The Financial Sector

The Financial Sector

SOURCES AND USES OF FUNDS OF THE FINANCIAL SYSTEM

In line with the improvement in overall economic performance, total assets of the financial system expanded significantly by RM96.5 billion, or 7.4%, in 2002 (RM42.1 billion, or 3.3%, in 2001). As at end-2002, the total assets of the financial system increased to RM1,401.8 billion. As a proportion of GDP, the total assets of the financial system remained high at 388% of GDP (390% in 2001).

Assets of both the banking system and the non-bank financial intermediaries (NBFIs) expanded in 2002. Assets of the banking system rose by RM58.5 billion, or 6.8% in 2002 (RM17.6 billion, or 2.1% in 2001), while assets of the NBFIs grew by RM37.9 billion, or 8.6% (RM24.5 billion, or 5.9% in 2001). The share of NBFIs in the total financial system assets continued to increase, rising to 34% as at end-2002 from 33.7% as at end-2001.

Within the banking system, the bulk of the increase in assets was due to the growth in assets of the commercial banks. This reflected mainly the increase in loans and advances, interbank placements, and investments in subsidiaries and associate companies resulting from the consolidation of the banking industry. Meanwhile, the growth in assets of the NBFIs was driven mainly by the expansion in the assets of the provident, pension and insurance funds (+RM27.8 billion), which accounted for 73.3% of the increase in total assets of NBFIs.

During the year, the bulk of new resources was contributed by deposits placed with the financial institutions and contributions to the provident, pension and insurance funds. Deposits mobilised by the financial institutions grew at a higher rate of 5.6% in 2002, compared with 2.5% in 2001. As in previous years, the banking institutions (comprising commercial banks, finance companies, merchant banks and discount houses) were the largest mobiliser of deposits. Deposits mobilised by the banking institutions accounted for 90.7% of the increase in deposits raised by the financial system in 2002, and 82.7% of total outstanding deposits of the financial system as at end-2002.

Graph 4.1
Assets of the Financial System as at end-2002*p* (% share)

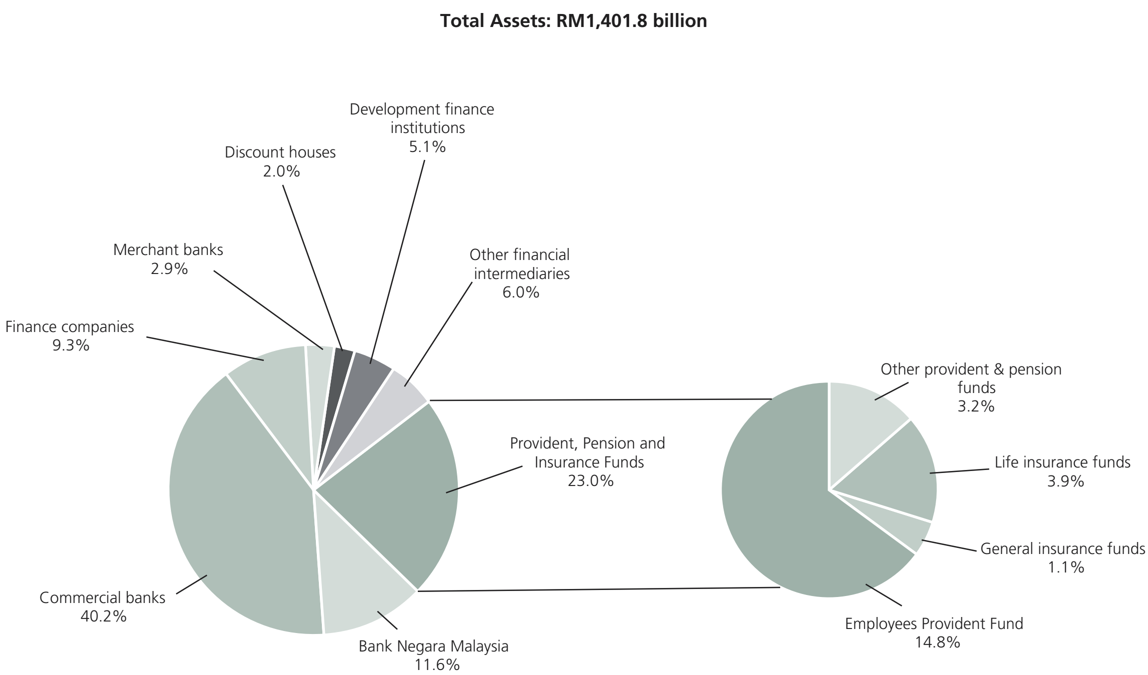

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Table 4.1
Assets of the Financial System

	Annual change		As at end
	2001	2002*p*	2002*p*
	RM billion		
Banking system	**17.6**	**58.5**	**924.6**
Bank Negara Malaysia	0.8	12.5	162.2
Commercial banks[1]	5.8	33.2	563.0
Finance companies	4.2	8.9	130.7
Merchant banks	4.1	0.3	41.3
Discount houses	2.7	3.6	27.4
Non-bank financial intermediaries	**24.5**	**37.9**	**477.2**
Provident, pension and insurance funds	25.4	27.8	322.6
Employees Provident Fund	*6.4*	*15.9*	*207.5*
Other provident & pension funds	*8.6*	*4.5*	*44.8*
Life insurance funds	*9.2*	*6.8*	*54.3*
General insurance funds	*1.2*	*0.6*	*15.9*
Development finance institutions[2]	6.7	3.1	71.1
Other financial intermediaries[3]	-7.6	7.1	83.5
Total	**42.1**	**96.5**	**1401.8**

1 Include the Islamic banks (since 1999).
2 Include Bank Simpanan Nasional, Bank Kerjasama Rakyat Malaysia Berhad, Bank Pertanian Malaysia, Malaysian Industrial Development Finance Berhad (MIDF), Borneo Development Corporation, Sabah Development Bank Berhad, Sabah Credit Corporation, Export-Import Bank Malaysia Berhad, Bank Pembangunan dan Infrastruktur Malaysia Berhad, Bank Industri dan Teknologi Malaysia Berhad, Malaysia Export Credit Insurance Berhad, Credit Guarantee Corporation Malaysia Berhad (CGC), and Lembaga Tabung Haji.
3 Include unit trusts run by Amanah Saham Nasional Berhad (ASNB) and Amanah Saham Mara Berhad, cooperative societies, leasing and factoring companies, venture capital companies, and housing credit institutions (comprising Cagamas Berhad, Borneo Housing Mortgage Finance Berhad, and Malaysia Building Society Berhad).
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Table 4.2
Sources and Uses of Funds of the Financial System

	Annual change		As at end
	2001	2002*p*	2002*p*
	RM billion		
Sources:			
Capital and reserves	2.9	21.0	144.8
Currency	-1.3	1.8	27.1
Deposits	14.7	33.4	634.4
Borrowings	2.6	6.4	43.8
Funds from other financial institutions[1]	0.9	4.0	72.6
Insurance and provident funds	19.4	16.8	272.8
Other liabilities	3.0	13.1	206.3
Total	**42.1**	**96.5**	**1401.8**
Uses:			
Currency	-3.5	-0.1	5.3
Deposits with other financial institutions	-6.4	11.7	188.8
Bills	-0.3	2.7	19.0
Treasury	*-0.2*	*1.6*	*5.7*
Commercial	*-0.1*	*1.1*	*13.3*
Loans and advances[2]	19.3	34.3	566.1
Securities	39.8	24.9	346.2
Malaysian government	*15.5*	*1.5*	*105.2*
Foreign	*0.9*	*0.5*	*2.7*
Corporate	*22.1*	*21.5*	*230.4*
Others	*1.2*	*1.4*	*7.9*
Gold and foreign exchange reserves	3.7	14.0	127.5
Other assets	-10.6	8.8	148.9

1 Includes statutory reserves of banking institutions.
2 Excludes loans sold to Danaharta.
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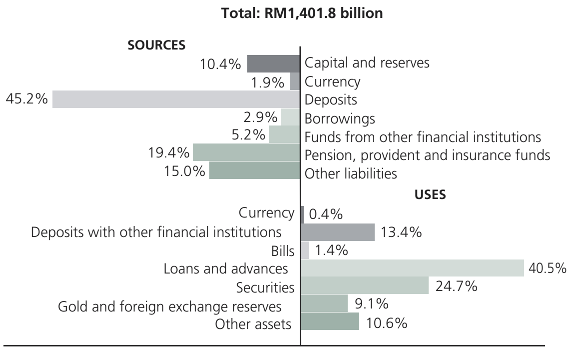
In terms of holders, deposits were mainly held by the non-financial private sector (comprising individuals and business enterprises), which accounted for 68.3% of total deposits outstanding as at end-2002. The deposits of this group grew by 5.7% in 2002, mainly on account of the increase in deposits placed by individuals. As in previous years, fixed deposits accounted for a significant proportion of the increase in non-financial private sector deposits, with holders continuing to exhibit a preference for deposits with shorter maturities.

Graph 4.2
Sources and Uses of Funds of the Financial System as at end-2002*p* (% share)



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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. Provident, pension and insurance funds grew by 6.6% in 2002, and accounted for 19.4% of the total funds raised by the financial system as at end-2002. Meanwhile, capital and reserves of the financial system increased by a significant 16.9% in 2002 (+2.4% in 2001), reflecting mainly the increase in banking institutions' profits and undistributed dividends of the provident and pension funds.

The increase in the total resources of the financial system in 2002 was mainly channelled into loans and advances and invested in securities. Loans and advances extended by the financial system increased by RM34.3 billion or 6.5% in 2002 (RM19.3 billion or 3.8% in 2001). The household sector continued to underpin the growth in loans and advances, with loans extended for the purchase of residential property and consumption credit accounting for a major proportion of the increase in total loans and advances in 2002.

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

	Annual change 2001	Annual change 2002p	As at end 2002p
	RM billion		
Deposits[3] with:			
Commercial banks	14.4	16.1	318.0
Finance companies	2.6	3.0	63.8
Merchant banks	-2.4	0.2	11.5
Discount houses	0.0	3.2	8.5
Bank Simpanan Nasional	0.8	0.7	8.1
Others[4]	1.1	0.1	23.2
Total	**16.5**	**23.3**	**433.1**
Demand deposits	2.1	5.9	64.1
Fixed deposits	9.0	9.5	282.2
Savings deposits	3.7	5.8	64.1
NIDs[5]	-1.1	0.5	2.3
Repos[6]	2.8	1.6	20.4
Fixed deposits of which:			
Up to 1 year	*3.8*	*15.4*	*243.9*
More than 1 year	*5.1*	*-6.0*	*38.3*

1 Refers to deposits placed by business enterprises (excluding NFPEs) and individuals.
2 Excludes provident and pension, insurance, and unit trust funds.
3 Refers to demand, savings and fixed deposits, negotiable instruments of deposits and repos.
4 Includes development financial institutions, cooperative societies and housing credit institutions.
5 Refers to negotiable instruments of deposit.
6 Refers to repurchase agreements.
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Investment in securities by the financial system continued to rise in 2002, albeit at a slower rate than in 2001 (7.8% in 2002; 14.1% in 2001). The bulk of the increase was due to investment in equity securities, in line with the higher issuance of new listings in 2002. As in previous years, the provident, pension and insurance funds accounted for most (85.7%) of the increase in securities investment by the financial system in 2002. Meanwhile, gross holdings of gold and foreign exchange reserves also recorded a significant rise of RM14 billion in 2002 (RM3.7 billion in 2001), reflecting mainly the foreign exchange inflows generated from the large trade surplus position and the overall favourable balance of payments position.

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

	Annual change 2001	Annual change 2002p	As at end 2002p
	RM billion		
Loans and advances	**20.4**	**37.9**	**536.3**
Agriculture	0.5	0.0	14.0
Mining & quarrying	-0.1	-0.2	1.0
Manufacturing	-1.2	-0.1	54.7
Construction and real estate	-3.6	-1.6	76.4
Purchase of residential properties	15.4	17.1	131.0
Retail, wholesale, restaurants and hotels	0.3	2.0	21.0
Transport, storage and communications	-0.8	1.3	14.1
Business services	1.2	-2.7	19.7
Consumption credit	9.9	12.7	86.3
Purchase of shares	-2.4	0.1	21.0
Others	1.3	9.2	97.0
Investments in corporate securities	**22.1**	**21.5**	**230.4**
Total	**42.5**	**59.4**	**766.7**

1 Excludes credit to non-financial public enterprises.
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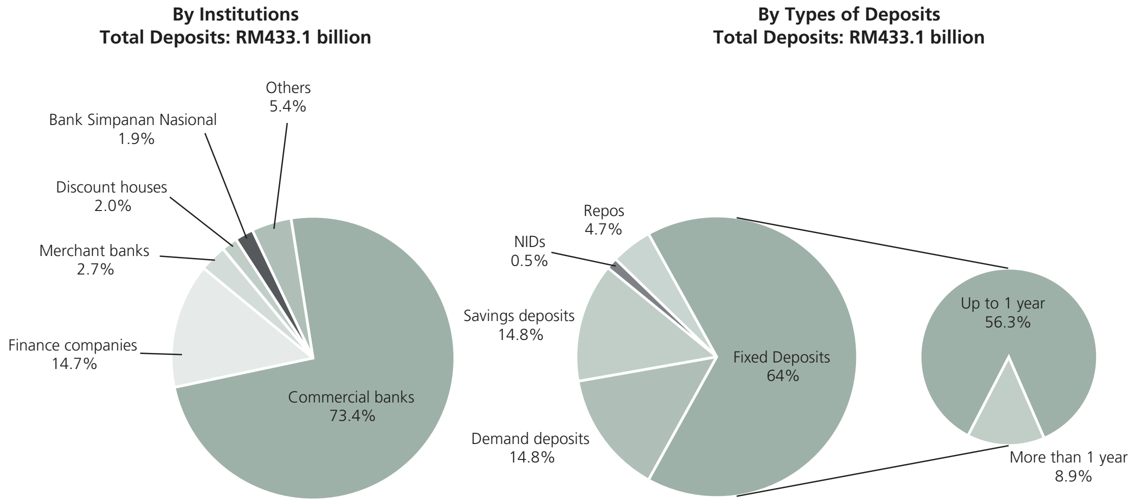
Graph 4.3
Non-Financial Private Sector Deposits with the Financial System as at end-2002*p* (% share)



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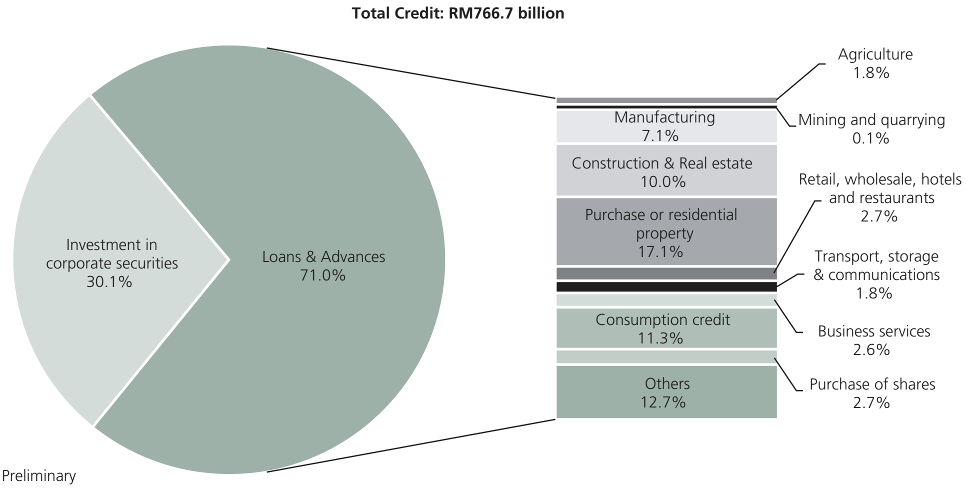
Graph 4.4
Direction of Credit to the Non-Financial Private Sector as at end 2002*p* (% share)



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MANAGEMENT OF THE BANKING SYSTEM

Policies implemented over the years have strengthened the resilience and improved the efficiency of the banking institutions thus positioning the banking sector to effectively support economic activities. Following the success of the consolidation exercise and improving economic outlook, the balance sheet of banking institutions has strengthened further in 2002. The risk weighted capital ratio (RWCR) of the banking system was sustained above 13% for most of the year, thereby providing sufficient capacity for the banking sector to efficiently channel funds to the various segments of the economy to support the higher level of economic activities. Total outstanding loans of the banking system increased by 4.2% in 2002, while total new loan approvals and disbursements rose by 9.4% and 10.2% respectively.

With the resilience of the banking sector enhanced, the thrust of banking policies in 2002 was aimed at building the necessary foundation and financial infrastructure for the medium and long term development of the banking sector to effectively meet the demands of an evolving economy. Efforts were, therefore, focused towards elevating the efficiency of the banking system in delivering quality and diversity of products and services at competitive prices.

Progress of Financial Sector Restructuring

The institutional arrangements put in place to restore stability in the financial system during the financial crisis achieved significant milestones in their operations in 2002. The closure of the Corporate Debt Restructuring Committee (CDRC) on 15 August 2002 represented an important conclusion of the debt restructuring efforts undertaken since 1998. During its four years of operations, CDRC had successfully resolved 48 cases involving debts of RM52.6 billion, representing approximately 65% of the cases under its auspices. Out of this, 32 cases with debts totalling RM36 billion have been fully restructured. The implementation of the remaining 16 cases with total debts of RM16.6 billion would further reduce the NPL level by two percentage points. About 83% of the recovery proceeds were in the form of cash, redeemable instruments and rescheduled debts.

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Table 4.5
Status of CDRC cases as at 31 December 2002

	Total debt outstanding* (RM million)	Number of accounts
Total referred to CDRC	67,644	87
Cases withdrawn / rejected	12,615	28
Transferred to Danaharta	2,470	11
Cases accepted	52,559	48
Resolved	52,559	48
Implemented	*35,969*	*32*
Pending implementation	*16,590*	*16*

* Including non-banking and offshore institutions

Table 4.6
Danaharta: Loan Recovery as at 31 December 2002

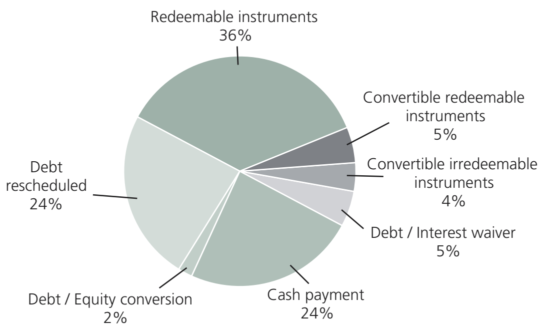
	Adjusted loan rights acquired[1] (RM billion)		Expected recovery rate (%)	
	Acquired NPLs	Managed NPLs	Acquired NPLs	Managed NPLs
Plain loan restructuring	3.2	6.3	80	79
Settlement	1.6	5.8	83	75
Schemes of arrangement	3.1	7.1	66	78
Schemes under Special Administrators	2.4	2.9	53	33
Foreclosure	9.8	4.1	29	45
Others	1.8	2.8	60	53
Legal action	0.3	1.4	-	-
Total	**22.1**	**30.4**	**50**	**63**
Overall	**52.5**		**57**	

[1] Comprising loan rights acquired of RM47.8 billion and accrued interest of RM4.8 billion.
Note: Total may not add-up due to rounding.

Danaharta, which ceased to acquire NPLs from the financial sector in 2001, has dealt with all of the NPLs under its purview amounting to RM52.5 billion. The focus of Danaharta was to implement the recovery strategies through restructuring, settlement, foreclosure and schemes of arrangements in order to maximise the recovery of the NPLs acquired. As at 31 December 2002, the average recovery rate achieved was 57% (50% for the acquired loans and 63% for managed loans) with expected recovery proceeds totaling RM30.2 billion, of which RM18.9 billion have been received in the form of cash and non-cash assets. The remaining RM11.3 billion are at various stages of recovery. From the RM18.9 billion recovery received, Danaharta has converted some of the non-cash assets into cash. Danaharta has distributed RM11.3 billion in cash and 55,899,542 units of securities to the Government and 30 banking institutions under the 80:20 surplus recovery sharing agreement between the financial institutions and Danaharta. As at 31 December 2002, Danaharta has RM6.1 billion in cash and cash equivalents.

Danaharta continued to conduct open property tenders as part of its recovery strategies. In 2002, Danaharta conducted its sixth and seventh property tenders in April and October respectively. The sixth property tender offered 265 pieces of property worth RM723.8 million and received 141 successful bids for a total consideration of RM326 million, representing a 12% surplus over their indicative value. Meanwhile, the seventh nationwide tender received successful bids for 37% of the properties offered. The 65 successful bids with total consideration of RM144.3 million, was slightly higher than the total indicative value of RM144 million. Up to 31 December 2002, Danaharta had conducted seven nationwide property tenders and five specific tenders, offering 890 properties worth RM2.3 billion to the market and successfully sold 745 or 84% of these properties with a total consideration value of RM1.4 billion or 97% of the aggregate indicative value.

Graph 4.5
CDRC: Recovery Profile as at 31 December 2002



Given the progress of its operations, Danaharta is on track to unwind its operations in 2005. To prepare for this, Danaharta has embarked on cash generation strategies in order to redeem its bonds when they mature. The first tranche of Danaharta bonds will mature on 31 December 2003, with the remaining tranches maturing in every subsequent quarter up to 31 March 2005. Danaharta has initiated a tracking system to monitor and manage the process of matching the receipt of recoveries and, where necessary, the subsequent conversion into cash to meet the redemption of the maturing bonds. In addition, Danaharta has streamlined its organisation structure to enhance its efficiency. As the date of closure approaches, Danaharta will be looking at reducing the number of staff in a timely and orderly manner.

In the case of Danamodal, no capital injection into a financial institution has been made since 1999. Its outstanding investment has declined to RM2.1 billion in three institutions, from the RM7.1 billion injected into 10 institutions since its inception. With the recapitalisation exercise already completed, Danamodal's focus has been towards managing its surplus funds and ensuring sustainable returns on its assets. As at 31 December 2002, the bulk of Danamodal's assets comprised substantially fixed income instruments. With net tangible assets of RM2.3 billion, Danamodal has the capacity to redeem its RM11 billion bonds in October 2003. Danamodal is expected to cease operations in 2003.

Another important achievement in the financial restructuring process was the completion of the merger programme for the domestic banking institutions. In June 2002, the merger of Arab-Malaysian Finance Berhad with MBf Finance Berhad was completed. This was followed by the completion of the acquisition of Bank Utama (Malaysia) Berhad by RHB Bank Berhad at the end of the year. With the completion of these mergers, the domestic banking system has been transformed from one that was highly fragmented with 71 institutions prior to the Asian crisis, to 30 banking institutions under 10 domestic banking groups. Banking institutions are now well-positioned to realise the synergies reaped from the mergers following the completion of the integration of their banking operations, especially in terms of computer and delivery platforms as well as human resources. The reengineering of operations through the pooling of resources, cross-selling of products and services and outsourcing of non-core operations have also resulted in gradual improvements in productivity and the level of customer service. A number of banking groups have also reconfigured their business models and reorganised their group structures in line with their new business strategies to offer a wider range of financial activities under one common brand. In addition to the mergers between domestic banking institutions, the year 2002 also saw the consolidation of United Overseas Bank (Malaysia) Berhad and Overseas Union Bank (Malaysia) Berhad, following the merger of their parent banks in Singapore in 2001.

Thrust of Policy Measures in 2002

Given the strengthened position of the banking system and significant progress achieved in the restructuring of the financial sector, the main thrust of the policy measures in 2002 focused on enhancing the capability and capacity of domestic banking institutions to compete in a more liberalised environment. These efforts were complemented by initiatives taken to promote efficiency, innovation and dynamism within the banking sector. The pursuits to attain higher levels of efficiency were, however, balanced with the need to ensure effective and continued intermediation of funds whilst preserving overall stability in the financial sector.

Another key thrust of banking policies was to ensure that all sectors of the economy continued to have adequate access to financing to sustain the momentum of economic growth. Towards this end, Bank Negara Malaysia conducted a study to identify gaps in the present infrastructure that affected the growth of small and medium-sized enterprises (SMEs). Arising from the study, a comprehensive framework has been developed to enhance the contribution of SMEs to the domestic economy. In addition, a framework has also been developed to address the issue of access to financing by microenterprises.

Recognising the importance of active consumerism in driving efficiency and financial performance within the banking sector, a critical thrust of policy measures in 2002 was to put in place the necessary foundation for the development of a comprehensive and market-oriented consumer protection infrastructure. To spearhead this process, a two-pronged strategy has been initiated, encompassing a 10-year consumer education programme to upgrade the level of financial literacy among the public and to strengthen the present consumer protection infrastructure to promote greater confidence in the banking sector. These policy measures were complemented by on-going measures and initiatives to promote financial stability through prudential regulations and vigorous supervisory oversight.

Enhancing Domestic Capacity

As domestic competition intensifies and consumers grow in sophistication, the ability for banking institutions to provide a broad range of products and services in an efficient and cost-effective manner is critical to enhance their competitiveness within the financial sector. Towards this end, the main initiatives during the year were targeted at strengthening the capacity and capability of the domestic banking institutions. Central to these efforts is the benchmarking exercise that was initiated in 2000. The benchmarking exercise is a powerful tool for banking institutions to measure their performance, by highlighting both operational and strategic opportunities as well as areas for strategy-building and skill enhancements. During the preliminary stages of the benchmarking exercise, a set of general benchmarks to measure the basic financial performance of banking institutions was developed. In 2002, Bank Negara Malaysia further refined these general performance indicators to allow the banking institutions to assess not only their financial performance, but also the quality of their customer service vis-à-vis their peers. These include benchmarks on turnaround time for loan processing and issuance of replacement credit cards, and the uptime of automated teller machines. The statistics on industry averages were provided to banking institutions on a quarterly basis to facilitate their internal monitoring. Banking institutions are also in the process of upgrading their systems to capture cost and returns of different products and customer segments. The performance assessment was also complemented by a number of site visits by Bank Negara Malaysia. In addition, the Bank holds regular discussions with the board of directors and senior management of banking institutions to review their institution's performance. These discussions provide an avenue for both banking institutions and the Bank to discuss areas that need to be addressed to enhance the effectiveness and competitiveness of the banking industry.

To complement the benchmarking exercise in the drive to achieve greater efficiency in the banking industry, Bank Negara Malaysia has initiated a programme to assess the needs and expectations of consumers, the extent to which this has been met, as well as shortcomings in the quality of the products and services provided by banking institutions and insurance companies. This programme, which includes a nationwide survey, will provide the foundation for the development of a service quality index for banking institutions. The survey would involve about 5,000 customers, comprising individuals, SMEs, large corporations and multinationals. The programme, which commenced in November 2002, is expected to span over four years, with the completion of the first full-scale market analysis in mid-2003.

Currently, banking institutions need to meet a product pre-approval requirement prior to introducing new activities or products. These requirements were imposed to ensure orderly development of the financial market and adequate safeguards to protect consumers' interest in the absence of a comprehensive framework on consumer protection. Whilst these requirements were deemed necessary, they generated uncertainty among banking institutions as to the regulatory requirements for new products and approaches. Moving forward, as the regulatory environment becomes more market-driven with greater reliance on market discipline and consumer activism to drive financial performance, these requirements would be removed gradually to incentivise banking institutions to invest in research and development to develop products and services that can capitalise on their niche area of businesses. Towards this end, a concept paper on the "Proposed Guidelines on New Product Approval Requirements" was circulated in November 2002, with the objective of providing a structured and transparent framework to replace the existing product pre-approval requirements. This guideline prescribes a simple new product notification and approval process, in line with the recommendation in the FSMP to adopt the principle of "What is not prohibited is allowed". Under this proposed framework, the products and/or characteristics of products that would require prior approval are identified, including the specific information that need to be submitted to Bank Negara Malaysia to expedite the approval process. To complement this new approach, surveillance would be enhanced to ensure the orderly development of products and services. In addition, requirements for greater product transparency and for consumers to have access to product information are embodied in the guidelines.

The Guidelines on Staff Training Fund were first introduced in 1985 to encourage banking institutions to train their own personnel rather than resorting to drawing staff from other financial institutions. Under the Guidelines, banking institutions that resort to staff pinching had to contribute to the Staff Training Fund administered by Institut Bank-Bank Malaysia (IBBM). As the banking sector develops, it has become increasingly crucial for banking institutions to be able to attract the best talent, particularly in areas where there are still shortages of skills such as risk management, systems development and alliance building. Hence, the wage moratorium was uplifted in 2000 to provide greater autonomy for banking institutions to determine the remuneration of employees based on productivity and performance. In line with this liberalisation, the penalty on staff pinching would be removed gradually. Hence, the Guidelines on Staff Training Fund were reviewed, whereby the scope of coverage has been narrowed to staff with a monthly gross salary of RM4,000 compared to RM2,000 previously. Banking institutions would be required to contribute to the Staff Training Fund a sum equivalent to six months of the new gross salary, if the previous employer did not agree to release the staff.

Another important avenue for banking institutions to accelerate the enhancement of their capacity and capability is through strategic alliances. One form of strategic alliance that has grown in importance in recent years in Malaysia is bancassurance, involving a tie-up between an insurance company and a banking institution to market insurance products through the banking institution's branches. This form of strategic

Banking Measures Issued in 2002

Significant progress was made in 2002 in implementing a number of measures aimed at enhancing the soundness of the financial sector and at improving the efficiency and competitiveness of the sector. In addition, initiatives on consumer and investor protection were introduced.

Measures to Enhance Safety and Soundness

(a) Informal Enforcement Actions Framework (IEAF)

For a structured approach towards enforcement of corrective measures on a timely basis especially arising from Bank Negara Malaysia on-site examination, the Guideline on the IEAF was issued to all banking institutions on 6 September 2002. The framework sets out the different types of informal enforcement action which may be taken by Bank Negara Malaysia to require banking institutions to take corrective action. In particular, the IEAF introduced two new informal enforcement actions, namely, the Board Resolution and the Letter of Undertaking, to complement Commitment given by an institution. The IEAF would thus contribute towards strengthening the resilience of banking institutions through timely intervention and pre-emptive corrective regulatory action.

(b) Guidelines on Minimum Requirement on Risk and Fraud Management of Credit Card Operations

Introduced in July 2002, these Guidelines were issued to all credit card issuers and credit card acquirers to address credit card fraud. The Guidelines specify the minimum requirements for preventive, detection, corrective and containment measures by credit card issuers and acquirers to mitigate the risk in credit card operations and to combat credit card fraud.

(c) Enhancing Controls to Combat ATM Related Fraud

To mitigate ATM related frauds by card cloning syndicates, banking institutions were required to institute tighter controls in their systems. Issued in October 2002, these include regular physical monitoring of ATMs for foreign objects, monitoring withdrawal patterns, as well as review of operating hours and withdrawal limits.

(d) Migration to EMV Chip Based Credit Card

In an effort to seriously combat credit card skimming fraud, the banking industry has initiated an industry wide migration from the existing magnetic stripe credit cards to the EMV chip based cards. The existing magnetic stripe credit cards are expected to be replaced with EMV chip based cards by the end of 2004 while the card readers will be upgraded or changed to accept EMV chip based cards by the end of 2005.

(e) Guidelines on Financing the Broad Property Sector (BPS) and Share Financing

Currently, banking institutions' exposure to the BPS and share financing sectors are subjected to limits based on the respective institution's total loans outstanding. Under the revised guidelines, these limits would be removed and the banking institutions' exposure to the sectors would be based on the respective institution's risk assessment. Additional capital would be required to support an institution's exposure to these sectors should it exceed the predetermined threshold. The responsibility is with the board of directors of the banking institution to ensure that appropriate policies and procedures are in place to measure and manage risks arising from exposure to these sectors. The underlying principle of the revised guidelines is to allow banking institutions which have robust capital and prudent risk management capabilities greater operating flexibility in managing exposure to the two sectors. The Guidelines will be issued in 2003.

Measures to enhance competition and efficiency in the banking industry

(a) Liberalisation of Policy on Internet Payment Gateway

The policy on requiring banking institutions which acquire merchants on the internet, to channel all payment instructions through the payment gateway operated by the Malaysian Electronic Payment System (1997) Sdn. Bhd. was abolished with effect from 30 September 2002. Effectively, this would allow banking institutions to establish their own internet payment gateways or subscribe to payment gateways of their choice. This would result in greater efficiency as market forces would shape the development of the payments system.

(b) Liberalisation on Repo Transactions

Effective 2 February 2002, banking institutions were allowed to undertake repo and reverse repo transactions of less than one month maturity, with non-licensed institutions. Previously, such transactions were allowed to be carried out only by Principal Dealers and discount houses. This privilege is removed to promote secondary activities and market liquidity.

(c) Extension of Services of Money Brokers to Universal Brokers

To promote the development of the Ringgit bond market, money brokers were allowed, with effect from 27 August 2002, to extend broking services to universal brokers in the unlisted debt market. In addition, universal brokers were also allowed to be members of FAST, BIDS and RENTAS as well as being authorized depository institutions of debt securities. For settlement through RENTAS, universal brokers are required to appoint a settlement bank(s).

(d) Guidelines on New Product Approval

As part of the process to implement the Financial Sector Masterplan recommendation to adopt the regulatory philosophy of "What is not prohibited is allowed" and to phase out product pre-approval requirements, the Guidelines on New Product Approval were drawn up and issued as a concept paper to the industry in November 2002.

Currently, banking institutions are required to obtain prior approval from Bank Negara Malaysia before introducing any new products or services. This requirement aims to ensure the orderly development of new banking and financial products and services. At the same time, the process allows for the effective assessment and management of the inherent risks of introducing the new products and services to the banking institutions and the financial system.

It is envisaged that the adoption of the new approach would provide greater clarity on new banking products that may be introduced, thus providing greater incentive in their offering of new products and services. The new approach, however, has to be complemented with a higher level of product transparency and consumer literacy. The Guidelines on New Product Approval will be effective from 1 April 2003.

(e) Negotiable Instruments of Deposit (NID) Guidelines

The NID Guidelines issued in 1993 were revised with effect from 30 April 2002 to align the Guidelines with that of the Islamic NID as well as to formalise market practices into the Guidelines.

Major changes made to the Guidelines were:

- Minimum denomination has been increased from RM50,000 to RM100,000.
- Maximum tenure of NID has been increased to 10 years.
- Total aggregate outstanding issue of NID (for both conventional and Islamic) is capped at five times of approved capital funds.
- Buyback of own NID is allowed after the NID has been issued and outstanding for at least one month.
- Branches of banking institutions are allowed to issue NID subject to appropriate monitoring, control and reporting mechanism.

(f) Banker Acceptances (BA) Guidelines

To keep pace with developments in the market, the BA guidelines were revised as follows:

- Minimum denomination of the BA has been increased from RM30,000 to RM50,000 in multiples of RM1,000 per invoice.
- Financing against Summary of Invoices is subject to discretion of the banking institutions.
- Extension of BA tenure or creation of new BA to repay an existing BA is prohibited.

Measures to protect consumers and investors interest

(a) Access to Savings Account Services

To ensure that all groups of consumers are granted access to savings account services, banking institutions were reminded that unless the savings account is inactive, no fees should be imposed on consumers for opening/operating savings accounts. The minimum initial deposit for opening such accounts was also determined at no more than RM250 and subsequent to opening the account, consumers should be allowed to maintain less than RM250 in the account with no charges or fees.

(b) Publication of Financial Statements in Newspapers

With effect from 3 October 2002, licensed institutions need only publish an abridged format of their financial statements in the newspapers if a full text of their financial statements including the Auditors' Report, is made available in the institutions' website. This is to ensure the salient features in the performance of the licensed institutions are highlighted to the public. The abridged format would include the following:

(i) Balance Sheet;
(ii) Income Statement;
(iii) Cash Flow Statement;
(iv) Auditors' Report; and
(v) The following Explanatory Notes to the Accounts:
  (a) Investment securities;
  (b) Loans, advances and financing;
  (c) Commitments and contingencies; and
  (d) Capital adequacy.

(c) Guidelines on Pass-Through Activities Conducted by Exempt Dealers

To promote greater level of protection for investors participating in capital market activities, Bank Negara Malaysia and the Securities Commission jointly issued guidelines governing the pass-through activities of exempt dealers, to the banking industry for consultation in July 2002. Pass-through activities are intended to cover only activities involving transactions in shares which are listed on the Kuala Lumpur Stock Exchange that are undertaken by exempt dealers on behalf of their clients, and not the other forms of activities as stipulated in the Securities Industry (Exempt Dealer) Order 1996. The Guidelines also require personnel handling such pass-through activities to sit for licensing examinations, as currently required for the stockbroking companies.

(d) Guidelines on the Specimen Financial Statements for Licensed Financial Institutions (BNM/GP8)

BNM/GP8 was first issued in 1988 primarily with the objective of ensuring that financial institutions comply with the provisions of the Companies Act 1965 and accounting standards and in the disclosure of all material and exceptional facts to facilitate users in their evaluation and assessment of the financial position and performance of a financial institution. The BNM/GP8 has since been revised to take into account new developments such as the operations of the Interest-Free Banking Scheme. In 2002, a review was undertaken to take into account the establishment of the Malaysian Accounting Standards Board (MASB) in July 1997, the subsequent issuance of accounting standards by MASB, as well as increasing requirement for greater public disclosure to foster market discipline. As a result, concept papers on the revised BNM/GP8 were issued to the banking industry, audit firms, MASB and the relevant professional bodies in 2002.

While the MASB accounting standards and the International Accounting Standard (IAS) 39 on fair value accounting formed the basis of changes made to BNM/GP8, other changes included greater focus on the role of the board of directors in the preparation of financial statements, assessment of the banking institution's operations in the past and for the coming year as well as corporate governance matters such as responsibility of the board, committees and risk management practices, taking into account international best practices.

Developments in the Credit Bureau

During 2002 several enhancements were made to the Credit Bureau operations of the Bank. Firstly, the newly developed database of borrowers, known as the Central Credit Reference Information System (CCRIS), launched earlier in October 2001, was successfully deployed. As a result, the previous database system was deactivated.

With the deployment of CCRIS, covering a database of nearly 5 million borrowers (less than 100,000 found in the previous system), the Credit Bureau's comprehensive and wide coverage has significantly enhanced its effectiveness as the credit information vehicle in Malaysia. Since the establishment of CCRIS, the number of credit searches on potential or existing loan customers by the financial institutions from the Credit Bureau averaged more than 300,000 per month, compared to less than 500 per month previously. The enhanced credit information has contributed greatly to the improved efficiency in the loan evaluation process at the financial institutions. Since the launch of CCRIS, decisions on 90% of loan applications were made by the financial institutions within one month. It is expected that the timeliness of credit decisions by the financial institutions would further improve in the future as most financial institutions are developing computerised credit scoring models, using the input from data derived from CCRIS.

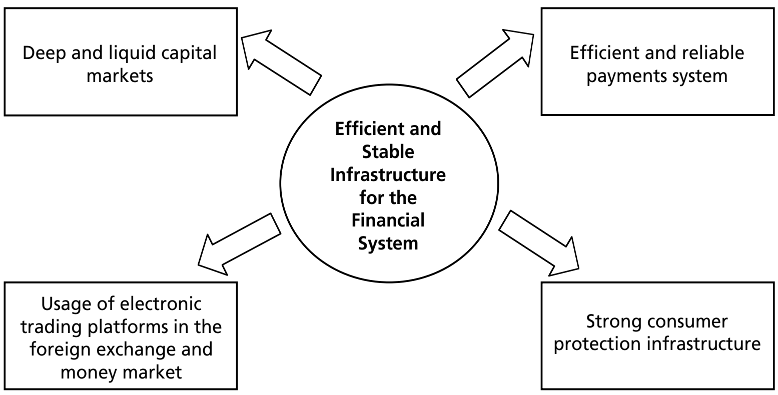
The year 2002 also saw the coming into force of legislative amendments to the Central Bank Of Malaysia Act 1958 and consequential changes to other laws relating to the Credit Bureau. The amendments were aimed at facilitating the operations of the Credit Bureau, protecting confidentiality of information in CCRIS and strengthening the protection of consumers. In this regard, the Credit Bureau is now empowered to disclose reported credit information on a bank customer to the customer so as to enable verification of the accuracy and completeness of such information. This is a significant and timely development as the process is now available for a borrower to expeditiously resolve information discrepancies with financial institutions. In the course of investigating information disputes, a number of cases of identity theft was discovered and rectified to the benefit of the customers.

To promote awareness and appreciation of the role of the Credit Bureau in the financial system, the Bank has published a booklet entitled "Credit Bureau" within the broader Consumer Education Program launched in January 2003. At the same time, information on the Credit Bureau and its activities is also made available on the Bank's website.

Introduction of Deposit Insurance in Malaysia

A strong consumer protection infrastructure is identified under the Financial Sector Masterplan (FSMP) as one of four elements underpinning the foundation for an efficient and stable financial system. Its importance stems from the ability to maintain public confidence in the reliability of the financial system under the changing business environment and different economic cycles, thereby contributing towards long-term stability.

Elements of the Foundation for an Efficient and Stable Financial System



In this context, the FSMP recommendation to introduce a deposit insurance system in Malaysia is a progressive step forward towards further strengthening the consumer protection framework in an increasingly market-oriented financial system. Deposit insurance provides an explicit guarantee on insured deposits up to a specified amount in the event that a deposit-taking institution that is a member of the deposit insurance system is unable to meet its obligations to depositors. Deposit insurance systems have been introduced in over 70 countries around the world, including both developed and developing countries, with the earliest system dating back to 1934. This article sets out the public policy objectives of the proposed deposit insurance system in Malaysia and some of the salient features being considered in the design of an appropriate and effective system for the Malaysian financial system.

Enhancing depositor protection in Malaysia

A strong and stable banking system in Malaysia is achieved through the vigilant supervision of banking institutions, supported by a comprehensive legal and regulatory infrastructure. Together with Bank Negara Malaysia's role as the lender-of-last-resort[1], the deposit insurance system will further strengthen the overall financial safety net by adding another dimension to depositor protection in Malaysia. More specifically, it will achieve this by:-

- ***strengthening incentives for the adoption of sound financial and business practices***
  The deposit insurance system will further reinforce Bank Negara Malaysia's role as the regulatory body and its efforts to promote the sound management of banking institutions (some of which are outlined under the "Management of Banking System") by creating additional incentives for the adoption of sound financial and business practices. These incentives include differential premium contributions from banking institutions and an appropriate level of protection that would cover the large majority of depositors and yet maintain sufficient incentives for large and institutional depositors with access to financial expertise to monitor the performance of banking institutions more closely. This would promote more effective market discipline.

[1] Under section 31A of the Central Bank of Malaysia Act 1958 and section 78 of the Banking and Financial Institutions Act 1989, Bank Negara Malaysia may grant loans, against sufficient security, to a licensed banking institution that is likely to become unable to meet all or any of its obligations or is about to suspend payment to any extent.

- ***providing explicit protection to depositors***
  The protection of depositors serves two purposes. Firstly, by providing an explicit guarantee on insured deposits, a deposit insurance system can significantly enhance public confidence in the financial system. This is essential for financial stability since any sudden widespread withdrawal of funds by depositors can create significant liquidity demands on a banking institution and lead to contagion effects on the rest of the banking system. Secondly, despite ongoing efforts to increase the level of disclosure and transparency in the banking industry, the increasing complexity of banking operations makes it difficult for many depositors to effectively monitor and analyse the financial condition of banking institutions. Given this constraint and the more competitive environment, an effective deposit insurance system that provides an explicit level of protection to depositors up to the insured amount will relieve depositors of the task of individually monitoring and assessing the financial condition of banking institutions.

- ***redistributing the costs of bank resolutions to the banking system***
  Under a privately-funded deposit insurance system, banking institutions bear the costs of deposit insurance through the contribution of premiums to a deposit insurance fund. The fund may be used to reimburse depositors of banking institutions in the event that an institution should become unable to meet its obligations to depositors or provide financial assistance for the implementation of an appropriate resolution to deal with the institution. This will reduce expectations for the Government to step in and support bank resolutions. The existence of such expectations creates moral hazard that can undermine the soundness of the banking system in the long term. In contrast, the redistribution of resolution costs to the banking system can promote peer discipline among banking institutions towards preserving a sound and stable financial system.

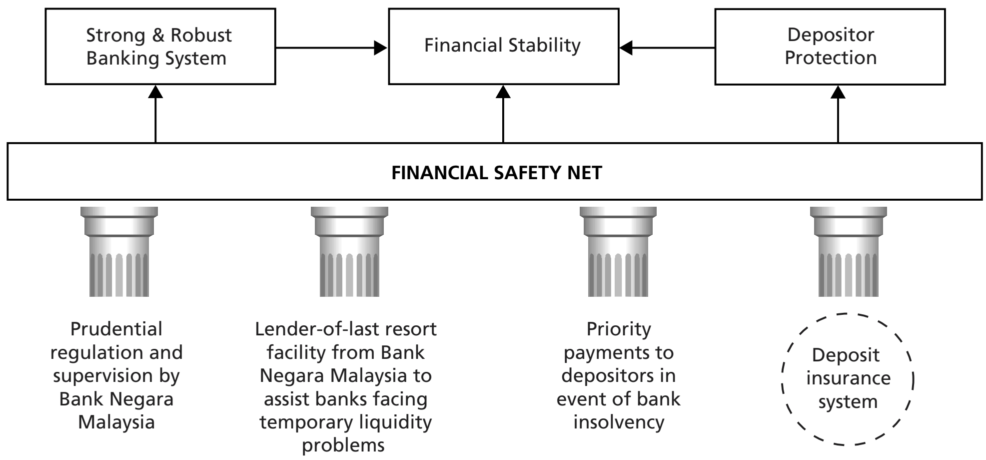
Favourable conditions exist in Malaysia for the successful introduction of a deposit insurance system. These include the strengthened economic conditions on the domestic front, with the underlying growth prospects remaining positive against a background of sound macro-economic policies and the strong performance of the banking system which entered its fourth consecutive year of profitability in 2002. The completed consolidation of the banking industry into 10 large domestic banking groups has also strengthened the banking sector. Together with the robust legal, regulatory and supervisory framework, these conditions provide the necessary foundation and the policy flexibility to consider a wider range of options in designing an effective deposit insurance system to achieve the principal objective of further contributing towards financial stability.

The design of an appropriate deposit insurance system for Malaysia will be guided by a number of key principles:-
- the system will incorporate features that reinforce sound financial and business practices in the banking system;
- the costs of providing deposit insurance protection will not impose a burden on consumers, and will not be passed on to depositors of banking institutions;
- the implementation of the system will not create destabilising effects on competitive structures in the financial system or the savings and investment behaviours of the general public;
- the system will be equitable to its stakeholders, having regard to the interests of depositors, the Government and the banking institutions that are members of the deposit insurance system;
- any duplication of functions or regulatory requirements associated with the introduction of the deposit insurance system will be minimised so as not to create an additional regulatory burden on banking institutions; and
- the system will be capable of being efficiently administered and effectively communicated to the public.

Strengthening the financial safety net
The deposit insurance system has an important role within the financial safety net. The specific powers and responsibilities accorded to the deposit insurer to support that role will depend on its mandate. It is envisaged that the proposed mandate for the deposit insurance system in Malaysia will be to administer a deposit insurance system in a manner consistent with promoting incentives for sound risk management,

reimburse depositors for the loss of part or all of their deposits in the remote event that a bank is unable to meet its obligations to depositors, and promoting or otherwise contributing to the stability of the financial system. Under this mandate, the deposit insurer may also implement bank resolutions to safeguard the interests of depositors.

Financial Safety Net for the Malaysian Financial System



The coordination of the roles of Bank Negara Malaysia and the deposit insurance system will ensure the effective functioning of the financial safety net and avoid the duplication of supervisory functions carried out by Bank Negara Malaysia. This is achieved by having a clear mandate for the deposit insurance system as well as a framework on the relationship between Bank Negara Malaysia and the deposit insurance system that will address issues of accountability, allocation of powers and responsibilities as well as the coordination of actions.

Engendering confidence and ensuring viability through compulsory membership

In principle, membership of a deposit insurance system may include any deposit-taking institution. However, in practice, the membership of a deposit insurance system is influenced by a number of factors, including:-

(i) whether the institutions are subject to a strong regulatory and supervisory regime;
(ii) the nature of core activities and primary role of the institutions;
(iii) the existence of Government-backing or alternative protection schemes;
(iv) relevance of the institutions to financial system stability; and
(v) the potential impact of competitive distortions that may arise from excluding certain institutions from the deposit insurance system.

Taking into account these considerations, membership will be made compulsory for certain types of institutions in order to avoid adverse selection which could result in a system that includes only small or perceived weaker institutions. This requirement will preserve the long-term viability of the system.

Promoting greater market discipline through limited coverage

A key feature of an effective deposit insurance system is limited coverage set at an appropriate level that promotes stability by providing an adequate level of protection to the vast majority of depositors, while encouraging larger depositors and institutions that are not fully insured to play a more active role in exerting market discipline on banking institutions. Deposit insurance systems around the world typically cover between 80% to 90% of depositors or accounts in the banking system in full. Full coverage for the large majority of retail depositors is important to maintain public confidence. Within the Asian region, a higher level of coverage is generally observed with most deposit insurance systems covering more than 90% of depositors or accounts in full.

Similarly, the scope and limit of coverage for the proposed deposit insurance system in Malaysia will be appropriately defined to provide full coverage for at least 90% of individual and business depositors. At the same time, the coverage up to a specified limit will ensure that sufficient incentives are retained for larger and institutional depositors to exercise greater market discipline over banking institutions.

Strengthening incentives for sound financial and business practices through differential premiums

Sound funding arrangements are critical to the effectiveness of a deposit insurance system and the maintenance of public confidence. Under a privately-funded system, banking institutions that are members of the deposit insurance system contribute premiums which are used to meet the administrative costs, depositors' claims and other resolution costs incurred by the deposit insurer. These contributions may be made in advance on a regular basis (ex-ante) or after the event of a payout or bank resolution (ex-post).

A funding structure that combines ex-ante and ex-post funding which is being considered for the proposed deposit insurance system in Malaysia offers several advantages. The regular premium contribution enables the smoothing out of premiums over time and is more equitable as a banking institution that is resolved under the deposit insurance system would have also borne part of the costs of its own resolution through its earlier premium contributions. At the same time, the ability to impose ex-post levies to fund a payout or bank resolution allows for the deposit insurance fund to be built up over time and avoids the need to maintain a large contingency fund that could be more efficiently invested by banking institutions.

The premiums levied on banking institutions that are members of the deposit insurance system can either be at a flat rate or at differential rates corresponding with the risk profile of individual institutions. While a flat-rate system is relatively easier to administer, it would not reflect the different risks of each member institution and thus, would not effectively address moral hazard since banks can engage in excessive risk-taking without incurring additional deposit insurance costs. It is also considered to be less equitable in that member institutions with lower risk profiles will be effectively subsidising higher-risk institutions.

In line with its objective of promoting sound financial and business practices, the proposed deposit insurance system in Malaysia will adopt a risk-adjusted differential rating model. The premium rates levied on banking institutions under various risk categories will seek to strike a balance between avoiding any significant impact on the profitability of individual banking institutions or on the cost of financial services to consumers, while ensuring that the rates serve as an effective incentive for banking institutions to make meaningful improvements in their risk profiles and thus, lower their premium contributions.

Protecting Islamic deposits in a manner consistent with Shariah principles

As an integral component of the mainstream banking system in Malaysia, the proposed deposit insurance system will also accord protection to Islamic deposits in a manner consistent with Shariah principles. This will be achieved by incorporating specific features in the design of the deposit insurance system that caters to the distinct elements of Islamic banking, while maintaining equity between the treatment of conventional and Islamic deposits.

Enhancing effectiveness through a comprehensive communication programme

The introduction of the proposed deposit insurance system will be supported by a comprehensive communication programme to educate the public on the benefits of the system. The main objective of the programme will be to develop a sound understanding of the deposit insurance system both among the public as well as its member institutions, thereby providing the foundation for an effective deposit insurance system in Malaysia.

alliance complements efforts of banking institutions to provide a wider array of financial products to customers. In 2002, a survey was conducted to gauge the extent of strategic alliances within the banking sector and to identify the issues that may affect the viability of strategic alliances. The survey indicated that while banking institutions did explore opportunities to enter into strategic alliances, the alliances that have taken place were mainly in the areas of retail banking and information technology. The findings of the survey would be used to review the present legal and regulatory framework and identify ways to encourage more strategic alliances.

In 2000, a blanket approval was granted for banking institutions to conduct cross-selling activities and to rationalise their internal operations to maximise group synergy and economies of scale. Moving forward, banking groups would be encouraged to further rationalise their internal operations to maximise economies of scale. Towards this end, Bank Negara Malaysia has initiated work to facilitate the merger of the operations of commercial bank and finance company within a domestic banking group into a single entity that provides the whole spectrum of financial products that are related to commercial banking and finance company activities. This legal entity would hold both the commercial bank and the finance company licences, thereby minimising duplication of resources and allowing for greater costs savings. Towards this objective, the Banking and Financial Institutions Act 1989 (BAFIA) would be amended and is expected to be tabled in Parliament in 2003.

Mergers between merchant banks, stockbroking companies and discount houses to create investment banks would be pursued in line with the recommendation in the FSMP. Bank Negara Malaysia together with the Securities Commission (SC) and the Kuala Lumpur Stock Exchange (KLSE) are finalising a single regulatory capital framework for the investment banks to harmonise the differences in the current capital adequacy rules for merchant banks and stockbroking companies. In developing these capital rules, which would form a single capital adequacy framework for investment banks, the regulatory agencies have taken into account the need to minimise the regulatory burden on investment banks, as well as the fact that the capital framework should accurately capture the underlying risks of the activities of the investment banks. A concept paper on the establishment of investment banks will be issued to the industry in early 2003. This would be followed by the amendments to BAFIA envisaged to be tabled in Parliament in 2003, to facilitate the creation of investment banks.

Ensuring Continuous Access to Financing

Sustainability of economic growth requires access to financing to support the growth process. As the banking system remains the main source of financing within the economy, a major focus of policy measures in 2002 was to ensure that the lending activities of the banking system were supportive of economic growth. A notable development has been the increasing trend in financing to the small borrowers. This is partly attributed to the shift to the bond market by the corporate sector, and the growing focus by the banking institutions on consumer lending and lending to SMEs. In recent years, the outstanding loans to the household sector have recorded strong growth, with an average annual growth rate of 15% since 1997, while lending to SMEs as a percentage of total business loans has increased from 22.2% to 30.1%.

......a number of measures were introduced in 2002 to ensure that the business community, in particular the SMEs and Bumiputera enterprises, continued to have access to funding.

Recognising the importance of the business sector in supporting economic growth, a number of measures were introduced in 2002 to ensure that the business community, in particular the SMEs and Bumiputera enterprises, continued to have access to funding. In formulating these measures, it was recognised that the issues facing small business borrowers require a comprehensive review of the existing practices and infrastructure, as financing issues were often connected with other problems that affect the viability of this group of borrowers. To ascertain the problems faced by the SMEs in Malaysia, Bank Negara Malaysia conducted a survey in 2001 to assess the needs and problems faced by the SMEs. The findings of the survey highlighted that access to financing rather than borrowing cost, was one of the main issues faced by the SMEs. In addition, other problems including lack of financial, management and marketing skills, low usage of technology, as well as lack of research and development activities affect the viability of SMEs. Based on the findings of the survey, the Bank recommended "A Comprehensive Framework for the Development of the SMEs" to promote an enabling environment for SME development in Malaysia.

A factor constraining the ability of the SMEs to obtain financing is their lack of adequate and satisfactory financial records. The survey findings also indicated that SMEs required access to advisory services, including on accounting and finance, and management and marketing. Banking institutions have thus been encouraged to enhance the provision of financial advisory services to SME borrowers. In 2002, 18 out of 25 commercial banks have already provided ancillary services to these borrowers. Almost all commercial banks also have dedicated SME units. Amongst the services provided are identifying and structuring products and services to meet the financial requirements of SMEs, conducting training, workshops and other advisory services such as financial and cash management as well as insurance consultancy.

In addition, various initiatives have been undertaken to enhance access to financing by the SMEs. In particular, it was recognised that the lack of collateral is one of the main constraints facing the SMEs in obtaining financing. Hence, an efficient guarantee mechanism is critical to address this problem. Measures were thus implemented to enhance the operational efficiency of the Credit Guarantee Corporation (CGC) through various initiatives. In 2000, CGC received an injection in capital of RM1 billion from Bank Negara Malaysia. New branches were also opened and an internet application system was launched to enable SMEs to have easier access to CGC. In line with the recommendation in the FSMP, Bank Negara Malaysia is also assessing the effectiveness of the current infrastructure with the aim of enhancing the efficiency and scope of CGC. Meanwhile, due to the strong demand for loans from the SMEs under the Fund for Small and Medium Industries 2 (FSMI2) and the New Entrepreneurs Fund 2 (NEF2), Bank Negara Malaysia has increased the allocation for the two schemes by RM250 million each, to RM650 million and RM500 million respectively in October 2002.

The development of Bumiputera entrepreneurs continued to be emphasised by Bank Negara Malaysia. Strategies were developed and reviewed periodically to seek the best approach to facilitate their development. Towards this end, effective 3 June 2002, all functions and roles of the Bumiputera Development Unit in Bank Negara Malaysia were transferred to ERF Sdn Bhd (ERF), a company in which the Bank is the major shareholder. The ERF is established as a "special purpose vehicle" to act as a "one-stop centre" to deal with issues related to the development of Bumiputera entrepreneurs, including the provision of financing, training and advisory services. In addition, ERF also handles and monitors issues raised by Bumiputera entrepreneurs, with regard to the effectiveness and quality of services of banking institutions. This move is to create a more efficient and effective mechanism to assist the development of Bumiputera entrepreneurs.

Whilst continuous efforts have been made to ensure that all segments of the economy have adequate access to financing to support economic growth, it is recognised that one of the challenges facing microenterprises or very small enterprises is access to financing. Given their characteristics, including the lack of financial records, limited credit history and insufficient collateral, the global experience of microenterprises generally is their difficulty in accessing credit from the formal banking system. The provision of finance to microenterprises, that is microfinancing, often involves very small loans, frequent repayment intervals and close monitoring by the institutions to ensure timely repayment of the loan. Therefore, while the banking system represents an important source of financing for SMEs, international experiences have highlighted that the conventional banking system is not the appropriate mechanism to address the financing needs of microenterprises due to the unique features of microfinance. Instead, specialised institutions, namely, microfinance institutions, are often used as the main provider of financing to this group of borrowers. More often than not, these are with special assistance from the Government, non-governmental organisations and international institutions. Although a number of institutional arrangements have been established in Malaysia to specifically meet the financing needs of this group of borrowers, they have not been adequate. Bank Negara Malaysia has completed a study including the recommendations to further strengthen the existing infrastructure, enhance their effectiveness as well as to establish new institutional arrangements so as to extend the outreach of provision of financial services to all microenterprises and low-income groups.

Promoting Active Consumerism

Apart from measures to strengthen the resilience and capacity of the banking sector, efforts were also channelled towards encouraging more active consumerism and strengthening the overall consumer protection infrastructure in line with the recommendations in the FSMP. The strategies to achieve an adequate and effective consumer protection framework as outlined in the FSMP, involve a comprehensive and structured consumer education programme, increased transparency by financial institutions, the expansion in the role of the Banking Mediation Bureau and the implementation of anti-trust regulations which would encompass anti-competition policies and unfair practices.

Significant reliance had previously been placed on Bank Negara Malaysia to monitor the practices of banking institutions which encompass, amongst others, mediating complaints from consumers relating to banking practices, prescribing detailed rules and regulations to govern the practices of banking institutions as well as introducing measures to drive efficiency within the banking sector. As financial markets grow in sophistication, all stakeholders would need to play their role in promoting greater efficiency and stability in the financial system. In this regard, active consumerism plays an important role in driving efficiency within the banking sector. As consumers become increasingly financially savvy, they would demand a wide range of financial products and services at competitive prices, thereby providing greater impetus for banking institutions to constantly innovate and attain greater levels of efficiency in order to compete with one another. Hence, active consumerism can contribute towards the creation of a strong and competitive banking sector.

The development of active consumerism relies on the existence of knowledgeable banking customers who have strong understanding of the products and services of banking institutions, including the roles and functions of the financial players, the types of banking products and services offered, the salient terms and conditions of banking products, the rights and responsibilities of customers and that of banking institutions, as well as the associated risks and benefits of these products. To spearhead the consumer education programme, a long-term structured consumer education programme (CEP) known as "BankingInfo" was launched on 30 January 2003. This 10-year programme is divided into three phases to ensure effectiveness in the dissemination of information to different groups of banking consumers, with the ultimate objective of reaching out to all segments of the banking population.

...the strategies taken to achieve an effective consumer protection framework involve a comprehensive and structured consumer education programme, increased transparency by financial institutions, the expansion in the role of the banking mediation bureau and the implementation of anti-trust regulations which would encompass anti-competition policies and unfair practices.

Under Phase 1 of the programme, information would be disseminated to the public in the form of information booklets and via the website *www.bankinginfo.com.my.* To date, a total of 12 booklets have been published, covering a wide range of topics. These booklets can be obtained from the branches of commercial banks and finance companies.

The booklets provide information on basic banking-related issues that consumers should be aware of. More detailed information aimed towards raising greater financial literacy among banking consumers would be disseminated over time on other retail banking products and related issues. This programme would be enhanced over time, based on the feedback obtained from consumers and banking

Table 4.7
Information booklets issued under the Consumer Education Programme in 2003

1	Housing Loan	7	Illegal Transactions in Foreign Currencies
2	Hire Purchase	8	What is Islamic Banking?
3	"Bad" Cheques	9	Making a Banking Complaint
4	Credit Card	10	The Malaysian Currency
5	Internet Banking	11	Credit Bureau
6	Managing Your Money	12	Bank Negara Malaysia

institutions. To gauge the effectiveness of this programme, periodic surveys would be conducted, while the number of visitors that visit the website would be monitored.

With the move towards a more market-driven supervisory approach and consumers becoming increasingly aware of their rights in dealing with banking institutions, a comprehensive and effective consumer protection framework is also essential to provide some avenue for redress for consumers, in particular retail consumers. Hence, to complement the initiatives taken under the CEP, work on other areas to strengthen the overall consumer protection infrastructure is being developed. A framework is being developed to improve the level of transparency on all retail financial products offered by banking institutions. The minimum disclosure standards are expected to help retail banking customers choose suitable banking products that are compatible with their needs as basic contractual terms such as fees and charges, interest rates and yields would have to be disclosed to the customers upfront. The standards require banking institutions to communicate all vital information to allow consumers to make informed decisions at inception, thereby minimising any uncertainty or dispute at a later stage. This would also facilitate "comparison shopping" by customers. Emphasis is placed on retail customers since corporate borrowers are deemed to have the necessary expertise or have the access to such expertise to enable them to make informed decisions. In addition, a dictionary of common terms used to describe and compare products would also be issued to promote greater understanding of banking products and the financial terms by consumers.

In 2001, banking institutions were required to establish a dedicated Complaints Unit to provide the initial form of redress for consumers. Moving forward, the Complaints Unit is expected to play a greater role as consumers seek greater information and clarification regarding their banking transactions. In addition, the role of the Banking Mediation Bureau (BMB) is currently being reviewed with the intention of enhancing the scope of disputes which can be handled by BMB. Currently, BMB only mediates disputes relating to excessive interest and penalty charges, misleading advertisements, illegal ATM withdrawals and credit card transactions and discriminatory action against guarantors, with a maximum claims award of RM25,000. Hence, with the expansion of the BMB, it will provide another avenue for speedier resolution of banking disputes and diminish the need for customers to resort to legal action. With the growth of bancassurance, efforts are also being initiated to merge the BMB and the Insurance Mediation Bureau so as to strengthen and enhance the dispute settlement mechanism.

Maintaining Financial Stability

In tandem with efforts to promote greater efficiency and competition, due emphasis continued to be given to strengthen the resilience of banking institutions and maintain financial stability. This is crucial to enable the banking institutions to effectively support the economic growth process. As the scope of banking activities becomes increasingly complex as a result of greater innovation and advances in technology, prudential standards need to be continuously enhanced to reflect the changes in the risk profile of banking institutions and ensure risk management standards are able to measure and manage these risks. Greater focus is, therefore, being directed towards fostering sound risk management practices within banking institutions in line with developments in the domestic and global financial markets.

With greater competition arising from disintermediation and the entry of non-traditional players into the financial markets, financial institutions globally are entering into alliances with other banking institutions and non-banking institutions to penetrate into new and non-traditional markets to cater for the increasing demands of customers. In line with these developments, domestic banking institutions are reorganizing themselves within their group and establishing new alliances to engage in a wider range of financial activities under one common brand. Structures of financial conglomerates and inter-relationships between different companies within the group are becoming increasingly complex, resulting in the need for an enhanced consolidated supervisory framework for financial conglomerates. In the past, the regulation of financial conglomerates has been imposed on an administrative basis, focusing mainly on certain operational aspects and investments of the financial conglomerates. Hence, Bank Negara Malaysia is currently developing a formal regulatory and supervisory framework for financial conglomerates to enable an assessment of the financial health of the conglomerates on a group-wide basis and impose prudential requirements to safeguard their financial soundness. A concept paper will be issued in 2003, focusing on four main areas, namely group structures, capital requirements, corporate governance and intra-group exposures. This framework would be extended later to include other areas such as reporting requirements and exposures to a single entity. To underpin the new regulatory framework, the necessary legal infrastructure needs to be put in place to ensure effective enforcement.

With greater liberalisation of financial markets, innovation in financial products and technological advancements, it becomes increasingly imperative for banking institutions to be managed by strong and competent management who are able to provide the strategic direction for the institution as well as manage the operations of their banking institutions in an effective and prudent manner. This more challenging operating environment requires active involvement of the board of directors. Strong corporate governance will contribute towards greater accountability, and thus better management of risks within the institutions. Bank Negara Malaysia is currently reviewing the present corporate governance framework for banking institutions to be in line with developments in the financial markets. The framework would embrace four fundamental principles relating to corporate governance, namely, responsibility, accountability, fairness and transparency. It will provide greater emphasis on the role and accountabilities of the board and senior management of banking institutions in managing the business and affairs of the institutions. The specific areas dealt in the framework comprise, amongst others, the responsibilities and oversight of the board of directors and audit functions. Shareholders of banking institutions are also expected to play a more active role in overseeing the effectiveness of the board of directors and management in the banking institutions. This framework will also ensure that the board and senior management of banking institutions are fit and proper, through the periodic review process conducted by Bank Negara Malaysia. The concept paper will be issued in 2003.

Efforts to prevent the use of the domestic banking system to launder money of illlicit origins were intensified in 2002. The framework was strengthened with the enactment of the Anti-Money Laundering Act 2001 (AMLA) in 2001 and the establishment of the Financial Intelligence Unit in Bank Negara Malaysia. Greater emphasis was also placed on strengthening the identification and verification procedures of customers at banking institutions pursuant to the "Know Your Customer" policy. Banking institutions are required to submit suspicious transaction reports to the Unit. In addition, provisions relating to reporting obligations of the Act which were initially invoked on commercial banks, finance companies, Islamic banks and merchant banks, were extended to other financial institutions in 2002. In January 2003, several other financial institutions have also been included as reporting institutions under the auspices of AMLA such as Bank Kerjasama Rakyat (M) Berhad and Bank Simpanan Nasional. Further to this, several sections in the AMLA including those pertaining to record keeping, centralisation of information, the obligations of supervisory authorities, the power to enforce compliance and the examination of reporting institutions were also invoked in January 2003.

To ensure that the accounting standards adopted by the banking sector are in line with international standards, Bank Negara Malaysia participates actively in a number of working groups set up by the Malaysian Accounting Standards Board (MASB). One of the key developments in 2002 was the introduction of International Accounting Standard (IAS) 39, which sets out the standards on the recognition and measurement of financial instruments. Whilst MASB has yet to adopt this standard, the Bank conducted a survey to ascertain the level of awareness of financial institutions in this area. Encouragingly, the survey indicated a high level of awareness among banking institutions on the implications of IAS 39. From the regulatory viewpoint, the adoption of IAS 39 would entail significant enhancements to the internal controls and IT systems of banking institutions in order to be able to properly record and measure fair value. The adoption of this standard could also potentially result in high volatility in the earnings of financial institutions. Such volatility may result in misleading interpretations to the actual risk profile of the banking institutions. A main concern highlighted by the banking institutions was with regard to the determination of fair value due to the lack of liquidity in the trading of financial instruments. To enhance institutional transparency, a second concept paper on the revised "Guidelines on the Specimen Financial Statements for Licensed Financial Institutions" (BNM/GP8) has been issued by the Bank to better measure and reflect the substance of the items in the financial statements.

One of the major focuses in the development of prudential policies during 2002 was in the area of the New Basel Capital Accord or Basel II. The second consultative paper on Basel II that was issued by the

Bank for International Settlements (BIS) in January 2001 sets out the new global benchmark for the assessment of capital adequacy of financial institutions. Recognising the significant implications of Basel II on the banking institutions, efforts have been made to promote greater understanding amongst senior management of banking institutions so that they take necessary steps to comply with the new capital adequacy framework. During the year, Bank Negara Malaysia conducted a preliminary impact study to ascertain the impact of Basel II on the local industry using the Standardised approach, one of the two methods of capital recognition allowed under Basel II. In tandem with this study, a survey was undertaken to determine the readiness of banking institutions to adopt the Internal Ratings Based (IRB) approach, which requires banks to use internal ratings to calculate their capital adequacy requirements.

Given the complexities of the IRB approach, it is envisaged that at the onset, domestic banking institutions would be able to comply with the Standardised approach. However, in moving towards the adoption of Basel II by banking institutions, numerous challenges would be faced by various stakeholders involved in this process. One of the key stakeholders is the rating agencies. Given the significant reliance on the external ratings under the Standardised approach, BIS has provided certain criteria in which rating agencies must adhere to before their ratings are recognised for capital calculation purposes. Thus, local rating agencies would need to build up their capabilities in order to meet the requirements. The stringent requirements embodied, in particular those relating to the IRB approach, would pose significant challenges to the industry players as well as the regulators in assessing the capital adequacy of banking institutions. A considerable amount of time and resources are required to enhance the operations, data collection and business culture in order for banking institutions to be able to comply with the requirements imposed under Basel II. Expertise is also being developed at Bank Negara Malaysia to be able to assess the adequacy of these models under Pillar 2 as well as enhancing the framework of disclosure consistent with requirements of Pillar 3.

On the regional front, Bank Negara Malaysia was appointed as chairman of the EMEAP Working Group of Banking Supervision in May 2002 for a two-year period. As the chairman, Bank Negara Malaysia organised and chaired the 13th Meeting of the EMEAP Working Group in Kuala Lumpur which focused on issues relating to Basel II. Members of the Working Group also had the opportunity to meet with the Basel Committee on Banking Supervision (BCBS) during the meeting to raise and discuss regional issues of concern relating to the adoption of Basel II. A discussion between the BCBS and representatives from the banking sector in the Asia-Pacific region was also held during this period. Amongst the significant concerns highlighted by the various regulators and industry representatives during the discussion was the ineligibility of physical collateral as a credit risk mitigant under the Standardised approach for capital adequacy requirements. Given the regional environment where the usage of physical collateral, particularly real estate, provides a major source of credit protection for banking institutions, such stringent requirements would not provide any benefits in terms of capital savings for banking institutions in this region.

During the year, in line with various efforts undertaken by authorities to strengthen the capabilities of their industry players to comply with Basel II, the BIS conducted the third quantitative study (QIS 3) to gauge the impact of its latest proposals prior to the issuance of the third and final consultative paper around mid-2003. Two domestic banking institutions participated in this study as a broad proxy of the potential impact of these proposals on the domestic banking industry. The results of this study would be released in early 2003, followed by the issuance of the finalised proposals of the new capital accord towards the end of 2003 after the consultation period with the global financial industry. Taking into consideration that emerging countries like Malaysia would require more time to develop the capabilities of their domestic banking sector to comply with the requirements under Basel II, BIS has reiterated that the implementation of Basel II which is expected to commence in 2006, would only be made binding for G-10 countries. Nevertheless, efforts would continue to be taken by Bank Negara Malaysia to upgrade the capabilities of the industry players so that they would be in a position to comply with these new requirements within a reasonable period of time.

Although Basel II focuses mainly on the areas in relation to credit and operational risk, the element of market risk is also a critical risk component that requires adequate assessment and monitoring. Under Basel II, the calculation of capital for market risk has remained the same as the method of measurement stipulated in the guidelines issued by the BIS in 1996. While Bank Negara Malaysia had intended to introduce the framework in 1998, the incorporation of market risk into the capital framework was deferred due to the minimal impact of market risk at that point in time and the Asian financial crisis. Given the increasing use of financial instruments that expose banking institutions to greater market risk, the impact of market risk on the capital adequacy of banks has been reassessed. Whilst the study concluded that the impact of market risk remained small and manageable, the level of market risk has increased over time. Bank Negara Malaysia will thus be issuing the first concept paper to incorporate market risk to better reflect current conditions in the capital adequacy framework by the end of the first quarter of 2003.

In tandem with the objective of Basel II to attain greater risk sensitivity in the measurement of capital requirements for banking institutions, Bank Negara Malaysia also reviewed the Guidelines on Financing to the Broad Property Sector and Share Financing. In March 1997, prior to the onset of the financial crisis, Bank Negara Malaysia imposed caps on lending to the broad property sector and for share financing. The purpose of the caps was to ensure that the exposure of banking institutions to these two sectors were within manageable limits and did not pose excessive risk to the banking system. However, as the risk management practices of banking institutions develop in sophistication in line with technological advancements and enhancements in the risk management systems, such caps would be removed to provide greater flexibility for banking institutions with robust capital strength and prudent risk management capabilities to manage their exposures to these sectors. With good risk management capabilities and adequate capital as buffer to support their risk appetite, banking institutions would be in a position to manage their own risk exposures. The accountability to ensure that adequate systems and procedures are in place to manage the risks is with the board of directors and senior management of banking institutions. Bank Negara Malaysia has also issued a concept paper in November 2002 that outlines a scoring framework that measures the capital requirements needed to support the lending activities of banking institutions to these two sectors. Lending to these sectors above a certain threshold would attract additional capital requirements based on the scoring mechanism.

The strengthening of the financial safety net has been central in efforts to promote financial stability. Moving forward, a comprehensive financial safety net that would contribute towards promoting financial stability, is being put in place. Towards this end, efforts have been undertaken to develop a deposit insurance system to complement the other forms of financial safety net as well as to enhance the customer protection infrastructure in Malaysia. The main objectives of the deposit insurance system are to provide protection to depositors up to a specified limit and to strengthen incentives for prudent risk management.

Financial stability cannot be achieved by ensuring stability within the banking sector only. As the capital market takes on increasing importance in meeting the financing needs of the economy, there is a need to monitor the developments in both capital market and banking sector to ensure that overall financial stability is maintained. Given that both markets are subject to the purview of two different regulatory authorities, greater levels of cooperation and assistance between both authorities are important. To forge greater cooperation and facilitate the exchange of information between regulators, a memorandum of understanding (MOU) between Bank Negara Malaysia and the Securities Commission was signed in 2002 to strengthen the area of mutual assistance and cooperation to ensure the orderly development of the capital markets and banking sector. The MOU also aims to minimise any regulatory overlaps or gaps in the regulation and supervision of the banking industry and capital markets. In line with the objectives of the MOU, Bank Negara Malaysia and the Securities Commission have worked on a number of policies during the year, such as the development of a capital adequacy framework for investment banks and the participation of universal brokers in unlisted debt markets. To promote a greater level of protection for investors participating in capital market activities, Bank Negara Malaysia has also issued a concept paper entitled "Guidelines on Pass-Through Activities Conducted by Exempt Dealers" to the banking industry. The Guidelines prescribes record keeping requirements, best sales practices as well as licensing requirements for personnel of banking institutions that are involved in pass-through activities. These guidelines aimed to ensure that the interest of investors and market integrity are preserved. Bank Negara Malaysia also issued revised Guidelines on Negotiable Instrument of Deposits (NIDs) and Guidelines on Bankers Acceptances (BA's) during the year in an effort to streamline these guidelines with the current market practices. The NIDs guidelines were also reviewed to synchronize the standards of conventional NIDs with Islamic NIDs.

With the issuance of the Asset Backed Securities (ABS) guidelines by the Securities Commission in 2001, there has been increasing awareness and interest among financial institutions to participate in ABS transactions. While ABS is still at the early stage of development, the expanding ABS market offers a new avenue for banking institutions to not only improve their return on assets, but more importantly, to mitigate their credit risks more effectively and improve their asset portfolio mix. In this regard, Bank Negara Malaysia has issued a concept paper on the "Prudential Standards on Asset Backed Securitisation Transactions" to cover the general risk management and prudential requirements as well as regulatory treatment pertaining to these transactions. The Guidelines also aimed to ensure that licensed institutions involved in securitisation activities have full understanding and adequate knowledge to manage risks emanating from such transactions.

Moving forward

The developments in the next few years would be critical towards achieving the end-game envisaged under the FSMP. With the structural enhancements put in place to strengthen the resilience and competitiveness of the banking sector, the banking sector is well-positioned to support the economic transformation process as well as meet the requirements of a more challenging economic environment. Hence, strategies moving forward will continue to focus on elevating the performance of banking institutions so that they are resilient, efficient and able to support the needs of the growing economy. Efforts to promote financial stability would also be pursued through the development of an efficient infrastructure to drive innovation and dynamism within the banking sector. Taken together, these efforts would contribute towards enhancing the growth and development prospects of the banking sector and the economy.

SUPERVISORY ACTIVITIES

The overall thrust of the supervisory function in 2002 focused on promoting sound and stable banking institutions and building capacity in the financial system to enhance effectiveness in meeting the needs of the economy. With these underlying objectives, supervisory activities emphasized the vigilant monitoring of the financial condition and soundness of banking institutions, the adoption of pre-emptive strategies to address any adverse trend or weakness noted and the instilling of best practices to enhance the banking institutions' corporate governance structures as well as risk management systems which underpin their business performance.

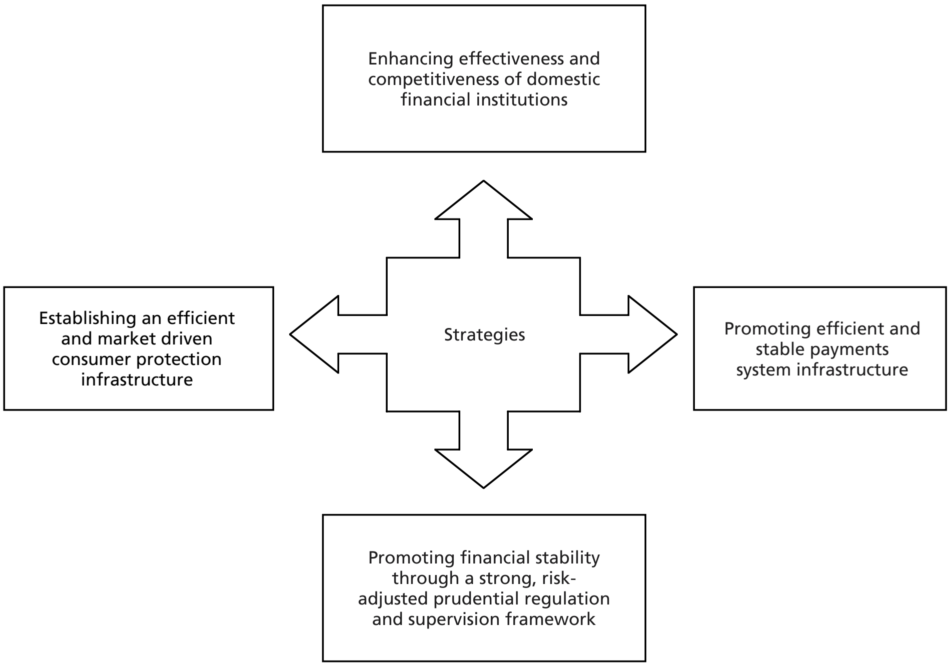
The supervisory process was thus premised on a forward-looking proactive risk-based model encompassing both a dynamic off-site surveillance and on-site examinations. The risk-based supervision approach allowed the Bank to direct supervisory attention and resources to areas that pose higher degree of risks. With this approach, the focus of attention includes the assessment of the adequacy of risk management systems to address the risks assumed by the banking institution. From a supervisory perspective, the Bank is able to independently examine situations or activities that may be detrimental to a particular banking institution or the banking system as a whole. With this methodology, pre-emptive actions may be instituted to ensure that banking institutions take appropriate measures to mitigate risk factors. To facilitate this, the enforcement process has been further strengthened with the implementation of the Informal Enforcement Action Framework. This framework has enabled enforcement actions to be taken on a pre-emptive basis to ensure banking institutions or bank holding companies rectify deficiencies before the condition deteriorates to an extent that requires resolutions which are both time consuming and costly.

In 2002, 91 examinations were conducted on banking institutions, comprising head offices, their local and overseas branches, bank holding companies and related companies of banking institutions. In addition to the supervision of banking groups, the supervisory scope was expanded to include the supervision of six development financial institutions with the enactment of the Development Financial Institutions Act 2002 and the examination of anti-money laundering measures taken by banking institutions to comply with the requirements of the Anti-Money Laundering Act 2001.

To complement the on-site examination of banking institutions, ongoing surveillance of the financial health of banking institutions was also undertaken through the off-site supervisory function. This includes the review and approval of financial accounts of banking institutions where financial statements were reviewed to ascertain compliance with the Central Bank's guidelines, particularly in respect of adequacy of provisions for bad and doubtful debts and diminution in value of investments. Besides the review of financial accounts, the banking institutions are

Financial Sector Master Plan

Ten recommendations of the Financial Sector Masterplan (FSMP) were implemented during the year bringing the total number of fully implemented recommendations to 19 as at end-February 2003. Excluding the recommendations that are being implemented on a continuous basis over the FSMP's 10-year period, 77 recommendations remain to be fully implemented. The focus under Phase I of the FSMP has been on building domestic capacity. A four-pronged strategy has been adopted.



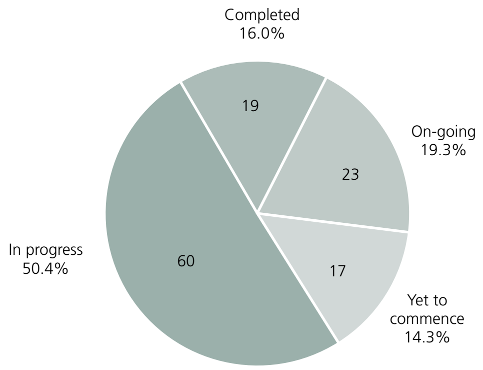
Towards increasing the capacity and capability of domestic financial institutions to enhance their level of effectiveness and competitiveness, the following strategies were implemented during the year:

- The development of benchmarking framework of the banking institutions including the assessment of practices and the extent to which individual banking institutions benchmark different business segments, products lines, delivery channels and service levels. These were complemented with discussions with the Boards and senior management of banking institutions to assess their performance relative to the industry and the areas for improvement.

- Commencement of a benchmarking programme for the insurance industry, encompassing regular assessment of performance against key indicators. Meetings were held with the industry to assess the effectiveness of the benchmarks as well as to gauge performance and to identify areas for improvement. Similar to the banking sector, both qualitative and quantitative performance indicators have been developed to drive and monitor performance improvements in the insurance industry.

- A four-year programme involving a nation-wide survey and market analysis to gauge the level of service quality offered by financial institutions and to develop a service quality index to assess the service quality of the industry as well as vis-à-vis other countries. This is to enable the monitoring of progress made in improving the quality of services provided by banking institutions and insurance companies.

Graph 1
Progress of Implementation of FSMP Recommendations



- Creating an environment for further rationalisation of the domestic banking sector through the establishment of full-fledged investment banks involving the merger of merchant banks, stockbroking companies and discount houses, and the merger of commercial banks and finance companies.

- Allowing greater operational flexibility for insurance companies to adopt effective outsourcing strategies through the removal of remaining restrictions on the outsourcing of non-core activities by insurers to resident service providers or their group resources located in Malaysia.

- Supporting the development of domestic skills and expertise through measures to promote a more effective transfer of expertise from expatriates employed in the insurance industry, particularly in the areas of specialised underwriting, product research and development, risk management and investment.

- Allowing acquisition of shares in direct insurers by domestic financial and non-financial institutions to further expand the opportunities available for insurers to create business synergies and tap new resources to support future development.

- Establishment of the Islamic Banking and Finance Institute Malaysia (IBFIM) which commenced operations in September 2002, to play a catalytic role to create and develop a pool of skilled manpower to meet the requirements of the Islamic financial industry.

Maintaining stability in the financial sector is one of the core objectives of the FSMP. During the year, efforts continued to be focussed on enhancing the regulatory and supervisory framework to ensure financial institutions are resilient to systemic and external shocks.

A key component in maintaining and promoting financial stability is the availability of a safe and efficient payments system. A safe and reliable payments system facilitates the smooth functioning of the financial markets and economic activities and hence, is central in preserving consumer confidence and promoting convenience in the financial system. In this connection, to further enhance efficiency in the payments system and in encouraging the provision of payment services that meet the needs of customers, some of the policies on payments system was liberalised during the year. Licensed banking institutions were accorded flexibility in the provision of payment gateway services. Locally incorporated foreign banks were allowed to participate in the Interbank GIRO system operated by Malaysian Electronic Payment System (1997) Sdn. Bhd.

Table 1
Completed Recommendations

Banking Sector	
R3.4	Liberalise restrictions on salaries and staff mobility in the banking industry to enable the industry to attract the best talent and reward them accordingly
R3.5	Uplift restriction on employment of expatriates to attract the best international talents to meet the demand for expertise in specific areas of banking
R3.12	Encourage outsourcing of non-core functions to gain greater strategic focus and efficiency
R3.14	Encourage the development of new delivery channels to increase the range of products and services to futher enhance competitiveness
R3.28	Allow market forces to shape developments in the payments system to allow greater competition and increase innovation in payments system
Insurance Sector	
R4.1	Remove restrictions on outsourcing to enable insurers to further develop their core competencies and effective business strategies
R4.2	Allow all players in the market to operate via the internet to enhance competitiveness and efficiency of the insurance industry
R4.6	Relax the restrictions on employment of expatriates to accelerate development of skills and expertise in the industry
R4.16	Increase the statutory minimum paid-up capital of insurers to enhance their financial resilience and to accelerate the consolidation of the industry in order for domestic insurers to capture the size and scale needed to compete effectively in a more deregulated and liberalised market
R4.29	Allow financial and non-financial institutions to acquire interests in direct insurers to create business synergies
Islamic Banking and Takaful	
R5.6	Increase the number of takaful operators to accelerate the expansion of takaful industry
Development Financial Institutions (DFIs)	
R6.4	Introduce a systematic framework for sourcing funds to ensure the appropriate and adequate funding for the operations of DFIs
R6.7	Establish a legislative framework to provide for the regulation and supervision of DFIs to ensure that DFIs' policies and objectives are consistent with the national policy objectives
Alternative Modes of Financing	
R7.2	Establish a RM500 million VC Fund to increase the availability of VC financing and stimulate new ventures
R7.3	Introduce further tax incentives for the VC industry to promote the growth of VC
R7.4	Liberalise the MESDAQ listing requirement to facilitate the exit of VC companies from their investments
Labuan International Offshore Financial Centre	
R8.3	Adopt a consultative and market driven approach to create a conducive tax and business environment to enhance the competitiveness and attractiveness of Labuan
R8.6	Strengthen Islamic banking and finance as well as takaful to develop Labuan with a strategic focus on Islamic products and services
R8.7	Enhance Labuan International Financial Exchange (LFX) to be a one-stop financial exchange for residents and global companies

Various measures have also been initiated to put in place an adequate and effective consumer protection infrastructure and to improve the level of financial literacy of the banking public. The measures include:

- Launching of the Consumer Education Programme, to provide a single point of reference on retail banking products and services, which can provide consumers with a fast and convenient way of looking for information and accelerate their learning curve. The programme, known as "BankingInfo", is a ten-year programme with the aim to develop banking customers who will make informed financial decisions and be confident in exercising their rights. The programme will be implemented in phases and in a structured and incremental manner. In the first phase of the programme, 12 information booklets on various banking topics have been published and the areas covered include information on consumer banking products, information on new and innovative banking channels as well as educational information on aspects of banking and currency. It also includes information on Islamic banking, the Central Credit Bureau, the Malaysian currency and on the Central Bank. The booklets are available from the commercial banks and finance companies and can also be accessed from the BankingInfo website, *www.bankinginfo.com.my.*

- Development of a framework to increase product-specific transparency which requires the disclosure of the key terms and conditions of financial products to ensure that consumers receive sufficient and relevant information to make informed decisions.

- A Consumer Education Programme for the insurance and takaful industries will be launched in the third quarter of the year. The programme and its ensuing initiatives will aim to increase consumers' understanding of the key terms and conditions of various types of policies, their rights and responsibilities under a policy contract, the proper channels to address grievances and standard market practices.

As envisioned in the FSMP, the future financial landscape will be characterised by an increasingly more diversified financial sector to meet the requirements of a changing economic structure. In this regard, several recommendations in the FSMP with regard to the development financial institutions (DFIs) were focussed on strengthening the strategic business focus and risk management practices as well as the formulation of relevant rules and regulations. Among the measures implemented during the year include:

- The enactment of the Development Financial Institutions Act 2002 (DFIA), which provides a comprehensive legislative framework for the regulation and supervision of DFIs. Six DFIs are currently under the purview of the DFIA. In addition, two guidelines were issued, namely, Guideline on the Statement of Corporate Intent and Guideline on Annual Funding Requirement, which are aimed at building capacity and enhancing efficiency of DFIs in utilising their financial resources to provide specialised financial services. A circular on policies and verification procedures for appointment of directors and chief executive officers was also issued during the year.

- A review on the existing mandated roles and activities of DFIs was also initiated. The review aimed to identify gaps and overlaps in the mandated functions of individual DFIs with a view to streamline and rationalise these functions as well as to determine the synergies among the DFIs in undertaking their activities. This review will form the basis to ensure a sharper focus in the mandated and strategic direction of each DFI.

Efforts were also focussed on enhancing the innovative capability, efficiency and market orientation of the Labuan International Offshore Financial Centre (IOFC). With the continuous effort to attract new players to the IOFC, eight new banks have been approved to operate in Labuan in 2002. This includes two Islamic investment banks from Saudi Arabia. A total of 486 new offshore companies were incorporated in 2002, compared with 364 in 2001, an increase of 33.5%. The IOFC, during its early years has succeeded in attracting a critical mass of core players. The Labuan Offshore Financial Services Authority (LOFSA) is now focusing on building the strength and expertise of existing players and encourage proactive expansion of the scope and breadth of products and services in the IOFC as well as to promote the development of Islamic banking and retakaful business. In this regard, initiatives undertaken during the year include:

- Amendments to several laws to facilitate expansion in the scope of activities and offshore business e.g. allowing investors to incorporate a company, either limited by shares or guarantee. The Labuan Trust Companies Act 1990 was also amended to enhance the activity of trust companies by converting their status to offshore companies.

- The setting-up of a Labuan Consultative Tax Committee (LCTC) comprising tax experts and representatives of Labuan offshore players. Several tax incentives were also implemented.

- Abolishment of the annual licence fees for companies carrying 'out-out' leasing transactions and capital requirement for offshore leasing companies to maintain the low-cost operating environment in the Labuan IOFC.

One of the strategic focus for the Labuan IOFC is to promote Islamic products and services given the growing interest in Shariah-based financial services and products in the global financial market. Various efforts have been directed at developing Labuan as a niche market in Islamic banking, finance and retakaful. The initiatives undertaken include the establishment of the International Islamic Financial Market (IIFM) to enhance cooperation among Islamic countries and financial institutions, specifically in the promotion of an active secondary market trading in Shariah compliant financial instruments. Another key function of IIFM is to encourage research and development into new products which are compatible to most Shariah's interpretation and therefore be acceptable to all major markets. The participants of IIFM are central banks, monetary authorities and Islamic financial institutions from several Muslim countries. The first Islamic financial instrument endorsed by the Shariah Supervisory Council of the IIFM was the sovereign global Islamic sukuk amounting to USD600 million issued by the Government of Malaysia in June 2002. The issue has won several awards including the most Innovative Capital Markets Transaction and Bond Deal 2002 and Best Asian Sovereign Bond of the year 2002.

In addition, the Shariah Advisory Council (SAC) for Labuan IOFC has also been set up to give input and advice to further promote the growth of Islamic financial market. The SAC comprises 5 local and 2 international scholars with strong credentials and wide experience. Futhermore, approval was granted in 2002 to two investment banks and a managed trust company from Saudi Arabia to conduct business in Labuan IOFC.

In the area of Islamic insurance, Labuan has one full-fledged takaful and retakaful operator as well as several conventional insurers offering takaful services. The retakaful operator has been appointed as the secretariat for the ASEAN Takaful Group (ATG) comprising takaful operators from Malaysia, Indonesia, Brunei Darussalam and Singapore. Recently, the membership of the ATG has been expanded to include Sri Lanka and Saudi Arabia. During the year under review, the Labuan takaful operator introduced the first investment-linked product, which is Shariah compliant.

Efforts to enhance the Labuan International Financial Exchange (LFX), was also intensified. From a single listing as at December 2001, there are currently 10 listings on the LFX, comprising a wide range of instruments including debt securities and mutual funds. Three of these instruments are Shariah compliant instruments, emphasising the versatility of LFX in meeting the needs of international investors. As an international exchange, LFX is well positioned to be a surrogate exchange for countries which are in the earlier stage of capital market development and require access to other international capital market. Towards meeting the objective of preserving financial stability and integrity, LOFSA had conducted on-site inspection with the assistance of Bank Negara Malaysia on 14 offshore banks and all insurance brokers in 2002. To safeguard Labuan from being used for money laundering activities, the Anti Money Laundering Act 2001 also covers offshore activities in Labuan. Labuan has also received positive evaluations from the Asia Pacific Group on Money Laundering and the Offshore Group of Banking Supervisors.

The thrust of financial policies in 2003 will be to enhance further the position of the domestic financial institutions to meet the more competitive environment that would emerge from the gradual liberalisation and deregulation that would take place during the second phase of the FSMP. It is envisaged that at the end of Phase I, a core of strong domestic players would emerge and the gaps between foreign and these core banking institutions would be narrowed.

monitored closely through regular reporting and rigorous financial and non-financial analysis for early detection of any emerging problems.

The banking sector has witnessed the evolution of a new financial landscape comprising fewer but larger domestic banking institutions that emerged as a result of the consolidation program initiated in 1999. The mergers also prompted the banking institutions to readjust strategic focus and revise business models. Although these developments have been designed to enhance institutional efficiency and competitiveness, the capability of the banking institutions' risk management system in detecting risks emerging from the complexities of new products and services, integration of systems and work culture, as well as from other operational areas are constantly assessed and monitored.

Another aspect of supervision activities was engaging banking institutions in discussions on supervisory issues on a regular basis. The objective is to facilitate banking institutions to undertake regular self-evaluation of risk profiles, develop alternative options and formulate plans to manage, as well as mitigate inherent risks. These discussions have also afforded Bank Negara Malaysia useful insight into the banking institutions' strategic direction and focus, as well as to evaluate their capacity and preparedness to meet impending challenges.

Sound corporate governance is a critical component of the banking institutions' risk management infrastructure. A more structured and comprehensive framework has been developed to assess the performance of directors, both on an individual as well as collective basis. This framework has allowed Bank Negara Malaysia to appraise the board and senior management more objectively to ensure members of the board have discharged their fiduciary duties effectively. The assessment provides valuable feedback both for the purpose of approving the appointment and reappointment of directors as well as for assessing the performance of the banking institutions' management.

The soundness of the banking institutions have also been evaluated using the CAMEL rating framework based on the evaluation of capital adequacy, asset quality, management capability, earnings performance and liquidity. In addition to credit, liquidity and operational risks, market risk and the adequacy of market risk management processes to ensure that it commensurates with the quantum of market risk and the impact of this risk to the banking institutions' earnings and capital is also assessed. Previously, the assessment of the impact of market risk was mainly reflected in the capital and earnings components of the CAMEL framework. To reflect the significance of market risk and its impact on the safety and soundness of banking institutions, the CAMEL rating framework has been expanded to incorporate "sensitivity to market risk" as a separate component resulting in the formation of the CAMELS rating framework. To enhance the assessment of the impact of market risk on individual banking institutions and the banking system, the Bank has also embarked on the development of a market risk measurement model. The model is to complement and enhance the existing methods used to conduct stress tests and scenario analysis to support the forward-looking off-site analysis of banking institutions' market risk exposure and the scope of the market risk assessment for on-site examinations.

While supervisory attention has been placed on the assessment of credit and market risks given that inadequate management of these risks can cause losses, focus is also given to operational risks given that losses can also arise from a wide range of possibilities of failed internal processes. Bank supervisors have now placed greater emphasis on the assessment of the ability of banking institutions to have a more integrated and structured approach in identifying, measuring and monitoring operational risk. This would facilitate the preparation for the introduction of capital requirements for operational risk in the proposed new capital accord. Stress testing remains an ongoing exercise whereby the banking institutions' current financial conditions are subjected to simulated stress under alternative adverse scenarios in order to detect potential areas of vulnerability. The results form the basis for the implementation of pre-emptive actions.

These proactive efforts have resulted in banking institutions taking effective measures to strengthen corporate governance and risk management processes. As a result, the boards of directors and the board committees, including the Audit Committee, have enhanced their roles in ensuring business objectives are achieved without compromising prudence and that adequate checks and balances are in place. At the same time, risk management systems are being upgraded, particularly on the identification and management of credit and market risks as well as the overall integration of the multiple risks faced by banking institutions. These improvements in risk management processes have enabled the banking institutions to be better apprised on risk exposures and risk appetite taken.

The Bank also assesses the health of financial conglomerates on a group-wide basis. Towards this objective, regular examination of bank holding companies, as well as offshore banking institutions and selected companies, which are related to a banking group were also conducted. In this regard, the Bank has developed a standardized rating framework for bank holding companies. The rating framework centered on determining the strength and ability of the holding company to lend support to the banking institutions within the group and evaluating the potential impact which other entities in the group may have on the banking institution. The supervisory focus is on the analysis of the financial condition of the bank holding company, its non-bank subsidiaries, the assessment of the quality of group management as well as the evaluation of the group earnings and capital strength. The implementation of the framework has enhanced the ability to identify risk areas within the banking group that could affect the safety of the banking institution and thus implement prompt corrective measures where required. During the year, Bank Negara Malaysia and the Labuan Offshore Financial Services Authority (LOFSA) jointly conducted examinations on offshore subsidiaries of domestic banks.

To monitor fraud incidences and to detect any new emerging modus operandi to perpetrate fraud, a fraud information database system (FIDS) has been established to allow banking institutions to lodge fraud information electronically. The real-time reporting of fraud incidences by banking institutions has allowed for banking institutions to be alerted on a timely basis of potential threats of fraud and the modus operandi particularly those with a systemic impact to enable early preventive action.

Supervisory attention has also been focused on the Information Systems (IS) functions of banking institutions to promote safe and sound Information Technology (IT) operations and minimize the associated risks. To achieve these objectives, both on-site examinations and off-site monitoring of the IT operations of banking institutions are conducted on a regular basis to ensure the adoption of best IT practices and compliance with regulations. The supervision of IS functions aims to ensure that the IT infrastructure which forms the backbone of all banking operations, is strategically aligned with the institutions' business objectives and plans. In the year 2002, 37 on-site IS examinations were conducted. The supervisory efforts will also continue to focus on financial institutions that are outsourcing part of their IT functions to third party service providers or business entities within their own group. The various systems in the banking institutions are also subjected to rigorous examinations to ensure full compliance with the requirements of the Anti-Money Laundering Act.

Efforts to also enhance the capacity and capabilities of Bank supervisors were primarily aimed at equipping them with the necessary knowledge and skills to meet the challenges and requirements of the risk-based supervision approach being adopted. The enhancement of knowledge and skills of the Bank supervisors is critical given the growing challenges encountered by the banking supervision function, amongst others, the increasing dynamism of the financial landscape and complexity and sophistication of banking products and services. Thus, Bank supervisors also need to specialize in specific areas of bank supervision. Several specialized groups of Bank supervisors were developed to effectively keep abreast with developments in specific banking areas. Each specialized group serves as a reference point in those specific areas of bank supervision.

In March 2002, Bank Negara Malaysia was awarded the MS ISO 9002 Quality System certification for the planning and monitoring of the performance of routine on-site examinations on banking institutions operating in Malaysia. The achievement of the certification was driven by the quest to maintain a high level of professionalism in undertaking the banking supervision responsibilities.

During 2002, collaboration between the Bank and other domestic and foreign supervisory agencies was further strengthened. Such collaboration has proven to be mutually beneficial and forward-looking as it facilitated cooperation and information exchange. It also provided an appropriate forum to deliberate on domestic or cross-border supervisory issues, as well as international best practices on banking supervision. Bilateral sessions were also held with other foreign supervisory agencies, mainly to discuss the supervisory issues of the overseas operations of specific domestic banking institutions or foreign banking institutions operating in Malaysia. Similarly in the year 2002, the Bank conducted eight examinations on overseas branches or subsidiaries of domestic banks. Arising from these examinations, discussions were held with the respective host supervisory agencies on the financial and general conditions of the branches or subsidiaries examined.

The evolution of the financial environment will continue to pose significant challenges for supervisors, not least the imminent implementation of the new capital accord. Since the new capital accord is based on an evolutionary approach with the adoption of progressively more sophisticated methodologies, supervisors need to keep pace with, if not, be ahead of the banking institutions. Supervisors would also have to play the dual role of ensuring the processes adopted by the banking institutions are appropriate as well as a consultative role in the implementation of more sophisticated methods. These represent the efforts considered important for ensuring financial stability.

PERFORMANCE OF THE BANKING SYSTEM

Overview

The banking system exhibited increased resilience and soundness in 2002. This was achieved against the backdrop of improved performance which was characterised by:

- Continued strong profitability, owing to high recoveries, lower provisioning requirements and higher revenue from fee-based activities;
- Narrowing of interest margins on lending activities due to increased competition especially in the household sector;
- Higher lending activities with strong growth recorded in lending to households and small businesses;
- Improving asset quality particularly in the latter half of 2002 as non-performing loans began to trend downwards on account of lower incidence of new NPLs and higher reclassification of NPLs as performing loans;
- Ample liquidity following large trade surpluses and inflows of foreign direct investments;
- Manageable level of exposure to market risks; and
- Strong capitalisation levels attributable to higher profit and capital injections.

Profitability

As competition intensified in the loan market, gross operating profit of the banking system rose by 2.2% to RM11.1 billion in 2002. The marginal increase in the gross operating profit reflected the flat growth in net interest income and the high overheads which offset the strong increase in fee-based income. Both the commercial banks and finance companies recorded a positive growth in gross operating profit of 3.5% and 0.2% respectively, which offset the 3% decline experienced by the merchant banks.

Loan loss provisions in 2002 were significantly lower compared to the preceding year due to the combined effects of lower provisions charged for loan losses which declined by RM2.2 billion (–19.2%) and higher recoveries of RM3.4 billion (+69.9%). This was achieved following favourable economic environment and debt restructuring exercises, which enhanced the debt servicing capacity of borrowers. Hence, the banking system recorded a preliminary unaudited pre-tax profit of RM9.3 billion in 2002. Consequently, both the returns on assets and equity of the banking system improved to 1.3% and 16.8% respectively.

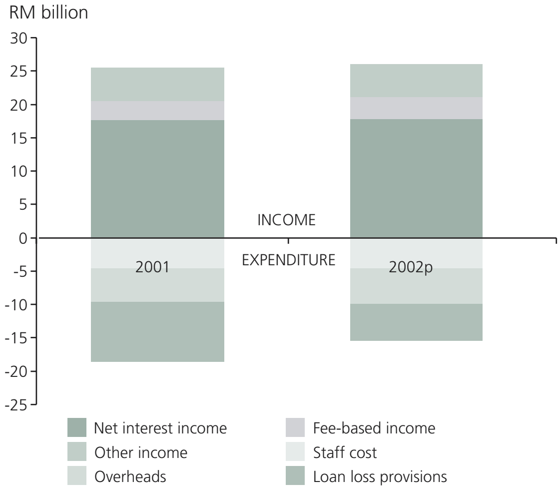
The decline in interest income was mitigated by a larger decline in interest expense resulting in an

Table 4.8
Banking System[1]: Income and Expenditure

	For the calendar year			
	2001	2002*p*	Annual change	
	RM million			%
Interest income net of interest-in-suspense	36,066	35,454	-613	-1.7
(Interest-in-suspense)	*5,730*	*5,570*	*-159*	*-2.8*
Less: Interest expense	18,436	17,723	-713	-3.9
Net interest income	17,631	17,731	100	0.6
Add: Fee-based income	2,964	3,325	361	12.2
Less: Staff cost	4,746	4,696	-50	-1.1
Overheads	5,018	5,288	269	5.4
Gross operating profit	10,830	11,072	242	2.2
Less: Loan loss provisions	8,797	5,459	-3,338	-37.9
Gross operating profit after provisions	2,033	5,613	3,580	176.1
Add: Other income	4,890	3,698	-1,191	-24.4
Pre-tax profit	6,923	9,311	2,389	34.5
Of which:				
Commercial banks	4,507	6,307	1,800	39.9
Finance companies	2,121	2,413	292	13.8
Merchant banks	295	591	297	100.6
Return on assets (%)	1.0	1.3		
Return on equity (%)	13.4	16.8		
Cost to income[2] (%)	47.4	47.4		

[1] Excludes Islamic banks
[2] Only taking into account staff cost, overheads, net interest income and fee-based income
p Preliminary
Note: Total may not add-up due to rounding

Graph 4.6
Banking System[1]: Profitability



[1] Excludes Islamic banks
p Preliminary

increase in net interest income of the banking system. By type of institution, the commercial banks and finance companies recorded a growth in net interest income of 1% and 0.5% respectively. However, net interest income of the merchant banks declined by 8.8% as their business strategies increasingly became focused on fee-based activities. The changing structure of the economy, increasingly demanding customers and greater disintermediation through the capital market necessitated banking institutions to restrategise their business operations and broaden the sources of income in order to sustain future profitability. Reflecting this development, fee-based income generated by the banking system recorded a significant growth of 12.2% resulting in the proportion of fee-based income to rise to 15.8% of total operating income (2001: 14.4%).

Given the nature of their business, a higher proportion of the merchant banks' income was derived from fee-based activities. In 2002, the fee-based income of merchant banks increased by 21.7% to RM338 million, accounting for 38.9% of their total operating income. The strong growth was generated from corporate advisory, underwriting and portfolio management activities. Income from corporate advisory activities which accounted for 43.6% of total fee-based income of the merchant banks increased sharply by 28.3%, following a large number of corporate restructuring exercises undertaken in 2002. The merchant banks have also benefited from increased activities in the equity and bond markets. Fees earned from underwriting activities rose by RM25 million, to account for 12.1% of total fee-based income compared with 5.8% recorded in 2001. Another notable development was the large increase in fees generated from portfolio management services (+244.7%), reflecting greater focus on wealth management services for high net worth customers. Still at its infancy, fees from portfolio management accounted for 5.9% of the total fee-based income of the merchant banks.

The operating cost to income ratio of the banking system remained unchanged at 47.4% in 2002. Despite reduction in the number of employees, staff cost per employee rose marginally from RM51,700 in 2001 to RM52,800 in 2002, as banking institutions offered better remuneration packages to attain, retain and reward talent. Nevertheless, the gross operating profit per employee improved from RM118,000 in 2001 to RM124,400 in 2002.

Interest Margin

While interest has been the largest source of income for the banking sector, as competition intensifies and banking institutions expand the scope of their activities to meet changing consumer demand, the sources of income are likely to become more diversified. The proportion of interest income to total income can be expected to decline over time. In 2002, the proportion of interest income to the banking system's total income still remained high at 70%. With the exception of merchant banks which focus on fee-based activities, interest income is expected to remain as the major source of revenue contributor for the banking institutions, reflecting the banking system's role as the main provider of funds to the economy.

The interest margin, which refers to the difference between the interest rate charged on loans and advances granted (average lending rate or ALR) and the rate paid by banking institutions on deposits and borrowed funds (average cost of funds or ACF), reflects the gross returns to banking institutions from their lending activities before taking into account operating costs as well as regulatory costs such as compliance with statutory reserve requirement. As a result of ample liquidity condition and intense competition in the loan market, the average interest margin of the commercial banks narrowed in 2002 to 3.87 percentage points from 4.14 percentage points in 2001. Similarly, the average interest margin of the finance companies fell to 6.23 percentage points in 2002 from 6.56 percentage points in the

Table 4.9
Weighted Average Lending Rates For New Loans Approved During The Month

	Commercial banks		Finance companies	
	For the month of (% per annum)			
	Jan. 2002	Dec. 2002	Jan. 2002	Dec. 2002
Business loans	6.45	6.25	7.95	7.02
Purchase of residential properties	4.77	4.38	5.11	4.03
Purchase of passenger cars	n.a.	n.a	7.70	6.52

n.a. Not applicable.

preceding year. The narrowing of the average interest margin was driven by the larger decline in ALR compared with ACF.

and 4.20 percentage points for the finance companies. Banking institutions also incur administrative costs in managing and monitoring the loans. The proportion of staff cost and overheads incurred in 2002 for lending activities was 24.6% of gross interest income for the commercial banks and 16% for the finance companies.

After taking into account interest-in-suspense and administrative costs, the net interest margin for 2002 was 1.09 percentage points for the commercial banks and 2.79 percentage points for the finance companies. As the loan market becomes more competitive, interest margin can be

Strengthened resilience enabled the banking system to play a more active role in meeting the financing requirements of the economy.

The ALR of the commercial banks and finance companies has been declining progressively in recent years. As at end-December 2002, the ALR of the commercial banks stood at 6.50% per annum, whilst that of the finance companies was 9.75% per annum (2001: 6.67% per annum for the commercial banks and 10.24% per annum for the finance companies). Strong competition has pushed the lending rates charged on newly approved loans lower. The lending rates charged on new loans extended (excluding credit card loans) in December 2002 averaged at 5.86% per annum for the commercial banks and 6.44% per annum for the finance companies. The reduction in ALR on new loans was experienced across the board, with both businesses and households benefiting from the decline.

The interest margin derived based on the spread between the ALR and ACF however does not reflect the actual amount of return earned by banking institutions from their lending activities. As the ALR recognises the accrued but unearned interest on NPLs (interest-in-suspense), the ALR therefore overstates the interest income earned by the banking institutions. While the banking institutions do not receive income from the NPLs, they continue to incur costs on funds that were borrowed, mainly deposits, to fund these loans. In 2002, interest-in-suspense accounted for 13% of the commercial banks' and 14.7% of the finance companies' gross interest income. The interest margin after adjusting for interest-in-suspense was 2.58 percentage points for the commercial banks

expected to narrow further. Under such environment, the challenge for banking institutions is to sustain profitability by improving operational and cost efficiency, as well as quality of assets.

Loan Activity

The banking system continued to play an active role in providing financing to both the household and corporate sectors during the year. The continued efforts to strengthen the resilience of the banking system, in particular the completion of the financial restructuring and consolidation programme, had placed the banking system on a stronger position to meet the financing needs of the economy. Thus, amidst strong demand for household spending on consumer goods and passenger cars and investment in houses, as well as sustained demand for financing by the corporate sector, lending activities of the banking system expanded steadily during the year. Indeed, the lending activities of the banking system in 2002 recorded the highest level since the Asian financial crisis.

Against the backdrop of these favourable developments, the amount of loan applications received by the banking institutions in 2002 increased by 10.5%. Responding to the strong demand for new financing, RM136.4 billion of new loans were approved during the year, whilst disbursements posted a strong growth of 10.2%. On average, RM33.7 billion of loans were disbursed monthly in 2002, compared with RM30.6 billion in 2001. Meanwhile, loan rejections

Table 4.10
Banking System[1]: Financing Activities

	For the year		Annual growth (%)
	2001	2002	
	RM billion		
Loan approvals	124.7	136.4	9.4
Loan disbursements	367.1	404.6	10.2
Loan repayments	359.7	396.9	10.1
	As at end		Annual growth (%)
	2001	2002	
	RM billion		
Outstanding loans[2]	424.5	442.6	4.2
Adjusted outstanding loans[3]	432.9	455.0	5.1

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

declined by 4.9% in 2002. Loan repayments however, increased significantly by 10.1% partly due to refinancing of loans by large corporations via the bond market. This, combined with loan conversions and write-offs of RM12.4 billion, resulted in a moderate expansion of outstanding loans of 4.2% to RM442.6 billion at the end of 2002. Including the two Islamic banks, outstanding loans grew by 4.5% to RM451.7 billion. Adjusting for the conversions and write-offs, loans outstanding of the banking system (inclusive of the Islamic banks) expanded by 5.4% in 2002. Undrawn loans increased only marginally by 1.7% to RM128 billion, compared with 8.8% in 2001.

Of significance was the shift in loan composition of the banking system towards small loans, primarily driven by the robust growth in loans to households and small businesses. Outstanding loans below RM100,000 and between RM100,000 and RM500,000 expanded by 15% and 12% respectively in 2002 (11% for each in 2001). As a result, outstanding loans below RM100,000 accounted for 30% of total outstanding loans (2001: 27%) and outstanding loans of between RM100,000 and RM500,000 was 23% of total outstanding loans (2001: 21%). Small businesses continued to have access to financing. In 2002, outstanding loans below RM100,000 to businesses expanded sharply by 17.1%.

The favourable lending activity was attributable to the strong performance in lending to the household sector particularly loans for the purchase of residential properties and hire purchase financing. This resulted in the strong growth in loans to the household sector by 15.6% in 2002. The strong demand for housing loans was also contributed by the extension of the waiver for stamp duty on all documentation relating to purchase of residential properties to June 2002 as well as the competitive financing packages offered by banking institutions. The banking system received a total of RM81.2 billion worth of loan applications from the household sector or 38.4% of total applications received during the year. Loan approvals amounted to RM66.8 billion or 13.1% higher than the level approved in 2001. Of the amount approved, 43% was for the purchase of residential properties, whilst 34% was for car financing. As a result, outstanding loans for purchase of residential properties and passenger cars increased by 16.3% and 20.2% respectively. Following several years of strong growth, household loans now account for 42% of total outstanding loans of the banking system. While credit card loans grew significantly by 19.9%, it accounted for only 2.4% of total outstanding loans of the banking system.

Lending activities to the business sector registered positive performance in 2002, particularly with regard to the small and medium-sized enterprises (SMEs). Supported by higher fiscal expenditure, particularly on housing and public amenities, combined with recovery in private sector investment, new loans approved to businesses turned around to increase by 7.4% to RM67.4 billion, after declining by 19.5% in 2001, to account for 49.4% of total new loans approved by the banking institutions during the year. Meanwhile, disbursements to businesses also registered an increase of 4.1% to RM275.8 billion. Nevertheless, high loan repayments from businesses of RM269.8 billion combined with loan write-offs and conversions into securities, partly arising from the implementation of CDRC-led restructuring cases, resulted in outstanding loans to businesses to decline marginally by 2.7% to RM245 billion at the end of 2002.

The business sector remained the main recipient of loans. During the year, 68.2% of total disbursements were to the business sector. In particular, disbursements to the manufacturing sector continued to account for a significant share of 25.4% of total loan disbursements or RM102.7 billion. During the year, RM28.9 billion or 7.1% was disbursed to the construction sector, RM64 billion or 15.8% to the wholesale and retail trade, restaurants and hotels sectors and RM23.6 billion or 5.8% to the financing, insurance and business services sectors.

Lower interest rate coupled with efforts to diversify the sources of financing for the economy through the bond market resulted in a significant growth in the issuance of private debt securities. While the strong growth in outstanding loans of the banking system prior to the Asian financial crisis was driven primarily by large borrowings of corporations to finance projects with long gestation periods, more corporations have in recent years turned to the bond market to meet their funding needs. With the low interest rate environment, funds totalling RM26.7 billion were raised from the bond market during the year (2001: RM31.5 billion), with a significant proportion channelled to the transport, storage and communications sector as well as the finance, insurance, real estate and business services sector. Of the total funds raised, RM5.9 billion was issued to finance new activities, RM14.5 billion was for refinancing and RM6.3 billion of the issue was for restructuring cases. There was also early redemption of bonds of RM7.9 billion during the year.

The banking institutions also remained focused on providing financing to the SMEs. During the year, loan applications from the SMEs amounted to RM47.2 billion, accounting for 36.9% of total applications received from businesses. Demand for financing from the SMEs was mainly for working capital (72.5%), whilst financing for asset purchases only constituted 18.2% of total applications received. More than 71,000 SMEs received financing from the banking institutions totalling RM29.8 billion in 2002. Nevertheless, with the level of repayments almost matching the amount disbursed during the year, outstanding loans to SMEs posted a marginal decline of 0.3% to RM73.7 billion at end-2002.

In supporting their business strategies to focus on SME financing, almost all the commercial banks have set up dedicated SME units. The scope of activities offered by these units extends beyond the normal provision of financing to encompass developmental role. These efforts include organising workshops, seminars and training programmes in areas such as financial and cash flow management and trade finance-related activities, as well as other ancillary services such as business matching.

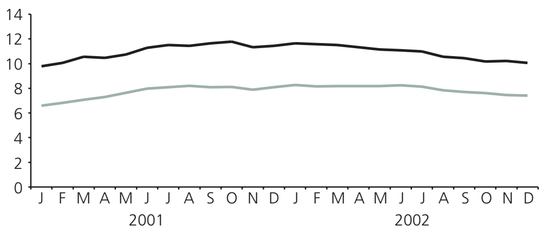
To ensure that the SMEs continue to have access to financing at a reasonable cost, an additional allocation of RM250 million each was extended by Bank Negara Malaysia for the Fund for Small and Medium Industries 2 (FSMI2) and the New Entrepreneurs Fund 2 (NEF2) in October 2002. These additional allocations bring the total amount allocated for FSMI2 and NEF2 to RM650 million and RM500 million respectively.

The favourable outlook for the economy, ample liquidity in the banking system and the strong position of the banking institutions would sustain the growth momentum in their lending activities in 2003. The household sectors are expected to continue to drive the overall growth in lending activities. Meanwhile, the implementation of various measures to stimulate domestic demand and the favourable underlying economic conditions will provide an impetus towards higher level of financing by the banking institutions to businesses, in particular to the SMEs. In addition, the continued accommodative monetary policy to support domestic economic activity would sustain demand for financing and thus growth in loans.

Asset Quality

The asset quality of the banking system improved in 2002 in line with the stronger economic growth and the substantial progress in corporate sector debt restructuring. Net NPLs of the banking system on a 6-month classification declined by RM1.2 billion or 3.7% to RM30.8 billion as at end-2002. Corresponding improvement was also recorded in net NPLs based on a 3-month classification, which declined by a larger amount of RM3.4 billion or 7.5% to RM41.8 billion as at end-2002. The net NPL ratio on a 6-month classification remained stable in the first half of 2002

Graph 4.7
Banking System[1]: Net Non-performing Loans Ratio



[1] Excludes Islamic banks

and improved further in the second half of the year to 7.4% as at end-December 2002. Similarly, the net NPL ratio on a 3-month classification improved to 10.1% from 11.4% as at end-2001.

The improvement in asset quality in 2002 was due to a favourable economic environment and rehabilitation efforts by the banking institutions. The favourable economic environment enhanced the capacity of borrowers to service their loans. As a result, NPLs reclassified as performing rose by 43% to RM13.2 billion while new NPLs declined by RM5.8 billion. During the year, recoveries were higher amounting to RM10.4 billion, compared with RM8.3 billion in 2001. RM9.5 billion of NPLs were written-off by the banking institutions during the year. The level of provisioning was sustained at a high level with a loan loss coverage ratio of 59.6% as at end-2002. Including the value of collateral, the total loan loss coverage ratio of the banking system strengthened further to 162.1% of NPLs as at end-2002, compared with 147.8% as at end-2001.

Most economic sectors recorded improvement in NPL positions. Reflective of the better performance in the manufacturing sector which was partly due to improved external demand, NPLs in this sector increased only marginally by 0.7%, compared with a large increase of 40.1% in 2001. Nevertheless, NPLs in the manufacturing sector continued to account for the largest share of NPLs of the banking system. In contrast, as the construction sector was one of the major beneficiaries of the Government's fiscal stimulus programmes, its NPLs declined by RM1.1 billion or 10.4% in 2002, to account for 15.1% of total NPLs of the banking system.

Quality of assets improved in 2002 with stronger economic growth, enhanced risk managment and progress in corporate debt restructuring.

Table 4.11
Banking System[1]: Non-performing Loans and Loan Loss Provisions

	As at end					
	2001			2002		
	Actual[2]	Classification		Actual[2]	Classification	
		3-month	6-month		3-month	6-month
	RM million					
Commercial banks						
General provisions	5,988.9	5,990.7	5,273.3	6,420.6	6,423.7	5,503.0
Interest-in-suspense	6,633.8	6,665.6	6,439.5	6,625.9	6,686.2	6,483.0
Specific provisions	14,274.5	14,111.2	13,326.1	12,939.0	12,970.8	12,392.2
Non-performing loans	46,912.0	51,556.1	41,659.9	43,932.6	47,957.3	40,012.4
Net NPL ratio (%)[3]	8.8	10.4	7.4	7.9	9.1	6.8
Total provisions/NPL (%)	57.3	51.9	60.1	59.1	54.4	60.9
Finance companies						
General provisions	1,815.7	1,795.9	1,795.7	1,820.4	1,819.8	1,820.4
Interest-in-suspense	2,625.1	2,833.8	2,564.3	2,534.1	2,621.8	2,485.7
Specific provisions	4,900.8	5,024.8	4,769.8	4,080.6	4,209.6	3,804.2
Non-performing loans	15,294.0	18,809.9	14,631.0	14,394.2	17,345.3	13,487.0
Net NPL ratio (%)[3]	9.1	12.9	8.5	8.3	11.2	7.6
Total provisions/NPL (%)	61.1	51.3	62.4	58.6	49.9	60.1
Merchant banks						
General provisions	371.2	340.5	374.6	276.1	276.6	276.5
Interest-in-suspense	517.0	540.0	522.8	534.1	547.4	534.1
Specific provisions	1,036.8	1,073.9	1,017.0	954.1	968.7	954.4
Non-performing loans	4,384.4	5,029.3	4,373.9	3,989.0	4,457.8	3,989.0
Net NPL ratio (%)[3]	21.7	26.3	21.7	20.9	24.6	20.9
Total provisions/NPL (%)	43.9	38.9	43.8	44.2	40.2	44.2
Banking system						
General provisions	8,175.9	8,127.1	7,443.6	8,517.1	8,520.1	7,599.8
Interest-in-suspense	9,775.9	10,039.4	9,526.7	9,694.1	9,855.4	9,502.9
Specific provisions	20,212.0	20,209.9	19,112.9	17,973.6	18,149.0	17,150.7
Non-performing loans	66,590.4	75,395.3	60,664.8	62,315.8	69,760.4	57,488.3
Net NPL ratio (%)[3]	9.3	11.4	8.1	8.3	10.1	7.4
Total provisions/NPL (%)	57.3	50.9	59.5	58.1	52.4	59.6

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%.
Note: Total may not add-up due to rounding.

Table 4.12
Banking System[1]: Non-performing Loans by Sector

	As at end				
	NPL by sector		Change	As percentage of total loans to sector	
	2001	2002	2001/2002	2001	2002
	RM million		%		
Agriculture, hunting, forestry & fishing	924.0	932.9	1.0	8.1	8.2
Mining & quarrying	244.6	158.9	-35.0	19.4	16.1
Manufacturing	12,425.2	12,509.1	0.7	20.3	21.0
Electricity, gas & water supply	358.8	422.5	17.8	7.3	6.6
Wholesale & retail trade, restaurants & hotels	4,984.5	4,316.7	-13.4	14.0	11.8
Wholesale trade	*2,127.6*	*1,851.8*	*-13.0*	*10.8*	*9.0*
Retail trade	*1,364.5*	*1,202.5*	*-11.9*	*12.3*	*10.4*
Restaurants & hotels	*1,492.4*	*1,262.4*	*-15.4*	*30.4*	*27.5*
Broad property sector	27,347.5	26,816.3	-1.9	17.1	15.8
Construction	*10,503.2*	*9,408.4*	*-10.4*	*31.7*	*30.3*
Purchase of residential property	*6,741.9*	*8,491.2*	*25.9*	*8.0*	*8.7*
Purchase of non-residential property	*4,928.8*	*4,813.3*	*-2.3*	*18.3*	*18.0*
Real estate	*5,173.7*	*4,103.4*	*-20.7*	*33.5*	*29.7*
Transport, storage & communication	1,595.0	1,406.5	-11.8	15.9	14.6
Finance, insurance & business services	4,680.7	3,105.3	-33.7	14.6	10.5
Consumption credit	5,784.1	5,419.6	-6.3	10.5	9.5
Personal use	*1,873.8*	*1,867.6*	*-0.3*	*14.2*	*13.4*
Credit cards	*409.4*	*434.2*	*6.1*	*4.6*	*4.1*
Purchase of consumer durable goods	*71.0*	*57.6*	*-18.8*	*15.0*	*15.9*
Purchase of transport vehicles [2]	*3,429.9*	*3,060.2*	*-10.8*	*7.0*	*5.3*
Purchase of securities	5,180.8	4,372.8	-15.6	24.5	20.4
Community, social & personal services	1,238.1	1,225.7	-1.0	21.0	21.7
Others	1,827.1	1,629.3	-10.8	18.0	16.8
Total	**66,590.4**	**62,315.8**	**-6.4**		

[1] Excludes Islamic banks.
[2] Includes commercial vehicles.
Note: Total may not add-up due to rounding.

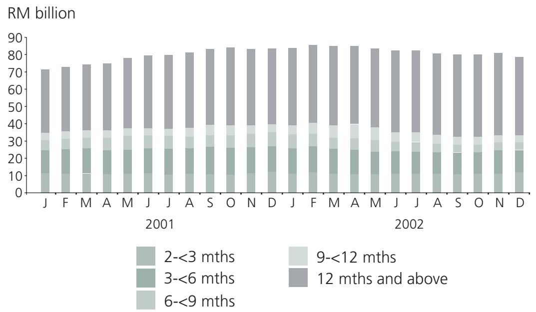
The finance, insurance and business services sector recorded one of the highest decline in NPLs of 33.7%, due mainly to the completion of debt restructuring exercises by several investment holding companies in 2002. As a result, NPLs in this sector accounted for only 5% of the total NPLs of the banking system, compared with 7% as at end-2001. Another sector which recorded a large decline in NPLs was the wholesale and retail trade, restaurants and hotel sector, where the NPLs declined by 13.4%, reflecting higher consumer spending. Despite the lacklustre performance of the stock market in 2002, NPLs for the purchase of securities declined by RM0.8 billion or 15.6%. The NPL ratio for loans to this sector also declined from 24.5% as at end-2001 to 20.4% as at end-2002.

A significant development in 2002 was the strong loan growth to the household sectors, particularly for the purchase of residential properties and hire-purchase financing, reflecting the strong growth in private consumption. Nevertheless, this development did not pose undue risk to the banking system given the relatively low level of NPLs in these sectors. Indeed, NPLs for the purchase of transport vehicles declined by 10.8% to RM3.1 billion as at end-2002, accounting for only 5.3% of total loans for this purpose. Similarly, NPLs for the purchase of residential properties remained manageable as it amounted to only 8.7% of total loans extended for this purpose. Enhancements in the risk management practices and the availability of the credit profile of borrowers in the banking system through the Central Credit Reference Information System (CCRIS) have enhanced the capacity of banking institutions to manage effectively loan expansion in these sectors.

Loans in arrears in the banking system moderated and remained at manageable levels throughout 2002, in line with the stronger economic growth. Outstanding loans which were in arrears between 2 to less than 6 months declined by 8.2% or RM2.2 billion in 2002. In aggregate, loans which were in arrears between 2 to less than 6 months accounted for only 5.5% of total outstanding gross loans as at end-December 2002.

The progress achieved in the corporate debt restructuring during the year improved the asset quality of the banking system. Having achieved its objectives, CDRC was disbanded on 15 August 2002.

Graph 4.8
Banking System[1]: Ageing Profile of Loans in Arrears



[1] Exludes Islamic banks

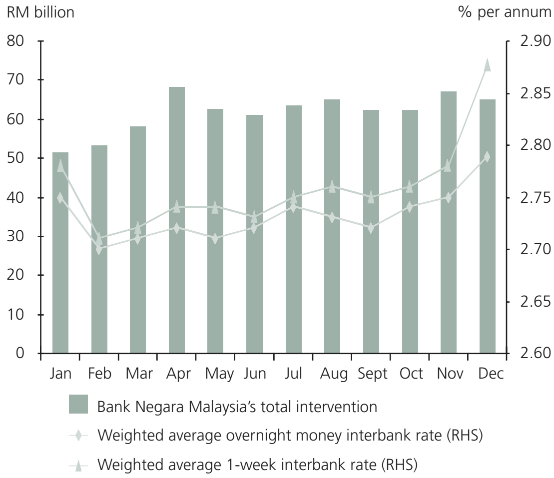
As at end-December 2002, CDRC had resolved 48 cases referred to it with debts amounting to RM52.6 billion. Of these, 32 cases had been fully implemented while the balance of 16 cases with debts amounting to RM16.6 billion were awaiting implementation. The successful completion of debt restructuring of a number of corporations led to a large amount of NPLs being reclassified as performing as well as resulting in higher recoveries. The full implementation of the remaining cases would reduce the gross NPL ratio of the banking system by approximately 2 percentage points.

With economic growth momentum sustained and the enhanced credit risk management practices, the asset quality of the banking system is expected to improve further. Indeed, with a high level of capitalisation, the domestic banking system is in a stronger position to continue to support economic activity in 2003.

Liquidity Management

There was ample liquidity in the banking system throughout 2002. Inflows from the external sector, mainly in the form of trade surplus and foreign direct investments had contributed to the high liquidity in the interbank market. To maintain interest rates at the appropriate levels, Bank Negara Malaysia conducted liquidity operations to absorb the excess liquidity. The outstanding amount of Bank Negara Malaysia's balances in the form of interbank borrowings and issuance of Bank Negara Bills and Negotiable Notes had increased from RM46.2 billion as at end-2001 to RM64.6 billion as at end-2002. As a result of the liquidity management by Bank Negara Malaysia, interest rates remained relatively stable throughout the year with the weighted average

Graph 4.9
Liquidity in the Banking System in 2002



overnight and one-week interbank rates fluctuating within a narrow band of 16 basis points over the course of 2002.

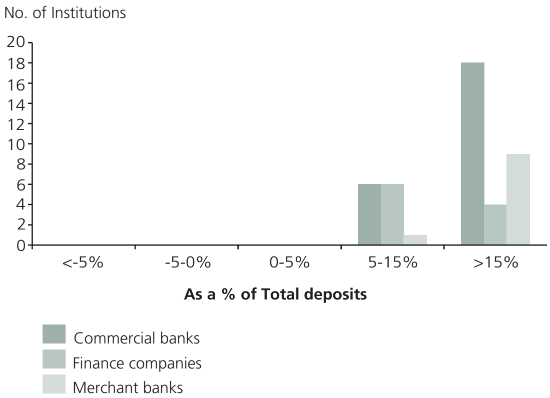
In terms of liquidity management, the banking system as a whole projected sufficient liquidity to meet any unexpected withdrawals for a period of up to one month. As at 31 December 2002, the banking system (excluding the two Islamic banks) projected a cumulative liquidity surplus of RM53.8 billion to meet demands of up to one week and a surplus of RM72.9 billion to meet demands of up to one month. As a group, commercial banks, finance companies and merchant banks projected surpluses in the 1-month bucket amounting to 16.8%, 15.6% and 26.5% of their total deposits base respectively. On an individual basis, all banking institutions have projected surpluses, well above the regulatory requirement of 3% and 5% for commercial banks and merchant banks and 5% and 7% for finance companies in the 1-week and 1-month bucket respectively.

Table 4.13
Banking System[1]: Liquidity Projection as at 31 December 2002

	Cumulative mismatch (RM billion)		Buffer as % of total deposits	
	1 wk.	1 mth.	1 wk.	1 mth.
Commercial banks[1]	39.0	56.1	11.7	16.8
Finance companies	9.1	12.9	10.9	15.6
Merchant banks	5.7	3.9	39.0	26.5
Banking system[1]	**53.8**	**72.9**	**11.0**	**14.9**

[1] Excludes Islamic banks.

Graph 4.10
Banking System[1]: Profile of Potential Liquidity Surplus/Shortfall up to One Month Ahead as at 31 December 2002



[1] Excludes Islamic banks

Interest Rate Risk
A major portion of the banking system's assets and liabilities are interest rate sensitive. Although interest rate risk of the banking system rose by 10.5% to RM 4.2 billion in terms of duration weighted net position, the banking system's exposure to interest rate risk remained at a manageable level. It has minimal impact on the banking system's risk-weighted capital ratio (RWCR) as at end-2002.

In quantifying the potential loss arising from movements in interest rates across all maturity spectrums, Bank Negara Malaysia adopts the duration weighted net position which measures the potential estimated loss in the economic value of a banking institution's interest rate sensitive on- and off-balance sheet positions, resulting from a one percentage point shift in interest rates. The analysis of the banking system's interest rate risk in 2002 using this concept, is shown in the table.

The most significant source of interest rate risk was concentrated in the more than 5 years maturity bucket with a high duration weighted net position of RM3 billion. This represented 73.3% of the approximated total duration weighted net position of the banking system. The large exposure of the finance companies was due primarily to hire purchase financing of RM39.7 billion or 39.9% of loans portfolio as at end-2002. For the commercial banks, their exposure was attributed to the longer term fixed rate loans, particularly housing loans based on Shariah principles and holdings of fixed rate debt securities. The merchant banks' exposure to the more than 5 years tenure was due primarily to holdings of fixed rate debt securities as the industry runs down their loan books and increased their holdings of capital market instruments.

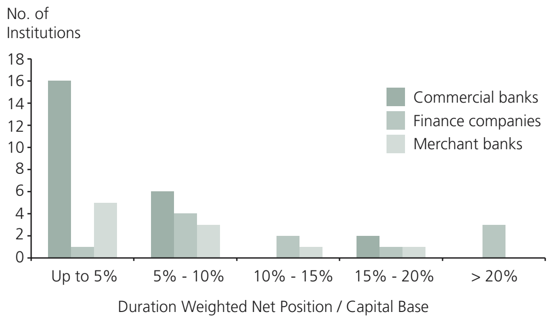
Table 4.14
Banking System[1]: Impact of 1% Rise in Interest Rate on Capital Strength

	Duration weighted net position					
	RM million		As a percentage of Capital base (%)		Impact on Risk Weighted Capital Ratio (percentage point)	
	2001	2002	2001	2002	2001	2002
Commercial banks	-1,881	-2,085	-4.3	-4.5	-0.8	-0.9
Finance companies	-1,686	-1,710	-17.6	-16.1	-2.5	-2.1
Merchant banks	-224	-392	-4.9	-8.9	-2.0	-3.8
Banking system[1]	-3,791	-4,187	-6.5	-6.8	-1.3	-1.3

[1] Excludes Islamic banks.
Note: Total may not add-up due to rounding.

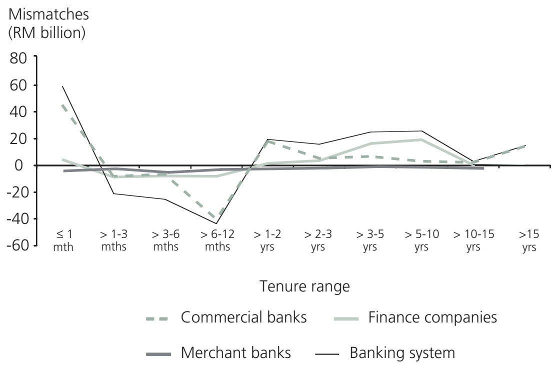
The impact of interest rate risk on the banking system was higher in 2002 due to an increase in fixed rate loans and holdings of fixed rate debt securities in the more than 5 years maturity bucket. Both the commercial banks and finance companies recorded an increase in fixed rate loans of RM3.9 billion and RM2.7 billion in the more than 5 years maturity bucket, respectively. Nevertheless, this was partially offset by an increase in their longer term fixed rate funding primarily through the securitisation of loan assets with Cagamas of RM3.2 billion and RM1.2 billion respectively. The impact of interest rate risk on the merchant banks registered a growth of RM168 million. Over 80% of the interest rate risk was due to the increase of RM2.2 billion in their holdings of fixed rate debt securities with maturities over 3 years.

Graph 4.11
Banking System[1]: Distribution by Duration Weighted Net Position as a Percentage of Capital Base as at 31 December 2002



[1] Excludes Islamic banks

Graph 4.12
Banking System[1]: Net Interest Rate Position Mismatches as at 31 December 2002



[1] Excludes Islamic banks

As at end-2002, the impact of a potential loss arising from a one percentage point rise in interest rate is a marginal 6.8% reduction in the banking system's capital base while the RWCR would reduce by 1.3 percentage points to 11.6%.

Interest rate risk had the largest impact on the capital of finance companies. A one percentage point rise in interest rate can potentially erode the capital base of the finance companies by 16.1% and reduce their RWCR by 2.1 percentage points to 9.3% as at 31 December 2002. The relatively large unhedged interest rate position carried in the books of the finance companies may be attributable to the ample liquidity in the banking system and expectations that interest rates would remain stable. Furthermore, the high exposure of the finance companies to interest rate risk will be mitigated upon the impending amalgamation of the finance companies into the commercial banks where synergies from portfolio diversification and risk management can be reaped.

Structurally, the banking system continued to record a net negative gap position for the shorter-term maturities not exceeding one year, as its main source of funding comes from deposits which primarily have a maturity of less than a year. Conversely, in the medium and longer term tenures of one year and more, there was a net positive gap position arising from hire purchase financing, fixed rate housing loans based on Shariah principles and holdings of fixed rate debt securities, particularly long term Government papers for liquidity, trading and investment purposes.

Equity Risk

Holdings of equity instruments by the banking system rose by 22.8% or RM492.1 million to RM2.6 billion as at end-2002 on account of a higher conversion of loans into equity. As the bulk of the increase was due to conversion of loans into equity, which merely represents a transformation of credit risk into equity risk, the banking system is not exposed to additional material risk. Equity holdings accounted for only 0.4% of the banking system's total assets as at end-2002.

Of the total equities held, quoted shares accounted for 64%, having increased by RM176.4 million to RM1.7 billion as at end-2002. The increase was attributable mainly to conversions of loan into equity, which accounted for RM146.9 million of the total increase. Shares purchased directly from the market rose by RM84.4 million. This was, however, partially offset by a contraction in shares held arising from underwriting and debt satisfaction, which declined by RM52.9 million and RM2 million respectively.

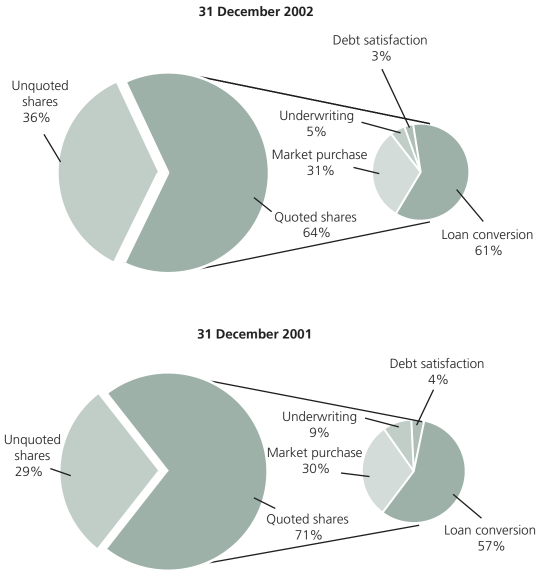
Finance companies recorded the highest increase of 20% in holdings of quoted shares while such investments by the commercial banks rose by 12% and merchant banks by 3.2%. However, in terms of exposure, the merchant banks had the highest equity exposure as their holdings of quoted shares accounted for more than 9% of capital base given the nature of their business as capital market

Table 4.15
Banking System[1]: Equity Exposure

	Equity[2] holdings (RM million)		Equity[2] / Capital base (%)		Potential equity[2] loss / Capital base (%)	
	2001	2002	2001	2002	2001	2002
Commercial banks	768.5	860.9	1.7	1.9	0.3	0.2
Finance companies	357.6	429.0	3.5	4.0	0.7	0.3
Merchant banks	398.1	410.7	8.4	9.3	1.6	0.8
Banking system[1]	1,524.3	1,700.7	2.6	2.8	0.5	0.2

[1] Excludes Islamic banks.
[2] Amount of investment in quoted shares.
Note: Total may not add-up due to rounding.

Graph 4.13
Banking System[1]: Composition of Equity Investments

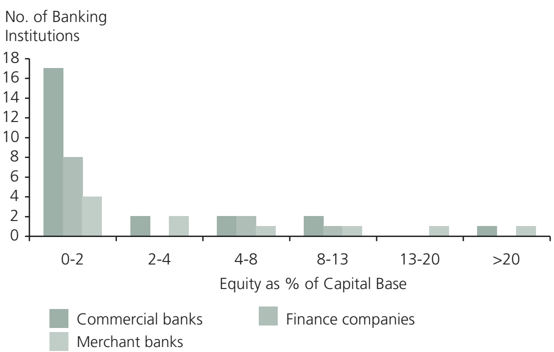


[1]Excludes Islamic banks

intermediaries. The bulk of the merchant banks' exposure was due to underwriting of equity and from loan conversions.

For the system as a whole, the potential maximum loss in equity value based on a 10-day volatility of the KLCI in 2002, was lower at 8.2% compared to 19% in 2001. Hence, potential loss to the banking system based on the estimated potential maximum loss of KLCI was estimated at only 0.2% of capital base in 2002 compared with 0.5% in 2001. For the merchant banks, the potential loss may amount to 0.8% of their capital base in 2002 as against 1.6% in 2001 while the potential loss for the commercial banks and finance companies remained insignificant.

Graph 4.14
Banking System[1]: Distribution by Equity as a Percentage of Capital Base as at 31 December 2002



[1] Excludes Islamic banks

The holding of unquoted shares registered a significant increase of 49.9% to RM948.3 million in year 2002. This was contributed largely by the conversion of loans into shares pursuant to restructuring exercises, including CDRC-led restructurings. Despite the sharp increase, holdings of unquoted shares accounted for an insignificant 0.1% of the system's total assets.

As the banking institutions are not allowed to write back the specific provision and interest-in-suspense attributable to the loans which have been converted into shares until the shares are disposed of, the conversion of the loans into shares will not have an impact on the profitability and capital position of the banking system. This is in view of the fact that the specific provision and interest-in-suspense had been accounted for in previous years.

Foreign Exchange Risk
Exposure of the banking system to foreign exchange risk remained within prudential levels in 2002. Throughout the year, the net open foreign currency position (NOP) of the banking system hovered within a narrow range of RM2.4 billion to RM2.7 billion. As a percentage of the banking system's capital base, the NOP registered a marginal increase from 4.7% as at end-2001 to 5.3% as at end-2002.

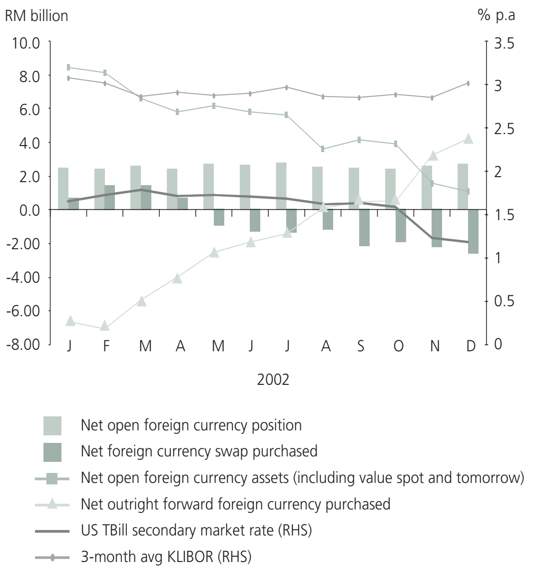
Total holdings of foreign currency assets by banking institutions remained relatively stable having increased marginally by RM2.8 billion in 2002. However, the foreign currency liabilities recorded a significant increase as banking institutions took advantage of the lower USD interest rates to source USD funds, most of which were used to hedge their foreign currency forward purchases. Foreign currency interbank borrowings of the banking institutions increased by RM10.1 billion during the year to RM27.6 billion as at end-2002. The increase in

Table 4.16
Banking System[1]: Foreign Currency Exposure

	NOP (RM million)		NOP/Capital base (%)	
	end-2001	end-2002	end-2001	end-2002
Commercial banks	2,221	2,631	5.1	5.7
Merchant banks	47	70	1.0	1.6
Banking system[1]	2,268	2,701	4.7	5.3

[1] Excludes Islamic banks.

Graph 4.15
Banking System[1]: Components of Foreign Currency Exposure

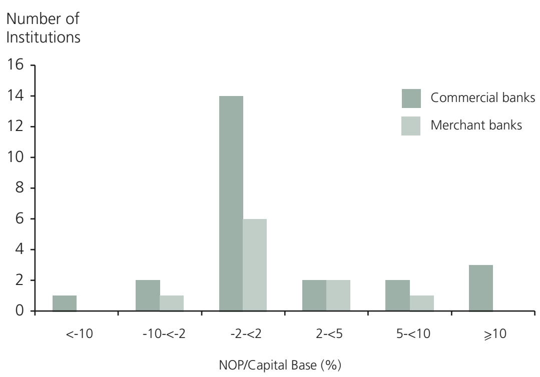


[1]Excludes Islamic banks

foreign currency liabilities from RM30 billion as at end-2001 to RM40 billion as at end-2002 resulted in a contraction in net foreign currency assets by RM7.2 billion to RM1.1 billion as at end-2002.

While the banking institutions were net sellers of foreign currency forwards in 2001, they were net purchasers in 2002 as exporters capitalized on the forward premium by selling forward contracts for their foreign currency proceeds. Foreign currency forwards purchased by the banking institutions rose by 97% to RM13.6 billion at the end of 2002 as the forward premium widened from 26 points as at end-

Graph 4.16
Banking System[1]: Distribution of Net Open Foreign Currency Position as at 31 December 2002



[1]Excludes Islamic banks

2001 to over 50 points as at end-2002 for the one-month forward rates. In view of the widening forward premium, the cost of hedging forward payments by importers were higher, hence resulting in foreign currency forwards sold declining by 27%. The decline in foreign currency forwards sold also contributed to the reduction in foreign currency swaps receivable by 20% during the second half of 2002.

The banking system is expected to remain a net foreign exchange forward purchaser in view of the forward premium as the interest rate differential between the USD and Ringgit remains positive.

Capital Strength

The banking system remained strong with risk-weighted capital ratio (RWCR) of 12.8% as at end-2002. Audited profits contributed RM3.4 billion to the increase in capital base in 2002 whilst new capital injections contributed another RM1.3 billion. The merger of two finance companies, in the first half of the year, together with the increase in investment in subsidiary companies by two banking institutions in late 2002, however had resulted in the capital base of the banking system, on a net basis, to grow only by 3.8% or RM2.3 billion during 2002. Risk-weighted assets of the banking system increased by 5.2%.

In tandem with the higher profits, total tier-1 capital increased by RM2.5 billion or 4.6% to RM55.9 billion, while the total tier-2 capital recorded an increase of RM1.9 billion resulting from the issuance of subordinated debts to partly finance the acquisition of a banking institution under the merger programme for domestic banking institutions. Reflective of the strong capital position of the banking system in 2002, the RWCR and core capital ratio of the banking system remained consistently above 12% and 10% respectively throughout the year.

The commercial banks' RWCR stood at 12.8% while the merchant banks' RWCR as a group declined from 19.6% to 18.4% due to the increase in investment in subsidiaries by a merchant bank. As for the finance companies, the increase of capital base by 4.6% during 2002 was offset by the greater asset expansion mainly from hire purchase financing, resulting in the RWCR to decline by a marginal 0.7 percentage point to 11.4%.

Bank Negara Malaysia had also conducted an industry-wide survey to assess the possible impact of the incorporation of the market risk capital charges into the capital adequacy framework. Initial estimates showed that the additional capital charge that would be required by the banking system would be rather minimal and would vary between the industries. The merchant banks' estimated additional capital charge of 3% on market risk, which would be greater than that of other banking institutions, is due to the nature of their investment and dealing with financial investments, in particular the private debt securities. Any additional capital requirement would be easily absorbed by the large capital base such that their RWCR would remain well above the minimum requirement. Similarly, the initial estimate on the capital requirement for operational risk based on a survey of the possible impact of Basel II proposed framework indicated that additional capital charge of 1% would be easily absorbed by the banking system.

The higher levels of economic activities and loan growth during the year have contributed to the increase in total risk-weighted assets of the banking system which grew by 5.2% or RM23.8 billion to RM479.3 billion as at end-2002. The increase was across most risk categories except for the 10% category where there was a reduction in interbank placements with discount houses. Notably, there had been an increase in the 0% category by RM18 billion to RM139.1 billion, mainly due to net issuance of Malaysian Government Securities as well as the issuance of Bank Negara Bills and Negotiable Notes as part of Bank Negara Malaysia's money market intervention activities. Similarly, the end-financing of residential properties in 2002 has led to the expansion of RM12.1 billion in the 50% risk category whilst the increase of RM16.8 billion in the 100% risk category was attributable to other loan financing.

Table 4.17
Banking System[1]: Constituents of Capital

	As at end		Annual change	
	2001	2002		
	RM million		RM million	(%)
Tier-1 capital	53,393.4	55,864.6	2,471.2	4.6
Tier-2 capital	14,786.3	16,718.9	1,932.6	13.1
Total capital	68,179.7	72,583.4	4,403.7	6.5
Less:				
Investment in subsidiaries and holdings of other banking institutions' capital	8,885.6	11,018.0	2,132.4	24.0
Capital base	59,294.1	61,565.4	2,271.3	3.8
Risk assets:				
0%	121,603.7	139,193.8	17,590.1	14.5
10%	15,846.2	15,546.7	-299.5	-1.9
20%	93,172.4	98,050.8	4,878.4	5.2
50%	90,533.6	102,611.9	12,078.3	13.3
100%	390,024.2	406,896.1	16,871.9	4.3
Total risk-weighted assets	455,510.1	479,366.8	23,856.7	5.2
Risk-weighted capital ratio (%)				
Banking system[1]	**13.0**	**12.8**	**-0.2**	
Commercial banks	12.8	12.8	0.0	
Finance companies	12.1	11.4	-0.6	
Merchant banks	19.6	18.4	-1.2	

[1] Not including Islamic banking institutions.
Note: Total may not add-up due to rounding.

The banking system remained strong following the successful completion of the consolidation programme. With healthy profits recorded in 2002, the banking system is well-positioned to meet the demands for financing to support economic growth in 2003.

ISLAMIC BANKING

The Islamic banking industry continued to expand during the year with the market share of Islamic banking assets of the total banking system increasing to 8.9% (8.2% in 2001), financing to 8.1% (6.5% in 2001) and deposits to 10.2% (9.5% in 2001). This expansion was underpinned by sustained economic growth as well as continued focus and commitment to further develop the Islamic banking sector as outlined in the Financial Sector Masterplan (FSMP).

In September 2002, the Islamic Banking and Finance Institute Malaysia (IBFIM) completed its transformation exercise from a bank-owned entity into an industry-owned training and research institute. The shareholding structure of IBFIM now comprises the Islamic banks, conventional banks participating in the Islamic Banking Scheme (IBS) and the takaful operators. The establishment of IBFIM contributes part of the on-going initiatives to enhance knowledge and expertise in Islamic banking. Going forward, focus will be directed to enhance the institutional capacity of IBFIM as part of the efforts to position IBFIM as a premier regional centre for training in Islamic banking and finance.

In the area of product development, a collaborative approach has been adopted with the industry players under the Consultative Committee on Product and

Table 4.18
Islamic Banking System: Key Data

	As at end		Annual change (%)
	2001	2002	2002
Number of financial institutions	**38**	**35**	**-7.9**
Commercial banks	14	14	0.0
Finance companies	10	9	-10.0
Merchant banks	5	3	-40.0
Islamic banks	2	2	0.0
Discount houses	7	7	0.0
Total assets (RM million)	**58,929**	**68,070**	**15.5**
Commercial banks	26,750	29,109	8.8
Finance companies	9,749	12,623	29.5
Merchant banks	1,353	1,430	5.7
Islamic banks	17,328	20,160	16.3
Discount houses	3,749	4,748	26.6
Total deposits (RM million)	**47,106**	**53,306**	**13.2**
Commercial banks	22,031	23,476	6.6
Finance companies	7,664	9,094	18.7
Merchant banks	673	684	1.6
Islamic banks	14,375	16,421	14.2
Discount houses	2,363	3,631	53.7
Total financing (RM million)	**28,201**	**36,718**	**30.2**
Commercial banks	12,256	16,706	36.3
Finance companies	7,613	10,050	32.0
Merchant banks	771	804	4.3
Islamic banks	7,561	9,158	21.1
Discount houses	–	–	–
Financing-deposits ratio (%)	**59.9**	**68.9**	**9.0**
Commercial banks	55.6	71.2	15.6
Finance companies	99.3	110.5	11.2
Merchant banks	114.6	117.5	2.9
Islamic banks	52.6	55.8	3.2
Discount houses	–	–	–
Number of branches	**132**	**138**	**4.5**
Commercial banks	8	8	0.0
Finance companies	2	2	0.0
Islamic banks	122	128	4.9
Number of counters	**2,065**	**2,065**	**0.0**
Commercial banks	1,335	1,335	0.0
Finance companies	730	730	0.0
Merchant banks	–	–	–

Market Development. Initiatives in this area included the development of a risk-sharing mode of financing based on the concepts of Mudharabah (profit-sharing) and Musyarakah (profit and loss sharing); and Islamic floating rate mechanisms for managing fluctuating market risks. In January 2003, Bank Negara Malaysia introduced a standard list of generic names of Islamic banking products and services. Of significance is the indicator “i” affixed at the end of the generic name. The standardization is aimed at enhancing uniformity of the product names to facilitate the identification of Islamic banking products and services in a dual banking environment. In addition, it will contribute to create greater awareness and enhance consumer education on Islamic banking products and services. Whilst the use of the generic name and indicator “i” is compulsory, the application of other names which relates to branding, Islamic concepts and Arabic terminologies can still be used by the banking institutions.

Bank Negara Malaysia also issued the Guidance Notes on the Sell and Buy Back Agreement in August 2002 to facilitate a structured trading of sell and buy-back agreement (SBBA) with best practices.
The SBBA, which is akin to a repurchase agreement, was introduced to enhance liquidity in Islamic money market transactions and provide another avenue for the Islamic money market participants to source their funding requirements. In addition, the Guidelines on Accepted Bills-i (AB-i) has been revised with the objective to incorporate the current trends and developments in trade finance. This exercise also constitutes part of the measures to enhance the competitiveness of Islamic banking products.

Sources and Uses of Funds

The total assets of the Islamic banking sector recorded a growth of 15.5% (RM9.1 billion) as at end-2002. As in previous years, a significant portion of the increase in total assets was attributable to the growth in total financing of IBS commercial banks (36.3%) and IBS finance companies (32.0%), constituting 72.9% of total financing. In terms of the market share, the largest portion of Islamic banking assets remained with the IBS commercial banks with a share of 42.8%, followed by Islamic banks (29.6%) and the IBS finance companies (18.5%). In terms of the growth in assets, IBS finance companies recorded the highest growth of 29.5%, followed by IBS

Table 4.19
Islamic Banking System: Sources and Uses of Funds

	Annual change		As at end 2002*p*
	2001	2002	
	RM million		
Sources			
Capital and reserves	908	1,269	4,703
Deposits	11,183	6,200	53,306
Funds from other financial institutions	-623	271	4,444
Other liabilities	392	1,401	5,617
Total	**11,860**	**9,141**	**68,070**
Uses			
Cash	-147	39	240
Reserve with Bank Negara Malaysia	154	318	1,196
Deposits with other financial institutions	2,759	-3,767	7,735
Financing	7,310	8,517	36,718
Securities	-504	4,014	19,277
Other assets	2,288	20	2,904

p Preliminary

discount houses (26.6%) and Islamic banks (16.3%). A notable trend observed during the year was the shift of funds from interbank deposits to investment in securities to secure a higher rate of return.

Deposits continued to be the major source of funds for the Islamic banking sector, constituting 78.3% of the total resources. Total deposits mobilized by the Islamic banking sector registered a moderate growth of 13.2% or RM6.2 billion to reach RM53.3 billion. Investment deposits continued to capture 67.5% of Islamic banking deposits, increasing by 7.4% in 2002. In contrast, demand and savings deposits recorded significant growth of 42.2% and 30.7% respectively mainly due to the competitive rate of return and increase in the retail customer base in Islamic banking. In terms of the maturity profile of investment deposits, 56.5% of the deposits continued to be concentrated at the shorter end of the yield curve, mainly in the one to three months maturity tenure as the incremental return between the shorter and longer placement tenures continued to remain small. The average rates for the one to three months maturity tenure were in the range of 2.8% to 5.0%, whilst the average rates for the maturity tenure of one year and above were in the range of 3.5% to 5.3%.

Total financing extended by the Islamic banking sector expanded by RM8.5 billion or 30.2% (RM7.3 billion or 35% in 2001), driven by the increase in financing for the broad property sector as well as strong consumer spending. The growth in financing was largely attributable to the significant growth in the financing for the purchase of residential property and passenger vehicles of 57.2% and 33.5% respectively. The higher consumer demand was further augmented by the attractive and competitive financing packages offered by the Islamic banking institutions. In consonance with the continued exposure to the broad property sector and vehicle financing, financing based on Bai' Bithaman Ajil concept remained dominant, constituting 49.1% of total financing while Ijarah Thumma Al-Bai' constituted 23.3%.

In 2002, the capital position of the Islamic banking sector strengthened significantly by RM1.3 billion to RM4.7 billion. The major portion of the increase in capital position of RM994.8 million originated from higher capital allocation by the IBS banks following the imposition of a separate compliance to the risk-weighted capital adequacy ratio (RWCR) framework

Table 4.20
Islamic Banking System: Deposits by Type and Institutions

	Annual change				As at end 2002*p*
	2001		2002*p*		
	RM million	%	RM million	%	RM million
Demand deposits	**-107**	**-1.6**	**2,727**	**42.2**	**9,184**
Islamic banks	-162	-5.8	834	31.9	3,450
Commercial banks	55	1.5	1,893	49.3	5,734
Savings deposits	**822**	**24.7**	**1,275**	**30.7**	**5,424**
Islamic banks	138	10.5	308	21.2	1,762
Commercial banks	553	35.0	897	42.1	3,030
Finance companies	131	30.4	70	12.5	632
Investment deposits	**9,041**	**37.0**	**2,463**	**7.4**	**35,968**
Islamic banks	3,066	43.1	909	8.9	11,090
Commercial banks	3,808	38.8	-1,032	-7.6	12,578
Finance companies	2,237	47.1	1,419	20.3	8,405
Merchant banks	-160	-30.2	7	1.9	377
Discount houses	90	4.0	1,160	49.2	3,518
Other deposits	**1,428**	**91.1**	**-266**	**-8.9**	**2,729**
Islamic banks	29	30.5	-5	-4.0	119
Commercial banks	1,524	165.1	-314	-12.8	2,133
Finance companies	-96	-45.3	-59	-50.9	57
Merchant banks	-34	-10.1	4	1.3	307
Discount houses	5	–	108	2,160.0	113

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Table 4.21
Islamic Banking System: Direction of Financing

	Annual change		As at end 2002*p*
	2001	2002*p*	
	RM million		
Agriculture, hunting, forestry and fishing	61.9	-45.6	1,594.0
Mining and quarrying	-14.5	10.5	74.5
Manufacturing	1,029.1	807.8	3,881.2
Electricity, gas and water	-312.0	-9.9	533.7
Community, social and personal services	60.4	-139.2	213.9
Broad property sector	3,276.2	4,953.2	15,735.7
Real estate	*202.7*	*103.5*	*669.3*
Construction	*126.3*	*579.9*	*2,278.2*
Purchase of residential property	*2,871.5*	*3,916.9*	*10,762.8*
Purchase of non-residential property	*75.6*	*353.0*	*2,025.4*
Wholesale, retail, restaurants and hotels	280.5	251.2	1,386.4
Transport, storage and communication	-24.9	61.8	824.8
Finance, insurance and business services	633.8	42.2	1,271.7
Purchase of securities	167.6	62.4	935.0
Consumption credit	2,769.6	2,474.5	9,287.2
Credit cards	*1.6*	*57.5*	*60.5*
Personal uses	*346.7*	*374.7*	*1,061.6*
Purchase of consumer durables	*12.1*	*8.1*	*63.3*
Purchase of transport vehicles	*2,409.3*	*2,034.1*	*8,101.8*
Others	-617.6	47.5	979.6
Total	**7,310.1**	**8,516.4**	**36,717.7**

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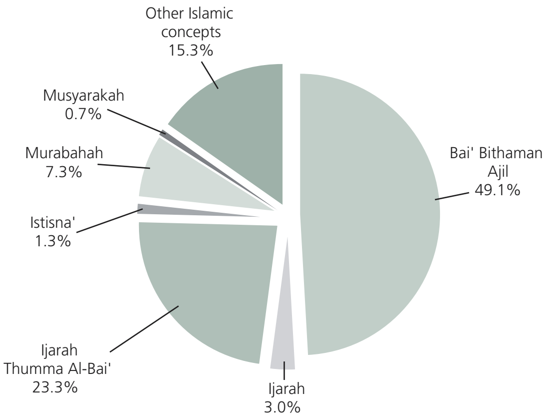
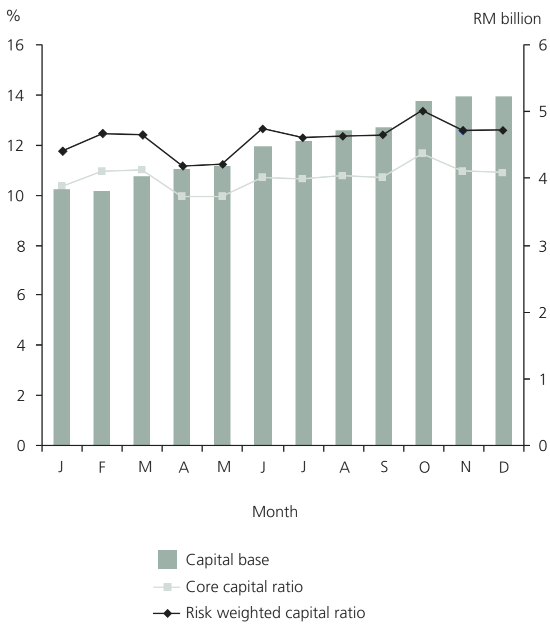
Graph 4.17
Islamic Banking System: Financing Concepts as at December 2002



Graph 4.18
Islamic Banking System: Capital Adequacy in 2002



for the Islamic banking portfolio, while the remaining increase of RM299.1 million was from retained profits. As at end-2002, the Islamic banking sector recorded a strong core capital ratio and risk-weighted capital ratio of 10.9% and 12.6%, respectively.

Profitability

The Islamic banking sector recorded an increase in pre-tax profit of 12.3% in 2002 to RM948 million. The return on assets remained relatively unchanged at 1.4% as the increase in pre-tax profit was

Table 4.22
Islamic Banking System: Income and Expenditure

		For the calendar year		Annual change	
		2001	2002*p*		
		RM million		RM million	%
Finance income net of income-in-suspense		2,752	3,196	444	16.1
(Income-in-suspense)		121	373	252	208.3
Less:	Finance expense	1,387	1,569	182	13.1
Net finance income		1,365	1,627	262	19.2
Add:	Non-finance income	432	495	63	14.6
Less:	Staff cost	180	199	19	10.6
	Overheads	227	269	42	18.5
Profit before provisions		1,390	1,654	264	19.0
Less:	Financing loss & other provisions	546	706	160	29.3
Pre-tax profit		844	948	104	12.3
Return on assets (%)		1.4	1.4		
Return on equity (%)		24.6	20.2		

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commensurate with the increase in assets. However, the return on equity declined to 20.2% as a result of the strengthened capital position of the Islamic banking sector. Despite the increase in financing loss and other provisions amounting to RM706 million, a higher pre-tax profit was recorded as the increase in finance income of 16.1% to RM3.2 billion and non-finance income of 14.6% to RM495 million more than offset the increase in provisions. The increase in financing loss and other provisions was partly due to the increase in financing activities and the introduction of profit equalisation reserve following the implementation of the standard framework for the calculation of the rate of return in 2002.

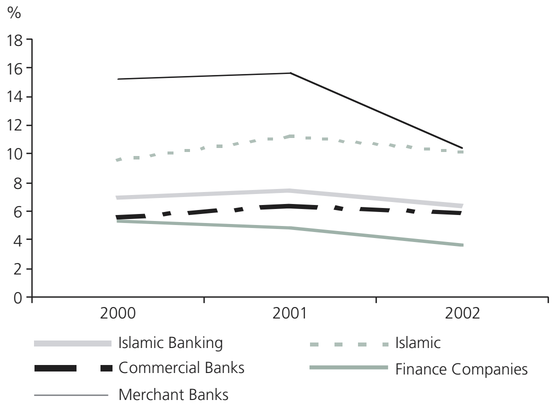
Asset Quality

The asset quality of Islamic banking industry improved during the year, with the net non-performing financing (NPF) ratio declining to 5.7% (7.0% in 2001) based on a 6-month classification. While the gross NPF increased by 13.8% to RM3.3 billion, the net NPF ratio declined due to the significant increase in income-in-suspense as well as increases in specific provision and total financing. Based on a 3-month classification, gross NPF stood at RM4.6 billion with the net NPF ratio declining to 7.9% (9.4% in 2001). The financing loss coverage (general provision, income-in-suspense and specific provision) position of the Islamic banking industry improved significantly to 59.4% (48.5% in 2001) mainly due to the increase in income-in-suspense of

128.1% and general provision of 55.0%. The increase in general provision reflected the prudent stance of a number of Islamic banking institutions in setting aside higher provisions for new financing as well as the separate apportionment of general provision for the Islamic banking financing portfolio of IBS banks following the introduction of the standard framework for the calculation of the rate of return.

The increase in NPF of RM519.4 million during the year primarily originated from the broad property sector which constituted RM366.5 million or 70.6%, of which the purchase of residential property accounted for RM341.4 million or 93.2%. Apart from the broad property sector, there was also an

Graph 4.19
Islamic Banking System: Net Non-performing Financing Ratio[1]



[1] Based on actual classification

Table 4.23
Islamic Banking System: Non-performing Financing and Financing Loss Provisions

	As at end					
	2001			2002*p*		
	Actual[1]	Classification 3-month	Classification 6-month	Actual[1]	Classification 3-month	Classification 6-month
	RM million					
Islamic banks						
General Provisions	134.8	134.8	134.8	209.1	209.1	209.1
Income-in-suspense	–	–	–	133.2	142.2	133.2
Specific provisions	430.2	472.2	430.2	395.4	436.4	395.4
Non-performing financing	1,237.8	1,580.2	1,237.8	1,396.4	1,933.0	1,396.4
Net NPF ratio (%)[3]	11.2	15.4	11.2	10.1	15.8	10.1
Total provisions/ NPF (%)	45.6	38.4	45.6	52.8	40.8	52.8
Commercial banks[2]						
General Provisions	155.7	154.9	150.5	250.0	226.5	247.9
Income-in-suspense	71.9	73.2	69.3	113.0	78.1	111.4
Specific provisions	143.8	147.5	143.3	222.4	222.4	222.3
Non-performing financing	991.7	1,110.2	879.7	1,300.0	1,604.2	1,085.0
Net NPF ratio (%)[3]	6.4	7.4	5.5	5.9	7.9	4.6
Total provisions/ NPF (%)	37.5	33.8	41.3	45.0	32.9	53.6
Finance companies[2]						
General Provisions	132.4	132.3	132.4	202.2	202.2	202.2
Income-in-suspense	93.6	95.5	82.9	129.8	158.7	126.3
Specific provisions	226.3	232.9	193.4	279.4	748.9	238.3
Non-performing financing	667.6	773.3	605.4	751.5	919.0	671.1
Net NPF ratio (%)[3]	4.8	6.1	4.5	3.6	0.1	3.2
Total provisions/ NPF (%)	67.8	59.6	67.5	81.4	120.8	84.5
Merchant banks[2]						
General Provisions	15.3	2.5	15.3	12.2	12.2	12.2
Income-in-suspense	17.3	17.3	17.3	15.6	15.6	15.6
Specific provisions	28.1	28.1	28.1	33.6	33.6	33.6
Non-performing financing	159.0	159.0	159.0	127.7	127.7	127.7
Net NPF ratio (%)[3]	15.6	15.6	15.6	10.4	10.4	10.4
Total provisions/ NPF (%)	38.2	30.1	38.2	48.1	48.1	48.1
Islamic banking system						
General Provisions	438.2	424.5	433.0	673.5	649.9	671.3
Income-in-suspense	182.8	186.1	169.5	391.7	394.6	386.6
Specific provisions	828.6	880.8	795.3	930.7	1,441.3	889.6
Non-performing financing	3,056.1	3,622.7	2,881.9	3,575.5	4,583.9	3,280.2
Net NPF ratio (%)[3]	7.5	9.4	7.0	6.4	7.9	5.7
Total provisions/ NPF (%)	47.4	41.2	48.5	55.8	54.2	59.4

[1] Financing classified as NPF based on individual banking institution's NPF classification policy i.e. 3-month or 6-month classification.
[2] Refers to Islamic banking portfolio of conventional banking institutions participating in Islamic Banking Scheme and represents a subset of the figures reported under the total banking system for commercial banks, merchant banks and finance companies.
[3] Net NPF ratio = (NPF less IIS less SP) / (Gross financing less IIS less SP) x 100%.
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increase in NPF in consumption credit of RM190.1 million, of which the purchase of transport vehicles accounted for RM134.5 million or 70.8%. The NPF level of the residential property and purchase of transport vehicle sectors however, remained manageable at 9.2% and 3.2% respectively, of the financing disbursed to these sectors.

Islamic Interbank Money Market (IIMM)

During the year, an ample liquidity position continued to be recorded in the IIMM. To stabilise the liquidity condition, Bank Negara Malaysia participated in the IIMM to absorb the excess liquidity. The daily average outstanding amount of liquidity absorbed from the IIMM through the liquidity management operations increased by 82.4% to RM6.2 billion (RM3.4 billion in 2001). The Bank's money market tender operations were concentrated on the 1 week to 1 month tenures.

This has led to an increase in the volume of transactions for the 1 week and 1 month tenure of 68.0% and 174.4% respectively. A new mechanism was also introduced for accepting Islamic interbank deposits under the liquidity management operations based on the Islamic concept of Wadiah Yad Dhamanah (Guaranteed custody). Under this concept, the Islamic banking institutions will offer to deposit their excess funds with the Central Bank over a period of time, as agreed between both parties. As a custodian to the deposits, the Bank is not under obligation to promise any return to the depositors. However, based on the Central Bank's discretion, a sum amount of money may be paid as hibah (gift) to the depositors on the maturity date.

The total volume of Islamic money market instruments (both short-term and long-term instruments) traded in the IIMM increased by 37.4% to reach RM32.7 billion in the year 2002 (RM23.8 billion in 2001). The trading of short-term instruments such as Accepted Bills-i (AB-i) and Bank Negara Malaysia Negotiable Notes-i (BNNN-i) recorded a higher growth of 94.9% and 83.3% respectively. The increase in the trading of Islamic instruments was mainly due to the increase in the size and frequency of issuance of Islamic instruments. The increase in the trading volume of BNNN-i amounting to RM2.2 billion was associated with the increase in BNNN-i issuance to RM2 billion (RM1 billion in 2001). Similarly for the long-term instruments, the increase in the total issuance of Government Investment Issue-i (GII-i) amounted to RM5.0 billion in 2002 (RM4.0 billion in 2001), resulting in an increase in the trading volume of GII-i to RM5.9 billion (RM2.5 billion in 2001). The trading of Islamic private debt securities (IPDS) also registered a significant increase of 96.3% which amounted to RM3.9 billion. The higher trading activities can be attributed to the ample liquidity position in the IIMM as well as the significant increase in the supply of the IPDS issued in the Islamic capital market. As at end 2002, the total outstanding amount of IPDS

Table 4.24
Islamic Interbank Money Market (IIMM)

	2001	2002	Annual change	
	RM billion		RM billion	%
Mudharabah Interbank Investments	241.2	247.0	5.8	2.4
Green Bankers Acceptances *	19.5	17.2	-2.3	-11.8
Accepted Bills-i *	3.9	7.6	3.7	94.9
Bank Negara Malaysia Negotiable Notes-i	1.2	2.2	1.0	83.3
Government Investment Issues-i	2.5	5.9	3.4	136.0

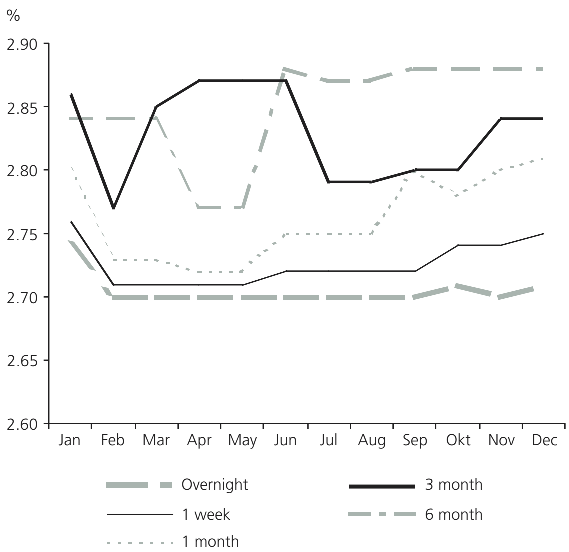
* Volume transacted through brokers.

Table 4.25
Islamic Interbank Money Market (IIMM) - Maturity Profile *

	2001	2002	Annual change	
	RM billion		RM billion	%
Overnight and weekends	184.0	207.0	23.0	12.5
1 week	48.8	82.0	33.2	68.0
1 month	19.6	53.8	34.2	174.4

* Volume transacted through brokers and money market tender.

Graph 4.20
Average Mudharabah Interbank Rates in 2002



amounted to RM46.6 billion, an increase of RM12.7 billion as compared with RM33.9 billion in year 2001.

The annual gross rate of return of the Islamic banking institutions ranged from 4.0% to 7.3% with an average of 5.5% for the year 2002. Meanwhile, the average Mudharabah interbank investment (MII) rate of return concluded in the IIMM were in the range of 2.7% to 2.9% for the overnight to 6-month tenure. Beyond the 6-month tenure, Islamic interbank investments were directed towards Negotiable Debt Certificate-i (NDC-i) with the rate of return ranging from 2.9% for 6-month to 3.0% for 1-year tenure. The shift in investment on the longer dated paper as contrary to the MII reflected the preference for fixed income financial asset over uncertain returns offered through MII. Furthermore, the investment decision was also influenced by the higher rate of return via investment in longer-dated instruments. During the year, the trading volume of NDC-i amounted to RM765 million.

National Shariah Advisory Council

During the year 2002, the Council deliberated various Shariah issues which are pertinent for the development of the Islamic financial system. Among the major issues discussed and deliberated by the Council were:

(i) **When Issue (WI)**
Players in the Islamic money market are allowed to perform WI transactions prior to the issuance date of the Islamic securities. WI is a pre-issuance transaction of debt securities that will be issued in the Islamic debt market to facilitate players in estimating the appropriate price to bid on the issuance date. The Council viewed that the WI transaction is allowed based on the permissibility to promise for sale and purchase transactions.

(ii) **Sell and Buy Back Agreement (SBBA)**
The SBBA transaction is permissible as long as it is an outright sale and purchase and enforced by two different contracts for each transaction. In addition, compensation can only be effected on the party who defaulted on his promise.

(iii) **Collateralised Borrowing**
The Council also approved the proposal to introduce the collateral borrowing transaction in the Islamic money market based on the principle of Rahnu. The transaction is an alternative to the SBBA and the loan extended is based on the concept of Qardh. Although there is no profit element being introduced in the transaction, the banks are expected to prefer this transaction due to its simplicity and its mutual-help feature; and

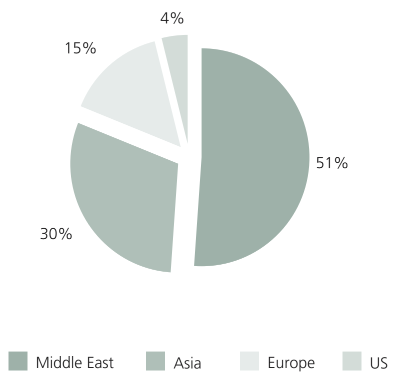
(iv) **Standardised Clauses**
The Council agreed to the proposal to standardise the major clauses to be incorporated in house financing agreements under Bai' Bithaman Ajil. The proposed clauses, such as illegality, suspense account and compensation clauses are deemed in line with Shariah principles provided that they do not contain any element of riba (interest), gharar (uncertainty) and maisir (gambling); and do not contravene the current legal framework.

Apart from the above, the Council also deliberated on the deposit insurance scheme, accounting policies for Takaful operators, hedging instrument for Islamic financial institutions and accounting standards for Ijarah. In view of the complexity of the issues, further study is undertaken before any decision is made.

International Developments

The year 2002 witnessed significant developments in global Islamic finance. On 25 June 2002, Malaysia successfully launched the **first sovereign global Islamic sukuk** amounting to USD600 million. The global bond, structured based on the concept of Ijarah, signified Malaysia's continuous and strong commitment to support the development of Islamic banking and finance on the global front. The move to access the international capital market based on Islamic principles was to give impetus to the development of the Islamic financial market, to create a new asset class for both Muslim and non-Muslim investors and to diversify the investor base for Malaysia. By geographical distribution, Middle Eastern

Graph 4.21
Malaysian Global Islamic Sukuk: Geographical Distribution



Islamic Financial Services Board

- The Islamic Financial Services Board (IFSB) was officially launched on 3 November 2002 with the signing of the Articles of Agreement of IFSB by its founding members comprising Bahrain Monetary Agency, Bank Indonesia, Bank Markazi Jomhouri Islami Iran, Central Bank of Kuwait, Bank Negara Malaysia, State Bank of Pakistan, Saudi Arabian Monetary Agency, Bank of Sudan and Islamic Development Bank (IDB) during the inauguration ceremony in Kuala Lumpur.

- The setting up of the IFSB is the culmination of an extensive two-year consultative process initiated by a group of governors and senior officials of the central banks, including Bank Negara Malaysia and the monetary authorities of several Islamic countries, together with the IDB, Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), and with the support of the International Monetary Fund (IMF).

- During the two-year consultative process, five Governors' Consultative (GC) meetings were held. At the first GC meeting held on 23 September 2000 in Prague, a Preparatory Committee (PC) comprising senior officials from Bahrain, Iran, Malaysia, Sudan, IDB, AAOIFI and the IMF was formed to carry out the ground work on establishing the IFSB. The PC convened four meetings from March 2001 to January 2002.

- Malaysia was given the mandate to host the secretariat of IFSB at a decision made during the GC meeting held on 13 November 2001 in Paris. At the GC meeting held on 21 April 2002 in Washington D.C., the Governor of Bank Negara Malaysia was appointed as chairperson of the Steering Committee which was established to undertake the necessary steps for the establishment and inauguration of IFSB in Kuala Lumpur.

- The objectives of IFSB, among others are:

  (a) To set and disseminate standards and core principles, as well as adapt existing international standards, for regulation and supervision of the Islamic financial services industry, consistent with the Shariah principles governing the industry, for voluntary adoption by member countries;

  (b) To liaise and co-operate with other standard-setters in the areas of monetary and financial stability; and

  (c) To promote good practices in risk management in the industry through research, training and technical assistance.

- The IFSB is established under the IFSB Act 2002 which was passed by the Malaysian Parliament on 24 July 2002 and has a permanent structure comprising the following constituent organs:

  (a) **The General Assembly**
  The representative body of all the members of the IFSB. The three categories of membership of IFSB are the Full Member, Associate Member and the Observer. The General Assembly is responsible to discuss, review and approve issues relating to accounts, external auditors, membership fees and overall objectives of IFSB.

  (b) **The Council**
  The Council consists of one representative from each of the Full Members. It is the senior executive and policy making body of the IFSB. Its roles include, among others, to formulate the policies and strategies of IFSB, review and approve standards and guidance on Islamic financial services recommended by the Technical Committee, as well as be a competent authority on issues relevant to the objectives of IFSB.

(c) **The Technical Committee**

The body responsible for advising the Council on technical issues, which comprising ten persons selected by the Council and have a 3-year term of office. The Technical Committee is responsible to appoint Working Groups (WG) for various technical issues and set the terms of reference for the WG, review and discuss all work submitted by the WG as well as recommend exposure drafts and standards to the Council for approval and adoption.

(d) **The Secretariat**

The permanent administrative body of the IFSB and headed by a full-time Secretary-General appointed by the Council. The Secretariat is accountable to the Council to manage all administrative work of IFSB, including to coordinate the work of the Technical Committee and related sub-committees or WG, disseminate standards and directions issued by the Council as well as to prepare the budget, manage and maintain funds established by the IFSB.

- The qualifying criteria for each category of membership is as follows:

(a) **Full Membership**

The lead financial supervisory authority of each sovereign country that recognizes Islamic financial services whether by legislation, regulation or by established practice, and inter-governmental international organisations that have the authority in promoting Islamic finance and markets. A Full Member has the right to attend, participate and vote at all meetings of the General Assembly, receive technical assistance and membership of the Council.

(b) **Associate Membership**

Associate membership is available to any central bank, monetary authority, financial supervisory, regulatory organisation or international organisation involved in setting or promoting standards for the stability and soundness of international and national monetary and financial systems, which does not qualify for Full Member status. An Associate Member has the right to attend but not vote at all meetings of the General Assembly and is entitled to technical assistance and to be upgraded to Full membership upon approval by the Council.

(c) **Observer Membership**

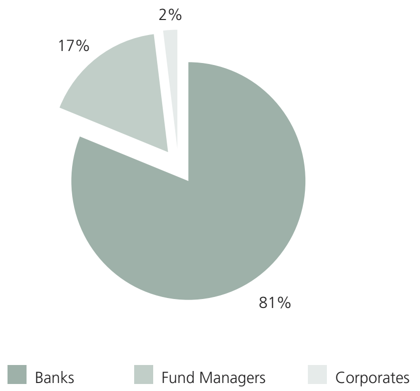
Observer membership is available to any national, regional, international professional or industry association (upon application for membership and approval by the Council). An Observer Member has the right to attend but not vote at all meetings of the General Assembly.

- The IFSB convened its first Council Meeting and General Assembly on 3 November 2002. The meeting discussed and approved the appointment of the Secretary-General of IFSB and members of the Technical Committee (including its Chairman and Deputy Chairman) for a term of 3 years. The meeting also discussed other administrative matters of IFSB.

- The formation of IFSB as an international standard-setting body is expected to contribute in ensuring the soundness and stability of the rapidly growing Islamic financial services industry globally by formulating and developing standards for best practices in the regulation of Islamic financial institutions worldwide.

- IFSB is also envisaged to provide consistency in terms of Shariah principles governing Islamic banking products and services offered by financial institutions worldwide. This will contribute towards promoting a more balanced growth of Islamic banking products and services, greater equity in the distribution of income, less disruptive capital flows and thus, relatively more stable Islamic financial markets.

Graph 4.22
Malaysian Global Islamic Sukuk : Investor Distribution



investors subscribed 51% of the Islamic bonds, followed by Asia (30%), Europe (15%) and US (4%). In terms of investor distribution, banks subscribed approximately 81% of the issue, followed by fund managers (17%) and corporates (2%). Apart from the listing in the Luxembourg Stock Exchange, the global bond is also listed on the Labuan International Financial Exchange, a move that will contribute to enhance the role of Labuan IOFC and its linkage to other Islamic financial centers.

Another important milestone in the global development of Islamic banking and finance was the inauguration of the Islamic Financial Services Board (IFSB) in Kuala Lumpur on 3 November 2002. The IFSB serves as an association of central banks, monetary authorities and other institutions, entrusted to develop and promulgate internationally accepted prudential regulatory standards and best practices, consistent with Shariah principles, for the Islamic financial services industry. It is envisaged that the IFSB would contribute to promote financial soundness and stability in the Islamic financial system and consequently, set the stage for its successful integration into the global financial system.

OTHER FINANCIAL INSTITUTIONS

Discount Houses

Amidst the ample liquidity in the financial market, total resources mobilised by the discount houses increased at a stronger pace of 15% or RM3.6 billion in 2002 (12.7% or RM2.7 billion in 2001). Deposits accepted, which were primarily in the form of short-term fixed deposits, increased sharply by 32.1% (8% in 2001). Of significance was that Sistem Perbankan Islam (SPI) deposits grew by 49.2% (4% in 2001), amidst sustained and stronger demand from depositors since its introduction in 2000.

The increase in total resources continued to be invested mainly in securities, which expanded by RM2.9 billion or 14.3% in 2002 (RM1.6 billion or 8.8% in 2001). Investment in PDS, which remained the main instruments held by discount houses, declined in 2002. The decline arose out of profit taking activities, the need to meet the guidelines specified in the Bank Negara Malaysia liquidity framework, which was extended to discount houses effective 1 June 2002, and also due to the lower supply of PDS in the market. The guidelines in the Bank Negara Malaysia liquidity framework encouraged discount houses to minimise the maturity mismatch between their assets and liabilities across different tenor and especially for maturities of less than one month. As a result, discount houses invested the bulk of new deposits in short-term instruments, particularly banker's acceptances (+RM2.8 billion) and interbank placements (+RM1 billion).

Discount houses also expanded their fee-based activities during the year. The industry arranged, lead-managed and co-managed the issuance of PDS worth RM7.9 billion (RM4.3 billion in 2001). The total amount underwritten by the discount houses was flat at RM1.1 billion (RM1.1 billion in 2001) for 26 PDS issues (19 issuance in 2001).

Table 4.26
Discount Houses: Sources and Uses of Funds

	Annual change		As at end
	2001	2002	2002
	RM million		
Sources:			
Approved capital funds	202	319	2,309
Deposits	1,117	4,834	19,904
Interbank borrowings	1,173	-1,370	4,728
Others	193	-202	444
Total	**2,685**	**3,580**	**27,385**
Uses:			
Investment in securities:	1,646	2,918	23,288
Government debt securities	*1,110*	*112*	*1,900*
MGS held	*993*	*-359*	*1,103*
Khazanah bonds	*222*	*-281*	*374*
BNM bills	*-590*	*229*	*348*
Private debt securities	*932*	*-62*	*11,575*
Bankers acceptances	*-941*	*2,754*	*5,988*
Negotiable instruments of deposit	*-124*	*-125*	*95*
Cagamas debt securities	*-224*	*471*	*1,558*
Others[1]	*1,260*	*-181*	*1,450*
Interbank placements	724	1,031	3,887
Others	315	-369	210
	2000	**2001**	**2002**
Number of discount houses	7	7	7

[1] Includes Danaharta and Danamodal bonds.
Note: Total may not add up due to rounding.

Provident and Pension Funds

Total resources of the 13 provident and pension funds (PPF) surveyed by Bank Negara Malaysia expanded further in 2002, with an increase of 8.8% to RM252.3 billion. The Employees Provident Fund (EPF) accounted for the bulk of the resources (82.2%). The increase in resources was largely attributed to the growth of accumulated contributions in existing accounts. Nevertheless, accumulated contributions increased at a slower rate of 4.7% or RM9.5 billion in 2002 (5.6% in 2001) and reflected lower gross contributions and dividend credited.

During the year, gross contributions of the PPF were slightly lower at RM23.9 billion, reflecting mainly a small decline in the total number of contributors. The decline in contributors by 3.7% to 18.5 million persons was associated with higher number of members reaching their retirement age in 2002, as well as the termination of membership by contributors of several PPF who opted for the Pensionable Employees Withdrawal Scheme (PEWS). In July 2000, the Government launched the PEWS which allowed civil servants under the pension scheme to withdraw their contributions from PPF while the employers' portion inclusive of dividends were transferred to the Pension Trust Fund (PTF). The bulk of the withdrawals under PEWS were made in 2001.

Notwithstanding the decline in gross contributions, net contributions increased substantially to RM10.2 billion following lower withdrawals during the year.

Table 4.27
Provident and Pension Funds: Selected Indicators

	2001	2002*p*
	RM million	
As at end		
Number of contributors ('000)	19,166	18,463
of which:		
EPF	*10,177*	*10,335*
SOCSO	*8,769*	*7,908*
Accumulated contributions	202,894	212,386
Assets	231,877	252,326
of which:		
Investments in MGS	*72,544*	*76,884*
During the year		
Gross contributions	25,736	23,921
Withdrawals	22,685	13,709
Net contributions	3,051	10,213
Dividends credited	8,717	7,375
Investment income	11,155	10,413

p Preliminary

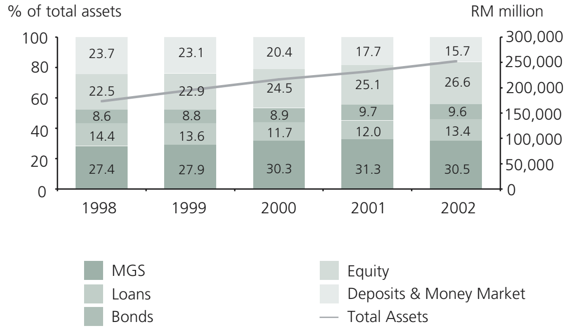
Source: Employees Provident Fund, Pension Trust Fund, Social Security Organisation, Armed Forces Fund, Malaysian Estates Staff Provident Fund, Teachers Provident Fund and seven other private provident and pension funds.

This was mainly due to the termination of several EPF schemes, including the Computer Purchase Withdrawal Scheme (CPWS) as well as discontinuation of annuity schemes in October 2001. The CPWS was discontinued after EPF detected that a significant number of withdrawals were not used to purchase computers. Furthermore, participation under the PEWS scheme during the year had also resulted in lower withdrawals. Another contributory factor was the increase in the employees' contribution rate to 11% from 9%, which took effect from April 2002. In April 2001, EPF contributors were given an option to reduce their monthly contribution from 11% to 9% for a period of one year, in line with the Government efforts to stimulate domestic demand.

In January 2002, the EPF's Annuity Scheme was replaced by the Monthly Payment Scheme. Under this new scheme, contributors can transfer not more than 50% of their savings from Account 1 to a new account, Account 4. The scheme allows contributors to make monthly withdrawals from Account 4 over a 20-year period on reaching the age of 55.

In terms of the composition of assets of the PPF, there was a moderate decline in the holdings of deposits and money market papers. With the low interest rate environment, preference was given for investment in assets with higher returns. Investment in equities and loans continued to grow and recorded increased shares of 26.6% and 13.4%, respectively. Investment in equity by PPF increased by 15% during the year in line with the significantly higher number of new companies listed on the KLSE and greater opportunities to accumulate undervalued stocks. The share of MGS and corporate bonds remained high at 30.5% and 9.6% respectively.

Graph 4.23
Provident and Pension Funds: Major Asset Composition



Venture Capital

The venture capital (VC) industry continued to play its important role in providing an alternative source of financing to the economy. Development in VC investment in Malaysia has been encouraging. As at end-2002, there were 46 VC companies/funds (VCCs) and 20 VC management companies (VCMCs) operating in the country, with a total fund size of RM2.5 billion. The total outstanding number of companies which received VC funding as at end-2002 totalled 297 companies with cumulative investments of RM1.1 billion, an increase of 14.9% from the previous year.

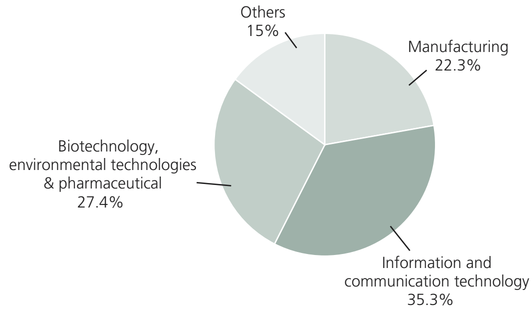
During the year, the VC industry undertook new investments amounting to RM191.4 million in 80 companies (2001: 47 companies with a total amount of RM118.7 million). In terms of investment by sector, the bulk of VC investment was channelled to the information and communication technology (ICT) sector, and the medical and pharmaceutical sector, accounting for 35.3% and 27.4% of total investment, respectively. During the year, investment in these areas amounted to RM50.8 million and RM39.4 million, respectively. While VC investment in the new technology sectors increased, the VC investment in the manufacturing sector continued to remain significant with a share of 22.3% (or RM32.1 million). A large portion was channelled to higher-end sub-sectors such as electrical and electronic, machinery, transport equipment and components industries, as well as the advanced electronics industry.

In terms of total outstanding investment as at end-2002, VC investment in the information and communication technology and biotechnology sectors have increased to account for 19.4% and 7.7% of total outstanding investment, respectively (17% and 4.8%, respectively in the previous year).

Table 4.28
Key Statistics of Venture Capital Industry

	As at end 2001	As at end 2002
Venture capital funds (RM million)	2,497.7	2,536.0
Total investment (RM million)	968.5	1,112.4
No.of venture capital companies/ funds	41	46
No. of venture capital fund management companies	19	20
No. of investee companies	235	297
	During 2001	During 2002
Total investment (RM million)	118.7	191.4
No. of investee companies	47	80

Graph 4.24
New Investment by Sector in 2002
(% share of total)



Meanwhile, investment in the manufacturing sector declined from 43.7% to 40.9% of total investment.

In terms of investment by stages, investment in the start-up, early, expansion as well as the mezzanine and pre-initial public offer (IPO) stages were significant, with the highest portion recorded in the start-up capital stage (24.8%). In comparison, VC investment in the seed capital stage remained small, indicating the lack of funding to seed companies which are viewed as relatively riskier.

Table 4.29
Outstanding Investment by Sector

	As at end			
	2001	2002	2001	2002
	RM million		% share	
Manufacturing:	423.3	455.4	43.7	40.9
of which:				
Wood and wood products, including furniture	*29.4*	*32.0*	*3.0*	*2.9*
Transport equipment, automotive components	*42.9*	*46.9*	*4.4*	*4.2*
Advanced technologies: electronics, automation systems, electro-optics, advanced materials.	*50.5*	*57.5*	*5.2*	*5.2*
Fabricated metal products, machinery and equipment	*20.7*	*30.7*	*2.1*	*2.8*
Electrical and electronic products (manufacture, assemble)	*116.4*	*113.5*	*12.0*	*10.2*
Information and communication technology	165.0	215.9	17.0	19.4
Medical, healthcare, biotechnology, environmental technologies and pharmaceutical products	46.6	86.0	4.8	7.7
Electricity, power generation, gas and water	125.4	127.9	12.9	11.5
Wholesale, retail trade, restaurant and hotels	1.7	3.2	0.2	0.3
Others	206.5	224.0	21.3	20.1
Total	**968.5**	**1,112.4**	**100.0**	**100.0**

Table 4.30
New Investment by Stages in 2002

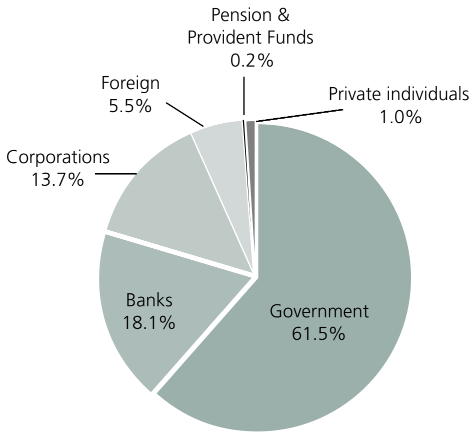
No. of Investee Companies	80	
Business Stage/ Amount	RM million	% share
Seed capital	1.4	0.7
Start-up capital	47.5	24.8
Early stage	32.3	16.9
Expansion, growth	35.6	18.6
Bridge, mezzanine, pre-IPO	41.8	21.9
Management buy-out	1.0	0.5
Cashing-out (secondary purchase)	15.0	7.8
Other types of investment	16.8	8.8
Total	**191.4**	**100.0**

In terms of outstanding investment by stages as at end of 2002, the bulk was in the expansion and pre-IPO stages, with a gradual shift to the early and start-up stages.

Realising the importance of VCCs in financing the technology sector, the Government continued to actively promote the growth of the VC industry. The contribution of the Government to the total resources of funds for the VC industry was significant, accounting for 61.5% of total funds. Contributions by banks accounted for 18.1%. An encouraging trend in recent years has been the growing participation by corporations, especially in the newly established VCCs, which accounted for 13.7% of total sources of VC funds.

The Government established the Malaysia Debt Ventures (MDV) in 2002 with a total fund of RM1.6 billion. This amount was sourced from a

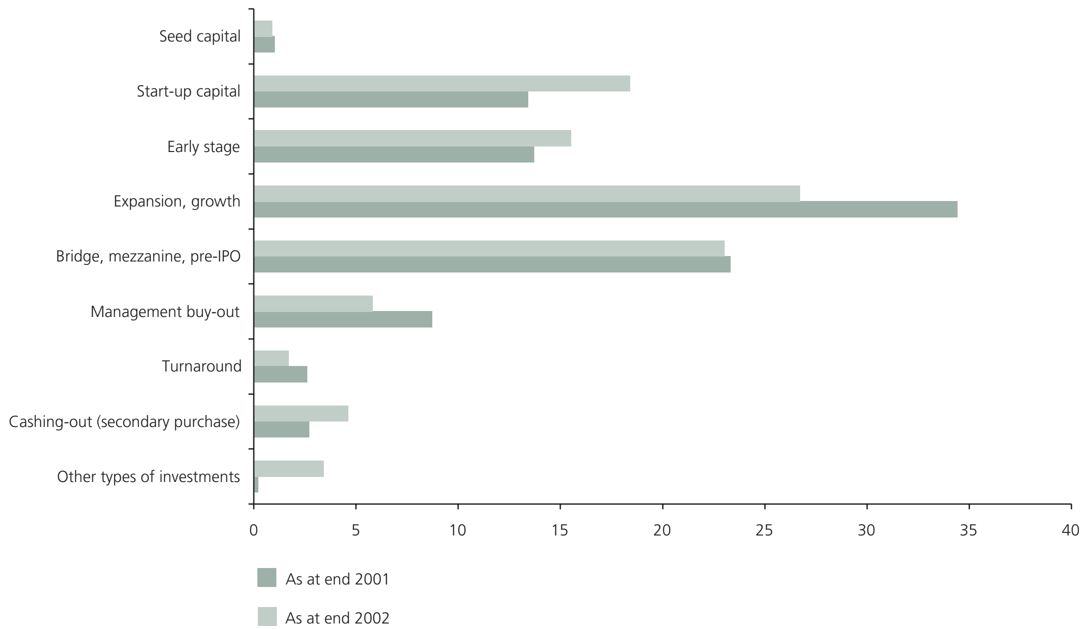
Graph 4.26
Sources of Venture Capital
(% share of total as at end-2002)



Government loan extended by the Japan Bank for International Cooperation. The MDV mainly provides project-based loans to high value-added ICT and high-growth sectors and therefore, supplements VC and bank financing to these sectors.

In July, the Venture Capital Consultative Council (VCCC) was established to ensure the effective and efficient development of the VC industry. The VCCC is represented by members from related Government agencies, the VC industry as well as the technoprenuer community. The main objectives of the VCCC are to resolve impediments affecting the expansion of the industry, as well as to design

Graph 4.25
Outstanding Investment by Stages (% share)



appropriate strategies for the further development of the VC industry.

In addition, there were greater efforts undertaken to promote entrepreneurship and greater awareness of the VC industry through events such as the Venture 2002 business plan competition, and the 'Ignite the Technopreneur Fire' series of workshops organised by the Malaysia Venture Capital Management Berhad. These events were aimed at improving the quality of the start-up companies and at the same time, provide networking opportunities to both VCCs and start-up companies. In October 2002, the Ministry of Science, Technology and Environment organised 'BioMalaysia 2002', which attracted interests among academicians, scientists, investors, entrepreneurs, venture capitalists and senior executives from a diverse range of industries. The event provided opportunities for all players to showcase their products, technologies, expertise, services and also served as a platform to forge strategic alliances and business partnerships.

Unit Trust Industry

Further expansion in the unit trust industry in 2002 was reflected by the increasing volume of units in circulation, number of unit trust management companies, and increase in the number of unit trust accounts. A total of 26 new funds were launched in 2002, which involved 14 unit trust management companies. Consequently, the Net Asset Value (NAV) of the industry rose for the third consecutive year to RM53.7 billion.

Gross sales of unit trust funds continued to exceed repurchases during the year. Net sales of RM7.6 billion were 24.6% higher than in 2001. Growth in the industry also reflected improving awareness and understanding on the value of professionally managed funds and the long-term investment benefits of unit trusts as a savings instrument. The low interest rate environment, improving corporate profits and income have helped sustain growth in the unit trust industry. In addition, withdrawals from Employees Provident Fund (EPF) under the Members' Investment Scheme remained high at RM1.2 billion in 2002. Marketing efforts were intensified further with the number of institutional unit trust agents increasing to 34. Consequently, the ratio of the industry's NAV to KLSE market capitalisation, increased to 11.1% from 10.2% at the end of 2002.

In line with the overall growth in the industry, the performance of Islamic unit trust segment also expanded in 2002. There were 38 Islamic unit trust funds, inclusive of 8 new Islamic funds launched in 2002. The NAV for Islamic funds stood at RM3.2 billion as at end-December 2002, and accounted for 6% of the NAV of the unit trust industry.

Graph 4.27
Unit Trust Industry - Gross Sales, Repurchases and Net Sales

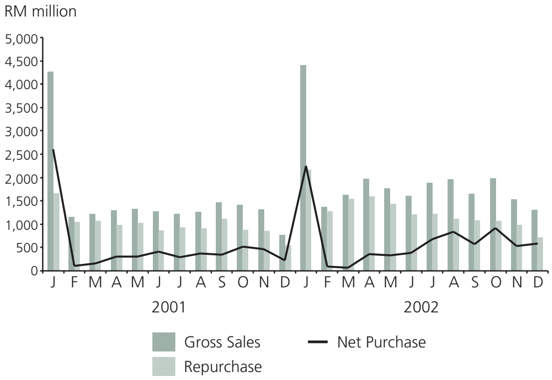


Table 4.31
Unit Trust Industry (Including Islamic Unit Trust Funds) – Selected Indicators

	2001	2002	2001	2002
			Growth (%)	
Number of Unit Trust Management Companies	37	39	8.8	5.4
Number of Unit Trust Funds*	149	175	25.2	17.5
Units in Circulation (billion)	71.4	81.8	11.9	18.4
Number of Accounts (million)	10	10.2	4.2	1.8
Net Asset Value (RM billion)	47.3	53.7	9.2	13.4
Net Sales (RM billion)	6.1	7.6		
Ratio of NAV to KLSE market capitalisation (%)	10.2	11.1		

* Refers to funds already launched.

Source: Securities Commission.

Table 4.32
Islamic Unit Trust

	2001	2002	2001	2002
			Growth (%)	
Number of Unit Trust Management Companies	23	27	53.3	17.0
Number of Unit Trust Funds*	30	38	76.5	27.0
Units in Circulation (billion)	4.3	5.8	36.1	35.0
Number of Accounts	266,917	303,000	12.9	14.0
Net Asset Value (RM billion)	2.4	3.2	44.0	33.0
Net Sales (RM million)	710.6	980.4		
Ratio of NAV to KLSE Syariah Index market capitalisation (%)	0.9	1.2		

* Refers to funds already launched.

Source: Securities Commission.

FINANCIAL MARKETS

Overview

Improved economic activities in 2002 saw higher trading volume in the equity, bond and foreign exchange markets. Trading volume was also higher in the exchange-traded derivatives market. In the money market, the ample liquidity situation in the banking system reduced the incentive for financial institutions to source funds from the inter-bank market. During the course of the year, the regulatory authorities and agencies introduced further new initiatives to improve market infrastructure and new products to better meet the needs of investors.

In line with the improved domestic economic performance, trading volume in the equity, bond and foreign exchange markets were higher in 2002. Increased trading in the futures market was also there to the introduction of new contracts.

The capital market, comprising the equity and bond markets, continued to provide a significant source of financing in 2002. Net funds raised by both the private and public sectors amounted to RM23.9 billion. The bulk of the funds was raised in the equity market (RM13.3 billion) while the balance was raised in the bond market (RM10.6 billion). Net funds raised by the public sector declined to RM8.6 billion as a significant portion of the financing needs of the Government was met from drawdown of accumulated assets.

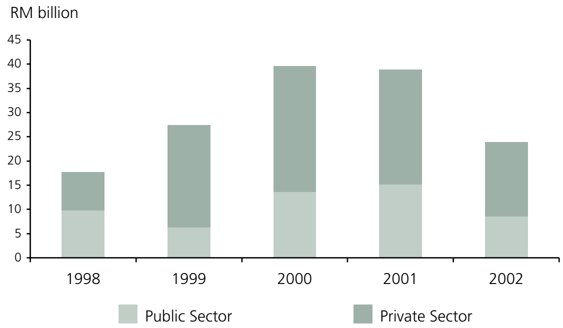
The private sector raised RM15.3 billion from the capital market, of which 86.6% came from the equity market. During the year, the Kuala Lumpur Stock Exchange (KLSE) continued to offer a broader spread of investment opportunities and liquidity enhancement with a larger number of initial public offerings (IPOs). As a result, market capitalisation was higher at RM481.6 billion, especially with two large and liquid new listings in infrastructure and telecommunication sectors. However, despite improving economic performance, the KLSE Composite Index (KLSE CI) recorded a moderate decline due to rising uncertainties in global economic developments and the impact on the prospects for growth. Nevertheless, the KLSE CI outperformed most major bourses in the region. Of significance was the merger of the Malaysian Exchange of Securities Dealing and Automated Quotation (MESDAQ) and the KLSE on 18 March 2002, which further facilitates the capital raising needs of the technology and high-growth companies. The merger is one of the recommendations in the Capital Market Masterplan to establish a single Malaysian exchange to enhance the competitive position and efficiency of Malaysian exchanges and clearing houses.

Table 4.33
Funds Raised in the Capital Market

	2001	2002*p*
	RM million	
By Public Sector		
Government Securities (gross)	23,087	16,266
Less Redemptions	7,100	8,900
Less Government holdings	0	0
Equals Net Federal Receipts	15,987	7,366
Khazanah Bonds (net)	-220	0
Govt. Investment Issues (net)	-195	738
Malaysia Savings Bond (net)	-359	464
Net funds raised by public sector	15,214	8,568
By Private Sector		
Shares	6,123	13,289
Debt securities[1] (gross)	37,932	36,195
Less Redemptions	20,355	34,137
Equals Net Issues	17,577	2,058
Net funds raised by private sector	**23,701**	**15,347**
Total Net Funds Raised	**38,915**	**23,915**
Short-term papers and notes (net)[2]	-2,093	-2,405
Total	**36,822**	**21,511**

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

Graph 4.28
Net Funds Raised in the Capital Market by the Public and the Private Sectors



Gross issuance of PDS in the bond market remained significant at RM36.2 billion. Amidst the low interest rate environment and ample liquidity situation, corporates with strong credit profiles took the opportunity to raise long-term funds at competitive cost. During the year, significantly higher redemptions, arising from major corporate debt restructuring exercises, resulted in lower net funds raised of RM2.1 billion. Islamic PDS registered a significant growth during the year and for the first time, the issuance of Islamic PDS surpassed those of conventional bonds.

In the derivatives market, trading activity was higher for Crude Palm Oil (CPO) Futures on the back of strong performance in CPO prices. Active trading of KLIBOR Futures was influenced by expectations on the interest rates outlook. The year 2002 also marked the debut of the new 5-year MGS Futures, which received good response from market participants.

Several measures and initiatives were undertaken in 2002 to enhance the fund-raising process through the capital market. Details of these measures are contained in the box "Key Capital Market Measures in 2002".

Money Market

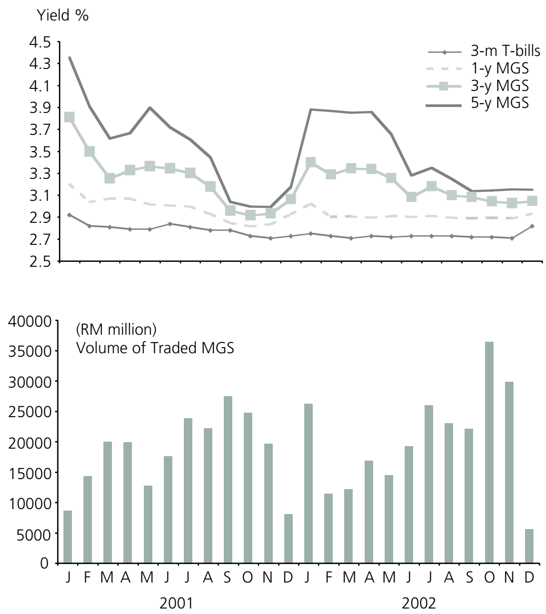
In 2002, the volume of transactions in the money market declined, reflecting entirely the contraction in the volume traded in the interbank deposits market.

Table 4.34
Money Market[1]

	2001		2002	
	Volume (RM billion)	Annual change (%)	Volume (RM billion)	Annual change (%)
Total money market transactions	**1500.8**	**5.3**	**1465.1**	**-2.4**
Interbank deposits	**1055.3**	**-3.3**	**1011.7**	**-4.1**
Money market papers	**445.5**	**33.5**	**453.4**	**1.8**
Bankers Acceptances(BAs)	60.5	-4.9	51.3	-15.2
Negotiable instrument of deposits (NIDs)	34.3	63.3	36.7	7.0
Malaysian Government Securities (MGS)	219.9	148.2	244.1	11.0
Khazanah bonds	17.9	15.5	15.5	-13.4
Treasury bills	13.4	-10.7	8.4	-37.3
Bank Negara Bills	55.2	8.4	54.4	-1.4
Cagamas bonds	25.9	-11.6	29.2	12.7
Cagamas notes	18.4	-63.1	13.8	-25.0

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

Graph 4.29
Money Market Instruments

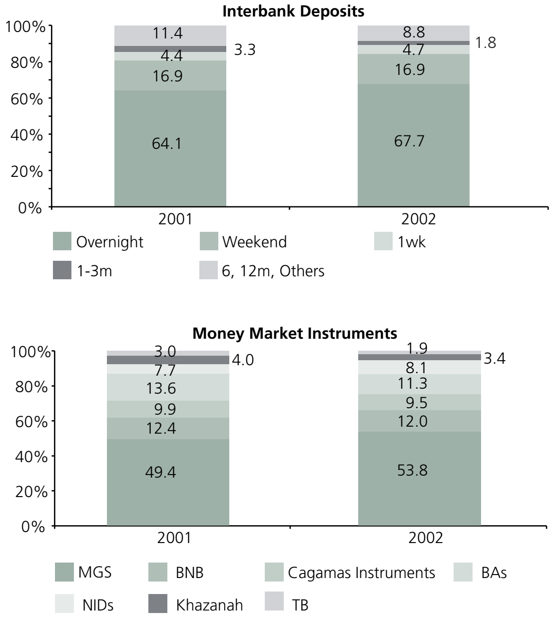


The continued ample liquidity situation in the banking system reduced the incentive for financial institutions to source funds from the interbank market. Overnight deposits remained the most actively traded tenure in the interbank market, accounting for 67.7% (64.1% in 2001) of the total volume transacted.

Trading in the money market papers was marginally higher during the year (+1.8%) and was concentrated mainly in the Malaysian Government Securities (MGS). There was significantly more active trading in MGS in January and in the second half-year. The revision in the minimum requirement on investment in low risk assets from 20% to 10% for the insurance companies led some money market players to liquidate MGS in January resulting in the yields on the 3-year and 5-year MGS firming to 3.40% and 3.88% respectively (3.07% and 3.18% at end-December 2002). The liquidation was however temporary, prompted by the expectation that insurance companies would reduce their holdings of MGS. Subsequently, yields eased with trading in MGS influenced by the outlook on the interest rates and expectations of continued low inflation in an environment of excess liquidity.

Trading was relatively subdued during the period of February to June, as positive sentiments on the prospects for the US economy, amidst the upward adjustment in policy rates by a few central banks (Australia, Canada, Korea and New Zealand), led to expectations that revival of growth would

Graph 4.30
Share of Total Volume Traded



improve and interest rates would likely rise in the latter part of the year. However, this expectation reversed from mid-year, amidst increasingly stronger signals showing less encouraging global economic outlook following the revelation of corporate malpractices in the US, bearish equity markets, weak corporate profitability and increased geopolitical risks. As a consequence, the expectation that interest rates would remain low in the second half-year generated greater interest among market participants to invest in higher-yielding longer dated papers, notably the MGS. Trading in MGS picked up in the second half-year to an average monthly volume of RM23.9 billion, compared with RM16.8 billion in the first half of 2002. By end-December, the MGS term structure shifted downwards, with the yields on the 3-year and 5-year MGS declining to 3.05% and 3.15% respectively. Besides the change in expectations, the introduction of the Five-Year Malaysian Government Securities Futures (FMG5) on 29 March also contributed to the more active trading in the MGS market.

The preference for the higher-yielding longer dated papers shifted interests away from short-term money market papers. As a result, trading in the short-term money market papers declined by 10.5%. Trading in Bank Negara Bills, nonetheless, was sustained, reflecting the steady supply of papers as the Bank continued to absorb excess liquidity from the banking system during the year.

Foreign Exchange Market

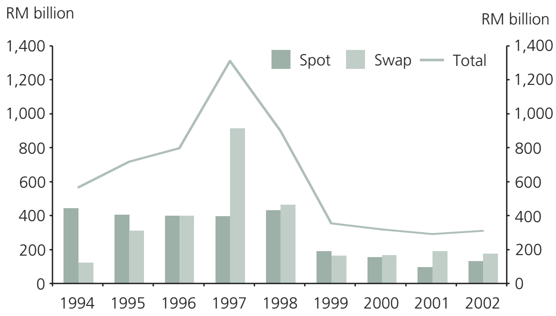
In early 2001, Bank Negara Malaysia installed the Ringgit Operations Monitoring System (ROMS) to capture data on all transactions in the Kuala Lumpur interbank foreign exchange market. Replacing the previous system of daily compilation of statistics from the eight Authorized Dealers, the ROMS allows real-time access to information on trading activities done in the domestic foreign exchange market, thus enabling Bank Negara Malaysia to efficiently monitor and manage liquidity conditions for the US dollar in the domestic market. The ROMS is also more reflective of market activity as it captures both transactions effected through the Authorized Dealers, as well as direct transactions between banks.

Based on the new data captured under the ROMS, the average daily volume of interbank foreign exchange transactions (spot and swap transactions) effected in 2002 increased by 4.8% to RM1.24 billion. The increase was due entirely to the increase in spot transactions, in line with the increase in Malaysia's trade activities. Foreign exchange trading comprised mainly trade-related transactions. Position-taking activity on the ringgit has been contained through the elimination of the offshore ringgit market and through guidelines governing the operating framework of banking institutions.

Equity Market

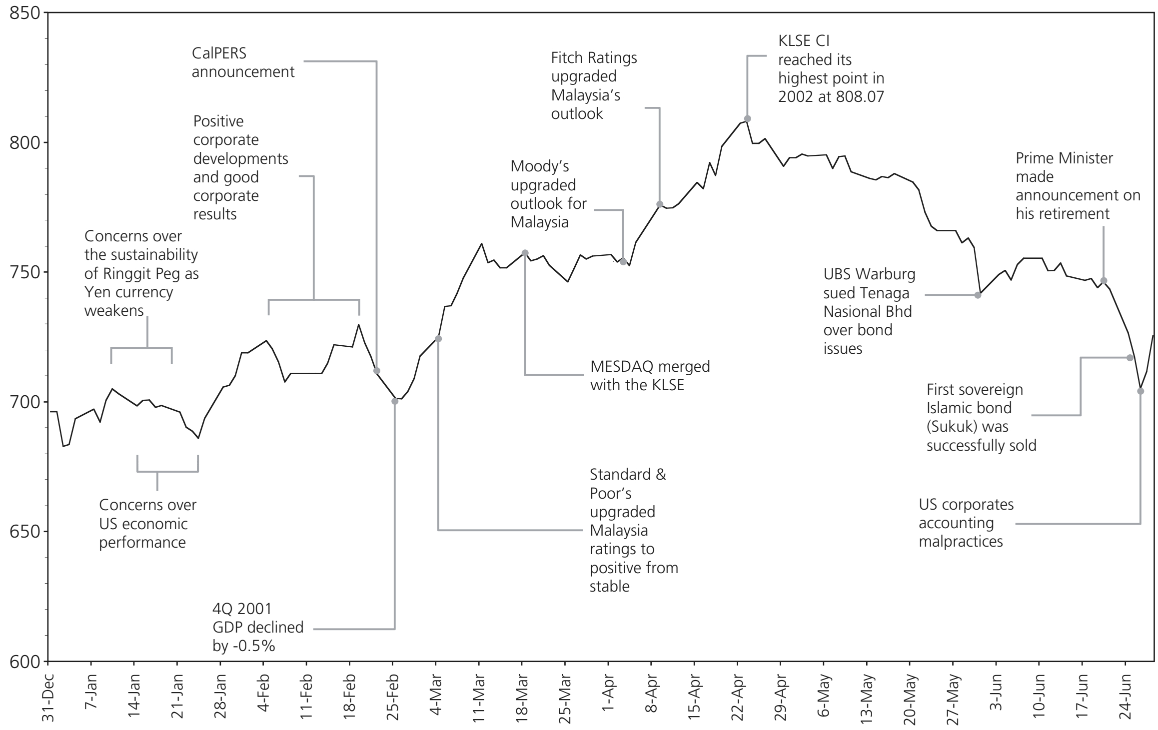
The year 2002 commenced on a firmer and active note for the Kuala Lumpur Stock Exchange (KLSE). Increased trading activity in the last two months of 2001 continued into early 2002. The strengthened economic fundamentals, improving economic outlook and ample liquidity situation supported

Graph 4.31
Volume of Interbank Transactions in the Kuala Lumpur Foreign Exchange Market

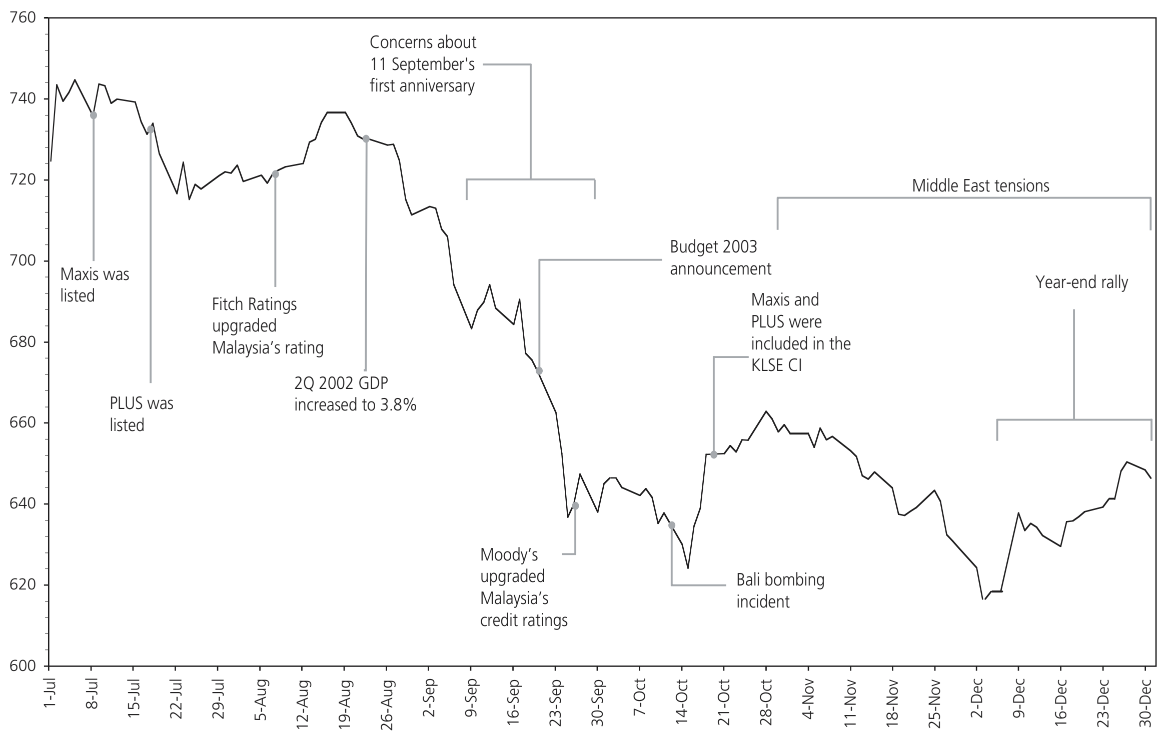


Note: Data for 2002 is based on the new Ringgit Operations Monitoring System (ROMS), whereas observations for previous years are based on transactions of the eight Authorised Dealers.

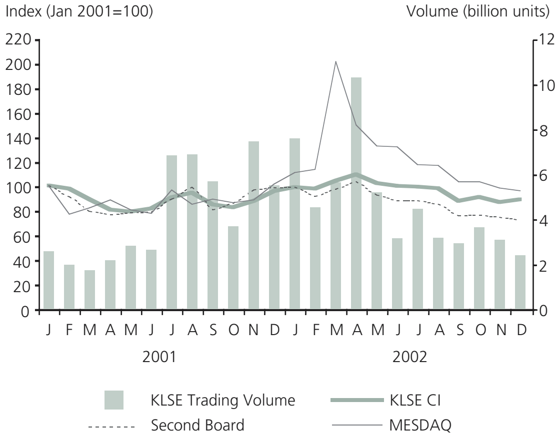
Graph 4.33
Performance of the KLSE Composite Index (31 December 2001 - 30 June 2002)



Graph 4.34
Performance of the KLSE Composite Index (1 July - 31 December 2002)



Graph 4.32
Kuala Lumpur Stock Exchange Composite Index Second Board Index, MESDAQ Composite Index and KLSE Trading Volume



Source: Kuala Lumpur Stock Exchange

buying interests in the first four months of the year. Positive developments in the domestic corporate sector as well as renewed foreign interest raised investors' confidence. Favourable market sentiments were also supported by ratings upgrades on the

Table 4.35
Kuala Lumpur Stock Exchange: Selected Indicators

	2001	2002*p*
Price Indices		
Composite	696.09	646.32
EMAS	165.23	157.25
Second Board	134.13	98.24
MESDAQ	88.08	83.25
Total Turnover		
Volume (billion units)	49.7	55.6
Value (RM billion)	85.0	117.0
Average Daily Turnover		
Volume (million units)	204.4	224.0
Value (RM million)	349.8	469.7
Market Capitalisation (RM billion)	465.0	481.6
Market Capitalisation / GDP (%)	139.0	134.9
Total No. of Companies Listed	812	865
Main Board	520	561
Second Board	292	292
MESDAQ	5	12
Market Liquidity:		
Turnover Value / Average Market Capitalisation (%)	19.7	23.2
Turnover Volume / Number of Listed Securities (%)	24.8	24.3
Market concentration:		
* 10 Most Highly Capitalised Stocks/ Market Capitalisation (%)	36.7	34.0
Average Paid-Up Capital of Stockbroking Firms (RM million)	138.2	164.1

* Based on market transaction only.
p Preliminary

Source: Kuala Lumpur Stock Exchange

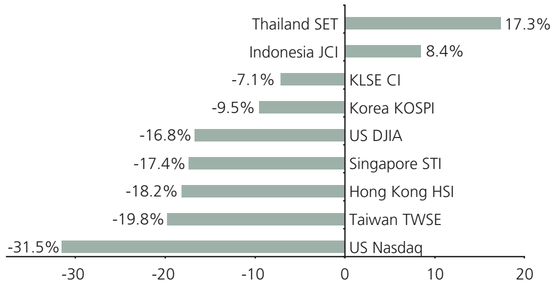
outlook for the Malaysian economy by major international rating agencies. The KLSE Composite Index (KLSE CI) rose to a 20-month high of 808.07 points on 23 April, or 16.1% higher from the level at end-2001.

The market eased gradually thereafter, affected by uncertain developments in the global economic outlook and weak investor sentiment following rising geopolitical tensions in the Middle East. These uncertainties were further aggravated by corporate governance and accounting malpractices in the United States and weakening US growth prospects. Despite improving economic growth in Malaysia, the KLSE CI was dragged down by the poor performance of global equities as investors sought safer havens in bonds and gold. The KLSE CI ended lower by 7.1% to close at 646.32 at end-2002. The factors influencing the performance in the local bourse during the course of 2002 are highlighted in the charts.

Compared with major regional bourses, the KLSE fared better than Hong Kong, Singapore, Korea and Taiwan markets. Despite the decline in the KLSE CI, market capitalisation increased by 3.6% to RM481.6 billion due to two very large initial public offerings. For the year as a whole, trading volume increased to 55.6 billion units valued at RM117 billion (49.7 billion units valued at RM85 billion in 2001).

On a sectoral basis, the plantation sector was the best performing sector, with the Plantation Index recording an increase of 14.7% following the marked increase in crude palm oil prices. Despite improving domestic economic performance, the Technology, Construction, and Property indices

Graph 4.35
Performance of Selected Stock Market Indices (% change from 2001 to 2002)



Source: International Federation of Stock Exchanges (FIBV)

Table 4.36
KLSE: Performance of Sectoral Indices

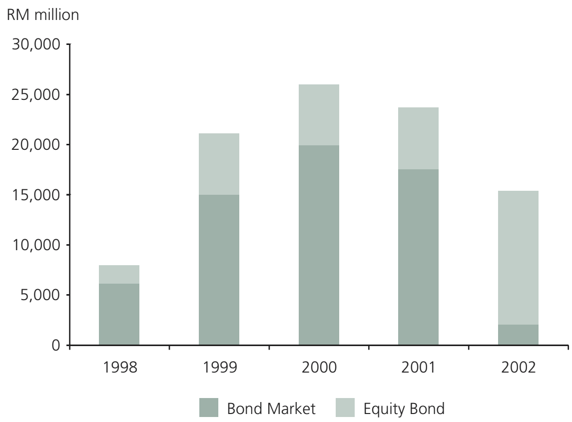
	2001	2002
	Annual change (%)	
KLSE Composite Index	2.4	-7.1
EMAS	3.4	-4.8
Second Board	0.9	-26.8
Industrial	10.8	0.1
Consumer Products	14.0	0.5
Industrial Products	3.4	-2.5
Construction	13.5	-14.9
Trading/Services	0.4	-6.1
Finance	0.5	-4.7
Properties	-5.2	-9.8
Mining	5.5	-5.1
Plantation	18.6	14.7
Syariah	2.9	-7.4
Technology	2.3	-17.9
MESDAQ	-5.4	-5.5

Source: Kuala Lumpur Stock Exchange

declined on expectations of weaker forward earnings.

During the year, a significant number of initial public offerings (IPOs) came into the market, including two major corporations. The larger spread of companies enhanced further the choice of investment opportunities and improved overall liquidity in the market. Improving economic growth and recovery in the equity market, especially in early 2002, encouraged more active recourse to the equity market for capital in 2002. Funds raised through the equity market exceeded the RM10 billion mark for the first time since 1997. The higher amount of funds raised of RM13.3 billion, accounted for 86.6% of the total funds raised through the capital market (RM6.1 billion or 25.8% in 2001). The bulk of the funds was raised mainly through IPOs and rights issues. During the year, there was a total of 51 IPOs,

Graph 4.36
Funds Raised by the Private Sector in the Capital Market



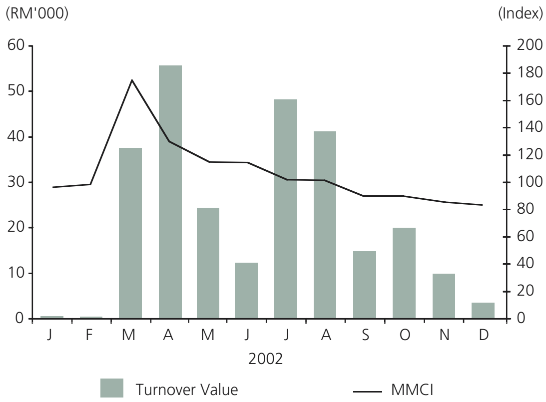
of which 22 were listed on the Main Board, 22 on the Second Board, while another seven on the MESDAQ Market. The IPOs raised a total of RM6.8 billion and accounted for more than one-half of the total financing raised in the equity market. Improved economic performance, the upgrades of Malaysia's sovereign ratings by major credit rating agencies, positive corporate results and restructuring helped to draw investors and provided opportunities for companies to raise long-term capital to finance their operations and expansion programmes. The listing of two major Malaysian corporations in the telecommunication and infrastructure sectors contributed significantly to improving the depth and liquidity of the market.

As part of the developments of the capital market, Malaysian Exchange of Securities Dealing & Automated Quotation (MESDAQ) was merged with the KLSE on 18 March 2002. The merger of the MESDAQ Berhad with the KLSE Group was in line with the recommendation in the Capital Market Masterplan to establish a single Malaysian Exchange through the consolidation of all exchanges by 2003. The objective of the merger is to enhance the competitive position and efficiency of Malaysian exchanges and clearing houses. As a result of the merger, the MESDAQ became officially known as the MESDAQ Market. Consequently, amendments were made to the MESDAQ Listing Rules to reflect the merger. The new Listing Requirements of KLSE for the MESDAQ Market included various provisions to ensure clarity and consistency with the KLSE Listing Requirements. In addition, all KLSE Members are able to trade on the MESDAQ Market without a separate licence. The roles of market makers were suspended but a separate register of Advisors and Sponsors of the Market was maintained. As at end-2002, there were twelve Advisers for the MESDAQ Market, of which nine are Merchant Banks and three are Universal Brokers.

The performance of the MESDAQ Market in 2002 closely tracked the KLSE. Following the merger, the MESDAQ Market Composite Index (MMCI) touched its highest point since the inauguration of MESDAQ to reach 177.53 on 26 March, a significant rise of 96% or 86.97 points from the beginning of the year. MMCI eased subsequently and by the end of the year, declined slightly by 4.8 points to settle at 83.25 points.

Trading activities on the MESDAQ Market improved significantly in 2002 with the total volume of trades of 412.7 million units valued at RM213.2 million (2.01 million units valued at RM1.6 million in 2001). The improved performance was due mainly to the

Graph 4.37
Malaysia Exchange of Securities Dealing and Automated Quotation: MESDAQ Market Composite Index (MMCI) and Trading Value



Source: Kuala Lumpur Stock Exchange

increase in trade accessibility via the SCORE System (System on Computerised Order Routing and Execution), which was opened to all KLSE Member Companies. Market capitalisation increased to RM0.77 billion, compared with RM0.18 billion in 2001. Eight new companies were listed during the year, resulting in a total of 12 companies listed on the MESDAQ Market. The new listings included two large companies with a total market capitalisation of RM398 million.

In 2002, new guidelines and initiatives were undertaken by the relevant authorities to further promote a more efficient, transparent, and competitive environment in the equity market. New guidelines included measures to strengthen the regulatory framework, improve market structure as well as enhance corporate governance. The details of these measures are contained in the box "Key Capital Market Measures in 2002".

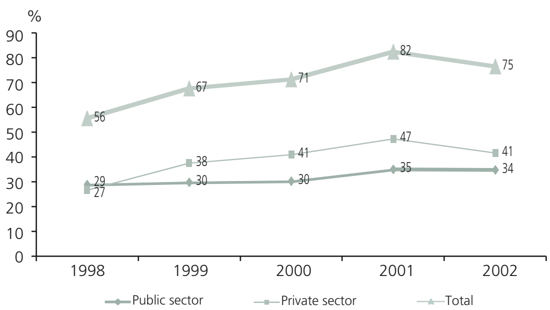
Bond Market

In 2002, gross funds raised from the bond market remained significant, amounting to RM55.7 billion and accounting for 80.7% of gross funds raised in the capital market. The low interest rate environment and ample liquidity situation provided strong incentive for the corporates, especially those with strong credit profiles to take the opportunity and issue long-term private debt securities (PDS) at competitive cost. For the first time, the issuance of Islamic bonds exceeded the issuance of conventional bonds. Asset-backed securities (ABS) of various structures were also introduced in the local bond market. Given the expansionary fiscal stance of the Federal Government, issuance of Malaysian Government Securities (MGS) remained significant. In the private sector, restructuring among corporates during the year led to higher redemptions and as a result, lower net funds of RM10.6 billion were raised in the bond market (RM32.8 billion in 2001). As at end-2002, total ringgit bonds outstanding stood at RM272.6 billion or 75% of GDP.

As announced in the auction calendar, the gross issuance of the MGS and the Government Investment Issues (GII) amounted to RM19 billion. The Government re-opened a total of three MGS issues while there were two private placements. The re-opening of the MGS issues marked a conscious effort by the Government to enhance liquidity of the bond market by increasing the size of the MGS market. Funds raised by the Government were to meet new financing requirements as well as to rollover the maturing issues. During the year, gross issuance of MGS was lower at RM16.3 billion, compared with RM23.1 billion raised in 2001, as part of the fiscal deficit was financed by the drawdown of accumulated assets. During the year, the third series of the Malaysian Savings Bonds (BSM 03) were issued by Bank Negara Malaysia for subscription by senior citizens and charitable organisations. BSM 03 was issued with the purpose of mitigating the impact of the low interest rates on these groups that depend on interest income as a primary source of income. After adjusting for redemptions, net funds raised by the public sector in 2002 amounted to RM8.6 billion.

Total gross funds raised by the private sector remained significant at RM36.2 billion. A total of 57 companies sourced financing from the PDS market and raised RM26.7 billion. The balance of RM9.5 billion was raised by Cagamas Berhad. During the year, as part of

Graph 4.38
Ratio of Bonds Outstanding to GDP



its corporate debt restructuring scheme, a major corporation undertook early redemption of a large portion of its outstanding bonds. This resulted in lower net funds raised from the bond market of RM2.1 billion for the private sector. Nevertheless, total outstanding private sector bonds was substantial, at RM148.6 billion (54.5% of the size of the total bonds outstanding) or equivalent to 41% of GDP. Companies from the transport and communication sectors were the largest issuers of PDS, accounting for 34.1% (RM9.1 billion) of the total funds raised through the PDS market. Major issuers within this sector were toll road concessionaires and telecommunication service providers that required long-term financing, especially to refinance existing borrowings at lower costs. Financial institutions or financial institution holding companies actively sought funds from the PDS market as well and accounted for the second largest share or 20.7% (RM5.5 billion) of the total funds raised. Funds mobilised were employed for merger and acquisition exercises as well as to increase the capital base. Funds raised by the government and other sectors, which accounted for the third largest share or 17.4% of the total PDS issued, were mainly from a state-owned company for the purposes of corporate debt restructuring. Power supply companies were also large issuers for the purpose of funding new investments. Meanwhile, construction and real property companies were the most active issuers with the most number of companies (15 companies) sourcing for funds, for both new activities and refinancing purposes.

In terms of total PDS issued, 54.3% were utilised for refinancing purposes, 23.5% were for restructuring purposes, 22.2% were for new activities, including merger and acquisition exercises. The significant utilisation of bonds for refinancing purposes reflected the opportunities to secure long-term funds at low borrowing costs. PDS issued for refinancing purposes was undertaken mainly by companies with strong credit profiles.

In terms of tenure, there was an increasing trend towards longer-term tenure for the PDS issues, with the longest tenure of up to 26 years by a company in the construction sector. The bulk of the PDS were issues with maturities between 10 to 15 years, followed by maturities of less than five years. The

The low interest rate environment and ample liquidity encouraged companies to issue long-term debt at competitive cost. In 2002, issuance of Islamic bonds exceeded conventional bonds.

Table 4.37
Funds Raised in the Bond Market

	2001	2002*p*
	RM million	
By Public Sector		
Government Securities (gross)	23,087	16,266
Less Redemptions	7,100	8,900
Equals Net Federal Receipts	15,988	7,367
Khazanah Bonds (net)	-220	0
Govt. Investment Issues (net)	-195	738
Malaysia Savings Bond (net)	-359	464
Net Funds Raised by the Public Sector	**15,215**	**8,569**
By Private Sector		
Private Debt Securities (gross)	37,932	36,195
Straight bonds	14,360	7,763
Bonds with Warrants	913	300
Convertible Bonds	1,493	2,852
Islamic Bonds	13,501	13,829
Asset Backed Securities	1,235	1,916
Cagamas Bonds	6,430	9,535
Less Redemptions	20,355	34,137
Private Debt Securities	15,040	28,770
Cagamas Bonds	5,315	5,367
Net Funds Raised by the Private Sector	**17,577**	**2,058**
Net Funds Raised in the Bond Market	**32,793**	**10,627**
Net Issues of Short-term Securities[1]	-2,093	-2,405
Total	**30,700**	**8,223**

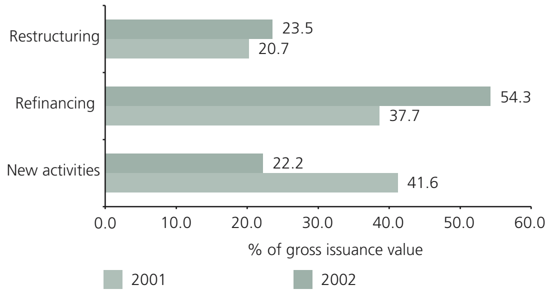
[1] Refers to Cagamas Notes and Commercial Papers only.
p Preliminary

Table 4.38
New Issues of Private Debt Securities by Sector[1]

Sector	2001		2002*p*	
	RM million	% share	RM million	% share
Agriculture, hunting, forestry and fishing	67.6	0.2	971.9	3.6
Mining and quarrying	0.0	0.0	0.0	0.0
Manufacturing	2,514.2	8.0	1,776.8	6.7
Electricity, gas & water supply	10,068.4	32.0	1,349.0	5.1
Wholesale & retail trade, restaurants and hotels	250.0	0.8	1,130.8	4.2
Construction	3,305.3	10.5	2,174.1	8.2
Transport, storage and communication	3,766.7	12.0	9,099.5	34.1
Financing, insurance, real estate and business services	5,147.9	16.3	5,513.8	20.7
Government and others	6,382.3	20.3	4,644.5	17.4
Total	**31,502.4**	**100.0**	**26,660.3**	**100.0**

[1] Excluding Cagamas Bonds.
p Preliminary

Graph 4.39
Private Debt Securities: Utilisation of Proceeds



long-dated PDS were mostly issued by infrastructure companies involved in toll road concessionaires, power plants and water projects, which require long-term project financing.

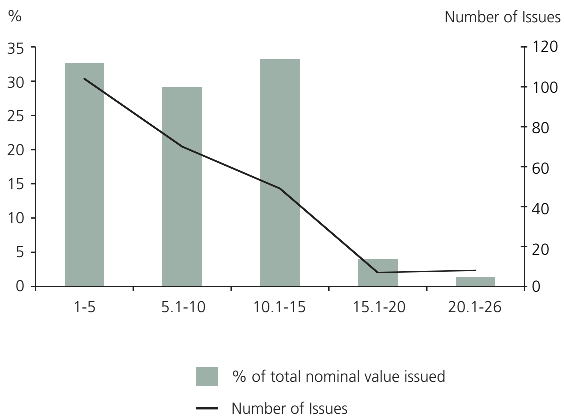
In terms of types of instruments, Islamic PDS and long-term straight bonds continued to be the preferred forms of funding, accounting for 38.2% and 21.4% of total issuance, respectively. Islamic PDS registered a significant growth to exceed the issuance of conventional bonds. Major issuers of these bonds were the toll road concessionaires and power supply companies. Islamic PDS attracted a wider range of investors, including both Islamic and conventional institutional funds. Greater demand for Islamic PDS led to more competitive bidding for these bonds and resulted in lower costs for the issuers.
As part of the efforts to further develop the Islamic financial market, the Government had, in the 2003 Budget, announced tax deductions for expenses incurred in issuing any Islamic PDS that adopts either the mudharabah, musyarakah or ijarah principles, for five years, commencing from 2003. The tax incentive given would further promote the growth of the Islamic PDS market in the coming years.

Islamic-based PDS gained prominence. Strong demand for Islamic based securities resulted in lower cost of financing for toll road concessionaires and power supply companies.

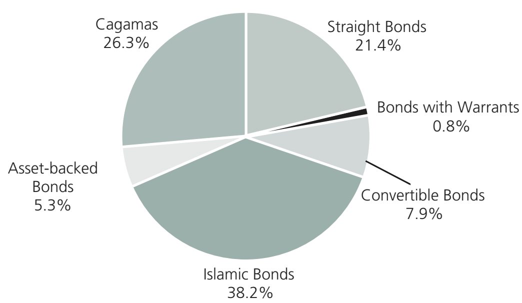
The overall size of PDS issues have increased over the years, with the average size per issue of RM118.5 million in 2002, compared to RM94.3 million in 2001. This reflected mainly the large financing needs of the infrastructure companies, as seen in the larger average size per issue for longer-term PDS (10 to 15 years) of RM190.6 million (2001: RM121.3 million). The average size per issue for the shorter-term PDS (less than five years) has also risen to RM88.4 million (2001: RM74 million).

Since the introduction of the Guidelines on the Offering of Asset-backed Securities in April 2001, five ABS totalling RM3.2 billion has since been issued. Two ABS were issued in 2002 (RM1.9 billion). These ABS had contributed to the range of securities offered to the investors. The types of ABS available in the domestic bond market are collaterised bond obligations, collaterised loan obligations and commercial mortgage-backed securities. In order to further improve market efficiency, a Report on Asset Securitisation in Malaysia approved by the National Bond Market Committee was released by the Securities

Graph 4.40
Tenure of PDS Issued in 2002



Graph 4.41
PDS Issues in 2002 by Type of Instrument



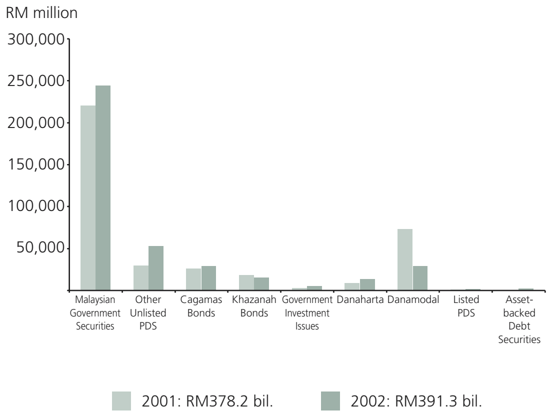
Commission in December 2002. The report highlighted the legal, regulatory, tax and accounting impediments to asset securitisation and outlined a comprehensive framework to address these issues. As the domestic bond market develops further, the supply and demand for ABS are expected to increase. In the near future, other classes of ABS, such as securities that are backed by hire-purchase and credit cards receivables, are expected to be issued.

During the year, Cagamas Berhad maintained its position as an active issuer in the PDS market with 37 issues (including short-term notes) with a total value of RM19.5 billion. A significant share of the issues were fixed rate bonds and Islamic principle bonds (19 issues with a total value of RM9.5 billion). This represented the highest amount of such bond issues by Cagamas Berhad in a single year. Demand for Cagamas bonds were high, as evidenced by the weighted-average over-subscription rate of 3.33 times.

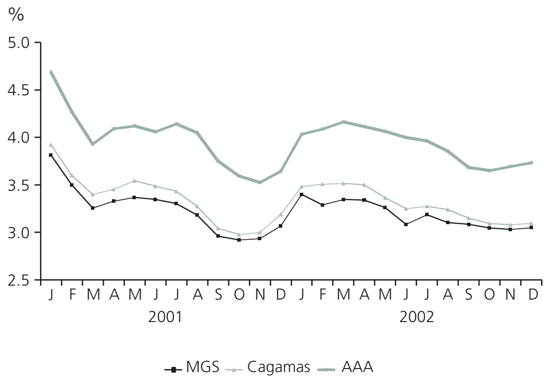
Trading activities in the secondary market for ringgit bonds were slightly higher in 2002, with trading volumes increasing by 3.5%, to RM391.3 billion. MGS papers were the most actively traded bonds, accounting for 62.4% of total trades (2001: 58.2%). Demand for corporate bonds, especially those with high investment grade, accounted for 13.5% of the total trades. Liquidity, as measured by the ratio of trading volume to total outstanding bonds, were highest for MGS and Danamodal bonds, at 2.2 times and 2.7 times, respectively. The introduction of the 5-Year MGS Futures had further enhanced liquidity in the MGS market. Liquidity for corporate bonds, however, was the lowest at 0.5 times of its outstanding value.

Yields of most fixed-income instruments (MGS, Cagamas securities and PDS) firmed in the first quarter of the year due to indications of improving recovery prospects. In January, the MGS yields across all tenures rose temporarily, partly due to the news of a reduction in the minimum limit on investments in low-risk assets to be maintained by insurance companies. The reduction was from 20% to 10% of the insurers' margin of solvency. During the rest of the first quarter, the MGS yield curve continued to shift higher and steepened, influenced by expectations that interest rates would rise due to positive prospects for the Malaysian and US economy. The MGS yield curve, however, began to shift downwards from May, following the weaker performance of the global and domestic equity markets amidst emerging concerns over the state of the US economy. In addition, domestic conditions of low inflation, ample liquidity in the banking system, as well as recognition of continued low interest rates, caused the MGS yield curve to flatten. In the second half of the year, the MGS yield curve resumed a downward trend to mirror the performance of the US Treasuries which was influenced by a combination of factors, including renewed expectations of further easing in interest rates in the major industrial countries, adverse sentiments on the equity markets from corporate accounting malpractices and the increased geopolitical risks. Yields for other papers followed the same trend. As expectations were for interest rates to remain low in the medium term, investors' appetite for the medium-term papers increased, resulting in the further flattening of the yield curve in December. Investors also took advantage of the cheaper prices for the longer-dated papers for which yields still had room to

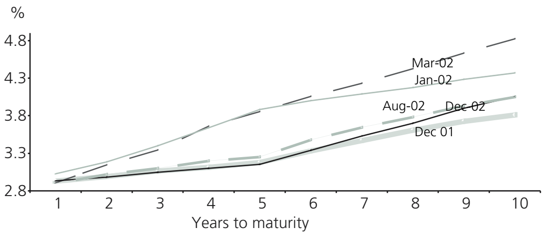
Graph 4.42
Trading of Ringgit Bonds



Graph 4.43
Indicative Yields of Selected Three-Year Bonds



Graph 4.44
Trends in MGS Yield

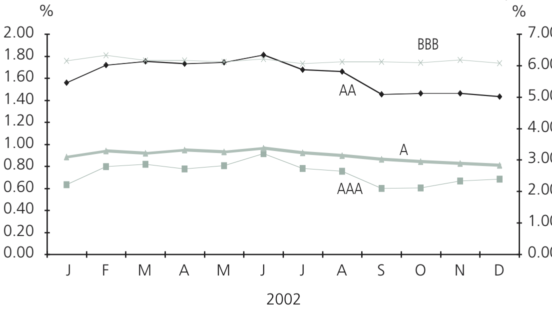


tighten, as opposed to shorter-end papers which were well priced-in by the market.

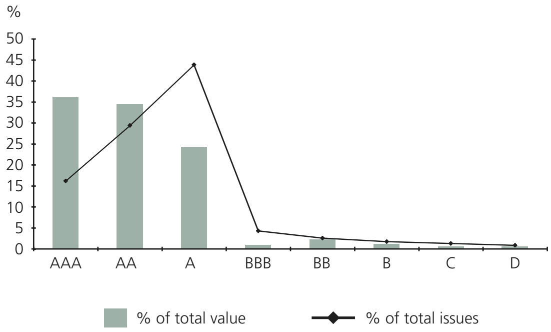
In terms of yield differentials, the spread between Cagamas bonds and MGS narrowed from 22 basis points in the first quarter to 5 basis points in the fourth quarter. The narrowing of the yield differentials was due to the increased demand for high quality liquid papers, such as Cagamas bonds, as an alternative to MGS. The narrowing spreads enabled Cagamas to provide funds at lower cost to the financial institutions. In the corporate bonds sector, the spreads of the AAA-rated and AA-rated PDS against the MGS narrowed since June, reflecting investor preference for such securities during this period, especially for high quality PDS that offered higher returns than MGS. This development resulted in the yields of PDS in these categories to decline. Yield differentials for BBB-rated bonds, however, remained relatively stable throughout the year.

During the year, rating activities remained high. In 2002, Rating Agency Malaysia (RAM) delivered 77 new ratings with the proposed gross issue value of RM28 billion. Long-term issues represented 72.7% and 83.4% of the total number and gross issuance value,

Graph 4.45
Yield Differentials for 3-Year Bonds vis-a-vis the 3-Year MGS



Graph 4.46
Rating Distributions of Outstanding PDS (As at end December 2002)



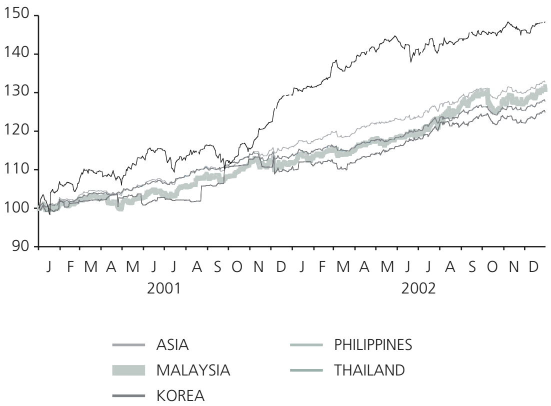
Source: RAM and MARC

respectively. Of the total amount rated, Islamic PDS constituted the largest portion. In terms of ratings profile, the issues were mainly distributed throughout the AAA, AA and A categories, with the heaviest concentration in the single A category (34 issues or 44.2% of the total issues rated). Meanwhile, the Malaysian Rating Corporation Berhad (MARC) delivered 26 new corporate debt ratings with a total rated value of RM11.6 billion. In value terms, about 75% of the PDS rated by MARC were in the form of Islamic Debt Securities and the issues rated were mainly in the AAA, AA and A categories. As banks grew more selective in extending guarantees since the Asian Crisis, only five newly rated issues with a combined worth of RM587 million were bank-guaranteed in 2002.

In terms of distribution of rating classes, PDS with single A rating accounted for 43.8% of the total number of outstanding issues in 2002. However, in terms of value, 70.5% of the total amount outstanding were in the AAA or AA rating classes, while only a small share of the outstanding issues were in the non-investment grade rating. During the year, RAM and MARC conducted a total of 134 rating reviews on the existing long-term debt securities. Of the total rating reviews, 96 were affirmations/reaffirmations, 20 issues were upgrades while 10 issues were downgrades. In line with the improved quality of issuance and corporate performance, the number of upgrades increased from 10 in 2001 to 20 in 2002, while the number of downgrades declined from 15 in 2001 to 10 issues in 2002.

On the international front, the Government also tapped the international capital markets for

Graph 4.47
Emerging Market Bond Index



Source: Bloomberg

benchmarking purposes, to take advantage of low costs, to diversify the investor base and to make inroads into the broader international financial markets in terms of financing based on Islamic principles. In March, the Government reopened Malaysia's US dollar Global Bond due 2011, adding US$750 million to the existing issues. The reopening was priced 175 basis points higher than the 10-year US Treasury notes, with a yield of 6.8%. Subsequently, in June, the Government successfully issued the first Global Islamic Sukuk due 2007, totalling US$600 million to act as a catalyst for the development of Islamic-based instruments in the international financial market. In August and September, Standard and Poor's and Moody's upgraded Malaysia's sovereign rating to BBB+/ Baa1, which reflected the ongoing improvements in economic fundamentals in the domestic economy. During the year, market sentiment for Malaysia's sovereign bonds and foreign currency corporate bonds were bullish following the expectations of low interest rates and the upgrades of Malaysia's sovereign ratings. Spreads for Malaysia's sovereign bonds progressively narrowed during the year 2002.

Table 4.39
Spreads Over US Treasury Benchmark

	Dec. 01	Mar. 02	Jun. 02	Sept. 02	Dec. 02
MALAYSIA 09	189	142	161	178	145
MALAYSIA 11	175	153	190	184	169
CHINA 11	106	81	108	115	85
INDONESIA 06	497	262	385	367	353
KOREA 08	137	90	99	123	109
PHILIPPINES 10	436	348	411	509	527
THAILAND 07	146	92	93	117	128
PETRONAS 06	168	92	113	129	126

Source: Bloomberg

Several measures were introduced to further develop the bond market in 2002. Among others, a new measure allowed Universal Brokers to trade in bonds in order to expand market participation in the domestic bond market. To improve the risk management process of market participants, principal dealers were allowed to trade on regulated short-selling basis for securities specified by the Bank. This is to facilitate financing and risk management activities of market makers in order to promote a liquid secondary trading environment. In addition, the introduction of 5-year MGS futures contracts by MDEX has also provided an additional instrument for risk management by bond market participants.

Exchange Traded Derivatives Market

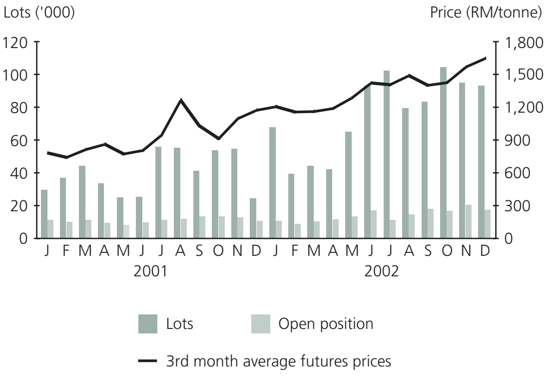
The total volume of contracts traded on the Malaysian Derivatives Exchange (MDEX) increased significantly by 56.5% in 2002, reaching a new record of 1,287,663 contracts. The sharp rise in trading activity was mainly in the Crude Palm Oil (CPO) Futures market (89.5%) and to a lesser extent, in the 3-month KLIBOR Futures contracts. Trading volume in the Kuala Lumpur Stock Exchange Composite Index (KLSE CI) Futures, ended the year on a softer note, closely mirroring the subdued performance of the underlying KLSE market. The migration from an open outcry system to electronic screen-based platforms, which commenced on 28 December 2001, also helped improve trading activities in the CPO Futures and the 3-month KLIBOR Futures contracts. Of significance, the introduction of the new 5-year MGS futures contract was well received by market players.

The Crude Palm Oil Futures market was the best performer on the MDEX in 2002, with the total trading volume increasing markedly by 89.5% to 909,073 lots (2001: 479,799 lots). The sharp increase in prices as well as the switch from an open outcry platform to the electronic-based system resulted in the encouraging performance in the futures market. During the year, the price

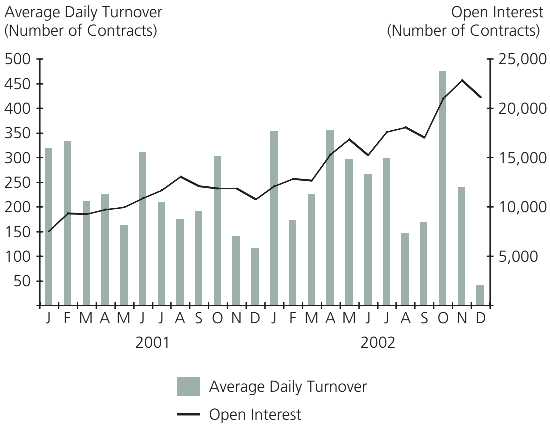
Table 4.40
MDEX
Turnover: Number of Contracts

	2001	2002	% change
KLSE CI Futures	287,528	233,863	-18.7
KLSE CI Options	565	1	-99.8
KLIBOR Futures	54,914	64,307	17.1
CPO Futures	479,799	909,073	89.5
5-Year MGS Futures	-	80,419	-

Graph 4.48
Crude Palm Oil Futures



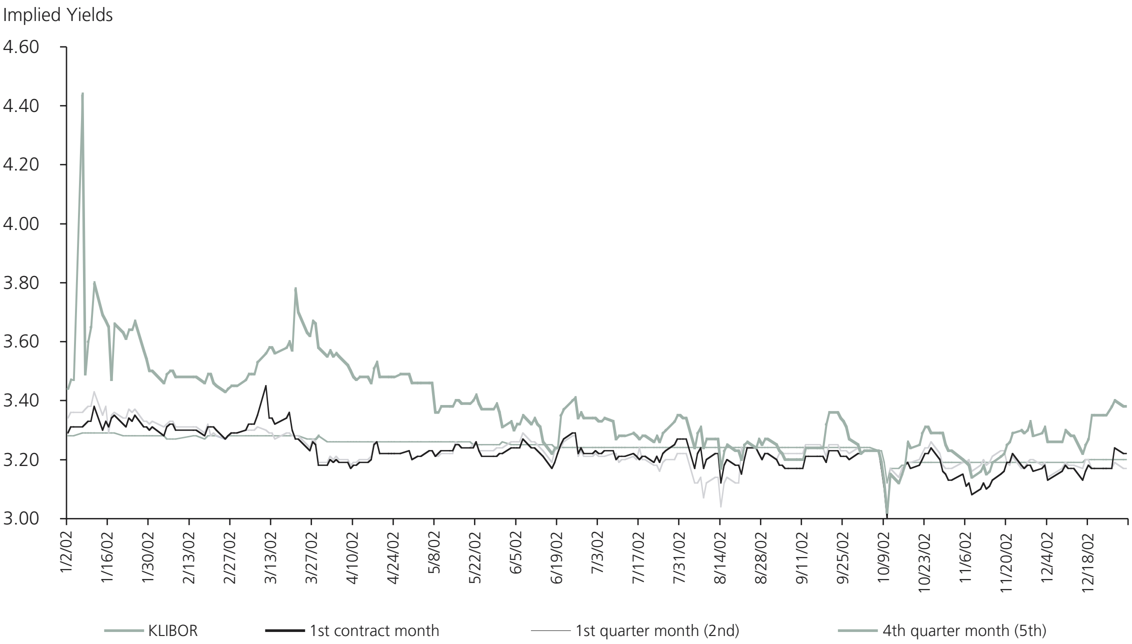
Graph 4.49
KLIBOR Futures



range for the benchmark 3rd month crude palm oil futures contract narrowed to RM587 (2001: RM622), with the highest daily price being traded at RM1,695 per tonne on 30 December 2002. After trading in the range of RM1,150 to RM1,280 per tonne in the first five months of 2002, the average monthly CPO futures prices strengthened to a range of RM1,400 to RM1,640 per tonne in the remaining months of the year. This is the highest level achieved in the past three years. The strong price performance in the second half of the year reflected the tight supply situation in the global oils and fats markets. Production of soyabean and palm oil increased only marginally, while output of rapeseed and sunflower oils declined. As a group, these vegetable oils accounted for 63% of total global supply of oils and fats.

Trading in the 3-month KLIBOR Futures also improved in 2002. The annual turnover increased by 17% to 64,307 lots from 54,914 contracts in 2001. Open interest position stood at 21,114 contracts as at December 2002. Given the ample liquidity in the system, sustained interest in the trading of 3-month KLIBOR Futures contracts was influenced by expectations of lower interest rates.

Graph 4.50
KLIBOR Futures Implied Yields and Spot Yields



Key Capital Market Measures in 2002

As at end-2002, 24 recommendations of the 152 recommendations outlined in the Capital Market Masterplan (CMP) had been fully implemented by the Securities Commission (SC). Another 74 recommendations were partially completed and at different stages of implementation. Most of the measures implemented in 2002 by the SC, the Kuala Lumpur Stock Exchange (KLSE) as well as the Institute of Internal Auditors Malaysia and the Malaysian Institute of Accountants were focussed on strengthening market infrastructure as well as intermediary services. These measures were also aimed at strengthening the regulatory framework, promoting a dynamic investment management industry as well as improving corporate governance practices. The key capital market measures introduced in 2002 were as follows:

Strengthening and Promoting the Fund Management Industry

- On 20 February, the SC released a set of **guidelines on the appointment of trustees for unit trust schemes** to address possible issues of conflict of interest. The guidelines contain provisions that include the requirement for at least one-third of the board of directors of the trustee to comprise independent members. Common directors on both the boards of directors of the trustee and the management company are not allowed.

- Effective 15 May, a new ruling by the SC **allows groups of companies or individuals to have interests in more than one unit trust management company (UTMC)**. Previously, interests by a group of companies were limited to only one UTMC. The new policy carries certain conditions. One of these conditions is that common shareholders can only have control over one unit trust management company at any one time. If the shareholders have minority interests in another UTMC, they will not be entitled to exercise more than 20% of the voting shares of that UTMC. In addition, the shareholders cannot be involved in the day-to-day management of the UTMC in which they have minority interest or be represented at the Board or Investment Committee level.

- Effective from 1 July, the SC **removed the minimum restriction on trustee fees** negotiated by trustees and management companies of unit trust funds. The purpose was to liberalise and enhance competitiveness in the fee structure for unit trust funds.

- In line with the SC's commitment to develop the Islamic capital market in Malaysia, two practice notes were released on 10 July, relating to Shariah-based unit trust schemes. Practice Note 18 on **Additional Requirement for Schemes Managed and Administered in Accordance with Shariah Principle**, stipulates the roles of the scheme's Shariah committee/Shariah consultant, investment committee as well as the trustee and compliance officer appointed to oversee the management of the scheme to ensure that a Shariah-based unit trust scheme will be managed and administered in accordance with its objectives. The Practice Note 19 on **Procedures for Registration and Appointment of Shariah Committee Members/ Shariah Consultants for Schemes Managed and Administered in Accordance with Shariah Principles**, sets out registration procedures and provides an efficient and expedient framework for the appointment of Shariah committee members/Shariah consultants by Shariah-based schemes.

- The **revised guidelines on property trust funds** were released on 13 November. The objective was to encourage the expansion of the property trust industry in Malaysia. The revision, among others, allows property trust funds to be opened to a wider group of investors and also enables property trust funds to invest in more diversified classes of assets, including permissible instruments such as real property-related assets. Investment limits in respect of the property trust funds' portfolio are also liberalised. Parties which are allowed to participate in the property trust industry were also expanded to include subsidiaries of property investment holding companies and property development companies, in addition to subsidiaries of financial institutions. The revision also contains several new requirements to enhance the level of disclosure and reporting by property trust funds.

Enhancing Competitiveness of Universal Brokers

- On 16 May, the SC released a practice note **allowing universal brokers (UBs) to offer more services at the sites of electronic access facilities.** This flexibility aims to further enhance the competitiveness of UBs and in the process, facilitate the consolidation of the stockbroking industry. The liberalised ruling allows sites of electronic access facilities to be set-up by UBs to undertake the following additional activities:
  - i) placement for licensed dealer's representatives, futures broker's representatives and dual licence holders;
  - ii) opening and closing of trading accounts and/or securities accounts;
  - iii) receipt and payment of clients' monies;
  - iv) marketing and selling of approved financial products and services provided by UBs; and
  - v) placement and utilisation of broker-front-end and CDS terminals and/or servers at the electronic access facility.

Apart from the incentive to allow additional activities to be undertaken at the electronic access facilities, UBs formed through the merger of four stockbroking companies will be **allowed to offer a full range of capital market services** as well as **establish additional branches** throughout the country.

- On 30 October, the SC issued **Guidelines for UBs to deal directly in Unlisted Securities**. Previously, UBs could only deal in unlisted securities through a licensed financial institution. The purpose was to broaden the intermediation structure of the bond market.

Enhancing Investor Protection

- Effective 1 March, the KLSE introduced **additional investor protection measures related to the Practice Note 4 (PN4) companies**. The purpose was to alert investors of the risks associated in the trading of the listed securities of PN4 companies. Under the new measures, a trading restriction will be imposed on the specific PN4 companies that fail to regularise their financial positions within the specific original time frame. The trading restriction is in the form of full payment to brokers before executing the purchase contract for their clients. In addition, a separate sector classification called "PN4 Condition" was created to segregate all PN4 companies from their original sectors.

- On 21 October, the Malaysian Central Depository (MCD) launched the **Consolidated Central Depository System** (**CDS) Statement of Account (CSA).** The CSA provides investors with multiple CDS accounts to receive details of all securities transactions in a monthly consolidated statement. Through the new facility, investors with multiple CDS accounts will be able to manage and reconcile their portfolio securities held through various CDS accounts more effectively. The CSA will be issued on monthly and half-yearly basis, and will contain detailed transactions in all active accounts, new accounts, inactive accounts and active accounts with no transactions for the period. However, investors with inactive accounts (where accounts indicate absence of transactions for 36 months consecutively) will only receive the half-yearly CSA.

Facilitating Corporate Restructuring Exercises

- In line with measures announced in the 2002 Budget to facilitate the restructuring of companies, the SC announced on 8 May the **relaxation of several conditions for the injection of foreign assets and multinational companies (MNCs) into Malaysian listed companies.** The relaxation provides listed companies, especially those which are in distress, with more options to acquire quality assets to diversify their income base. Malaysian listed companies will be able to acquire foreign assets that are either owned by Malaysians or foreigners through the issuance of securities, notwithstanding that the respective acquisitions are above the 25% threshold. The foreign assets need to fulfill the following criteria for acquisitions to take place:
  - i) the assets to be acquired must be quality assets;
  - ii) the respective acquisitions need to be financed entirely through the direct issuance of new securities to the vendors of the assets;
  - iii) there will not be an outflow of funds from the country for a period of three years after the completion of the acquisition; and
  - iv) the acquisition must bring benefits to the listed company and the country.

In addition, the injection of MNCs into distressed listed companies does not require the unlisted MNCs to comply with the National Development Policy (NDP). In other words, the MNCs are not required to restructure to meet the 30% Bumiputera equity participation when seeking listing on the KLSE via a reverse take-over of, or a back-door listing into distressed listed companies. This flexibility applies to foreign-owned companies incorporated in Malaysia or foreign-owned corporations registered in Malaysia that have been exempted by the Ministry of International Trade and Industry (MITI) from the said NDP requirement.

- On 3 December, the SC announced that the **deadline for undercapitalised companies listed on the KLSE to meet the minimum RM60 million and RM40 million paid-up capital requirement for the Main Board and Second Board companies respectively will be extended from 31 December 2002 to 31 December 2003**. The decision to extend the deadline took into consideration, weak market conditions which made it difficult for listed companies to undertake capital-raising exercises. Companies that fail to comply with the new deadline will be re-classified under a separate sector by KLSE and tagged as "Undercapitalised". Their shares will also be subject to trading restrictions and these companies are required to constantly keep all their shareholders informed of their non-compliant status in their quarterly financial results.

Enhancing Corporate Governance Practices

- On 5 July, the KLSE made **amendments to its Listing Requirements on provisions relating to quarterly reporting of financial statements**. Following the amendments, listed companies are required to comply with the approved accounting standards (MASB 26) issued by the Malaysian Accounting Standards Board. The MASB 26 defines the minimum content of an interim financial report and identifies the accounting recognition and measurement principles that need to be applied in an interim financial report.

- On 26 July, the Institute of Internal Auditors Malaysia launched a set of **guidelines on Internal Audit Function** to assist the board of directors of public-listed companies to effectively discharge their responsibilities in relation to their internal audit functions. The guidelines, which are in line with efforts to enhance corporate governance in Malaysia, were formulated to support the SC and KLSE on the benchmarking of the internal audit function against internationally accepted best practices and standards of internal auditing. The guidelines also provide guidance on audit committee assessment of the effectiveness of their internal audit functions.

- On 21 August, the KLSE established a **Taskforce on Corporate Disclosure Best Practices** in order to provide guidance to industry participants in developing relevant policies and procedures to promote best practices in corporate disclosure. The taskforce is to further facilitate the practice of good corporate disclosure in line with the KLSE Listing Requirements and relevant securities laws. The members of the taskforce include industry participants as well as representatives from established industry associations, professional bodies and companies listed on the KLSE.

- The KLSE on 28 November announced the **amendment on the Listing Requirement relating to directors and the signatory for the statutory declarations** accompanying annual audited accounts of public listed companies. In this regard, the KLSE issued clarifications on the amendments and certain other provisions of the Listing Requirements via Practice Notes (PN) 13 and 14. PN 13 contains specific requirements in respect of appointments of independent directors. It includes an enhanced definition of "independent director" as well as the qualifications for the signatory of statutory declarations. PN 14 provides further clarification on rules affecting related party transactions.

- In December, the Malaysian Institute of Accountants (MIA) announced that, with effect from 1 January 2003, **all auditing firms registered with it will be required to have their standards and auditing practices subjected to an independent review by the MIA**. This move aims to ensure that professional and ethical standards are maintained and upheld by all practising auditors in Malaysia. The objective was to raise the reliability and integrity of financial reports issued by Malaysian public listed companies.

Enhancing Market Competitiveness

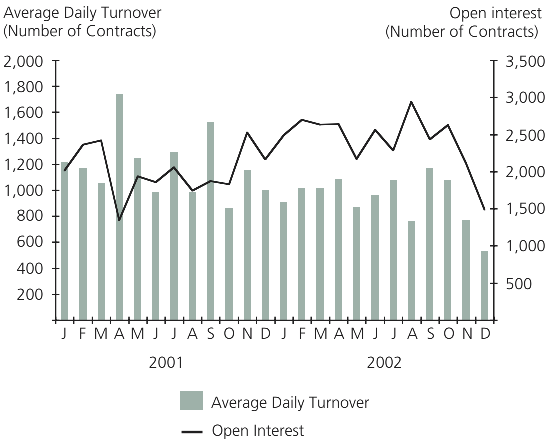
- In an effort to make transaction costs of the KLSE more competitive, the **second stage of the liberalisation of stockbroking commission rates** was implemented on 1 July 2002. The liberalisation of the commission rates as recommended in the CMP involved two stages. The first stage, implemented on 1 September 2000, involved the liberalisation of commission rates for all transactions above RM100,000 while transactions with contract values of RM100,000 and below were subject to a fixed rate of 0.75%. The second stage of liberalisation, which came into effect on 1 July 2002, allows commission rates for all transactions to be negotiable, subject to a cap of 0.70%.

In addition, expectations were affected by uncertainties over global developments and its impact on the domestic economy. These expectations were evidenced by movements in the implied yields of various KLIBOR Futures contracts. The implied yields (4th quarter month contracts) peaked at 4.44% in January 2002, before reaching a low of 3.02% in October 2002. Subsequently, the implied yields rose gradually to end the year at 3.38%. In line with the changes in interest rate expectations, there were higher activities in the bonds and local interest rate swap markets. Similarly, increased activities were also reflected in the higher volume traded on the KLIBOR Futures market, as market participants hedged their exposures.

Another factor which helped enhance trading activities in the 3-month KLIBOR Futures market was the introduction of the 5-year MGS futures contract, which provided market participants with more combinations of trading strategies.

Trading activities in the KLSE CI Futures declined in 2002. Turnover was lower by 18.7% to 233,863

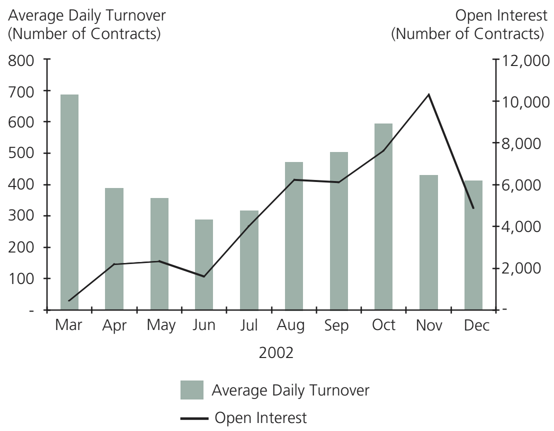
Graph 4.51
KLSE Composite Index Futures and Options



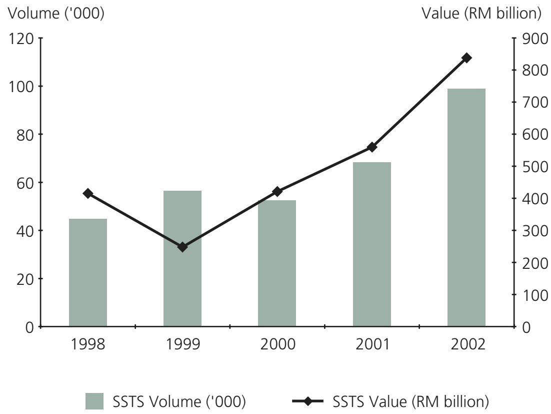
lots from 287,528 lots in 2001. The average daily volume transacted during the period was 943 lots, compared to 1,183 lots in 2001. The softer performance of the KLSE CI Futures was in line with the weak underlying KLSE market performance. The month-end open interest, which represents the number of unsettled positions, also declined. At the end of December 2002, open interest stood at 1,485 contracts, down from 2,164 contracts in December 2001. Trading activities in the KLSE CI Options contracts also declined significantly in 2002. Apart from the bearish sentiments affecting the cash and futures markets, the decline in trading activities was also due to a continuing lack of awareness and education about option contracts. The Derivatives Liquidity Ratio (DLR), which represents the ratio between the turnover value of futures against the turnover value of the underlying CI component stocks, eased marginally from 25.9% in 2001 to 24.2% in 2002. This decline was due mainly to the shift by market participants from trading in the KLSE CI Futures to trading in the CPO futures. The favourable outlook on CPO prices, generated greater liquidity on the CPO Futures market, compared with trading in KLSE CI Futures.

A new derivative instrument, the 5-Year MGS Futures, was introduced on 29 March 2002. The new instrument provides an opportunity for market participants to better manage their risks, especially interest rate risks, by hedging their bond portfolios. In 2002, domestic financial institutions were the major players in this new derivative and accounted for 98% of total trade. The 5-Year MGS Futures contracts performed well. Total turnover for the contracts was 80,419 and the total open position was 4,860 contracts. The average daily turnover during the period was 421 lots. Consistent with its role to develop and deepen the domestic derivatives market, MDEX will be adding new products in 2003. The Single Stock Futures

Graph 4.52
5-Year MGS Futures



Graph 4.54
RENTAS SSTS Turnover



contract is expected to be launched during the course of the year. Other products, such as commodity derivatives and US dollar-denominated futures, are also being planned.

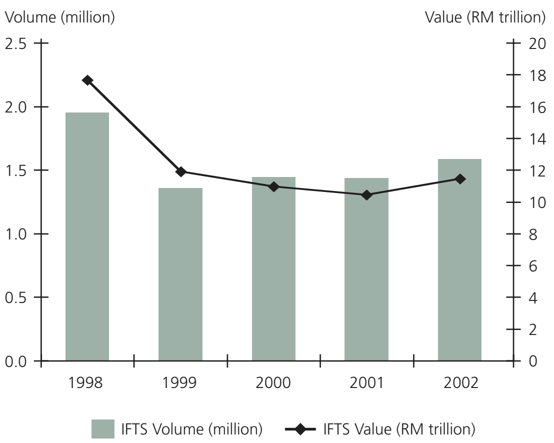
DEVELOPMENTS IN PAYMENT AND SETTLEMENT SYSTEMS

In 2002, several measures were implemented to improve the efficiency and security of payment systems. These were to ensure that they would be able to meet the challenges of a growing economy, yet mindful of the need to protect consumer interests.

RENTAS

During the year, it was agreed to allow universal brokers access to the RENTAS system, a real-time gross settlement system for funds and securities, where access hitherto had been limited to licensed banking institutions and Cagamas, the national mortgage corporation. This move will allow universal brokers to deal directly in the unlisted debt securities market through the Scripless Securities Trading System (SSTS), which would allow for a longer time window to conduct trading. The SSTS module was also enhanced to cater for market development and innovation in unlisted debt securities, including providing interface to facilitate settlement of interest and redemption proceeds at the RENTAS Central Host System.

Graph 4.53
RENTAS IFTS Turnover



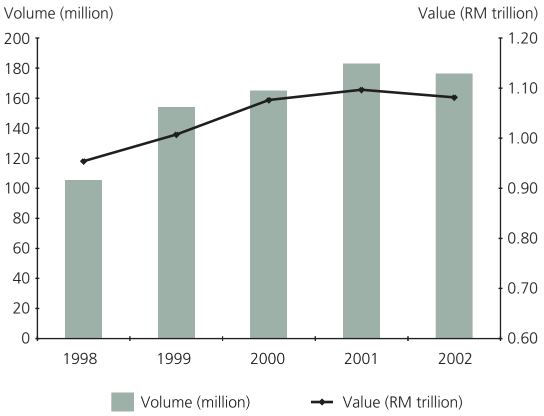
In December 2002, pilot banking institutions successfully implemented the RENTAS i-LINK project, which is operated on a web-based platform. Besides being a cost effective platform, RENTAS i-LINK allows personalised information for faster analysis. It delivers information to simplify and improve the RENTAS members' money market operations, management of cash and securities position, as well as the monitoring of capital market activities.

In 2002, the interbank funds transfer system (IFTS) of RENTAS saw an increase in volume and value of 10.7% and 9.7% respectively, compared with 2001. There was also a significant increase in the volume and value of SSTS transactions by 45% and 49.7% respectively, in 2002.

SPICK

Cheques remain the most popular non-cash retail payment instrument in Malaysia. Nevertheless, the volume of cheques processed through the three SPICK cheque clearing centres moderated slightly from 182.8 million cheques valued at RM1.10 trillion in 2001 to 176.4 million cheques valued at RM1.08 trillion in 2002, representing a decline of 3.5% and 1.4% in volume and value respectively from 2001.

Graph 4.55
Value and Volume of Cheques Cleared by SPICK Centres



This is attributed to the increase in the use of electronic payment modes particularly through Internet banking and credit cards for retail purchases.

Automated Teller Machines (ATMs)
The volume of cash withdrawals via ATM rose from 174.9 million in 2001 to 193.5 million in 2002, while the amount withdrawn increased from RM71.8 billion to RM77.6 billion in the same period. In June 2002, the ATMs of several banking institutions were affected by a spate of unauthorised withdrawals. To protect the consumers' interest and maintain confidence in the ATM network, banking institutions implemented several measures to address the situation.

The banking institutions in collaboration with Malaysian Electronic Payment System (1997) Sdn. Bhd. (MEPS) initiated the development of a chip-based Payment Multipurpose Card (now known as Bankcard) to replace the existing magnetic stripe ATM cards. The chip-based ATM card offers a high standard of security to deter counterfeiting. The initial applications incorporated into the Bankcard are the ATM, debit and MEPS Cash electronic purse.

Table 4.41
Payment and Settlement Systems

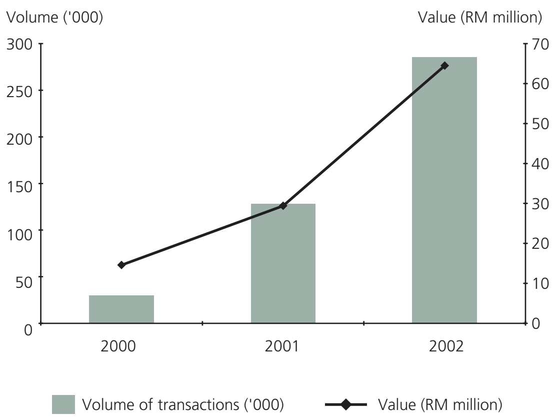
	2002			
	Value		Volume	
	RM billion	Annual change (%)	('000)	Annual change (%)
RENTAS				
IFTS Transactions	11,447.0	9.7	1,584.4	10.7
SSTS Transactions	838.0	49.7	99.0	45.0
SPICK				
Cheques Cleared	1,081.4	-1.4	176.4	-3.5
Inter-Bank Giro				
IBG Transactions	4.7	337.4	591.6	373.8

The ATM and MEPS Cash applications would also be made available in the MyKad, the national identification card. Several banking institutions have started issuing the Bankcard since the third quarter of 2002. As at end-2002, more than 200,000 Bankcards have been issued. The chip-based Bankcards would progressively replace the existing magnetic stripe ATM cards during the year. As at end-January 2003, approximately 4,000 ATMs have been upgraded to accept the chip-based ATM cards.

MEPS Cash
As part of the efforts to encourage the move from paper-based payments to electronic payments, the Bank has been working jointly with the banking industry to promote the use of the MEPS Cash electronic purse. The MEPS Cash application, which has been incorporated into Bankcard and MyKad, is a pre-paid purse which can be loaded up to a maximum value of RM2,000. It offers consumers an alternative electronic payment mode to using cash for making retail payments. The domestic banking institutions are currently upgrading the existing point of sale terminals at retail outlets on a nationwide basis for merchants to accept MEPS Cash. To facilitate the loading of electronic value into the electronic purse by cardholders, participating banking institutions have upgraded their respective ATMs to enable the loading of MEPS Cash via ATMs.

Financial Process Exchange System
In response to the growth in e-commerce, the Bank is working with MEPS to develop a national multi-bank payment infrastructure known as the Financial Process Exchange (FPX) to facilitate online payment for e-commerce transactions. The system, operating on an Internet-based platform, would enable participants to execute online payments to their bank of choice. The FPX system would provide a common platform for all banking institutions in the country to offer business-to-business payment and facilitate the establishment of payment-related standards to improve payment efficiency. It is expected that the system would be implemented in the third quarter of 2003. An FPX Steering Committee with membership comprising representatives from government agencies, banking institutions and other e-commerce players provides broad direction for the FPX implementation to ensure that the FPX system would be market driven.

Graph 4.56
Payment Gateway Transactions



Payment Gateway

During 2002, the use of the payment gateway operated by MEPS recorded a significant increase, the volume and value of transactions effectively doubled by 122.3% and 119.3% respectively, compared to 2001. During the year, the policy on the offering of payment gateway services by licensed banking institutions was reviewed with the aim of enabling licensed banking institutions to be responsive to the changing payments environment and allowing market forces to shape the development in payment systems. Effective September 2002, licensed banking institutions were allowed to subscribe to the payment gateway operated by MEPS and other payment gateways approved by the Bank.

Internet Banking and Other Electronic Payment Services

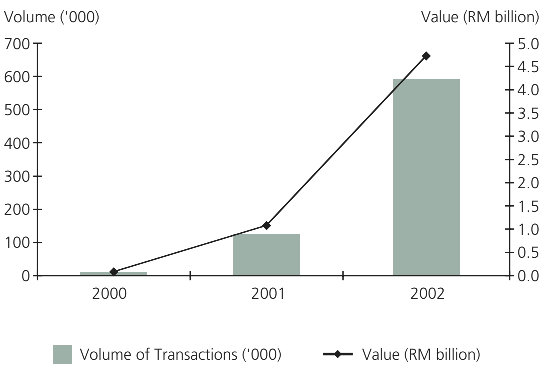
At the end of 2002, eight domestic banks and four locally incorporated foreign banks introduced transactional Internet banking services. There were 1.0 million individual Internet banking subscribers as at end-2002 following the introduction of Internet banking in Malaysia in June 2000. This represents approximately 4.3% of the total population in Malaysia, or 39.2% of the total number of Internet subscribers in Malaysia. Internet banking currently is used largely for bill payments. Leveraging on the popularity of the Short Messaging Service (SMS) amongst the Malaysian public, two domestic banks in collaboration with telecommunication companies have launched mobile financial services with SMS facilities during the year.

Meanwhile, the number of interbank Giro payments increased markedly in 2002. Interbank Giro transactions have more than quadrupled from 125,000 transactions in 2001 to 592,000 in 2002. As part of Bank Negara Malaysia's efforts to promote greater use of electronic payments, an education programme will be launched to create greater public awareness of electronic banking services.

Credit and Charge Cards

The usage of card payment had increased remarkably. The number of credit cards and charge cards in circulation increased by 25% and 19.3% respectively since last year. The value of credit card transactions had increased by 24.7% from RM20.3 billion in 2001 to RM25.3 billion in 2002. The value of charge card transactions increased by 5.3% from RM1.8 billion in 2001 to RM1.9 billion. Bank Negara Malaysia issued a "Guideline on Minimum Requirement on Risk and Fraud Management of

Graph 4.57
Inter-Bank Giro Transactions



Graph 4.58
Credit and Charge Card Operations in Malaysia

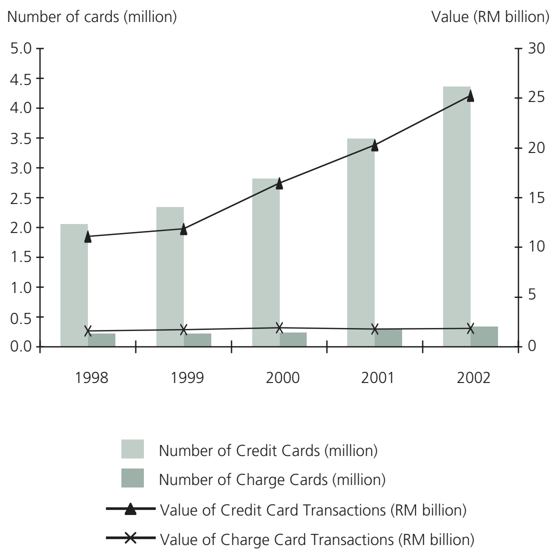


Table 4.42
Payment Cards

	2001		2002	
	No. of cards (million)	Value of transactions (RM billion)	No. of cards (million)	Value of transactions (RM billion)
Credit cards	3.5	20.3	4.4	25.3
Charge cards	0.3	1.8	0.3	1.9
Debit cards	n.a.	0.05	n.a.	0.07

n.a. Not available.

Credit Card Operations" in July 2002. The Guideline specifies the minimum requirement for preventive, detective, corrective and containment measures by card issuers and acquirers to mitigate the risk in credit card operations and fraud.

The banking institutions are working towards the migration of credit cards from magnetic stripe-based to the Europay-MasterCard-Visa (EMV) chip platform. The conversion is expected to be completed by end-2004, while card readers will be upgraded or replaced to accept EMV chip-based cards by end-2005. As at end-2002, there were a total of 20,800 chip-based credit cards that are EMV compliant in circulation.

Four financial institutions took part in a pilot programme to deploy the use of Magneprint in June 2002. Magneprint helps prevent card skimming by using the intrinsic physical properties of a magnetic stripe unique to every card to differentiate between an original and a cloned card. Magneprint technology provides a cost efficient interim solution, while the EMV migration is a long-term strategy.

Bank Negara Malaysia is also taking steps to increase consumer understanding, to promote the prudent use of credit cards, promote consumerism and consumer protection. Amongst the new requirements, banking institutions are to provide information on fees and charges to facilitate comparison by consumers, alert consumers on the implications of paying only the minimum monthly repayment amounts, highlight the key terms and conditions to the consumers and limit the consumers' liability for unauthorised transactions as a consequence of lost and stolen credit cards. These requirements would help consumers to be more aware of credit card fees and charges, their obligations as credit card users and to be prudent in managing their credit card debts. The new guideline on credit card operations was issued in March 2003 and the issuers of credit cards have been given six months to undertake the necessary system adjustments and ensure compliance by then.

Payment Systems in EMEAP Economies

In July 2002, "Payment Systems in Malaysia" was made available on Bank Negara Malaysia's website in conjunction with the release of the publication, "Payment Systems in EMEAP Economies", otherwise known as the EMEAP Red Book. The chapter on "Payment Systems in Malaysia" provides a comprehensive overview of the payment systems development in the areas of regulatory framework, role of the Central Bank and various types of payment instruments available. The EMEAP (Executives' Meeting of East Asia Pacific Central Banks and Monetary Authorities) is a forum comprising eleven central banks and monetary authorities of Australia, People's Republic of China, Hong Kong China, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore and Thailand. The EMEAP Red Book was initiated by the Working Group on Payment and Settlement Systems to provide up-to-date information and to promote further understanding of payment and settlement systems in the EMEAP region.

APEC Working Group on Electronic Financial Transactions Systems (E-FiTS)

The Asia-Pacific Economic Cooperation (APEC) Working Group on E-FiTS was established in September 2000 to develop and implement programmes to foster paperless trading in collaboration with the E-Commerce Steering Group. The Working Group met quarterly to examine how APEC could promote the development of electronic financial transactions within the region. In June 2002, a Final Report was published providing case studies on e-finance developments in Brunei Darussalam, Hong Kong China, Korea, Malaysia, Singapore and Thailand. Malaysia's study focused on "Electronic Banking in Malaysia". The factors that have contributed to the evolution of e-banking in Malaysia include the development of a progressive regulatory framework and the efforts by the financial institutions to encourage their customers to use online banking facilities. A compelling factor was the efforts of the Central Bank and the Government to reduce the digital divide, as well as efforts to promote electronic financial services under the Multimedia Super Corridor initiative, the e-government agenda and the introduction of the MyKad and Bankcard.

MALAYSIA'S NATIONAL ANTI-MONEY LAUNDERING PROGRAMME

In July 2001, the Anti-Money Laundering Act 2001 (AMLA) was gazetted as law. Upon the appointment of Bank Negara Malaysia as the competent authority under the AMLA, a new department, the "Financial Intelligence Unit (FIU)" was established within Bank Negara Malaysia on 8 August 2001 to carry out the functions of the competent authority as provided in the AMLA. The AMLA came into force on 15 January 2002 and the ministerial order appointing Bank Negara Malaysia as the competent authority was also gazetted on the same day.

The national anti-money laundering programme set out in the AMLA provides for its implementation in a non-integrated manner with the existing domestic regulatory, supervisory and enforcement agencies, thus, extending their functions to include countering money laundering and terrorist financing. The AMLA provides for the FIU to collaborate with the relevant domestic regulatory, supervisory and enforcement agencies in intelligence gathering, analysis and dissemination.

Following September 11, the national anti-money laundering programme was extended to include the fight against terrorism, with particular emphasis on terrorist financing. International terrorism offences under the Penal Code were included as money laundering predicate offences in the Second Schedule to the AMLA by a ministerial order, which also came into force on 15 January 2002. Any person funding terrorists is deemed to be abetting the terrorists and commits an offence under the Penal Code. Those receiving the funds also commit money laundering offences for dealing with proceeds from illegal activities.

The National Coordination Committee to Counter Money Laundering (NCC) was established in April 2000 to enhance cooperation among domestic agencies involved in the fight against money laundering and terrorist financing. Bank Negara Malaysia is the lead agency for the NCC that consists of 12 other Ministries and government agencies. The scope of the NCC's terms of reference was also extended to include the fight against terrorist financing. The FIU, being the NCC's Secretariat, regularly updates the members on the experiences in other countries in combating money laundering, reviews existing investigative processes and fine-tunes the national anti-money laundering programme.

As recommended by the evaluators of the Asia/Pacific Group on Money Laundering (APG), Malaysia would extend the application of the AMLA to non-bank institutions and expand the Second Schedule to the AMLA to include a more comprehensive list of money laundering predicate offences. As money laundering is a multi-jurisdictional crime, Bank Negara Malaysia will enter into arrangements with corresponding authorities of foreign states for the sharing of financial intelligence in order to effectively combat money laundering and the financing of terrorism.

The national anti-money laundering programme developed by Bank Negara Malaysia in consultation with the members of the NCC include the following goals:

Goal 1 : Protecting the financial sector from being used as a conduit for money laundering
The AMLA provides for the offence of money laundering, the reporting of suspicious transactions as well as the powers to investigate and freeze assets believed to be the subject matter of any money laundering predicate offence or evidence relating to such offence. Apart from the larger aim of protecting the national economy from being tainted with these illegal proceeds, these provisions ensure the safety and soundness of the financial system to protect the financial sector from being abused for money laundering activities. The First Schedule to the AMLA lists the reporting institutions which are subject to the AMLA.

The FIU invokes the provisions of the AMLA on the reporting institutions in stages. A self-assessment questionnaire exercise was carried out during the year to gauge the level of preparedness of the reporting institutions to meet the reporting obligations set out in the AMLA. In order to ensure the reporting institutions' effective compliance with their obligations under the AMLA, the FIU conducts briefing sessions for the compliance officers of these institutions. These briefing sessions provide a platform for clarification on issues and problems relating to anti-money laundering measures and the reporting mechanism. To date, the AMLA has been invoked on the following reporting institutions:

- Commercial banks, finance companies, merchant banks and Islamic banks with effect from 15 January 2002;
- Discount houses, offshore banks, offshore trust companies, offshore insurers, reinsurers, life

insurers, general insurers, insurance brokers and takaful operators with effect from 15 April 2002;
- Money-changers with effect from 1 June 2002.

Supervisory authorities of the respective reporting institutions are also required to report to the FIU any information received which relates to activities pertaining to any unlawful activity or serious crime. The AMLA further provides for the sharing of financial intelligence by the FIU with the relevant law enforcement agencies to assist them in their investigations into money laundering predicate offences.

Goal 2 : Capacity building

Technical assistance and training is critical to ensure successful implementation of the national anti-money laundering programme. To this end, the FIU in co-operation with other training institutions such as the Institute of Bankers Malaysia provide training programmes, which include money laundering methods, financial investigation techniques and establishment of compliance framework. Officers from the various enforcement agencies involved in the fight against money laundering also participate in international money laundering seminars and conferences. In addition, the FIU regularly updates these agencies of any developments, both in the domestic and international arena, on money laundering issues.

Under the ASEM Anti-Money Laundering Project, two ASEM consultants have conducted on-site visits in December 2002 in respect of the training and technical needs linked to existing anti-money laundering initiatives in Malaysia. Upon completion of the training and technical assistance needs analyses, capacity building for Malaysia would include:

- identification and detection of money laundering;
- development of laws, regulations, policies as well as procedures related to the reporting of suspicious transactions and the identification of customers;
- strategies to ensure the timely analysis and dissemination of information on money laundering trends; and
- investigation techniques.

Malaysia will be hosting an Anti-Money Laundering Seminar in July 2003 for ASEAN members as well as co-hosting an international conference on money laundering with Germany in October 2003.

Goal 3 : Enhancing international cooperation

The AMLA allows the FIU to disclose financial intelligence to a corresponding authority of a foreign State if there exists an arrangement between Malaysia and that foreign State. The FIU and the relevant enforcement agencies are empowered to collaborate with any law enforcement agency in and outside Malaysia with regard to investigations into any serious offence. For this purpose, Bank Negara Malaysia has reviewed several arrangements for the sharing of financial intelligence with various jurisdictions within the region for the coming year. Malaysia has also applied for membership in the Egmont Group of Financial Intelligence Units. This body, consisting of financial intelligence units from sixty-nine jurisdictions, aims to provide a forum for financial intelligence units to expand and systemize the exchange of financial intelligence as well as the sharing of expertise and capabilities.

Goal 4 : Adoption of best practices in line with international standards

A new evaluation standard, the Methodology for Assessing Compliance with the Anti-Money Laundering and Combating the Financing of Terrorism Standards, was developed by the IMF and the World Bank in 2002. This Methodology comprises 120 criteria which should be put in place to counter money laundering and terrorist financing, including criminal justice measures, international cooperation, preventive measures by financial institutions and sector specific assessment. An evaluation based on this new Methodology was carried out on the Labuan Offshore Financial Centre on 30 September - 11 October 2002 by a team of experts from the IMF. Pending the release of the team's final report, the members of the NCC will work towards complying with the recommended criteria.

Goal 5 : Enhancement of supervisory framework

With the coming into force of the AMLA, the supervisory role of Bank Negara Malaysia was strengthened further to ensure that financial institutions are able to fully comply with the requirements of the AMLA. Financial institutions are required to ascertain that they have sufficient controls in place to prevent their institutions from being abused by money launderers, and as a result, being subject to concentration, legal and reputational risks.

In this regard, Bank Negara Malaysia conducts on-site examinations on banking institutions to assess the adequacy and effectiveness of their anti-money laundering policies, procedures, systems and controls that have been put in place to ensure that they will be able to comply with the requirements of the AMLA. The scope of the examinations encompass an assessment of the anti-money laundering infrastructure, the institution’s compliance with its own internal policies and procedures, the identification of account holders, monitoring of transactions, record-keeping, as well as the detection and reporting of unusual and suspicious transactions. It also includes an assessment of the training and awareness programmes for employees, an internal audit of the anti-money laundering initiatives as well as the roles and responsibilities of the anti-money laundering compliance officer. These anti-money laundering infrastructure and procedures enable financial institutions to be equipped to identify suspicious customers, report suspicious transactions to the FIU and assist the law enforcement authorities through providing an audit trail.

In ensuring the above tasks are effectively carried out, examiners who are specially trained in the area of anti-money laundering undertake the examinations of the anti-money laundering initiatives of the financial institutions. The examinations on anti-money laundering activities are based on the international best practices as advocated by international bodies such as the Financial Action Task Force (FATF) and the Basel Committee on Banking Supervision.

During the year 2002, 20 examinations on anti-money laundering were conducted on the financial institutions and their branches by Bank Negara Malaysia. The anti-money laundering issues identified during these examinations have been raised with the managements of the respective institutions and actions have been taken by these institutions to rectify the shortcomings.

Moving forward, the supervisory process will be further enhanced in the coming year with the development of a comprehensive anti-money laundering supervisory framework. This framework will also be complemented with enhanced supervisory skills of the examiners on supervisory techniques and methodologies to assess the effectiveness of anti-money laundering initiatives at the financial institutions as well as keep abreast with the global developments in the area of money laundering and terrorist financing.