

The 3-month Kuala Lumpur Interbank Offered Rate (KLIBOR) futures contract traded on the Commodity and Monetary Exchange of Malaysia (COMMEX) performed better than in the previous year. The higher trading activity was a result of the ample liquidity situation in the inter-bank cash market, as well as increased interest in the local bond and interest rate swap (IRS) markets. In addition, the revival of the market maker scheme, since August 1999, which requires a market maker to make two-way quotes, has helped to enhance liquidity in the futures market.

Trading activities of the Crude Palm Oil (CPO) Futures on COMMEX were thin, reflecting bearish market sentiment during the year and low price volatility. During the year, the price range for the benchmark 3-month futures contract narrowed to RM490 (1999: RM1,240). The CPO future prices generally stabilised during the first eight months of the year before declining to close at RM803 per tonne in December (January 2000: RM1,144 per tonne).

Box V

The Role of the Payment System in Financial Stability

The payment system is an integral component of financial stability, being the main infrastructure in the financial system that facilitates transactions. When the system fulfills this role effectively, it also produces three important spin-off effects. Firstly, it promotes public confidence in the financial system. Secondly, it improves the efficiency of the financial system and, by extension, the economy as a whole by ensuring payments are transacted promptly and efficiently. Finally, it provides special benefits to central banks by facilitating the conduct of monetary policy by allowing greater use of market-based instruments to achieve desired outcomes.

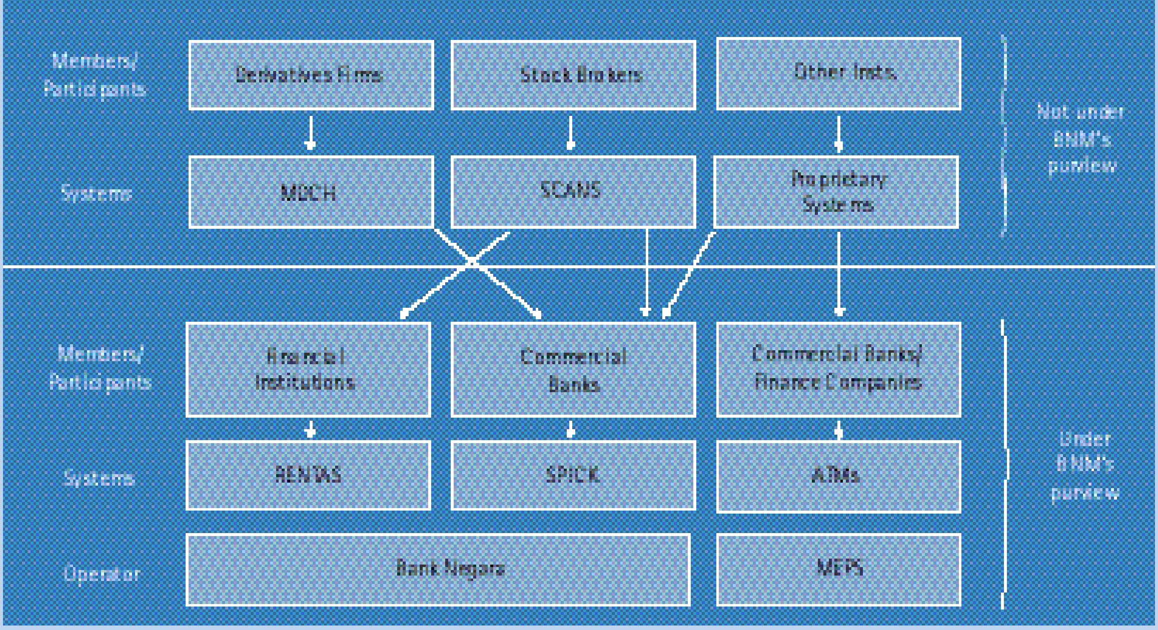
Robust payment systems are essential in maintaining financial stability. Payment system failures can disrupt financial stability if there is no ready alternative means of making payments. Should agents not be able to effect payments for one reason or another, it can result in destablising consequences on the financial system. Thus, Bank Negara Malaysia has always accorded significant attention to the design and operation of, and oversight over the payment system. However, recent developments in the financial system and technology demand that central banks' play an even more active role. In addition to prudential and regulatory reasons for greater central bank oversight, the increasing complexity and interconnectedness of the global financial system brings new risks. Furthermore, the emergence of new payment links and mechanisms is also changing the modes of financial settlement. Finally, the increasing volume of payments that need to be settled within a short period of time also places demands on payment systems and requires investment in infrastructure.

Payment Systems in Malaysia

In Malaysia (then Malaya), the issue of currency notes only commenced in 1897, while settlement by cheques only commenced with the introduction of the Bills of Exchange Act in 1949. The clearing and settlement of cheques was undertaken by the commercial banks themselves prior to the establishment of the central bank in 1959. In tandem with the technological developments around the world, cards for payment, including debit and credit cards, were introduced in the 1980s. The latest innovation was e-money in September 1999. E-money is digital money that is used to settle transactions using the electronic medium. It can be in the form of a trade unit that carries monetary values for the conduct of business through the Internet.

The main facilitator in making payments has been the banking institutions. To expedite and

Overview of the Malaysian Payment System



facilitate settlement amongst the banking institutions, the central bank and the banking institutions have established several computerised payment systems as central platforms to undertake the delivery and transfer of money. Among others, these systems cater for the clearing and settlement of cheques, interbank transfers of funds and the processing and settlement of scripless securities.

The payment system in Malaysia is centralised at Bank Negara Malaysia. Today, this system consists of the Real Time Electronic Transfer of Funds and Securities (RENTAS) and the Sistem Penjelasan Imej Cek Kebangsaan (SPICK), both of which are operated by Bank Negara Malaysia. The systems in Bank Negara Malaysia are complemented by a host of other proprietary systems owned and operated by financial institutions and other private entities. The proprietary systems consist of credit and debit card systems, ATM networks, the giro system, stored value cards, the securities Clearing Automated Network Services (SCANS) and the Malaysian Derivatives Clearing House (MDCH).

RENTAS is a high-value interbank funds transfer system, which also incorporates the processing and settlement of designated scripless securities on a Delivery versus Payment (DvP) basis for the participating financial institutions. RENTAS represents an important component of the payment system infrastructure in Malaysia as it caters to wholesale clients, especially banking institutions. SPICK, on the other hand, deals with retail clients. It is a combination of the automated cheque clearing system with the imaging of inward cheques for purposes of examination and verification of signatures by the Head Office and respective Regional Office of the paying banks.

Design and Risks in Payment Systems

The evolving financial and economic environment brings new challenges. A well-designed payment system, complemented by appropriate payment system policies and effective banking supervision, can assist countries avoid disruptions. As such, the robustness and security of the systems are prerequisites for their proper functioning, as well as to mitigate the inherent risk factors in the payment systems. These risks take a variety of forms and are usually categorised as follows:

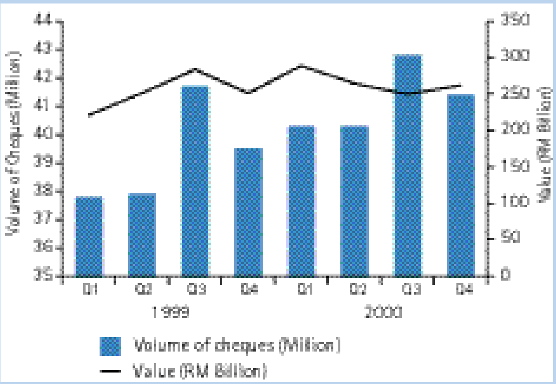
- **Credit Risk:** The risk that a counterparty will not meet an obligation for full value, either when due or at any time thereafter.

- **Settlement Risk:** The risk that a counterparty is not able to settle an obligation in full when due, but at some time thereafter. This could lead to liquidity problems if it were to become widespread.

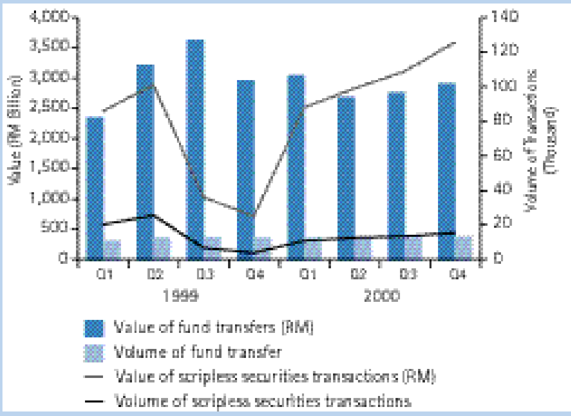
- **Operational Risk:** The risk that hardware or software problems, or mistakes will cause a system to break down or malfunction giving rise to financial exposures and possible losses.

- **Security Risk:** The risk of the security of payment system being compromised, resulting in monetary losses.
- **Systemic Risk:** The risk that the failure of one participant to meet its required obligations will cause other financial

Graph V.1
Cheques Cleared at SPICK



Graph V.2
IFTS and SSTS Turnover at RENTAS



institutions to be unable to meet their obligations when due.

All of these types of risk, whether in isolation or in combination, can have systemic consequences. A payment systems failure could cause widespread liquidity or credit problems and, as a result, could threaten the stability of the system and the financial markets. As the lender of last resort to the financial institutions, a central bank is directly involved once systemic risk threatens the system to provide the liquidity to restore stability. In view of this, the prevention and control of systemic risk is important for the central bank. In essence, the system need to be sufficiently protected against the risks.

To reduce these risks, several modalities are employed, usually in relation to payment systems that function in the inter-bank markets, in order to ensure that the risks are mitigated. These modalities may take the form of bilateral netting with settlement with a commercial bank, multilateral netting with settlement in the books of the central bank or bilateral settlement across the books of the central bank on a gross basis. Each of these systems impacts financial stability in its own unique manner.

The trend in recent years has been towards bilateral settlement in central bank money on a gross basis, that is, settlement of individual transactions across the accounts held by the participants with the central bank. Such a mode of payment or real time gross settlement system (RTGS) ensures immediate finality for each and every payment. RTGS systems have become the most common means of controlling risks associated with large value payments in developed financial markets. Bank Negara Malaysia adopted the RTGS system in July 1999 by introducing RENTAS to replace the end of day net settlement system known as SPEEDS.

RTGS is concerned with reducing credit, settlement and systemic risks. While the mechanics of individual systems may vary, an RTGS system is characterized by the requirement for immediate and final bilateral settlement between transacting parties. In an RTGS system, the time lag that would allow for settlement failures due to credit and settlement risks would be eliminated. RTGS systems also improve market transparency. As settlements are done bilaterally, it is possible to identify market players and monitor unusual developments.

RENTAS, the RTGS in Malaysia, is basically a host computer located at Bank Negara Malaysia to which all participating financial institutions are linked via COINS (Corporate Information Superhighway operated by Telekom Malaysia Berhad). Payment instructions are relayed electronically to the host computer, which effects the corresponding accounting entries on a real-time basis. These payments can only be effected provided the paying institution has sufficient funds in its accounts or has adequate collateral lodged with the system to avail itself of intraday credit provided by the Central Bank. In the event the paying institution does not have the adequate funds or securities, the transaction will be queued, pending the availability of funds and/or securities. The processing, transfer and settlement of interbank funds and scripless securities transactions take place in real-time and simultaneously. The transfers are effected on a gross basis (i.e. without netting debits against credits) and provide finality (i.e. payee banks are able to receive funds with certainty for individual transfers).

Since both the RENTAS and SPICK are critical systems, Bank Negara Malaysia has contingency set up in "hot standby" mode, with continuous transfer of data from the prime site, so that in the event of a breakdown, processing can resume in a matter of hours. All participants have also been advised to have a back-up site. Additionally, business continuity arrangements that include a "minimum level of service" to be used, in circumstances of severe disruption, are also in place for the RENTAS and SPICK systems. The contingency approach adopted by Bank Negara Malaysia will ensure that the critical payments in the country would not be disrupted.

International Cooperation on Payment Systems

There are several international initiatives under way to maintain financial stability by strengthening the financial infrastructure. Recent initiatives include an EMEAP Working Group on Payment and Settlement Systems, which was established in 1998 to study developments in domestic and cross-border payment and settlement systems.

In January 2001, the Central Bank Governors of the Group of Ten (G10) countries released a set of key standards on payment systems that would contribute to the soundness of financial systems. The standards, known as "Core Principles for Systemically Important Payment Systems", set out the principles that can be applied in all countries. They establish the key characteristics that all systemically important payment systems should possess. More recently, in February 2001, APEC had set up a Working Group on Electronic Financial Transactions to promote the further development of electronic financial transactions.

Challenges to Payment Systems

The ability to use electronic networks to store and handle funds instead of having to rely on physical transfer has had significant positive impact for the participants and users of the RENTAS and SPICK systems. Payments, both local and external, can now be made at greater speed and security. Floats (i.e. amounts debited, but not yet credited or vice-versa in the course of completing a payment transaction), particularly relating to remittance of funds and cheque clearing, have been reduced owing to the shortened timing of debits and credits to the accounts.

The continuing developments in IT are forcing changes on the existing payment systems. Such changes have rendered some legacy systems ill-equipped to handle recent trends and entrants such as e-money, trade exchanges, and e-commerce facilitated by the Internet. Moreover, the implications of these developments on financial stability have yet to be fully understood. The developments pose new challenges for regulators and Governments. Some of these issues include the impact on money supply, tax revenue, and effective regulation in a virtual and borderless world. Technological progress, however, offers new possibilities to improve payment systems such as increasing the range of products and services available, reducing cost and addressing the risks. Bank Negara Malaysia has had an important role in the development of the payment system and in ensuring the safety and efficiency of the system given the responsibility of the Central Bank in ensuring the efficient functioning of the money markets and the efficient implementation and transmission of monetary policy and in maintaining public confidence in the domestic currency and in the financial system.