4 The Financial Sector

Sources and Uses of Funds of the Financial System

The improved economic activity in 1999 was reflected in the total assets of the financial system which rose by 6.9% to RM1,171 billion at the end of 1999 (a decline of 1.7% in 1998). This was attributable to the increase in the assets of both the non-bank financial intermediaries (NBFIs) (11.6%) and the banking system (4.8%). The banking system recorded a significant turnaround in the growth of its assets, compared with a decline of RM45.3 billion or 5.6% in 1998. Nevertheless, given the increased pace of growth of the assets of the NBFIs, the banking system's share of the financial system assets declined marginally from 70% at the end of 1998 to 68.6% at the end of 1999. Within the banking system, the assets of the commercial banks (including Islamic banks) registered an increase of 5.2% compared with a decline of 5.4% in 1998, reflecting mainly the increase in deposit placements with other domestic financial institutions. The total assets of the finance companies declined further but at a moderate rate, reflecting the more favourable economic environment. The decline in assets of the finance companies reflected the constraint in their lending activities arising from the merger and other restructuring exercises undertaken in the industry, as well as the absorption of eight finance companies by the parent commercial banks.

Table 4.1
Assets of the Financial System

	Annual change		As at end-1999*p*	
	1998	1999*p*		
	RM billion			% share
Banking system	**145.3**	**37.2**	**803.9**	**68.6**
Bank Negara Malaysia	15.8	22.3	147.0	12.6
Commercial banks[1]	–26.3	24.0	483.2	41.3
Finance companies	–28.8	–7.7	115.9	9.9
Merchant banks	–5.1	0.0	39.2	3.3
Discount houses	–1.0	–1.4	18.6	1.6
Non-bank financial intermediaries	**26.5**	**38.1**	**367.1**	**31.4**
Provident, pension and insurance funds	24.0	30.0	243.6	20.8
Employees Provident Fund	*16.2*	*20.0*	*168.6*	*14.4*
Other provident & pension funds	*3.4*	*3.5*	*28.5*	*2.4*
Life insurance funds	*3.1*	*5.5*	*32.3*	*2.8*
General insurance funds	*1.4*	*1.0*	*14.2*	*1.2*
Development finance institutions[2]	4.4	2.6	22.4	1.9
Savings institutions[3]	–0.3	1.8	20.9	1.8
Other financial intermediaries[4]	–1.7	3.7	80.3	6.9
Total	**-18.8**	**75.2**	**1,171.0**	**100.0**

[1] Includes Bank Islam Malaysia Berhad and Bank Muamalat Malaysia Berhad (since 1999).
[2] Includes Malaysian Industrial Development Finance Berhad,Bank Pertanian Malaysia, Borneo Development Corporation, Sabah Development Bank Berhad, Sabah Credit Corporation, Export - Import Bank Malaysia Berhad, Bank Pembangunan dan Infrastruktur Malaysia Berhad and Bank Industri Malaysia Berhad (Renamed "Bank Industri dan Teknologi Malaysia Berhad" as of 28 February 2000).
[3] Includes National Savings Bank, Bank Kerjasama Rakyat and co-operative societies.
[4] Includes unit trusts (ASN, ASB, ASW 2020 and ASM Mara), building societies, Pilgrims Fund Board, Credit Guarantee Corporation, Cagamas Berhad, leasing companies, factoring companies and venture capital companies.
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For the NBFIs, total assets rose faster by 11.6% in 1999, compared with a growth of 8.8% in 1998. Consequently, their share of total financial system assets increased further from 30% at the end of 1998 to 31.4% at the end of 1999. The higher growth was principally supported by strong expansion in the assets of the provident, pension and insurance funds (14%), which accounted for 78.7% of the increase in the total assets of the NBFIs. Total assets of the development finance institutions also continued to grow, albeit at a slower rate of 13.2% (28.8% in 1998). The growth was due mainly to the increase in loans extended by Bank Pembangunan dan Infrastruktur Malaysia Berhad, following the large increase in its paid-up capital to RM1 billion to enable the bank to undertake financing of infrastructure projects.

Concomitant with the improved economic activity, large trade surplus, and general rise in income and business profits during the year, deposits mobilised by the financial institutions recorded a stronger increase of 10.9% in 1999 (2.2% in 1998). As a result, deposits continued to be the main source of funds for the financial system, accounting for 47.9% of total sources of funds at the end of 1999 (46.1% in 1998). The

Table 4.2
Sources and Uses of Funds of the Financial System

	Annual change 1998	Annual change 1999*p*	As at end-1999*p*	
	RM billion			% share
Sources:				
Capital and reserves	–3.0	6.3	109.6	9.4
Currency	–4.0	9.9	30.5	2.6
Deposits[1]	10.7	55.3	560.6	47.9
Borrowings	–24.0	–0.2	8.5	0.7
Funds from other financial institutions[1]	–83.5	1.6	72.7	6.2
Insurance and provident funds	19.3	25.3	213.0	18.2
Other liabilities	65.9	–23.1	176.1	15.0
Total	**-18.8**	**75.2**	**1,171.0**	**100.0**
Uses:				
Currency	–0.8	4.6	7.9	0.7
Deposits with other financial institutions	–67.2	28.8	180.6	15.4
Bills	–11.1	6.1	16.4	1.4
Treasury	*–0.1*	*–0.1*	*3.7*	*0.3*
Commercial	*–10.9*	*6.2*	*12.8*	*1.1*
Loans and advances	–1.3	–12.5	471.9	40.3
Securities	17.5	14.9	239.5	20.5
Malaysian Government	*5.5*	*3.6*	*75.1*	*6.4*
Foreign	*0.0*	*0.3*	*1.5*	*0.1*
Corporate	*12.8*	*11.7*	*156.8*	*13.4*
Others	*–0.7*	*–0.7*	*6.1*	*0.5*
Gold and foreign exchange reserves	39.2	17.5	113.8	9.7
Other assets	4.8	15.8	140.9	12.0

[1] Effective 1998, the statutory reserves of banking institutions have been reclassified as "Funds from other financial institutions" rather than "Deposits". In this regard, data from prior years have also been revised accordingly.
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banking institutions (comprising commercial banks, finance companies, merchant banks and discount houses) accounted for 83.1% of total deposits mobilised by the financial system (86% in 1998). Among the banking institutions, the significant growth of deposits placed with the commercial banks more than offset the decline in deposits mobilised by the finance companies and merchant banks.

The non-financial private sector (comprising individuals and business enterprises) accounted for the bulk (62.6%) of the outstanding deposits with the financial institutions. The faster growth in deposits of this group with the financial system (5.4%, compared with 3.7% in 1998) reflected improved incomes as economic expansion and stock market activities gathered momentum in 1999. Fixed deposits continued to account for the bulk of deposits placed by the non-financial private sector, accounting for 95.1% of the increase in total deposits of the sector (118.4% in 1998). By maturity, fixed deposits continued to be concentrated in shorter-end maturities. At the same time, both demand and savings deposits also registered significant increases of 28% and 20.8% respectively.

Contractual savings with provident funds and contributions to insurance funds remained as major sources of funds for the financial system, expanding by 13.5% (11.4% in 1998), to account for 18.2% of the outstanding total funds of the financial system. With the exception of borrowings and other liabilities, other sources of funds also registered increases. Capital and reserves of the financial system increased by 6.1% (–2.9% in 1998), consonant with healthier business profits and gains from investments in the stock market recorded during the year. Funds obtained from other financial institutions registered a small increase in 1999, compared with a large reduction in 1998 which was due to the reduction in the statutory reserve requirement from 13.5% to 4%.

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

	Annual change 1998	Annual change 1999*p*	As at end-1999*p*	
	RM billion			% share
Deposits[3] with:				
Commercial banks	5.0	21.5	250.1	71.2
Finance companies	4.0	–7.3	59.0	16.8
Merchant banks	–0.5	–0.4	10.9	3.1
Discount houses	0.0	0.2	3.9	1.1
National Savings Bank	0.6	0.9	8.0	2.3
Others	2.7	3.1	19.1	5.4
Total	**11.9**	**18.0**	**351.1**	**100.0**
Demand deposits	–5.2	9.0	41.2	11.7
Fixed deposits	14.0	17.1	239.1	68.1
Savings deposits	2.3	9.0	52.5	14.9
NIDs[4]	0.1	–15.5	2.9	0.8
Repos[5]	0.6	–1.6	15.5	4.4
Fixed deposits				
Of which:				
Up to 1 year	19.6	18.9	220.8	62.9
More than 1 year	–5.5	–1.7	18.2	5.2

[1] Refers to deposits of business enterprises (excluding NFPEs) and individuals.
[2] Excludes provident, pension and insurance funds, and other financial intermediaries.
[3] Refers to demand, savings and fixed deposits, negotiable instruments of deposit and repos.
[4] Refers to negotiable instruments of deposit.
[5] Refers to repurchase agreements.
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Table 4.4
Direction of Credit[1] to Non-Financial Private Sector

	Annual change		As at end-1999*p*	
	1998	1999*p*		
	RM billion			% share
Loans and advances	–12.3	–8.0	438.9	73.7
Agriculture	*0.1*	*1.2*	*10.2*	*1.7*
Mining & quarrying	*0.4*	*–0.3*	*1.4*	*0.2*
Manufacturing	*–0.7*	*–1.5*	*56.0*	*9.4*
Housing	*6.2*	*5.7*	*71.1*	*11.9*
Construction[2]	*1.0*	*–7.3*	*85.5*	*14.4*
Business services	*0.3*	*10.9*	*20.8*	*3.5*
General commerce	*–15.5*	*0.2*	*17.7*	*3.0*
Transport & storage	*1.8*	*0.2*	*14.2*	*2.4*
Purchase of shares	*–7.2*	*–5.3*	*23.2*	*3.9*
Consumption credit	*–5.5*	*–0.5*	*50.7*	*8.5*
Others	*6.8*	*–11.3*	*88.1*	*14.8*
Investment in corporate securities	12.8	11.7	156.8	26.3
Total	**0.5**	**3.7**	**595.7**	**100.0**

[1] Excludes credit to non-financial public enterprises.
[2] Includes loans for real estate.
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Total loans and advances extended by the financial system contracted by RM12.5 billion (–RM1.3 billion in 1998). However, including loans sold to Danaharta and Cagamas during the year, total loans and advances outstanding would register an increase of RM5.2 billion in 1999. Loans and advances (excluding loans sold to Cagamas and Danaharta) extended to the non-financial private sector registered a smaller decline of RM8 billion, compared with a decline of RM12.3 billion in 1998. Large declines were recorded for loans and advances extended for the purchase of shares (–18.7%) and to the construction sector (–7.9%). Meanwhile, loans and advances extended to the agriculture sector increased by 13.5% (0.7% in 1998).

On the other hand, investment in corporate securities by the financial system continued to register a significant increase of 8.1% (9.7% in 1998). In particular, there were marked increases in investment in corporate securities by the Employees Provident Fund (RM8.9 billion), life and general insurance funds (RM5.2 billion) and unit trust funds (RM5.1 billion). The continued strong growth was in line with the improved stock market performance during the year. Deposits placed with other financial institutions increased by 18.9%, reflecting mainly the increase in placements of deposits by the banking system with BNM. Meanwhile, gross holdings of gold and foreign exchange reserves of BNM increased significantly by RM17.5 billion to RM113.8 billion, reflecting mainly Malaysia's sustained large current account surplus in the balance of payments in 1999.

Management of the Banking System

The year 1999 was clearly a year of recovery and consolidation for the banking system. This was evidenced by the marked improvement in the performance of the banking sector which registered preliminary unaudited pre-tax profit of RM5.3 billion for the calendar year 1999 compared with a pre-tax loss of RM5.7 billion in the previous year. At the same time, further industry consolidation through the merger process took place, resolving some of the problems associated with smaller and weaker banking institutions which became apparent during the financial crisis. The thrust of banking policies during the year aimed at further enhancing the financial intermediation activities of the banking institutions to provide the required financing to support economic recovery. A number of measures were also implemented to address structural imbalances in the banking system and to lay the foundation for a more resilient, efficient and competitive banking system that would also contribute towards macroeconomic stability.

A strong, efficient and stable banking system is a prime pre-requisite for a sustainable economic recovery, since only a viable and resilient banking system can allocate and mobilise domestic resources efficiently and effectively within the economy. Any disruption to the functioning of the intermediation process would adversely negate the economic recovery process. Against this backdrop, a comprehensive restructuring plan was implemented during the second half of 1998, as described in the 1998 Annual Report, to address weaknesses emanating from high incidence of non-performing loans (NPLs), capital deficiencies in the banking system as well as the distressed corporate sector. Taking advantage of the period of stability in the domestic environment following the imposition of the selective exchange controls in September 1998, the restructuring efforts were accelerated to address weaknesses within the banking sector. At the same time, reductions in interest rates to support recovery also eased the burden of high corporate debts which facilitated the restructuring process in both the corporate and banking sectors.

The banking system as a whole remained relatively resilient throughout the last two years given the strong conditions prior to the crisis. Nonetheless, given the magnitude of its impact, some banking institutions suffered substantial losses arising primarily from high levels of NPLs which rapidly eroded their capital. In order to prevent further deterioration in the financial health of these banking institutions, BNM assumed control over the operations of four banking institutions, namely Kewangan Bersatu Berhad, MBf Finance Berhad, Sabah Finance Berhad and Sime Merchant Bankers Berhad. The move also aimed to pre-emptively contain any possibility of a systemic failure in the system. With the exception of MBf Finance Berhad, the control over the operations and management of the three ailing banking institutions still remain under BNM. The three banking institutions have also been restricted from engaging in new lending activities so as to preserve their balance sheets and various schemes have been worked out to address problems relating to these institutions. As part of the rescue operations, Kewangan Bersatu Berhad and Sabah Finance Berhad will be absorbed by Mayban Finance Berhad and Multi-Purpose Bank Berhad respectively. The purchase of assets and assumption of liabilities of these weak institutions by stronger entities will ensure that the operations and services of the former will not be disrupted. Meanwhile, resolution of Sime Merchant Bankers Berhad was achieved via an open tender exercise conducted towards end-1998. The weak capital position of MBf Finance Berhad was resolved through capital injection amounting to RM2.3 billion in the form of tier-1 capital by Danamodal Nasional Berhad (Danamodal). Danamodal has also appointed its nominees to oversee its investment as well as to enhance the effectiveness of the Board and management of MBf Finance Berhad.

In addition, two of the larger domestic commercial banks, namely Bank Bumiputra Malaysia Berhad and Sime Bank Berhad, also incurred large losses as a result of substantial provisions arising from high NPLs. Given the size and the potential impact of these institutions on the overall system stability and depositors' confidence, these two institutions were merged with stronger commercial banks. Bank Bumiputra Malaysia Berhad was absorbed by Bank of Commerce (M) Berhad and Sime Bank Berhad was taken over by RHB Bank Berhad. To ensure that the mergers would not weaken the strength of the acquiring banks, the distressed assets of the weaker institutions were removed to subsidiaries of Pengurusan Danaharta Nasional Berhad (Danaharta) that were specifically set up to manage the distressed assets of these banks prior to the merger and for a subsequent period which ranging from 12 to 18 months from the date of their mergers. The two mergers involving Sime Bank Berhad and Bank Bumiputra Malaysia Berhad were successfully completed on 30 June 1999 and 30 September 1999 respectively.

Following the accelerated implementation of the restructuring plan, together with lower interest rates and improved liquidity conditions, the strains on the banking sector began to subside. The removal of NPLs by Danaharta and recapitalisation by Danamodal placed the banking sector in a better position to undertake the intermediation function more effectively. Furthermore, the success of Danaharta and Danamodal in achieving their targets six months ahead of schedule has enabled the banking sector to play its rightful role in supporting economic activities.

The ample liquidity in the banking system and low interest rates means that borrowers have greater and easier access to financing and are less burdened by high debt servicing cost. Nevertheless, as in any economy recovering from a recession, demand for large-scale and capital investment-related financing has been slow as several industries were experiencing excess capacity. Until the economy is operating close to its full capacity, most of the financing needs during this period are focused on working capital requirements, leaving a large proportion of approved and committed facilities largely unutilised. The rate of loan repayments has also been high as businesses optimise their resources by utilising surplus cash to ease their dependence on bank borrowings and reduce their leverage. The high rate of loan repayments in turn reflects the higher turnover in economic activities which have increased the capacity of borrowers to repay their loans. Such repayment in itself while benefiting businesses in reducing their leverage, was also instrumental in enhancing the stability of the banking sector as it improved the quality of assets of banking institutions, thus resulting in healthier balance sheets.

On the prudential front, BNM recognised that injection of capital funded by short-term borrowings would result in a high incidence of double leveraging in the banking system which could increase the vulnerability of the banking system. The mismatch between long-term capital investments and short-term funding may exert undue pressure on the banking institutions to generate the necessary returns in the short run to enable the shareholders to service their debts at the expense of long term risks. To contain such imprudent practices, BNM now requires that any new capital injection by shareholders of banking institutions must be funded through non-debt sources or very long-term debt instruments. Banking institutions are also no longer allowed to lend to their shareholders with controlling and/or influential interest to minimise occurrence of connected lending within the banking institution.

This new measure effectively complements the existing rules of prohibiting banking institutions from lending to their directors and officers. This prohibition is aimed at curtailing any potential misuse and irregular practices by the shareholders, being owners of the institutions themselves in steering credit decisions related to themselves or parties related to them.

The crisis has also highlighted the weaknesses in the management of some banking institutions. Given the nature of banking operations in assuming and managing risks, the strength and effectiveness of its management would undoubtedly affect the strength of the banking institution itself. Indeed, the first line of defence against unsound banking institutions is competent banking management. Thus, to ensure that the banking institutions continue to be managed by competent management, equipped with a high degree of integrity and professionalism, the suitability of the chief executive officers and directors of banking institutions will now be reviewed once every two years.

During the recent financial crisis, it was evident that a fragmented banking sector is highly vulnerable to shocks and can pose systemic risks to the banking sector. Growing competition and strong pressures emerging from the external front to further liberalise the banking sector has also clearly shown that the domestic banking sector can no longer remain protected. The financial liberalisation envisaged under the ASEAN Framework Agreement on Services and the General Agreement on Trade in Service, to gradually remove barriers to entry and access among the ASEAN countries and among the WTO (World Trade Organisation) Members, has highlighted the crucial need for the domestic banking sector to gear itself and be able to meet the challenges and competition arising from increasing globalisation and technological advancements. Furthermore, in the global market, rapid consolidation of banking institutions is now taking place to take advantage of economies of scale and tap potential synergies.

The banking crisis in the mid-1980s had clearly highlighted the vulnerabilities of the weaker banking institutions which were not adequately capitalised to withstand shocks. Against this backdrop, BNM has always recognised the importance of and the need for consolidation in the banking sector in order to attain the critical mass to meet the demands of the changing domestic economic structure, future challenges from globalisation and liberalisation as well as to contribute towards sustainable economic growth. During the economic boom in the late 1980s and early 1990s, calls for rationalisation and consolidation were often ignored. The buoyant economic growth during that period has led to significant improvements in the performance of the banking system. While some were simply satisfied with the returns earned on their investments and did not realise the urgency for further strengthening and consolidation, others had resorted to short-term funding for their capital expansion. Voluntary mergers were not forthcoming. Since the mid-80s crisis, only two market-oriented mergers were successfully implemented, between Kwong Yik Bank Berhad and DCB Bank Berhad and between Chung Khiaw Bank (Malaysia) Berhad and United Overseas Bank (Malaysia) Berhad.

The sooner the domestic banking sector in Malaysia undergoes a consolidation and rationalisation exercise, the more well-placed will the domestic banking sector be to meet future challenges. In this regard, the merger programme for the finance company industry initiated in 1998 was extended to the domestic banking sector as a whole in 1999. Specifically, all domestic banking institutions were given the flexibility to form their own merger groups and choose their own leader in each group to lead the merger process and revert to BNM by end-January 2000. In response to this approach, approval was granted for the formation of 10 banking groups to be led by Malayan Banking Berhad, RHB Bank Berhad, Public Bank Berhad, Bumiputra-Commerce Bank Berhad, Multi-Purpose Bank Berhad, Hong Leong Bank Berhad, Perwira Affin Bank Berhad, Arab-Malaysian Bank Berhad, Southern Bank Berhad and EON Bank Berhad, each with minimum shareholders' funds of RM2 billion and asset base of at least RM25 billion. With the formation of these 10 banking groups, the number of domestic banking institutions would be reduced substantially from the current 54 to 29 banking institutions. The consolidation exercise would enable the banking groups to reap maximum synergy and enhance their profitability and efficiency. To ensure that the industry consolidation exercise is not delayed, BNM has set the target date of end-December 2000 for the completion of the entire consolidation exercise.

Prudential regulation of banking institutions is necessary as these institutions serve as the intermediaries for the productive mobilisation and distribution of capital within the economy and the prime channels of monetary policy. In order to maintain the safety and soundness of the financial system as well as the position of the banking system to thrive within a dynamic and competitive environment, prudential regulations will continue to be emphasised. In this regard, additional prudential regulations will be introduced in the near future. These include measures to inculcate sound and effective credit risk management, refining the existing risk-based capital adequacy framework, developing a system of prompt corrective measures as well as limiting the Government's financial safety net so that it will not contribute to excessive risk-taking and not undermine market discipline.

The recent experience showed that there is a tendency for bankers as well as corporate players to forget the lessons learned from the crisis in the mid-1980s. Despite the costly experience in the previous recession stemming from imprudent and excessive exposures to the property sector, similar over-concentration was also observed during the recent crisis. In the pursuit of high returns in the property market, substantial amount of resources was channeled to finance various real estate activities. Such decisions were often induced by the wrong assumption that collateral value alone is sufficient to demonstrate creditworthiness and repayment capacity of the borrowers. This imprudent lending practice, on the part of the banking institutions, and the over-optimistic expectations of the property developer, had contributed to a large overhang in certain segments of the property market, in particular, the high-end residential properties and shophouses as well as commercial properties. Therefore, to contain further accumulation in the supply of high-end residential and commercial properties and to clear the abundant stock of unsold properties created by the recession, financing restriction was imposed on the provision of bridging finance for the development of residential properties and shophouses valued in excess of RM250,000 per unit as well as commercial properties. This prohibition is aimed at preventing further downward adjustments in the different segments of the property market. At the same time, two home ownership campaigns were organised during the year at the national level to reduce the overhang of properties in the market. The two campaigns were extremely successful with a total of RM6.4 billion worth of properties sold during the campaign periods. The lending restriction to the high-end property market is also expected to free up resources to other sectors of the economy, including for the development of affordable residential properties where demand has remained high even during the crisis. Moving forward, it is imperative for the banking institutions to remember that property booms are often fueled by the easy and excessive credit and oversupply can result. Given the long cycles in property prices, the challenge is to ensure that the next generation of credit officers and managers do not repeat the same mistake in the future. In this regard, BNM has issued a consultative paper to the banking industry on "Minimum Standards on Credit Risk Management" in November 1999, which outlines the minimum principles which banking institutions should observe in their credit operations. These minimum standards aim to develop and enhance credit risk management standards in the banking sector.

The crisis has also highlighted the losses suffered by the banking institutions due to weak internal and risk management controls. The mismatch between the risk profile of a banking institution's portfolio vis-à-vis the minimum capital requirement led to an overstatement of the banking institution's capability in absorbing potential shocks. Generally, these banking institutions would also be the ones experiencing higher levels of NPLs and capital deficiencies. Such observation also highlighted the deficiencies of the present capital adequacy framework which classifies the assets of banking institutions into five broad risk weight categories, without taking into consideration the risk profile of the loan exposures and the inherent strength or weakness of the banking institutions in managing credit risk. Preliminary studies are currently being conducted to refine the capital adequacy framework to reflect capital charges which commensurate with the risk profile and strength of risk management of banking institutions.

The setting up of Danamodal to address the recapitalisation of weak banking institutions during the crisis has also shown that timely supervisory intervention is critical to minimise capital erosion and subsequent potential financial costs to the Government. On a larger scale, it would also ward off the contagion effect of a bank-specific crisis from becoming endemic, which would have adversely affected the stability of the banking system as a whole. In this regard, a system of prompt corrective measures is being developed and would be introduced to act as a first line of action against banking institutions which are found to be operating in a manner that would potentially threaten their future solvency. The measures would comprise a set of actions that would automatically be instituted if certain transparent prudential indicators as specified by BNM were triggered. This would ensure that capital can be conserved and that further build-up of risks in an ailing or potentially ailing institution can be avoided. While this is not a pre-emptive measure to prevent an institution from failing, it would certainly act as a damage control instrument to minimise capital erosion by allowing BNM to undertake the necessary course of action to contain and rectify the problems.

The concept of disassociating non-supervised entities from banking groups would be introduced primarily to ensure that the obligation of the Government in assuring the safety of deposits would not be extended to other non-supervised institutions of a financial group. In the past, instances have emerged in which the failure of a non-bank entity had affected the confidence of the public in the banking entity within the same financial group. To minimise the occurrence of such events in the future, a bank holding company would have to be set up separately to hold only banking institutions and subsidiaries which are supervised by BNM and the Securities Commission. The harmonisation of holding companies that merely hold investments in supervised entities across all banking groups would also facilitate the implementation of prudential regulations on bank holding companies in the future.

As a developing nation, Malaysia requires a strong and efficient banking system that is resilient and capable of supporting the financing needs of the economy in its next phase of development so that the nation can continue to achieve a strong and sustainable growth in the future. The development of a resilient, efficient and competitive banking sector however, cannot be achieved within a short period of time. It requires considerable effort and commitment as well as a comprehensive set of policies which need to be nurtured and implemented over time. The merger and consolidation exercise is only one of the necessary pre-conditions to create strong, efficient and competitive domestic banking institutions and cannot on its own be expected to fully realise these objectives. This needs to be supplemented and complemented with other measures which would need to be introduced over the medium and longer-term.

In this regard, BNM has embarked on a comprehensive masterplan for the Malaysian financial system that focuses on building the foundation and charting the strategic direction of the banking sector for the next 10 years. The masterplan will provide a clear and common long-term vision for the development of a resilient, efficient and competitive banking sector which is able to operate effectively in an environment of emerging new technological advances and more sophisticated consumer demands. The objective of the masterplan is not only to ensure that the banking sector continues to be able to meet the needs of the changing domestic environment but also to play a catalytic role in the transformation of the economy. Within this broad objective, the main thrust will be to develop a core of strong and forward looking domestic banking institutions which will form an integral part of the Malaysian banking system. The masterplan will identify key issues for the Malaysian banking sector as well as formulate strategies and action plans that need to be pursued over the medium to long term to increase the resilience, competitiveness and dynamism of the banking institutions in the context of the impending challenges of a globalised and liberalised environment. In doing so, a more holistic assessment of the banking sector will be undertaken to ensure that reforms are co-ordinated and objective-oriented. The masterplan will also identify the optimal regulatory and supervisory framework to be adopted by BNM to achieve these objectives.

The years ahead will undoubtedly witness significant changes within the banking sector. A major pre-requisite to be able to adjust and adapt to this changing environment is the development of a sound and strong financial system and institutions. In this regard, BNM has and will continue to consciously develop a modern and sophisticated financial system which will effectively mobilise and allocate resources for productive use in tandem with the rapid transformation of the economy. For the banking institutions, in rising to this challenge, greater focus on improving efficiency and competitiveness needs to be accorded. The impetus to the improvements would rely on innovation, flexibility, skill enhancements, customer-orientation, product development and the need to pay close attention to the return on equity and consolidation of the banking sector. In this context, the importance of achieving critical size would assume greater significance in order for banking institutions to be able to reap the gains from economies of scale and reduce costs and excess capacity, as well as enable higher spending on information technology to remain efficient and competitive. Larger institutions that are well-capitalised and well-managed would be able to position themselves to meet the challenges of an increasingly liberalised operating environment and market driven approach that are unfolding across the globe. A core of strong, efficient, resilient and competitive banking institutions would not only be able to withstand future shocks, thereby minimising the adverse implications on macroeconomic stability, but would also enhance the payments system infrastructure and market surveillance mechanism to monitor capital flows and other sources of risk in the banking system and the economy as a whole. The merger programme is an important step towards accomplishing this objective.

Banking Measures in 1999

Abolishment of the Two-Tier Regulatory System (TTRS): The Two-Tier Regulatory System (TTRS) for banking institutions was abolished on 10 April 1999. As a result, incentives that were previously accorded to Tier-I banking institutions were made available to all institutions, subject to the approval of BNM. The blanket approval previously granted to all Tier-I domestic banks to open new branch offices was withdrawn.

The TTRS, with its emphasis on absolute capital size as one of the pre-requisites for the attainment of Tier-I status, led banking institutions to embark on over-zealous capital expansion program funded by shareholders' borrowings. As a result, significant pressures were exerted on the management of these banking institutions to aggressively increase their loan portfolio in order to generate the requisite returns to meet debt servicing obligations of their shareholders. This, in turn, contributed to poor credit decisions in a number of banking institutions which subsequently affected their asset quality, particularly during the economic downturn.

Approval for Increases in Capital Funds: Arising from lessons learnt under the TTRS, BNM, with effect from 14 April 1999, requires future capitalisation of banking institutions by controlling shareholders to come from non-obligatory sources of financing such as equity, internally generated funds and very long-term debt (preferably by way of bond issue) of at least 10 years maturity. Banking institutions which seek BNM's approval to issue new capital (ordinary shares, preference shares, hybrid capital and subordinated term loans) will have to provide BNM a statement from their controlling shareholders participating in the capital injection on the degree of leverage they will incur in raising the funds to be injected into the banking institution.

Prohibition on Lending to Controlling and/or Influential Shareholders: With effect from 4 August 1999, BNM's guideline on 'Prohibition of loans to its directors, staff and their interested corporations' (BNM/GP6) was expanded to also prohibit the granting of credit facilities to shareholders with controlling and/or influential interest in the banking institution and to any related companies of the shareholder, any firm in which the shareholder has interest as a partner, manager, agent or guarantor and any person for whom the shareholder is a guarantor. Existing credit facilities granted to controlling/influential shareholders and their related parties would be allowed until their maturity or the next review date. An individual or legal entity shall be deemed to be a controlling shareholder of a banking institution if it fulfils either one of the following criteria:- a) controls more than 50% of the voting rights; b) holds more than 50% of the issued share capital; c) controls the composition of the board of directors; d) has the power to appoint or remove all or a majority of the directors; or e) controls the controlling shareholder of the banking institution. Influential interest is defined as:- a) if the person, together with other parties which he controls or acts in concert with, holds 20% or more interest in the voting rights of the banking institution; or b) if the person has the power to appoint at least one person to the board of directors.

Amendments to the New Liquidity Framework: On 30 September 1999, BNM extended the transitional period for banking institutions to cross over to the new liquidity framework by another year to 31 December 2000.

The extension of the transitional period is to accommodate the integration efforts of the merger programme among banking institutions.

Cagamas Berhad Bonds - Liquid Asset Status: With effect from 1 April 1999, holdings of bonds issued by Cagamas Berhad to finance the purchase of commercial and industrial property loans can be classified as liquid assets for purposes of meeting banking institutions' liquid asset ratio requirement under the old liquidity framework.

In 1997, Cagamas Berhad expanded its housing loan securitisation scheme to encompass commercial and industrial property loans. Unlike bonds issued to finance housing loans, bonds issued to finance the purchase of commercial and industrial property loans initially did not qualify as liquid assets. This had led to a disparity in pricing among bonds issued by Cagamas Berhad. As at 31 December 1999, total outstanding bonds issued by Cagamas Berhad for this purpose amounted to RM699 million. To streamline incentives given to Cagamas for its loan securitisation activity and to remove the disparity in the pricing among Cagamas bonds, all bonds issued by Cagamas Berhad have been designated as liquid assets under the old liquidity framework.

Investment in "BB" Rated Private Debt Securities: With effect from 19 July 1999, banking institutions are allowed to invest and trade in corporate bonds rated "BB" and above. Previously, banking institutions were only allowed to hold bonds rated at least "BBB".

The economic downturn has caused the rating of a number of corporate bonds held by banking institutions to be downgraded to below BBB rating. Relaxation of the above requirement would allow banking institutions to continue holding these bonds which have been downgraded to BB, rather than to subject them to mandatory disposal when market sentiment on these bonds is already poor.

Disposal of Shares Acquired in Debt-Equity Conversion Scheme: With effect from 2 March 1999, pursuant to section 66(3) of the Banking and Financial Institutions Act 1989 (BAFIA), banking institutions may hold shares acquired from debt-equity conversion schemes for a period of up to five years from the date the shares are acquired. Previous guideline on debt-equity schemes required banking institutions to dispose the shares not later than six months after the published audited results of the investee company show an operational profit.

The restructuring exercise in the banking sector has resulted in banking institutions holding substantial amount of shares from debt-equity conversion schemes. The extension of the holding period to five years is to avoid unnecessary capital losses for the banking institutions which may be incurred if banking institutions are forced to pre-maturely sell the shares before allowing them to appreciate to their full potential value.

Accounting Treatment for Bonds Acquired Under Debt to Bond Conversion: On 19 July 1999, BNM had prescribed the accounting treatment to be adopted by banking institutions for debt restructuring schemes where book debts have been converted into bonds issued by the borrower. Bonds received are recognised at its fair value (i.e. present value) on inception. Where the fair value of the bonds is lower than the net book value of the original debt (the outstanding amount of the debt, net of specific provision and interest-in-suspense), the losses should be charged to the profit and loss account in the current accounting period. When the fair value is higher than the net book value, the gain should not be recognised as income, but transferred to the "Provision for diminution in value" account and netted off from "Investment/Dealing securities" account in the balance sheet. The unrealised gain can only be recognised as income upon disposal or redemption of the bonds by the issuer. Where unconditional forgiveness of debt is involved in the restructuring scheme, the amount forgiven should be written off from the loan outstanding.

In line with the existing treatment on private debt securities(PDS), bonds treated as investment securities will be stated at cost less provision for any permanent diminution in value. Only bonds that are either guaranteed by the Government or by other banking institutions or bonds that have been otherwise permitted by BNM, may be stated at cost adjusted for amortisation of premium or accretion of discount. Bonds treated as dealing securities will be stated at the lower of cost and market value.

In view of the numerous debt restructuring schemes participated by banking institutions as a result of the economic downturn, the accounting treatment has been recommended in order to bring consistency in treatment and encourage the prudent recognition of income.

Extension of Permissible Activity for Finance Companies and Discount Houses to Facilitate Corporate Debt Restructuring Schemes: With effect from 1 March 1999, finance companies are permitted to hold unsecured debt securities issued by the borrower pursuant to a debt restructuring exercise with respect to the portion of debt for which the finance companies have been lenders. This permissible investment has been gazetted under the Banking and Financial Institutions (Credit Facility Without Security) (Licensed Finance Company) Order 1999 pursuant to Section 60(2) of the BAFIA.

With effect from 22 October 1999, discount houses are allowed to invest in equity-linked debt securities, whether redeemable or irredeemable, with remaining maturity of more than 10 years that are issued pursuant to a debt restructuring scheme. The exercise is subject to the condition that if any such investments are convertible into shares, the discount houses must dispose them before conversion date; or redeem for cash on maturity; or line up buyers prior to conversion date so as to dispose of the shares obtained from the conversion on conversion date. This additional permissible investment has been gazetted under the Banking and Financial Institutions (Investment Business of Discount Houses) Order 1999.

Companies undertaking corporate debt restructuring schemes normally offer a combination of debt and equity instruments. Nevertheless, the schemes cannot be implemented without the consent of the majority of creditors, especially if finance companies and discount houses are also involved as lenders. This relaxation will provide the finance companies and discount houses greater operational flexibility to participate in debt restructuring schemes to enhance recoverability of distressed debts.

Progress of Banking Sector Restructuring

As at 31 December 1999, Danaharta acquired and is managing NPLs with loan rights amounting to RM45.5 billion from the financial system, of which RM35.7 billion was the loan rights acquired from the banking system. The book value of the loans removed from the banking system amounted to RM34 billion, representing approximately 42% of NPLs in the banking system. The removal of these NPLs from the banking sector has reduced the residual NPL level to 6.6% (based on 6-month classification) as at end-December 1999, from the peak of 9% (based on 6-month classification) as at end-November 1998. The overall weighted average discount rate for the acquired NPLs was about 56%. A total of RM10.3 billion nominal value zero-coupon bonds have been issued up to end-December 1999 as consideration for the loan acquisitions. This is considerably lower than the total financing requirement of RM15 billion budgeted earlier. Danaharta has also embarked on the secondary carve out of NPLs in October 1999. With the bulk of the NPLs successfully removed during the primary phase, the amount of NPLs to be acquired under the secondary phase is expected to be minimal. The secondary carve-out will focus on common borrowers whose other accounts are already in Danaharta's portfolio, loans of borrowers with a total gross value exceeding RM50 million, unsecured loans granted to public listed companies or loans from banking institutions with net NPL ratio in excess of 10%.

Danaharta has now entered into the loan and asset management stage. As at 31 December 1999, a total of RM17.6 billion of the loans and assets under its management has been restructured or disposed, with an average recovery rate of 80.2%. Danaharta has also conducted two successful restricted open tenders to dispose of foreign currency loans and papers in August 1999 and December 1999 involving 43 accounts worth US$394.25 million. Under the initial tender exercise, Danaharta achieved a recovery rate of 55.3% on 13 of the accounts, whilst a 71% recovery was achieved on 25 accounts in the second tender exercise. With these two tender exercises, Danaharta has successfully disposed of foreign currency assets with principal value of US$339.8 million.

On the asset management front, Danaharta has conducted its first open tender exercise involving foreclosed properties in December 1999. Out of the 44 properties opened for the tender with indicative value of RM122.6 million, 24 bids were successful raising total consideration of RM17.8 million. The amount received on the successful bids represented an 8% surplus over the indicative value of RM16.5

million. The remaining 20 properties with an indicative value of RM106.1 million were transferred to an asset subsidiary of Danaharta at the minimum bid price. This would allow Danaharta the opportunity to manage and enhance the value of the properties for future disposal.

In the case of recapitalisation exercise by Danamodal, total capital injection into the initial 10 banking institutions has declined to RM5.3 billion as at end-December 1999 following repayments by five banking institutions. The recapitalisation by Danamodal has helped to strengthen the RWCR position of these institutions from 9.9% as at end-September 1998 to 12.3% as at end-December 1999.

On the corporate debt restructuring exercise, Corporate Debt Restructuring Committee (CDRC), as at 29 February 2000, has successfully completed the restructuring of 19 cases with debts amounting to RM14.1 billion, whilst 10 cases have been referred to Danaharta. Reflecting the improved conditions of the corporate sector, there has not been many new applications submitted to CDRC since late 1999. CDRC expects to complete the debt restructuring of 26 cases involving debts amounting to RM16.4 billion currently outstanding by the third quarter of 2000. Apart from corporate restructuring, CDRC is also actively looking into the restructuring of the transportation, telecommunication and steel industries involving nine companies (of which four companies are currently under CDRC) to ensure that the restructured companies operating within the industry would become feasible and viable. The scope of the industry restructuring would differ depending on the nature and extent of structural inefficiencies within the industry.

Performance of the Banking System

Profitability

Two and a half years after the onset of the financial crisis which plagued the Asian region, the Malaysian banking system has turned around to record a pre-tax profit of RM5.3 billion for calendar year 1999, from a pre-tax loss of RM5.7 billion in 1998 (which was largely contributed by exceptionally large losses of three banking institutions). With the improvement in profitability, the banking system was again able to provide a positive return on assets of 0.8% and a return on equity of 11.5% for the year. Although still considerably lower than the levels enjoyed during the pre-crisis period, the encouraging improvement clearly indicates that the banking system is on the path towards recovery and has been able to do so within a respectably short period of time.

On a quarterly basis, the banking system continued to experience its fourth consecutive quarter of losses up to 31 March 1999. The losses recorded by the banking system in the first quarter of 1999, which was lower than the average quarterly loss recorded in the preceding three quarters, were due to exceptionally large losses recorded by one banking group as well as by two other commercial banks and one finance company. After experiencing a pre-tax loss totalling RM8.5 billion during the 12-month period ended 31 March 1999, the performance of the banking system began to take a turn for the better and it began generating profits beginning from the second quarter of 1999 in line with the turnaround in overall economic growth. The banking system rebounded strongly from the crisis to achieve an aggregate pre-tax profit of

Table 4.5
Banking System: Income and Expenditure

	For the calendar year			
	1998	1999*p*	Annual change	
	RM million			%
Interest income net of interest-in-suspense	60,749	38,653	–22,096	–36.4
(Interest-in-suspense)	*4,983*	*3,406*	*–1,577*	*–31.6*
Less: Interest expense	45,893	24,233	–21,660	–47.2
Net interest income	14,856	14,420	–436	–2.9
Add: Non-interest income	6,017	6,767	750	12.5
Less: Staff Cost	3,905	3,508	–397	–10.2
Overheads	5,304	4,870	–434	–8.2
Profit before provisions	11,664	12,809	1,145	9.8
Less: Loan loss provisions	17,396	7,543	–9,853	–56.6
Pre-tax profit	–5,732	5,266	10,998	
(excluding 3 institutions)[1]	-1,258	3,992	5,250	
Of which:				
Commercial banks	–2,687	6,428	9,115	
Finance companies	–2,388	–996	1,392	
Merchant banks	–657	–166	491	
Return on assets (%)	–0.9	0.8		
(excluding 3 institutions)[1]	*–0.2*	*0.7*		
Return on equity (%)	–12.3	11.5		
(excluding 3 institutions)[1]	*–2.8*	*9.0*		

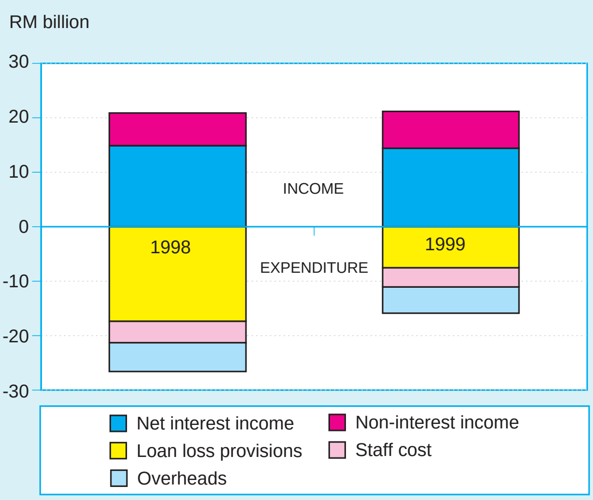
[1] Excluding three banking institutions that made exceptional loss in 1998.
p Preliminary

RM7.4 billion during the last three quarters of 1999. Generally, most banking institutions turned profitable again in the last three quarters of 1999, whilst those that were still incurring losses (15 banking institutions) were registering lower losses as compared with the preceding three quarters.

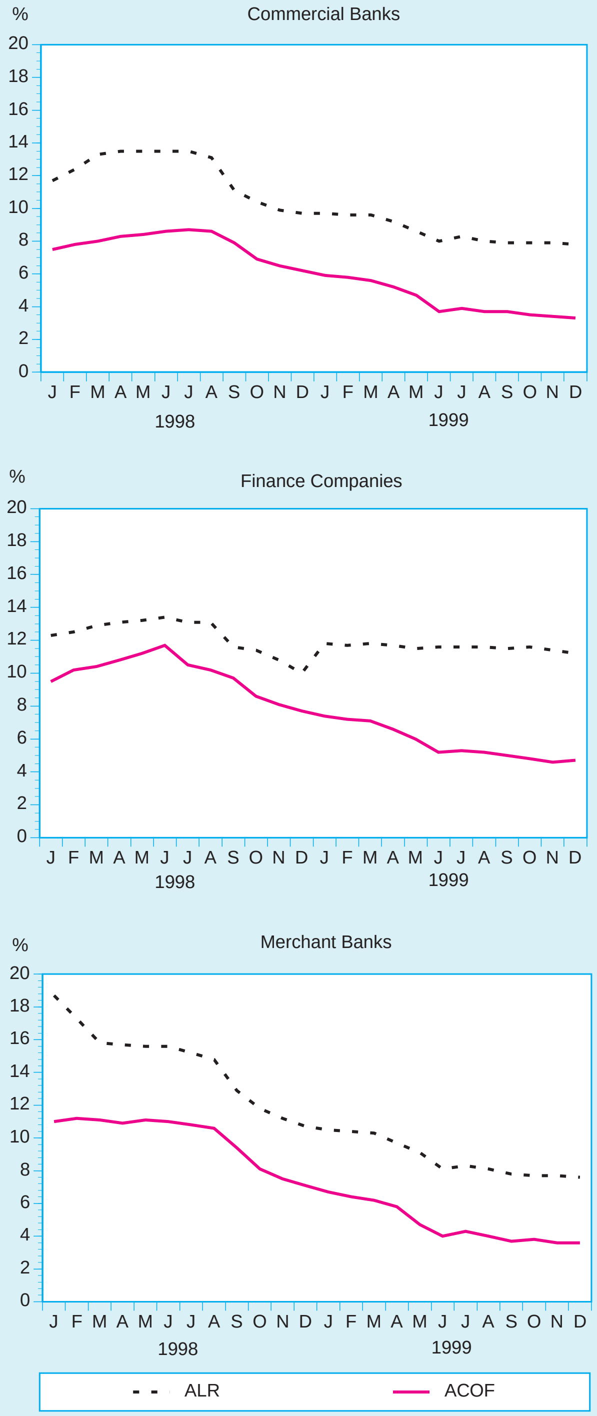
The higher profitability recorded in 1999 was largely due to significantly lower bad debt provisioning that had to be set aside against NPLs. During the year, the banking system charged RM7.5 billion for loan loss provisions, 56.6% less than the amount provided in the previous year (1998: RM17.4 billion). The lower loan loss provisioning for 1999 was as a result of lower additional specific provisions required for the year, as well as significant write-back of provisions already made previously. The improved profitability position of the banking system was attained even after charging RM399 million to their profit and loss account for losses incurred as a result of sale of loans to Danaharta, leaving a total of RM1.4 billion still to be amortised.

However, at the operating level, the banking system still recorded a decline in net interest income of RM436 million (–2.9%) although it was much lower than the decline of 11.1% recorded in 1998 as interest-in-suspense charged in 1999 dropped by 31.6%. Nevertheless, net interest income continued to decline in 1999, due to the negative growth in total outstanding loans (excluding loans sold to Danaharta) while the average net interest margin of the banking system for the year remained virtually unchanged at 3.7 percentage points.

Graph 4.1
Banking System: Profitability



Graph 4.2
Average Lending Rates and Average Cost of Funds



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

In reviewing the interest rate trends throughout 1998 and 1999, the banking system experienced a decline in net interest margin between June 1998 and March 1999 before it gradually widened from the second quarter of 1999 onwards. There was a rapid decline in deposit rates due to excess liquidity in the market coupled with lower lending rates which were brought down by a series of downward base lending rate adjustments, as a result of progressive reductions of the statutory reserve requirement and lowering of the intervention rate. The gross unadjusted interest rate margin (difference between average gross lending rates and average cost of funds) of the commercial banks declined to a low of 3.2 percentage points in September 1998 due to the locked-in deposit funds, before gradually improving to 4.5 percentage points in the final quarter of 1999 when interest rates level stabilised. The finance company industry, which suffered severe interest margin contraction throughout 1998 when deposit rates rose on the back of fixed rate loans, gained the most from the low interest rate environment when it saw tremendous improvement in net interest margin, from 2.1 percentage points in 1998 to 4.3 percentage points in 1999.

Table 4.6
Banking system: Loan Activity

	For the year		Annual growth
	1998	1999	
	RM million		%
Loan approvals	65,124	104,804	60.9
Loan disbursements	251,127	323,169	28.7
Loan repayments	270,546	335,587	24.0
	As at end-		Annual growth
	1998	1999	
	RM million		%
Adjusted total financing[1]	435,638	447,712	2.8

[1] Adjusted for loans sold to Danaharta, bad debts written off during the year, private debt securities held and loans converted into equity and other assets.

The non-interest income of the banking system increased by RM750 million or 12.5% in 1999. This was mainly due to gains from the sale of investment securities, as well as higher dividend income received from investment securities, in tandem with the general improvement in the stock market and better performance of the corporate sector. The improved pre-tax profit position of the banking system was also aided by lower staff cost incurred during the year (–10.2%) as a result of a 4.4% reduction in the number of employees in the banking sector, as well as a decline in overheads (–8.2%).

Loan Activity

Amidst an improving economic environment and greater economic activities, the banking system continued to play its intermediation function by providing financing to support the increased demand. New loans approved in the banking system increased by nearly two-fold in 1999 to RM104.8 billion, as compared to RM65.1 billion in 1998. Disbursements of approved credit facilities also improved by 28.7%, from RM251.1 billion in 1998 to RM323.2 billion in 1999. However, loan repayments increased by 24%, from RM270.5 billion in 1998 to RM335.6 billion in 1999. The encouraging rate of turnover of loans clearly reflected the improvement in the business environment brought about by a low interest rate environment, ample liquidity situation and rising investor's confidence, which translated into a strong GDP growth of 5.4% for the overall Malaysian economy in 1999.

For the year 1999, the banking system directed the largest proportion of new financing to the manufacturing sector and for the purchase of residential properties. Over 33% of new loans approved in the banking system were channelled to these two sectors. More importantly, loans approved for the purchase of residential properties costing RM250,000 and below accounted for about 74% of new loans approved for the purchase of residential properties. The finance, insurance and business services sector also benefited from the increase in loan approvals, accounting for over 10.1% of total new loans approved in 1999.

In terms of loan disbursements, the manufacturing sector alone accounted for 26.3% of total loans disbursed in 1999. The bulk of loans was also disbursed to the wholesale, retail, restaurants and hotels, and finance, insurance and business services sectors, totalling over 29.9% of loan disbursements in 1999. Although loans disbursed to the broad property sector accounted for 17.6% of total loan disbursements in 1999, 74.8% of these loans were channelled to the construction sector and financing for the purchase of residential properties.

Despite the strong improvement recorded in loan approvals and loan disbursements in 1999, this was not translated into a significant increase in the amount of total outstanding loans due to several developments, namely, the large amount of loans sold to Danaharta, bad debts written off during the year, and loans converted into private debt securities, equity and other assets. If these items were added back, including the banking institutions' holdings of private debt securities (PDS), the adjusted total financing provided by the banking system would have increased by 2.8% from 1998 to 1999. The strong increase in loan disbursements in 1999 was also offset by higher loan repayments which grew by 24% from 1998 to 1999.

During the financial crisis, a great deal of attention was focused on the growth in bank lending because of its importance in the economic recovery process. However, it needs to be recognised that the outstanding loan figures do not reflect the growth in new loans due to the various adjustments mentioned earlier, and that it would not be entirely appropriate to link directly the outstanding loans with the supply of funds into the economy.

Loan growth is a function of both the demand and supply of credit. The provision of credit by banking institutions should be measured against their willingness to provide new financing or allow further drawdown of existing approved credit facilities. Therefore, a more accurate barometer of banking institution's supply of credit to the economy should be the amount of new loans approved and disbursements of approved credit facilities. From the analysis of the credit performance in terms of loan approvals and loan disbursements, there was clearly no evidence of constraints on the supply of credit into the economy.

In terms of demand for credit, most businesses were hesitant to expand their operations especially during the early months of 1999 given the uncertainties in the outlook of the economy. With the existing excess capacity in the economy, most businesses scaled down their operations to meet the underlying demands. Therefore, many credit facilities were left unutilised, as indicated by the large amount of undrawn credit facilities in the banking system, totalling RM113.1 billion as at end-1999. It was also noted that most businesses chose to use their surplus cash reserves to repay their loans to reduce their leverage positions, as observed in the higher loan repayments recorded by banking institutions in 1999. With such high levels of repayments, the outstanding loans of several institutions registered a flat, marginal or even negative growth although financial resources were actually channelled to meet the increase in demand for financing.

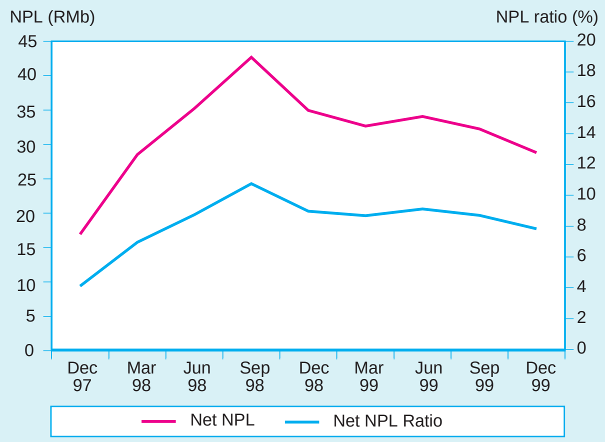
In summary, an increase in the turnover of loans is a better reflection and indication of economic activity, rather than outstanding loans. A higher rate of turnover in loans, measured by loan disbursements and loan repayments, can be expected to result in the generation of increased economic activities and overall GDP growth.

Asset Quality

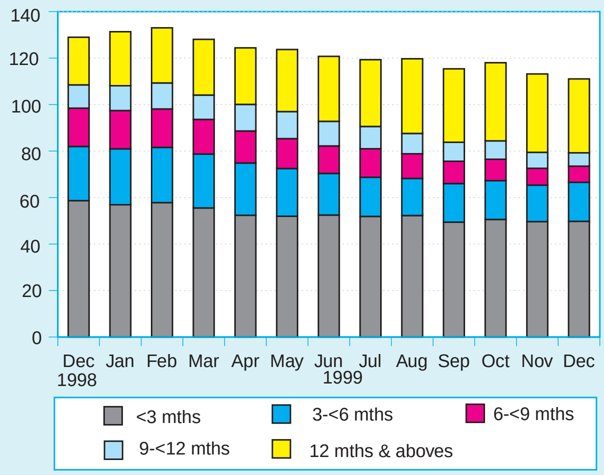
The asset quality of the banking system improved in 1999, after being adversely affected by the financial crisis the previous year. NPLs net of provisions of the banking system declined from 9% to 7.8% of total loans or from RM34.9 billion to RM29.7 billion. Net NPLs of the banking system for the year 1999 peaked in January and since July, have been trending downwards. Even if loans sold to Danaharta are added back, NPLs in the banking system have trended downwards since August 1999. The sale of NPLs to Danaharta had kept NPLs in the banking system at manageable levels and relieved the banking institutions from the burden of managing high levels of NPLs. Three significant sales to Danaharta were made in December 1998 (RM12.1 billion), March 1999 (RM7.8 billion) and December 1999 (RM4.4 billion). As at 31 December 1999, a total of RM34 billion NPLs had been sold to Danaharta, of which RM21 billion was sold in 1999.

Of the remaining loans outstanding with the banking institutions, the amount of loans which were in arrears had declined in 1999. Customers who were previously deferring the servicing of their loans as a result of high interest rates and lower economic activity, were able to service them again. Overall, total loans that were in arrears experienced a decreasing trend throughout the year in line with the stronger economic growth. Total loans that were in arrears for more than one month declined by RM17.9 billion or 13.9% in 1999. However, total loans which had been in arrears for a period of more than twelve months increased in 1999, in part due to the migration of doubtful or sub-standard

Graph 4.3
Banking System: Net Non-performing Loans



Graph 4.4
Banking System: Ageing Profile of Loans in Arrears (excludes loans sold to Danaharta)



loans as well as the longer time period needed to recover bad loans. Some of the loans in the more than 12 months category also consisted of loans which were undergoing restructuring under the CDRC. Around 8% or RM31.3 billion of total loans in the banking system have been restructured or rescheduled.

Both commercial banks and merchant banks experienced similar trends in the ageing profile of their loans as a result of loan concentration to similar sectors of the economy, namely the manufacturing, construction and financing, insurance and business services sectors. These sectors were adversely affected during the financial crisis and took a longer time to recover, the result of which was evident in the increase in NPLs in the construction and financing, insurance and business services sectors. Total loans in arrears of the finance companies reflected a different pattern as a more significant portion of their loans were directed mainly to the real estate sector and for the purchase of transport vehicles and securities. As the economy picked up towards the end of 1999, customers were able to service their loans for the purchase of transport vehicles while the bullish trend in the Kuala Lumpur Stock Exchange boosted the servicing of share financing loans. NPLs in the real estate sector also declined as a result of loans being sold to Danaharta. Hence, a much better turnaround was observed for finance companies.

Despite the decrease in NPLs, the loan loss provisions (interest-in-suspense, specific provisions and general provisions) of the banking system did not decline, but increased slightly from RM33.1 billion as at end-1998 to RM33.2 billion as at end-1999 due to increases in interest-in-suspense outstanding which was offset by similar declines in general provisions, and the excess general provisions being transferred to specific provisions. Interest-in-suspense outstanding increased by RM619.4 million in line with continued suspense of interest on the NPLs of the banking system. The increase in interest-in-suspense, however, was not as much as that in 1998 (RM12.2 billion), hence, banking institutions were still able to record an increase of RM5.3 billion in their pre-tax profit. The drop in general provisions by RM553.7 million was in line with the reduction in the loan base of the banking system which shrank by 5%. Specific provisions outstanding of the banking system remained relatively stable.

In terms of the performance of different banking institutions, both commercial and merchant banks were found to experience a slight decline in their specific provisions outstanding as a result of increases in their collateral value, which increased by RM3.2 billion and RM488.8 million respectively to RM33.2 billion and RM3.2 billion in 1999. However, the situation was reversed for the finance companies. Although NPLs had declined slightly, straight line amortisation policy on vehicle loans resulted in declining collateral values and hence, increased level of provisions. Collateral value of

Graph 4.5
Ageing Profile of Loans in Arrears: By Type of Institution

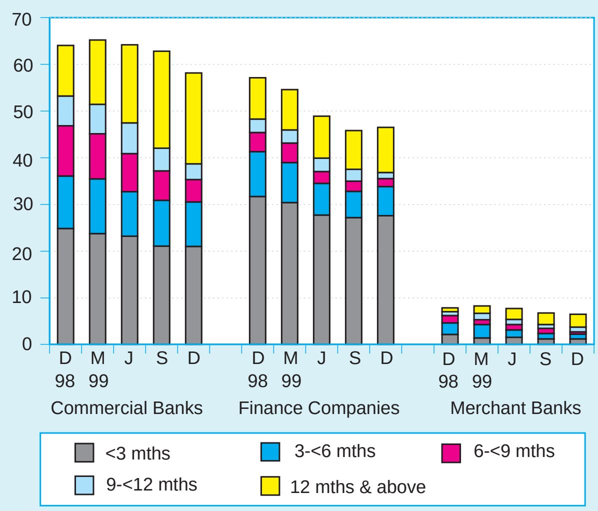


Table 4.7
Banking System: Non-performing Loans and Loan Loss Provisions

	As at end-			
	1998	1999		
	Actual[1]	Actual[1]	Classification	
			3-month	6-month
	RM million			
Commercial banks				
General provisions	6,540.4	6,376.3	6,419.5	5,033.8
Interest-in-suspense	4,081.9	4,845.4	4,934.7	4,397.2
Specific provisions	12,688.5	11,317.0	11,492.9	10,179.4
Non-performing loans	37,253.5	35,561.5	41,184.8	30,402.3
Net NPL ratio (%)[2]	*7.3*	*7.0*	*9.0*	*5.7*
Total provisions / NPL (%)	*62.6*	*63.4*	*55.5*	*64.5*
Finance companies				
General provisions	1,823.5	1,442.1	1,211.1	1,258.8
Interest-in-suspense	2,193.1	2,031.3	2,091.7	2,010.1
Specific provisions	3,606.5	5,187.5	4,893.7	5,194.3
Non-performing loans	17,901.3	14,415.2	19,073.4	13,570.6
Net NPL ratio (%)[2]	*14.0*	*9.8*	*16.4*	*8.6*
Total provisions / NPL (%)	*42.6*	*60.1*	*43.0*	*62.4*
Merchant banks				
General provisions	423.6	415.4	406.7	407.6
Interest-in-suspense	463.6	481.2	520.6	441.0
Specific provisions	1,320.9	1,083.6	997.6	879.9
Non-performing loans	4,122.1	3,764.5	5,582.7	3,487.5
Net NPL ratio (%)[2]	*11.5*	*12.7*	*23.4*	*12.3*
Total provisions / NPL (%)	*53.6*	*52.6*	*34.5*	*49.6*
Banking system				
General provisions	8,787.5	8,233.8	8,037.3	6,700.3
Interest-in-suspense	6,738.6	7,358.0	7,547.1	6,848.3
Specific provisions	17,615.9	17,588.1	17,384.2	16,253.5
Non-performing loans	59,276.9	53,741.2	65,840.9	47,460.3
Net NPL ratio (%)[2]	*9.0*	*7.8*	*11.1*	*6.6*
Total provisions / NPL (%)	*55.9*	*61.7*	*50.1*	*62.8*

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

NPLs of finance companies dropped by RM5.7 billion to RM14 billion in 1999.

The combined effect of decreasing NPLs and slight increase in loan loss provisions resulted in an increase in the loan loss coverage ratio of the banking system from 55.9% to 61.7% in 1999. Including the value of collateral, the total loan loss coverage of the banking system amounted to 155.2% of NPLs as at 31 December 1999.

Non-Performing Loans by Sector

In general, the level of NPLs associated with most economic sectors declined in 1999 due mainly to the sale of NPLs to Danaharta. Loans to the manufacturing and construction sectors and for share financing formed the most significant portion of loans acquired by Danaharta.

The level of NPLs for the purchase of securities in the banking system recorded a healthy decline of 35.8% in 1999, due mainly to sales to Danaharta. The gross NPL ratio for the purchase of securities fell from 23.2% as at end-1998 to 19.2% as at end-1999. Even if NPLs sold to Danaharta are added back, NPLs for the purchase of securities declined by 2.6% in absolute terms. Loans to this sector also shrank significantly not only due to recoveries but also due to lower utilisation of such facilities.

Given the high exposure of the banking system to the broad property sector, NPLs to this sector continued to account for the largest portion of total NPLs in the banking system. The construction sector accounted for 40.6% of total NPLs to the broad property sector. Of this, 39.6% was attributable to loans for the construction of commercial complexes and infrastructure projects. Nevertheless, sales to Danaharta contained the level of NPLs at manageable levels.

In line with the Government's call to promote house ownership, the banking system continued to channel a significant portion of total loans for the purchase of residential properties. During 1999, loans for the purchase of residential properties (excluding loans sold to Danaharta) increased significantly by RM6.4 billion or 11.4%. Nevertheless, the NPL ratio of such loans remained relatively low at 7.9% of total loans to this sector. In addition, NPLs to this sector accounted for only 9.2% of total NPLs in the banking system, although loans to this sector (excluding loans sold to Danaharta) constituted 16% of the total loan portfolio in the banking system.

NPLs to the manufacturing sector accounted for 16.1% of total NPLs in the banking system as at 31 December 1999. Nevertheless, about 60% of NPLs to the manufacturing sector had outstanding balances of RM5 million and below and were channelled to the small- and medium-sized industries, and thus were not eligible for sale to Danaharta. To assist these smaller borrowers, the Government has established the

Table 4.8
Banking System: Non-performing Loans by Sectors

	As at end-					
	NPLs by sector (Excluding loans sold to Danaharta)		As percent of total loans to sector: Excluding loans sold to Danaharta		As percent of total loans to sector: Including loans sold to Danaharta	
	1998	1999	1998	1999	1998	1999
	RM million		(%)		(%)	
Agriculture, hunting, forestry & fishing	818	704	10.6	8.1	11.7	12.2
Mining & quarrying	259	232	15.5	16.4	16.1	20.6
Manufacturing	9,018	8,678	14.3	14.3	16.6	19.5
Electricity, gas & water supply	52	104	0.9	1.5	1.1	2.1
Wholesale & retail, restaurants & hotels	3,912	4,428	11.1	12.8	12.6	16.1
Wholesale trade	*2,051*	*2,057*	*11.0*	*11.3*	*12.4*	*14.6*
Retail trade	*1,119*	*1,333*	*10.9*	*12.6*	*12.3*	*15.1*
Restaurants and hotels	*742*	*1,038*	*12.1*	*17.6*	*13.6*	*22.6*
Broad property sector	20,830	19,814	14.3	13.9	16.1	19.0
Construction	*8,053*	*8,051*	*18.7*	*21.5*	*21.8*	*29.9*
Purchase of residential property	*4,102*	*4,932*	*7.3*	*7.9*	*7.3*	*8.0*
Purchase of non-residential property	*3,880*	*3,755*	*12.9*	*13.8*	*15.6*	*18.2*
Real estate	*4,796*	*3,076*	*28.9*	*20.6*	*30.7*	*32.6*
Transport, storage & communication	2,701	2,091	18.0	15.1	19.2	17.0
Finance, insurance & business services	4,591	4,274	12.4	14.0	13.9	19.1
Consumption credit	7,585	7,019	14.1	13.6	14.1	14.2
Personal uses	*2,076*	*2,052*	*15.4*	*15.3*	*15.6*	*17.3*
Credit cards	*750*	*352*	*17.4*	*6.4*	*17.4*	*6.4*
Purchase of consumer durable goods	*150*	*191*	*18.1*	*21.0*	*19.4*	*22.8*
*Purchase of transport vehicles**	*4,609*	*4,424*	*13.0*	*13.8*	*13.0*	*14.0*
Purchase of securities	7,524	4,827	23.2	19.2	34.2	37.4
Community, social & personal services	882	769	13.2	11.1	13.4	12.7
Others	1,105	801	12.6	8.1	13.2	19.1
Total	**59,277**	**53,741**	**14.3**	**13.7**	**16.8**	**19.1**

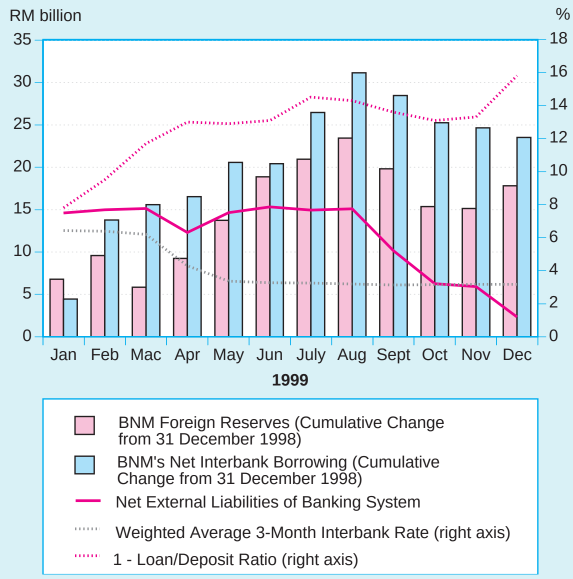
* Includes commercial vehicles

Rehabilitation Fund for Small and Medium Industries and Bumiputera Entrepreneur Project Fund to restructure their loans and ensure that these borrowers continued to have access to financing and remain viable in the longer run.

Liquidity Management

The strong export performance during 1999 resulted in a large trade surplus of RM72.3 billion and a substantial increase in the net external reserves of BNM of RM17.8 billion. With the consequent increase in liquidity from the inflow of reserves, total deposits of the banking system expanded by 4% or RM17.2 billion. As a result, the weighted average 3-month interbank rate eased from 6.43% per annum in January 1999 to 3.15% per annum as at end-1999. The excess liquidity situation necessitated BNM to mop up the excess liquidity through borrowing in the interbank market. Between December 1998 and December 1999, BNM's net interbank borrowings increased from RM18.3 billion to RM41.8 billion (+RM23.5 billion). Moreover, BNM had reduced its intervention rate three times during the year, in March (7%6.5% per annum), May (6.56% per annum) and August (6%5.5% per annum). The move had resulted in the maximum BLR for commercial banks to ease from 8.04% per annum

Graph 4.6
Liquidity of the Banking System

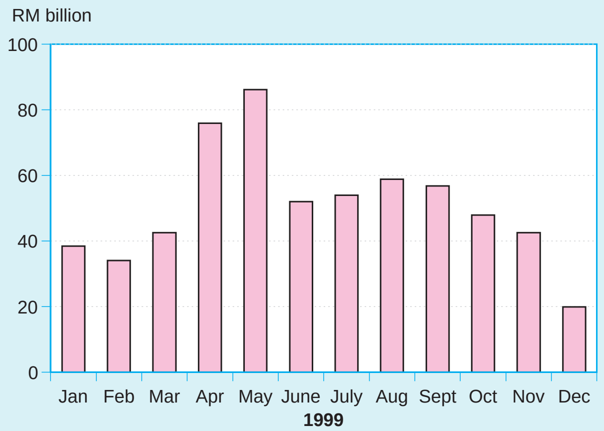


in January 1999 to 6.79% per annum since August 1999, and for the finance companies from 9.5% per annum to 7.95% per annum. This assisted in supporting economic activities and expediting recovery.

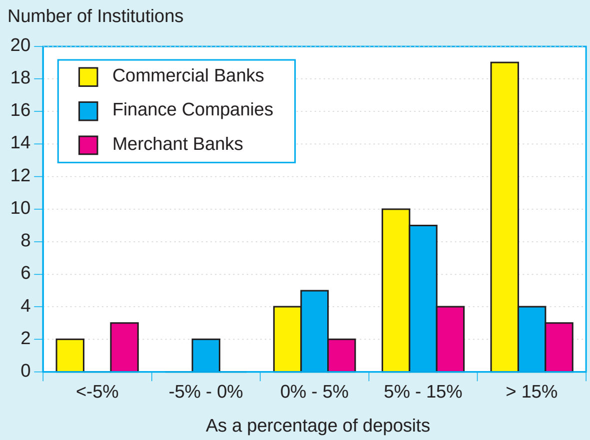
The exchange control policy introduced on 1 September 1998, with the minimum holding period requiring foreign portfolio capital to remain in Malaysia for at least 12 months, had stabilised short-term capital flows and contributed significantly to the stability of the financial markets. On 15 February 1999, the one-year minimum holding period was relaxed, where the principal capital and profits were allowed to be repatriated subject to a graduated levy depending on when the funds were brought into Malaysia and the duration of investment. In September 1999, following the expiry of the one-year minimum holding period, there was a net outflow of portfolio funds of RM5.2 billion, of which a substantial proportion were deposits by non-residents. Subsequently the outflow moderated to RM3.1 billion during the period from October to December 1999. Nevertheless, during the same period, net external liabilities of the banking system experienced a further decline of RM8 billion. This was mainly due to the reduction in foreign currency interbank borrowing by the banking system arising from the US dollar interest rate hike which coincidentally occurred in September 1999. The impact on the banking system liquidity was, however, easily offset by the continuous inflow of export proceeds and some easing of BNM's borrowing in the interbank market.

The activities of Danaharta in removing NPLs from the banking system played a pivotal role in improving the liquidity of banking institutions in 1999. Non-liquefiable NPLs were replaced by Danaharta bonds which can be discounted or sold under repo with BNM to yield liquidity for the affected banking institutions.

Graph 4.7
Banking System: Liquidity Surplus to Meet Withdrawal Obligation of up to One Week in 1999



Graph 4.8
Banking System: Profile of Potential Liquidity Surplus/ Shortfall up to One Month Ahead as at 31 December 1999



In terms of managing liquidity to meet withdrawal obligations, the banking system as a whole was able to maintain sufficient liquidity, including a buffer stock of liquefiable assets to meet any unexpected requirement. As at 31 December 1999, the banking system had a cumulative liquidity surplus of RM19.9 billion to meet estimated liquidity demands of up to one week and a surplus of RM24.6 billion for demands of up to one month. The amount for December was much lower than the amount normally maintained throughout 1999, partly due to the festive seasons as well as the withdrawal of deposit placements, following the expiry of capital outflow moratorium and US interest rate hikes since September 1999.

In terms of the liquidity position by type of institutions, there was notable difference in the liquidity profile, with merchant banks and finance companies maintaining somewhat lower levels of liquidity surplus due to their smaller deposit base. About 73.1% of banking institutions forecasted surpluses to meet excessive withdrawal based on the past one year historical data (commercial banks: 82.9%, finance companies: 65% and merchant banks: 58.3%), for at least one month ahead as at 31 December 1999, compared to 77.3% as at 31 December 1998.

Interest Rate Risk

The interest rate exposure profile of Malaysian banking institutions is typically signified by a negative gap (net liability) position in the shorter term and a positive gap (net asset) position for tenures above one year. This is because for most banking institutions, their main source of funding comes from their deposits which normally have a maturity of less than one year. The positive gap positions in the longer term tenures arise from holdings of fixed rate debt securities and long term government papers for liquidity and investment purposes. As for finance companies, their positive gap positions were due to their fixed rate loan activities such as hire purchase, block discounting and lease financing.

In terms of the amount of risk, the main source of banking institutions interest rate risk comes from positive gap positions in the 3- to 10-year maturity. Exposures in these tenures have a duration weighted net position of RM1.4 billion for commercial banks, RM0.9 billion for finance companies and RM132 million for merchant banks. (Duration weighted net position indicates the potential loss in the economic value of banking institutions' on- and off-balance sheet positions for a one percentage point increase in interest rate). This 3- to 10-year tenure accounted for 74% of the approximated total duration weighted net position of the banking system. The lack of sufficient medium- to long-term fixed rate funding instruments in the market has constrained the ability of banking institutions in hedging their interest rate risks arising from net asset positions in the longer-term tenures. For commercial banks and merchant banks, exposure to holdings of fixed rate debt securities (amounting to RM25.9 billion) attributed to this phenomenon, while for finance companies, fixed rate loans amounting to RM16.5 billion

Graph 4.9
Banking System: Net Interest Rate Position Mismatches as at end 1999

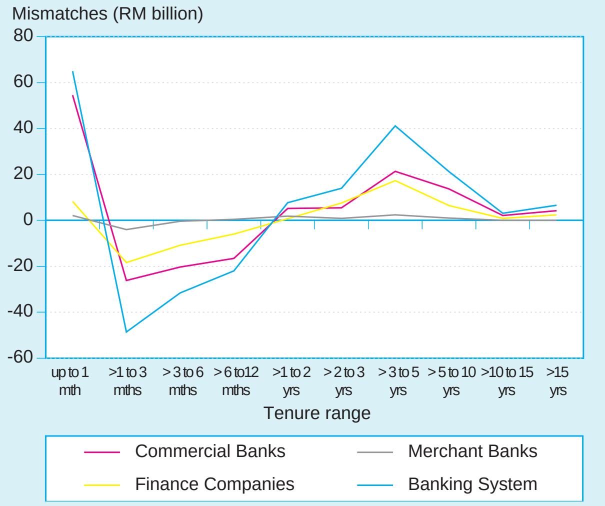


Table 4.9
Banking System: Impact of 1% Rise in Interest Rate on Solvency and Balance Sheet

	Duration Weighted Net Position		
	(RM million)	As a Percentage of Capital Base (%)	As a Percentage of Balance Sheet Size (%)
Commercial Banks*	–1,929	–4.5	–0.4
Finance Companies	–1,265	–12.9	–1.1
Merchant Banks	–174	–5.3	–0.4

* Includes Bank Islam Malaysia Bhd. and Bank Muamalat Malaysia Bhd.

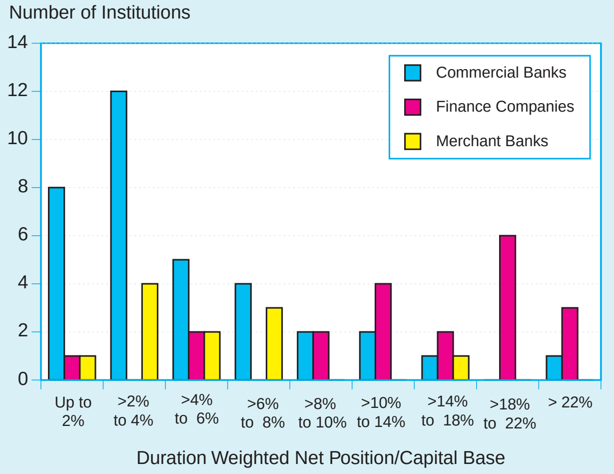
accounted for a larger portion of the positive gap position in this tenure. Most banking institutions' interest rate exposure is in ringgit. Non-ringgit interest rate risk accounted for less than 8% of the banking system's interest rate risk.

In measuring the ability of banking institutions to absorb the potential losses that the mismatches produced, the total approximated duration weighted net position is divided by capital base and total assets respectively.

Interest rate position mismatches have the greatest impact on the solvency and balance sheets of finance companies. A one percentage point rise in interest rates can erode finance companies' capital base by 15.9%. The higher impact reflects the inherent risk of finance company business as approximately 53% of its lending activities are in long-term fixed rate products such as hire purchase, block discounting, leasing and some fixed rate mortgages. The impact of interest rate position mismatches on the solvency of commercial banks and merchant banks is 3.5 times lesser. A one percentage point increase in interest rates would only impact the capital base of commercial banks and merchant banks by 4.5% and 4.3% respectively. Similarly, in terms of sensitivity of the banking institutions' balance sheets to movements in interest rates, finance companies exhibit the highest degree of sensitivity where 1.1% of the balance sheet value would move with every one percentage point change in interest rates. This is 2.8 times more sensitive compared to commercial banks and merchant banks which recorded a sensitivity of 0.4% each.

In reviewing the distribution of banking institutions according to the duration weighted net position as a percentage of capital base, approximately 11% of commercial banks and 1% of merchant banks would

Graph 4.10
Banking System: Distribution by Duration Weighted Net Position as a Percentage of Capital Base as at end 1999



suffer an erosion in economic value of more than 10% of their capital base for a one percentage point increase in interest rates. However, on the same basis, 75% of finance companies would suffer an erosion of more than 10% of their capital base for the same magnitude of change in interest rates.

Equity Risk

As at end 1999, the banking system's exposure to equity was not significant, amounting to RM711 million or 0.1% of total assets. Commercial banks recorded the highest equity position amounting to RM293 million followed by merchant banks at RM244 million and RM174 million for finance companies. Relative to the size of their capital base, merchant banks seemed to have the highest equity exposure at 6.0% compared to commercial banks (0.7%) and finance companies (2.2%). Merchant banks have significantly higher equity exposure as a percentage of their capital base due to their operations in underwriting of equities which amounted to approximately 56% of their total equity exposure at end-1999.

Table 4.10
Banking System: Equity Exposure

	Equity Position (RM million)	Equity/Capital Base (%)	Potential Equity Loss/ Capital Base (%)
Commercial Banks	293	0.7	0.1
Finance Companies	174	2.2	0.4
Merchant Banks	244	6.0	1.2

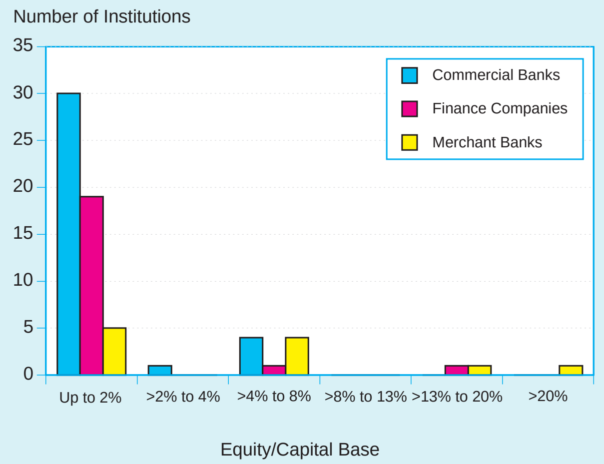
Based on a 10-day volatility of the Kuala Lumpur Composite Index for the period between January 1999 to December 1999, an estimated potential loss of 20% in equity value was possible. Based on such potential loss yardstick, the equity risk faced by the banking system was not significant. Merchant banks had the potential to suffer the highest erosion in capital at 1.2% followed by finance companies at 0.4%, and commercial banks at 0.1%.

Most banking institutions had less than 2% of their capital base exposed to the equities market. Nevertheless, one merchant bank had equity position amounting to more than 20% of its capital base due to the erosion in their capital base arising from the impact of the recent financial crisis.

Foreign Currency Risk

The banking system's net open foreign currency position increased steadily throughout the year. The net open foreign currency position rose from a net short (liability) foreign currency position of RM20.3 million at end January 1999 to a net long (asset) foreign currency position of RM2.3 billion at end-December 1999. This was due to the reduction in net foreign currency liability position by approximately RM8.2 billion to result in a net asset position of RM4 billion as at end-December 1999. The major component driving this increase was the reduction of foreign currency borrowing from the inter-bank market from a high of RM28.3 billion at end-January 1999 to RM19.6 billion at end-December 1999. This gradual reduction in foreign currency borrowing was due to

Graph 4.11
Banking System: Distribution by Equity as a Percentage of Capital Base as at end 1999



Box VI

The Financial Sector in a Globalised Economy

Introduction

In the changing operating environment, the Malaysian financial system must evolve to play its appropriate role in the next stage of the country's economic development. The challenge to the financial system in Malaysia is in terms of its ability to position itself not only to support, but also to act as a catalyst in transforming the economy, particularly, as Malaysia evolves towards becoming a higher value-added and knowledge-based economy (K-economy). The challenges that confront the financial system include meeting the financing needs of these new economic activities and increasingly sophisticated customers, increasing competition, enhancing risk management processes, and changes in the scope of banking business. In addition, the forces of liberalisation and globalisation, together with the rapid advancement of technology, pose additional challenges to the domestic financial system. The ability of the financial system to meet these challenges would be critical in ensuring the prospects for sustainable economic growth. In the context of these challenges, this box article will discuss the implications for the domestic financial system and the broad areas that need to be addressed to enhance the role of the financial system in supporting the changes in the real economy while continuing to strengthen in order to manage new risks in the more globalised financial system. Addressing these issues involves changes by the financial services industry themselves as well as the regulatory authorities.

Challenges in a Dynamic Operating Environment

Financing the New Economy

One of the biggest challenges facing the Malaysian economy amid the rapid transformation of the global economy and emergence of lower cost competitors is to formulate new strategies to support future growth, and to strengthen the structure and improve the efficiency of the economy. The current strategy of moving towards higher value-added economic activities to sustain economic growth is also being reinforced further by the fast pace of development in information and communications technology (ICT). In this connection, while efforts are being directed to further diversify the economic base, strengthen the competitiveness of industry and enhancing productivity-driven growth, the scope of economic transformation needs to take account of global developments in ICT and the increasing role of knowledge-based activities.

The challenge facing the financial system, is to recognise this economic transformation and adapt and adjust to meet the **changing requirements for financing in these new areas of economic activity** in an effective and efficient manner. In particular, the new areas of growth in the K-economy have different characteristics which may limit their access to the traditional form of bank-based financing. These characteristics reflect the nature of these new activities which rely on intangible assets such as knowledge, skills, human capital, while the innovative and "path-breaking" nature of their products lack track record and require long lead time from investment to fruition. Given the characteristics of these new areas of economic activity, their financing needs are in some cases better met by non-bank forms of financing, such as the bond market and venture capital.

Impact and Challenges of Globalisation

The rapid intensification of globalisation in recent years has significantly affected the structure and operations of financial institutions. The global trend towards deregulation and liberalisation in the financial system has led to the blurring of traditional demarcation lines separating the activities of the different groups of financial institutions and removed barriers to competition. As a result, the range of activities that can be undertaken by different groups of financial institutions is converging. Financial institutions worldwide are also undertaking consolidation and mergers, driven primarily by the desire to increase global presence as well as to maximise economies of scale and the scope of activities. Competition can be expected to intensify with the expansion of e-banking activities. The Federal Deposit Insurance Corporation estimates that the number of financial institutions with transactional websites in the US will increase by more than 50% by the end of 2000.

Technological advances in telecommunications, information processing and computing have been a key factor in integrating financial markets, and in enabling the design of innovative and complex financial instruments that have helped to improve risk management and shifted risks to those who are better able to manage them. Consequently, economic agents have become more willing to assume greater risk, while short-term capital funds have flowed rapidly and in large amounts between developed economies and emerging economies since the late 1980s. The integration of financial markets, and the rapid expansion of innovative financial instruments have brought new challenges and transformed the global financial landscape, as reflected in the changes in the relative significance of players in financial markets, nature of financial instruments and volume of activity in the markets.

The above developments will undoubtedly present increased challenges to the financial institutions in Malaysia. In particular, the globalisation process brought about by the trend towards greater liberalisation of domestic financial systems would further reduce the barriers to entry to the domestic financial markets, and as a result, further **intensify competition** in these markets over time. The momentum for liberalisation of the domestic financial system can be expected to pick up as multilateral and plurilateral forums such as the WTO and ASEAN bring about more open financial markets. Domestic financial institutions therefore have to equip themselves to be able to operate competitively in a more liberal and globalised market.

Another important challenge of globalisation is the **management of international capital flows**. Globalisation has made it possible for large amounts of funds to be moved around at a very rapid pace. Short-term capital flows, and new financial products and instruments, while bringing benefits, also bring increased risks, both for the macro economy and financial institutions. In particular, large amounts of short-term capital inflows can complicate the management of macroeconomic policy, as they could increase inflationary pressures or cause significant appreciation of the exchange rate. Similarly, the reversal of the flows could, as was the experience during the Asian crisis, lead to severe macroeconomic implications. These flows are by nature highly volatile and sensitive to market perception of the appropriateness of macroeconomic policies. Therefore, globalisation has increased countries' vulnerability to swings in market sentiments. In such an operating environment, speculative positions against a currency quickly become self-fulfilling and even fundamentally strong economies are adversely affected. The problem is more acute for a small open economy like Malaysia where the volume of international capital flows is huge relative to the size of the domestic financial markets. Given the small size and the stage of development of the domestic financial markets, such flows can result in sharp movements in interest rates, exchange rates and asset prices.

In this environment, financial institutions have to be increasingly vigilant in monitoring and managing market risks. This is because adverse movements and excessive volatility in market prices such as interest rates, currencies and equities could adversely affect an institution's financial condition and pose risks to national financial systems. The Malaysian financial sector needs to take steps to enhance risk management at all levels, namely the national level and the individual institution level. This is crucial to ensure that the benefits of globalisation can be enjoyed, while keeping the associated risks at a prudent and manageable level.

Nevertheless, given the global nature of the problem caused by short-term capital flows, efforts by individual economies to promote financial stability by maintaining sound macroeconomic policy and a strong financial system are not sufficient. There is a need for simultaneous efforts to be pursued at the international level to promote stability in the international financial system and minimise the risks of destabilisation associated with capital flows. In particular, there is a need to enhance transparency and disclosure, as well as regulate the activities of large market players, particularly highly leveraged institutions so as to reduce their ability to cause instability in the global financial markets. Co-operation at the international level, involving the developed and developing countries as well as the private sector, would help to ensure that the international financial system is more stable and not prone to frequent instability and crisis, thereby ensuring the prospects for sustained prosperity.

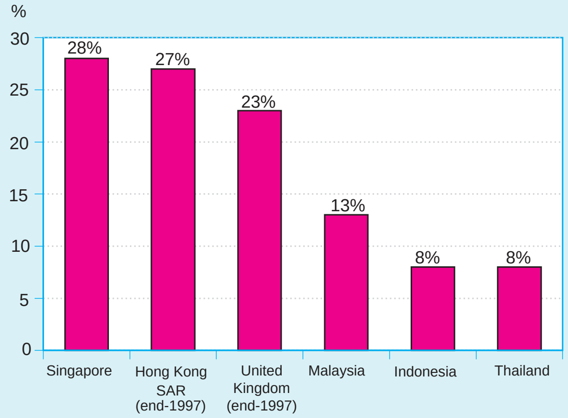
Financial Sector as a New Area of Growth

Efforts to increase the effectiveness, efficiency and competitiveness of the domestic financial sector to meet the challenges of globalisation as well as the financing needs of the economy would present opportunities to develop the financial sector as a growth sector, in line with the vision of promoting services as a source of new growth. In particular, this would result in an increase in the financial sector's contribution to the nation's gross domestic product (GDP). The contribution of the broad financial sector to GDP at 13% in Malaysia is low (Graph VI.1) suggesting that there is scope and opportunity for the sector to increase its contribution. In addition, a progressive and well-developed financial sector would also help to reduce the demand for financial services from abroad, and thus assist in reducing the services deficit of the balance of payments.

Response to Challenges

The further development of the financial system is an area of priority in the national agenda, and resources have been committed to draw up the Master Plans for the development of the financial sector over the next ten years. The Government will formulate the blue-print for the development of the financial sector, including the necessary regulatory framework to ensure a resilient, sound and stable financial sector. The focus on strengthening the financial sector will form the foundation on which further development will take place to develop an efficient and competitive financial sector. On the part of the financial institutions, there is a need to continually enhance their ability to meet the new requirements of customers and the economy, as well as maintain competitiveness by increasing efficiency and effectiveness.

Graph VI.1
Broad Financial Sector as a Share of GDP
(at end-1998)



Strengthening the Financial System

The recent economic and financial crisis has heightened the need for developing more diversified forms of financing in the economy and to reduce over-reliance on the banking system. The crisis also demonstrated the vulnerability of the banking institutions, particularly the finance companies, given the fragmented nature of the industry, and the inadequate risk management processes of the banking institutions. Measures were therefore undertaken to address the rising non-performing loans and erosion of capital, as well as providing a platform to restructure corporate debt. In addition, a merger programme for the finance companies was also introduced. At the same time, steps were taken to further strengthen the regulatory and supervisory framework, including the refinement of the capital adequacy framework, greater information disclosure and initiatives to improve risk management of banking institutions.

(a) Regulation and risk management

Given the changes brought about by the globalisation process and advances in technology, efforts to ensure the soundness and stability of the financial system will have to be intensified. Appropriate standards of prudential supervision would need to be maintained to ensure that the benefits of increasing competition and sophistication could be reaped without compromising safety and stability in the financial system. In this regard, BNM will balance between over-regulation, which could limit innovation and inhibit growth and development of the financial system, and under-regulation, which could, on the other hand, undermine the soundness of the system.

In this context, new modalities in bank regulation have to be explored. There has been a global trend towards a market-driven approach as the foundation for the regulatory framework to reap the benefits of competition. Under the market-driven approach, the market is entrusted to allocate risks and resources, while the main task of the supervisor is to contain excessive risk-taking activities, minimise the effect of moral hazard and protect consumers' interests. Under this arrangement, the prudential regulatory and supervisory framework is complemented by the requirement for greater disclosure, transparency and market discipline among market participants.

In the design of the regulatory framework, BNM will strive to balance the elements of protective and preventive regulations. By definition, protective bank regulation is designed to provide support given that the playing field is not level. Meanwhile, preventive bank regulation is designed to curb excess risk-taking by banks and, thereby, reduce the prospect of liquidity and solvency problems. In the market-driven approach, regulation will provide a framework within which competition is allowed to generate a more competitive banking environment without increasing systemic risks, and causing economic and social dislocation. Towards this end, less emphasis will be placed on micro managing, while according greater adherence to a consistent and transparent supervisory philosophy.

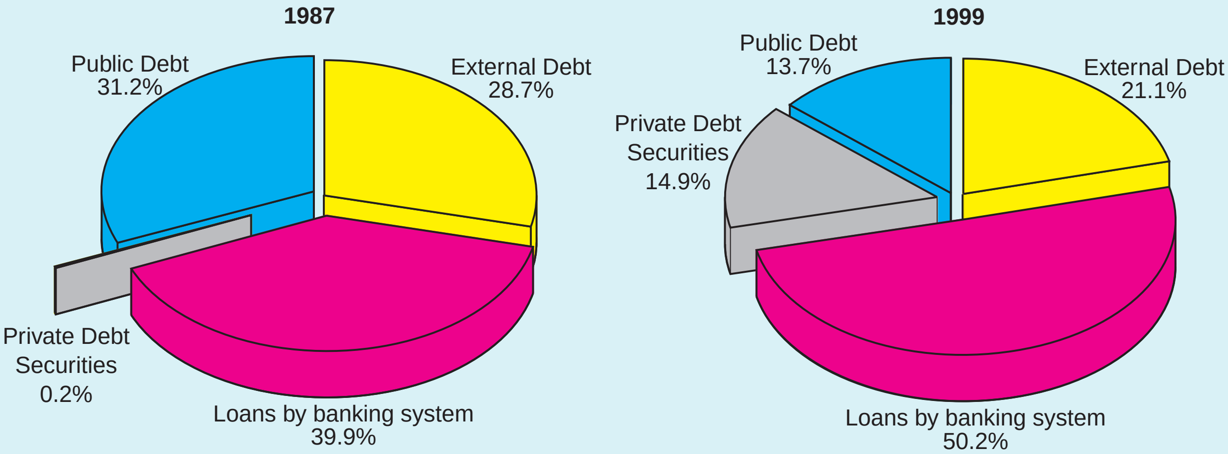
In addition to the role of the authorities, the market-driven approach will also have wide implications on the role of the financial institutions in ensuring the resilience of the banking sector. The accountability, transparency and appropriate skills level of Board members and management will be of paramount importance to promote this development. Bank management will be under greater scrutiny, and needs to be responsive to market requirements to stay competitive. Banking institutions will increasingly have to focus on improving their efficiency and competitiveness. The impetus for these improvements would depend on the banking institutions' capacity for innovation, flexibility, skill enhancement, customer-orientation and product development. Equally important is the need to pay closer attention to the return on equity. In this operating environment, the banking institutions would also have to increase their risk management capability and improve corporate governance. Adequate internal control and systems need to be in place to ensure that there is no excessive risk-taking that could result in adverse consequences. Towards this end, guidelines will be issued to inculcate sound and effective credit risk as well as to set the minimum standards on risk management practices for derivatives. Best practices have also been outlined in order to govern the role of management and employees of banking institutions to ensure that they exhibit high standards of competency, experience and integrity.

(b) Broadening and deepening financial markets

Traditionally, much of the financing for the Malaysian economy is intermediated through the banking system as reflected by the high ratio of bank credit (excluding loans securitised by Cagamas and sold to or managed by Danaharta) to GDP of 126% at the end of 1999 (138.7% at the end of 1998) as well as the high ratio of bank loans to net funds raised in the capital market of 263.0% during 1997. This suggests the potential for developing alternative sources of financing to meet the financing needs of the economy, which would also help diversify risks in the economy. In this regard, there is a need to further deepen and broaden the financial system in terms of financial products and markets.

As there is already a well-functioning and active equity market in Malaysia, efforts have been stepped up to further develop private debt securities as well as to encourage secondary trading in the Government securities markets. The development of an active private debt securities market would enhance the capability of the domestic capital market to accommodate large and more complex funding arrangements and diversify financing away from the banking sector. The bond market would allow companies to obtain long-term fixed rate financing at a lower cost relative to bank credit. This is because intermediation would be minimised, and as risks are diversified among a large pool of investors and liquidity risks for investors

Graph VI.2
Financing of the Economy



are reduced, investors are prepared to accept a lower return.

The commencement of trading of the Malaysian Exchange of Securities Dealing & Automated Quotation Bhd. (MESDAQ), a stock exchange targeted specifically at growth and technology companies, is also a significant step in providing an alternative source of financing**, and would also serve as an exit mechanism for venture capital companies**. At the same time, the Government recognises that the venture capital industry has an important role to play in providing equity capital to finance high-risk investments to support the emergence of a knowledge-based economy**, and has granted the industry tax incentives.** Other alternative sources of finance such as “business angel” investment and “specialist seed capital” firms would complement venture capital financing and would also have to be promoted.

The development of non-bank based sources of financing bode well for the development of a K-economy. Given the different nature of the business, alternative sources of financing for high-risk investments are required. In the case of venture capital, it allows investors to share more fully in the rewards to a successful venture and it helps firms avoid the cash flow problems associated with debt finance. Equally important is the development of instruments that enable the unbundling of risks so that such risks will be borne and managed by those who are best able to do so, so that the risk tolerance of the economy increases and financing would be available at reasonable cost.

Liberalisation

The Government recognises that gradual and progressive liberalisation of the financial system would contribute towards creating a more efficient, competitive and market-driven financial sector, thus enabling the sector to play a more efficient and effective role in the economy. It is clear that the protection of the domestic economy, including the financial system, is not a permanent option in a global economy. Protective measures if maintained for too long would erode competitiveness and prospects of economic growth in the longer term. In addition, the circumvention of regulatory obstacles will reduce the effectiveness of protection. Such circumvention would be difficult to detect with new technology and the emergence of e-transactions.

The Malaysian financial sector already has significant foreign presence**.** In the banking sector, there are 13 commercial banks that are wholly foreign-owned, with foreigners in the aggregate, accounting for about 30% of total assets of commercial banks. Similarly, foreign presence also features significantly in the insurance industry, with foreign market share amounting to 74% of life insurance premiums and 35% of general insurance premiums. Thus far, Malaysia has adopted a gradual and progressive approach to liberalisation where liberalisation is undertaken at a pace that is consistent with the prevailing conditions, infrastructrure and regulatory framework and the needs of the economy, taking into consideration the need to ensure that liberalisation does not marginalise the domestic financial institutions.

The strengthening of the financial system is a necessary first step in the liberalisation process. At the same time, the forces of globalisation and the momentum of multilateral fora to open up financial markets would place greater urgency on banking institutions to focus efforts to enhance their competitiveness. In this context, the measures taken thus far to strengthen the banking system and the present merger process in the banking industry would help the institutions to achieve critical size. This would enable such institutions to reap the gains from economies of scale, reduce costs and excess capacity, as well as afford higher spending on information technology and risk management systems.

New Sources of Growth for the Financial Sector

As competition increases, intermediation margins would narrow and reduce traditional interest incomes of the banking institutions. This trend will intensify as capital markets develop further and the process of disintermediation lead more corporations to access the capital markets directly for financing. In order to meet these challenges, the domestic banking institutions must seek new sources of income. In this regard, non-interest based activities represent a significant source of potential growth for the domestic banking sector, given that only 29% of the earnings of the banking institutions in Malaysia are accounted for by non-interest income, compared to approximately 50% for British banks. These activities include traditional fee-based activities such as equity underwriting and guarantee as well as consultancy.

The financial system would also have to play a role in developing products and solutions that can meet the changing and more sophisticated needs of new areas of economic activity. In this operating environment, bank customers will no longer be satisfied with the traditional “bread and butter” products and banking institutions need to strive to bring the right products and solutions that anticipate the needs of their customers. In addition, the development of alternative sources of financing, such as a vibrant capital market, is a vital complement to the role of the banking institutions. In this regard, technology would enable the financial institutions to further enhance their services, tap new opportunities and develop new products. For instance, those with the capacity and the necessary skills would be in a position to provide other services such as document handling and transmission services relating to trade financing. The broadening and deepening of the financial markets would also stimulate the growth of the financial sector, particularly in the form of increased activities, and hence fee-income, for a multitude of financial institutions, including, investment banks and securities and research houses, as well as support services such as rating agencies and consultancy firms.

New Technology

Investment in new technology is important to enable the financial institutions to enhance their effectiveness, efficiency and ability to provide value-added services, while also being better able to meet the financing needs of the new economy. This need to invest in new technology is continual and is primarily the result of the rapid pace of IT innovation which has resulted in an acceleration of “creative destruction”, with capital shifting from failing technology into new, cutting-edge technology. Financial institutions which fail to invest in the latter would soon find themselves increasingly disadvantaged to compete, as they would lack the ability to develop innovative products, while efficiency deteriorates and delivery costs increase. Over time, efficiency of the financial system and economy would be affected.

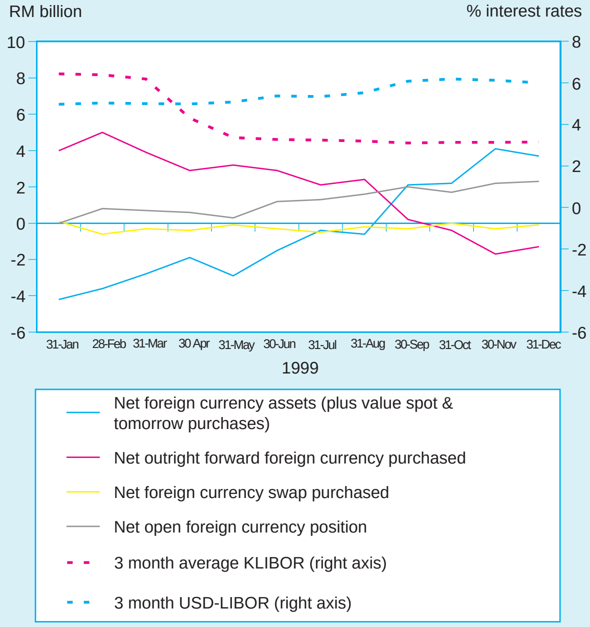
Human Capital

A necessary complement to the above efforts is the development of human capital. In particular, the transition to a truly knowledge-based financial sector which is more competitive, effective and better able to manage risks would require further developments in a number of key areas. *Firstly*, **commitment of management teams:** the management of financial institutions need to be vibrant and innovative in adding value to the traditional financial activities, and in exploring new avenues to enhance services. In this regard, an environment conducive for innovation and creativity must be promoted. The importance of management support is reflected by the results of a recent MORI poll, which revealed that 91% and 65% of companies surveyed in the US and Europe respectively had a board member in charge of e-business. *Secondly*, **human and intellectual capital:** knowledge-based financial activities such as e-banking and on-line share trading will require financial services employees to be technologically competent and able to think, assimilate and apply information and knowledge. In addition, in marketing the multitude of new financial products, financial services employees must have a thorough understanding of these products and the associated risks so that customers obtain the benefits of these products with a full understanding of the risks involved. *Thirdly*, **knowledge infrastructure:** this would allow ideas and knowledge to be transmitted, shared and built within and across companies and countries. The infrastructure will consist of physical networks and, possibly, their interconnections with knowledge or 'thought' centres such as universities, and business centres globally.

Conclusion

Given the important role of the financial sector in the economy, it is clear that meeting the above challenges would require efforts on the part of both the Government and the financial industry. The Government would focus on creating a conducive regulatory and supervisory framework that encourages efficiency and competition while maintaining the soundness of the financial system. Ultimately, it is in the interest of the financial institutions themselves to continually enhance their resilience, efficiency and competitiveness. The ability of the financial system to assume higher risks while remaining efficient, competitive and resilient in the face of these challenges would ensure its continued prosperity.

Graph 4.12
Banking System: Foreign Currency Exposure



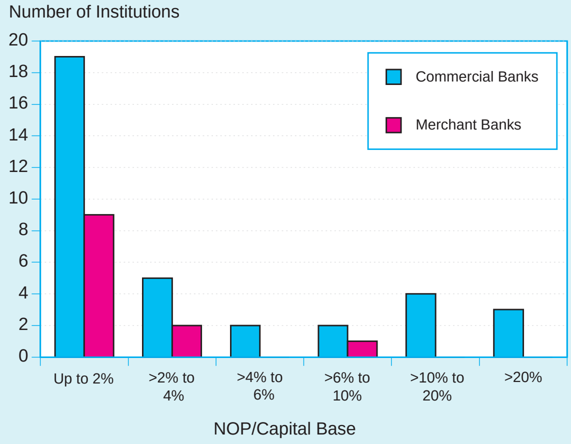
the declining attraction of US dollar (US$) borrowings as opposed to ringgit borrowings as the weighted average 3-month KLIBOR rate fell from 6.43% per annum at end-January 1999 to 3.15% per annum at end-December 1999. In contrast, the 3-month US$ LIBOR interest rate rose from 4.97% per annum at end-January 1999 to 6.00% per annum at end-December 1999.

During the year, the outstanding amount of gross forward foreign exchange contracts purchased by the banking system declined from RM11.1 billion as at end-January 1999 to RM7.3 billion as at end-December 1999 despite the consistent improvement in gross exports. In contrast, the outstanding amount of gross forward foreign exchange contracts sold by the banking system increased from RM7 billion as at end-January 1999 to RM8.5 billion as at end-December 1999. This reversed the banking system's position from being a net purchaser of forward foreign exchange contracts

Table 4.11
Banking System: Foreign Currency Exposure

	Net Open Foreign Currency Position (NOP) (RM million)	NOP/Capital Base (%)
Commercial Banks	2,217	5.1
Merchant Banks	92	2.3

Graph 4.13
Banking System: Distribution by Net Open Foreign Currency Position as a Percentage of Capital Base as at end 1999



in January 1999 with a net outstanding balance of RM4 billion to a net seller of forward foreign exchange contracts (from October 1999 onwards) with a net outstanding balance of RM1.3 billion as at end 1999. This change in position was due to the shift in interest rate differential from favouring the ringgit to favouring the US$. With the ringgit-US$ exchange rate pegged at RM3.8, exporters were becoming less attracted to the increasing forward discount rate caused by the falling ringgit interest rates. The 3-month average KLIBOR fell by 2.83 percentage points from 6.19% per annum at end-March 1999 to 3.36% per annum at end-May 1999, while the 3-month US$-LIBOR rate rose from 5.52% per annum at end-August 1999 to 6.08% per annum in September 1999. As a result, importers were buying US$ forward contracts to take advantage of the forward discount rate which contributed to the increase of RM1.5 billion for the year.

Nevertheless, despite the size of foreign exchange activity, the commercial banks and merchant banks normally hedged their positions and maintained their net exposure within a manageable range. As at end-December 1999 commercial banks' net open foreign currency position as a percentage of their capital base stood at 5.1% compared to 2.3% for merchant banks. All merchant banks and 80% of commercial banks had net open foreign currency positions not exceeding 10% of their capital base. A number of commercial banks, however, were maintaining significant long foreign currency positions partly to take advantage of the favourable interest rate differentials which existed between domestic ringgit interest rates and US$ interest rates towards the second half of 1999.

Table 4.12
Banking System: Constituents of Capital

	As at end- 1998	As at end- 1999	Annual change	
	RM million		RM million	(%)
Tier-1 capital	42,102	43,829	1,728	4.1
Tier-2 capital	18,302	15,008	–3,294	–18.0
Total capital	60,403	58,837	–1,566	–2.6
Less:				
Investment in subsidiaries and holdings of other banking institutions' capital	4,665	4,892	227	4.9
Capital base	55,739	53,945	–1,793	–3.2
Risk assets:				
0%	87,976	121,707	33,731	38.3
10%	26,160	21,735	–4,426	–16.9
20%	109,742	103,670	–6,072	–5.5
50%	62,452	67,828	5,376	8.6
100%	414,994	381,813	–33,181	–8.0
Total risk-weighted assets	470,785	438,634	–32,151	–6.8
Risk-weighted capital ratio (%)				
Banking system	11.8	12.3	0.5	
Commercial banks	11.7	12.5	0.8	
Finance companies	11.1	10.4	–0.7	
Merchant banks	15.2	14.6	–0.6	

Capital Strength

In consonance with the recovery of the Malaysian economy, total Tier-1 capital of the banking system increased by RM1.7 billion (4.1%) to RM43.8 billion as at end-1999. The increase was due to better overall profitability of the banking system and the conversion of some banking institutions' Exchangeable Subordinated Capital Loan of RM2.6 billion to either ordinary or preference shares. The year, however, saw a reduction in the paid-up capital of finance companies due mainly to the absorption of eight finance companies by their parent banks. Tier-2 capital funds showed a significant decline as a result of conversion and repayment of Exchangeable Subordinated Capital Loan totalling RM4.5 billion. Overall, capital base declined by 3.2% or RM1.8 billion.

Total risk-weighted assets of the banking system declined by 6.8% or RM32.2 billion to RM 438.6 billion as at end-1999, due mainly to negative loan growth of the banking system. This contraction of credit contributed in large part to the decrease of RM33.2 billion or 8.0% in assets of the 100% risk-weight category. Similarly, risk-weighted assets in the 10% category fell significantly by RM4.4 billion or 16.9% as banking institutions reduced the holdings of Cagamas papers. On the other hand, assets in the 0% and 50% risk-weight category increased for the year to RM121.7 billion and RM67.8 billion respectively due mainly to inter-bank placement with BNM and the expansion in home financing.

On the whole, the RWCR of the banking system showed an increase of 0.5 percentage points to 12.3% as at end-1999. The commercial banks showed an improvement in their RWCR from their end-1998 position to 12.5%. Finance companies and merchant banks, however, experienced a decline in their RWCR ratio due to overall losses for the year 1999.

Islamic Banking

Sources and Uses of Funds

The strong and early economic recovery had positive spillover effects on the Islamic banking system which was also affected by the economic crisis. The total assets of the Islamic banking sector continued to increase strongly by RM14.1 billion or 65.3% to RM35.8 billion as at end-1999. The growth was contributed mainly by a sharp increase in trading and investment securities held by the banking institutions (121.8% or RM11.2 billion) and holding of cash and short-term funds (123.8% or RM3.5 billion). The Islamic banks recorded the highest asset growth of 97.5%, although the commercial banks still have the largest market share of assets in Islamic banking of 44.2%. The share of Islamic banking assets in the banking system rose to 5.4% from 3.4% in 1998.

During the year, a major portion of funds in the Islamic banking sector continued to be sourced from deposits placed with the banking institutions, which recorded a growth of 50.6% (RM8.3 billion) to RM24.7 billion, accounting for 69.2% of the total resources of the Islamic banking sector. As in previous years, the commercial banks and the Islamic banks accounted for the bulk of the increase in these deposits, mobilising 81% of total deposits in the Islamic banking sector. In terms of types of customers, the deposits were held mainly by the domestic non-financial private sector, comprising individuals and business enterprises, which constituted about 59.8% of total deposits. Investment

Table 4.13
Islamic Banking: Key Data

	As at end-		Annual Change (%)	
	1998	1999	1998	1999
Number of financial institutions	49	52	–5.8	6.1
Commercial banks	25	22	4.2	–12.0
Finance companies	18	16	–18.2	–11.1
Merchant banks	5	5	–	0.0
Islamic banks	1	2	–	100.0
Discount houses	–	7	–	–
Total assets (RM million)	21,632	35,754	21.0	65.3
Commercial banks	11,835	15,812	30.4	33.6
Finance companies	3,321	4,704	13.6	41.6
Merchant banks	778	1,407	14.9	80.8
Islamic banks	5,698	11,253	9.5	97.5
Discount houses	–	2,578	–	–
Total deposits (RM million)	16,432	24,739	59.1	50.6
Commercial banks	9,108	10,366	63.9	13.8
Finance companies	2,677	2,642	123.1	–1.3
Merchant banks	607	909	73.9	49.8
Islamic banks	4,040	9,713	25.3	140.4
Discount houses	–	1,109.0	–	–
Total financing (RM million)	10,943	14,007	1.8	28.0
Commercial banks	4,764	5,203	1.2	9.2
Finance companies	2,108	2,996	–3.7	42.1
Merchant banks	421	778	–16.3	84.8
Islamic banks	3,650	5,030	8.9	37.8
Discount houses	–	–	–	–
Financing-deposits ratio (%)	66.6	56.6	–37.5	–15.0
Commercial banks	52.3	50.2	–32.4	–4.0
Finance companies	78.7	113.4	–103.8	44.0
Merchant banks	69.4	85.6	–74.8	23.4
Islamic banks	90.3	51.8	–13.6	–42.7
Discount houses	0.0	0.0	0.0	0.0
Number of branches	90	128	n.a	2.4
Commercial banks	7	6	n.a	–14.3
Finance companies	3	2	n.a	–33.3
Islamic banks	80	120	n.a	50.0
Number of counters	2,391	2,095	n.a	–21.5
Commercial banks	1,619	1,370	n.a	–15.4
Finance companies	766	719	n.a	–6.1
Merchant banks	6	6	n.a	–

deposits continued to account for the bulk of deposits placed in Islamic banking, accounting for 65.6% of the increase in total deposits. In terms of maturity profile, investment deposits remained concentrated in the shorter-end maturities. Notably, current deposits recorded a growth of 79.9% in 1999 thereby constituting 22.2% of total Islamic banking deposits, as compared with a decline of 8.2% in 1998.

The shareholders' funds of the Islamic bank and the Islamic banking capital fund of the conventional banking institutions also improved during the year, increasing by RM589 million to RM2.2 billion as at end-1999. The increase was contributed by the new capital injection into the second Islamic bank and the Islamic banking fund of the discount houses as well as the higher amount of retained profits. In terms of profitability, the Islamic banking sector recorded an impressive pre-tax profit of RM352 million for the financial year ended 1999, higher by 137.8% than the pre-tax profit of RM148 million recorded for the financial year ended 1998. The improved profit was largely due to higher financing income and lower financing loss provisions made by the banking institutions in 1999. The lower financing loss provisions charged during the year were largely due to higher write-backs and recoveries.

The Islamic funds mobilised were utilised mainly for financing activities, while the remaining funds were largely placed as deposits with other banking institutions, in particular in the form of Mudharabah inter-bank investment, and invested in Islamic securities. In 1999, total financing extended by the Islamic banking sector continued to expand by RM3.1 billion or 28%. However, the growth in financing was much lower than the growth in deposits (50.6%). As a result, the financing-deposits ratio declined from 66.6% as at end-1998 to 56.6% as at end-1999.

The exposure of Islamic banking to the broad property sector remained significant at 42.6% of total

Table 4.14
Islamic Banking: Sources and Uses of Funds

	Annual change		As at end-1999	
	1998	1999		
	RM million			% share
Sources:				
Capital and reserves	220	589	2,191	6.13
Deposits	5,647	8,307	24,739	69.19
Amount due to financial institutions	691	3,220	6,498	18.17
Other liabilities	–1,451	2,006	2,326	6.51
Total	5,108	14,121	35,754	100.00
Uses:				
Loans, financing and advances	584	2,872	13,333	37.29
Investment securities	1,752	3,357	6,844	19.14
Dealing securities	1,381	2,808	4,381	12.25
Amount due from financial institutions	1,084	1,822	4,062	11.36
Other assets	308	3,263	7,134	19.95

Table 4.15
Islamic Banking: Deposits by Type and Institutions

	Annual change				As at end-1999
	1998		1999		
	RM million	%	RM million	%	RM million
Current deposits	–273	–8.2	2,434	79.9	5,480
Commercial banks	–134	–6.2	1,288	63.6	3,313
Islamic banks	–139	–12.0	1,146	112.2	2,167
Savings deposits	225	12.4	349	17.1	2,395
Commercial banks	171	20.0	–107	–10.4	917
Finance companies	47	36.4	108	61.4	284
Islamic banks	7	0.8	348	41.1	1,194
Investment deposits	5,180	108.9	5,428	65.8	16,472
Commercial banks	3,217	150.3	470	8.8	5,828
Finance companies	1,439	138.2	–123	–5.0	2,357
Merchant banks	258	73.9	302	49.8	909
Islamic banks	266	21.7	4,779	320.7	6,269
Discount houses	–	–	1,109	–	1,109
Other deposits	970	223.0	–1,014	–72.1	391
Commercial banks	296	73.1	–393	–56.1	308
Finance companies	–9	–30.0	–21	–98.6	–
Merchant banks	–	–	–	–	–
Islamic banks	683	•	–600	–	83
Discount houses	–	–	–	–	–

financing, followed by the manufacturing sector which accounted for 9% of total financing. The growth in the broad property sector was driven mainly by the rapid growth in house financing which increased by RM1.1 billion. The high demand for house financing was due mainly to the fixed-rate nature of Islamic financing as well as the competitiveness of its financing rate, which provided the borrowers with an opportunity to lock

Table 4.16
Islamic Banking: Direction of Lending

	Annual change		As at end-1999
	1998	1999	
	RM million		
Agriculture	–22	319	491
Mining & quarrying	–4	5	74
Manufacturing	15	–46	1,252
Electricity	–66	188	221
Real estate & construction	–431	270	2,132
Housing	675	1,142	3,841
General commerce	104	–1	627
Transport and storage	0	270	990
Finance, insurance & business services	151	444	901
Purchase of stocks & shares	–275	–108	745
Consumption credit	314	–69	878
Others	–270	650	1,855
Total	**194**	**3,064**	**14,007**

Table 4.17
Islamic Banking: Non-performing Financing and Financing Loss Provision

	As at end-	
	1998	1999
	RM million	
Islamic banking		
General provisions	170	238
Income-in-suspense	224	373
Specific provisions	61	110
Non-performing financing (NPF)	1,451	1,585
Net NPF ratio (%)	10.94	8.15
Total provisions/ NPF (%)	31.36	45.49

their cost of financing over the long term. Bai' Bithaman Ajil or deferred payment sale remained the most popular mode of Islamic financing with a share of 58.7% of total financing as at the end of 1999.

Asset Quality

The asset quality of Islamic financing improved in 1999 in line with the improved economic conditions. With the economy recovering, the ability of borrowers to service their debts had improved significantly. This was evident in the decline in the non-performing financing (NPF) ratio from 10.9% in 1998 to 8.2% in 1999. Total provisions set aside on these NPF amounted to 45.5% of NPF.

In terms of NPF by sector, as at end-December 1999, the broad property sector accounted for 49.0% of total NPF. A major proportion of NPF to the broad property sector originated from the real estate and construction sectors, which accounted for 60.3% of total broad property sector NPF.

Developments

An important event in Islamic banking during 1999 was the setting-up of the second Islamic bank in Malaysia, namely Bank Muamalat Malaysia Berhad (BMMB). The establishment of BMMB arose from the merger between Bank Bumiputra Malaysia Berhad (BBMB) and Bank of Commerce (M) Berhad (BOCB). Under the merger arrangement, the Islamic banking assets and liabilities of BBMB, BOCB and BBMB Kewangan Berhad (BBMBK) were transferred to BMMB, while the conventional operations of

BBMB, BOCB and BBMBK were transferred to BOCB. In addition, BMMB was given 40 branches of BBMB and BBMBK in various locations throughout Malaysia with a staff workforce of 1,000. The bank commenced operations on 1 October 1999. The setting-up of the second Islamic bank is expected to play a key role towards fostering an active and progressive Islamic banking system.

BNM also allowed full-fledged Islamic banking branches operated by banking institutions participating in the Islamic Banking Scheme (SPI banks) to accept conventional deposit placements, facilitate withdrawal of conventional deposits and receive payments for conventional loans from customers of conventional branches. The move is to enable customers of the same banking institution to perform their banking transactions with all branches, although the approval is subject to the condition that the full-fledged Islamic branches implement adequate mechanisms to ensure proper segregation between the conventional and Islamic funds.

One of the requirements to be met by the SPI banks by end-1999 was the attainment of a minimum target of 5% market share in terms of deposits and financing granted by their respective banking institutions. Nevertheless, taking cognizance of the financial crisis and the merger exercise currently being carried out by the domestic banking institutions, BNM has decided to defer the compliance deadline to end-2000. Notwithstanding the deferment, 10 SPI banks, all of which are domestic banks, managed to surpass the 5% target in terms of deposits and financing at end-1999. In terms of financing, three commercial banks, five finance companies and two merchant banks met the target, while seven commercial banks, two finance companies and one merchant bank reached the 5% minimum market share for deposits. It is expected that once the merger exercise has been completed, the SPI banks will channel more resources and efforts towards meeting the 5% target.

The first term of the National Syariah Advisory Council for Islamic Banking and Takaful (the Council) ended on 30 April 1999. Among the decisions made by the Council were as follows:

(i) Banking institutions are allowed to charge compensation on the default financing;

(ii) Women and non-Muslim lawyers could attest to all Islamic financial documents;

(iii) Pledging an asset for more than one contract is allowed subject to the following:
   (a) permission from the first chargee;
   (b) sufficient value to cover all contracts; and
   (c) no "dharar" (harmful) to any party to the contract;

(iv) Cross default clause is allowed to be incorporated in the Islamic banking agreement in order to ensure justice;

(v) For Islamic hire purchase, only the concept of Al-Ijarah Thumma Al-Bai' (Lease and then purchase) will be applied; and

(vi) All banking institutions would be compensated under the RENTAS system for extending overnight financing to other banking institutions, and the amount of compensation is based on the overnight average rate of return of Islamic banks and SPI banking institutions.

For the second term of the Council, BNM has re-appointed four Council members, and appointed two new Council members.

Other Financial Institutions

Discount Houses

The discount houses experienced a further contraction in activities, with total resources declining by RM1.4 billion or 7.1% to RM18.6 billion at end-1999 (–RM970.2 million or –4.6% in 1998). Nevertheless, the environment of ample liquidity and low interest rates enabled the discount houses to achieve a higher level of profitability in 1999 as income earned on investments exceeded the cost of funds appropriated by the discount houses.

The decline in the industry's total resources was due to lower interbank borrowings (–RM2.9 billion or –30.3%). Lending by banking institutions to discount houses had declined due, to some extent, to changes in liquidity requirements under the New Liquidity Framework introduced by BNM, as well as the consolidation of the banking system, which saw several mergers and absorptions taking place in 1999. In addition, interest rates on interbank borrowings were higher than interest rates on fixed deposits throughout the year, which made such borrowings a relatively more expensive source of funding for discount houses.

Table 4.18
Discount Houses: Sources and Uses of Funds

	Annual change		As at end-1999
	1998	1999	
	RM million		
Sources:			
Approved capital funds	157	549	1,596
Deposits	–4,274	933	10,095
Interbank borrowings	2,977	–2,873	6,596
Others	169	–24	272
Total	**-970**	**-1415**	**18,559**
Uses:			
Investments in securities	911	–2,388	16,051
Government debt securites	653	–333	631
MGS held	644	–363	591
Private debt securities	3	–1,512	10,362
Bankers acceptances	–169	–1,096	3,185
Negotiable instruments of deposit	544	38	947
Cagamas debt securities	–211	206	452
Others	91	309	474
Interbank placements	–1,231	828	1,819
Others	–650	145	689

Nevertheless, total deposits mobilised by discount houses increased by 10.2%, reflecting mainly an increase in deposits by non-bank entities. In terms of type of deposits, fixed deposits increased by RM1.4 billion or 23.6% (+RM660.6 million or 12.4% in 1998) mainly due to higher deposits by non-bank financial institutions (+RM906.2 million) and business enterprises (+RM539.4 million). As the economy recovered, many corporations had surplus liquidity and the discount houses were able to tap some of these funds by offering higher rates than those offered by banking institutions. Meanwhile, call money placed with discount houses declined by RM401.4 million or 14.6% (–RM4.8 billion or –63.6% in 1998), mainly as a result of lower placements by commercial banks (–RM674.5 million) and finance companies (–RM456.8 million). The decline was partially offset by higher deposits from non-bank financial institutions (+RM426.9 million) and business enterprises (+RM314.1 million).

Following the contraction in total resources, total investment of discount houses declined by 13% in 1999 (5.2% in 1998). The bulk of the decline was due to lower investments in private debt securities, bankers acceptances and Malaysian Government Securities. On the other hand, investments in negotiable instruments of deposits increased marginally.

During the year, the fee-based activities of the discount houses, however, increased. The industry as a whole arranged, lead-managed and co-managed the issuance of private debt securities (PDS) amounting to RM1.9 billion (RM180 million in 1998). Meanwhile, the total amount underwritten by the discount houses increased to RM585.6 million (RM508 million in 1998), representing a total of 15 PDS issues (seven issues in 1998). As in the previous year, there were only three discount houses appointed as principal dealers in 1999. However, following the annual review of the Principal Dealer System by BNM at the end of 1999, the number of discount houses appointed as principal dealers has been reduced to two, effective January 2000.

National Savings Bank

During the year, the National Savings Bank (NSB) reviewed its corporate mission to be a total financial services provider following the banking sector merger programme, which involved NSB's associate company, BSN Commercial Malaysia Berhad and its subsidiary companies, BSN Finance Berhad and BSN Merchant Bank Berhad. Following the review, the decision was taken to focus on its core business of retail banking with an emphasis on personal finance, catering for the total financial requirements of individuals and households.

Total resources of the NSB increased by RM594 million or 7.2% to RM8.8 billion at end-1999 (+RM697.9 million or 9.2% in 1998). The increase was due mainly to higher deposits, although the number of active account holders declined marginally from 8.7 million at the end of 1998 to 8.5 million at the end of 1999. By type of deposits, the main source of increase was fixed deposits, GIRO and Sistem Perbankan Islam (SPI) deposits. Fixed deposits rose by 29.8% reflecting mainly an increase in placements by corporate clients from RM1.2 billion to RM1.8 billion. Fixed deposits by individuals also increased by RM124.8 million. GIRO deposits turned around to increase by 7.7% in 1999 (a decline of 3.5% in 1998). Of significance was that SPI deposits more than doubled, partly attributable to higher returns relative to fixed deposits.

During the year, fixed deposits remained the most popular deposit scheme, accounting for 44.8% of total deposits outstanding at the end of 1999, followed by GIRO deposits with a share of 34.5%. On the other hand, savings deposits continued to decline by 5.3% in 1999 reflecting, to some extent, a shift from savings to fixed deposits to take advantage of relatively higher interest rates. Savings rates were in the range of

1.50–3.75% while fixed deposit rates were in the range of 3.20–3.75%. Meanwhile, the number of Premium Savings Certificates sold during the year declined by 7% to 482,200 certificates. However, the value of these new certificates exceeded the value of certificates redeemed during the year. Thus, the outstanding amount of Premium Savings Certificates stood at RM556 million at the end of 1999 (RM543.6 million at end-1998). In 1999, NSB introduced a new deposit scheme, namely the Children's Higher Education Savings Scheme (CHESS).

As at the end of 1999, the bulk of funds mobilised by NSB was invested in securities (34.6%), deposits with financial institutions (25.4%) and loans (21.5%). As in previous years, the bulk of investment in securities was in Malaysian Government Securities (MGS), which accounted for 29.6% of the total investment as at end-1999. The investment in MGS continued to decline to RM904.9 million at end-1999 primarily due to redemption to meet cash needs to prepare for potential withdrawals in conjunction with the rollover to year 2000. The statutory requirement for minimum holdings of Government securities (comprising MGS, Government promissory notes, Government guaranteed bonds and Cagamas bonds) by NSB stood at 30% of total investments as at end-1999. Despite redemption of MGS, NSB exceeded this minimum requirement by 17.8 percentage points. Other investments as at end-1999 included trustee stocks (RM845.3 million), Government guaranteed bonds (RM378.3 million), non-trustee stocks (RM250 million), Government promissory notes (RM158.3 million) and unquoted shares (RM145.1 million).

Table 4.19
National Savings Bank

	Annual change		As at end-1999*p*
	1998	1999*p*	
	RM million		
Deposit[1]	717	1,024	7,681
Savings	–136	–77	1,373
Fixed	897	789	3,438
Save-As-You-Earn	–5	–1	16
GIRO	–90	189	2,650
Sistem Perbankan Islam(SPI)	52	124	205
Premium Savings Certificates	–41	12	556
Investments (book value)	–114	–899	3,060
Malaysian Government Securities	–193	–288	905
Other investments	80	–612	2,155
Deposit with financial institutions	568	994	2,244
Gross loans	185	–198	2,008
Net loans (less provision for doubtful debts, bad debts and interest in suspense)	162	–210	1,901
Number of NSB branches[2]	–20	–9	426
Number of post offices with NSB facilities	–1	0	641
Number of account holders ('000)	–204	–156	8,518

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

Lending operations of NSB contracted in 1999. Total loans outstanding declined by RM198.4 million or 9% (+RM185.3 million or 9.2% in 1998) to RM2 billion as at end-1999. The lower volume of loans outstanding was mainly the result of a decline of RM205.6 million in loans extended for the purchase of passenger cars. Nevertheless, loans extended for the purchase of residential property, which accounted for the largest share of total loans outstanding (51.6%), increased by RM30.6 million. The moderate increase relative to that of banking institutions reflected greater competition. Although NSB's average lending rate for housing loans was lower in 1999, at 8.5% (9.5% in 1998), it was less competitive than the housing loan packages offered by some banking institutions which were lower than the average base lending rate of the banking system.

The bulk of loans continued to be extended to individuals, amounting to RM1.7 billion or 85.7% of total loans outstanding. Of this portion, RM1 billion or 58.9% was granted for the purchase of houses and RM0.5 billion or 31.6% was utilised for hire-purchase financing. While corporate loans increased by RM35 million or 33.9% (–RM4.8 million or –4.4% in 1998), subordinate loans declined by RM25 million. As at end-1999, provisions for doubtful debts and non-performing loans (NPLs) amounted to 4.3% (3.4% in 1998) and 8.2% (9.1% in 1998) respectively of NSB's total loans outstanding. The NPLs were mainly related to hire purchase and credit card loans.

Deposits placed with financial institutions increased by RM994 million to RM2.2 billion at end-1999, accounting for a higher share of 25.4% of total assets (15.2% as at end-1998).

In 1999, several branches of NSB were merged, reducing the total number of branches and sub-branches from 435 to 426 at the end of 1999. Savings account facilities were provided in 626 permanent and 15 mobile post offices. Meanwhile, the total number of Automated Teller Machines increased by 10 to 597 as at end-1999.

Provident and Pension Funds

Total resources of the 14 **provident and pension funds (PPF)** surveyed by Bank Negara Malaysia continued to grow in 1999, by 13.5% or RM23.5 billion (1998: +12.7%). As at end-1999, the total resources of the PPF amounted to RM197.1 billion, the bulk (85.5%) of which were the resources of the Employees Provident Fund (EPF). The significant growth in the resources of the PPF was largely due to the growth of accumulated contributions in contributors' accounts. Accumulated contributions grew by 12.2% or RM18.9 billion during the year (1998: +11.3%), reflecting mainly the higher net contributions and dividends credited during the year.

Net contributions to the PPF during 1999 was higher by 22.9%, amounting to RM9.8 billion. This reflected higher gross contributions of RM17.5 billion and lower withdrawals of RM7.7 billion. The increase in gross contributions was due to higher income levels of the contributors amidst strong economic performance and the increase in the number of contributors. The total number of contributors increased by 3.0% to 18.4 million persons at the end of 1999. Meanwhile, the lower withdrawals in 1999 reflected mainly the unusually large amount of withdrawals under the Age 55 Withdrawal Scheme in the previous year.

Another factor contributing to the higher accumulated contributions in 1999 was the higher amount of dividends credited to the accounts of contributors amounting to RM10.4 billion. This was attributed to the higher investment income during the year of RM12.1 billion.

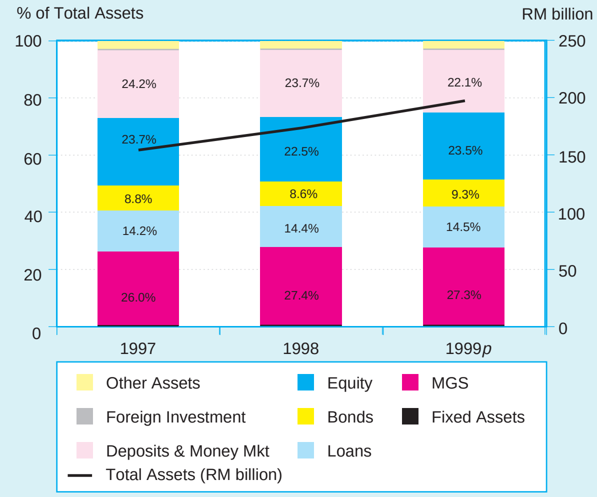
Table 4.20
Provident and Pension Funds: Selected Indicators

	1997	1998	1999p
	RM million		
As at end			Number of
Contributors ('000)	16,788	17,833	18,366
Of which: EPF	*8,275*	*9,158*	*9,532*
: SOCSO	*8,253*	*8,429*	*8,598*
Accumulated Contributions	139,246	155,034	173,944
Assets	154,082	173,597	197,096
Of which: Investments in MGS	*40,021*	*47,481*	*53,775*
During the year			
Gross Contributions	16,888	17,097	17,511
Withdrawals	6,378	9,104	7,683
Net Contributions	10,510	7,994	9,828
Dividends Credited	8,179	9,110	10,376
Investment Income	10,223	11,131	12,140

p Preliminary

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

Graph 4.14
Provident and Pension Funds: Assets



p Preliminary

In terms of the **composition of assets** of the PPF, there was some shift from the holdings of deposits and money market papers to corporate bonds and equities. The share of deposits and money market papers declined to 22.1% (1998: 23.7%) while the share of corporate bonds and equities increased to 9.3% and 23.5% respectively (1998: 8.6% and 22.5% respectively). The shift reflected the preference for higher return assets in an environment of robust economic growth. Meanwhile, the share of investments in Malaysian Government Securities and loans remained relatively unchanged at 27.3% and 14.5% respectively (1998: 27.4% and 14.4% respectively).

Several measures were announced in the Budget 2000 that affected the PPF industry. Firstly, it was proposed that income tax relief up to RM1,000 be given on annuity premiums for annuities purchased under the EPF annuity scheme. This was to support the EPF's effort to promote its annuity scheme. The EPF annuity scheme, which is expected to be launched in June 2000, will provide contributors with an option of receiving a monthly income upon retirement, instead of withdrawing their savings in a lump sum. Secondly, it was announced that civil servants who had been emplaced in the pension scheme would be allowed to withdraw the balance of their contributions with EPF before reaching the age of 55, while the Government's contribution would be transferred to the Pension Trust Fund. This measure was aimed at enhancing purchasing power as well as increasing demand and economic activity. Thirdly, a Children's Education Withdrawal Scheme was proposed to ease the burden of EPF contributors in educating their children. The scheme would allow contributors to withdraw a portion of their EPF contributions for the purpose of tertiary education of their children. In addition, it was announced that EPF contributors would be allowed to make withdrawals for the purchase of computers.

Pilgrims Fund Board

The activities of the Pilgrims Fund Board continued to expand in 1999, although like other financial institutions, it faced challenges, arising from the weak performance of the KLSE in the early part of 1999 and low returns from deposits placed with domestic banking institutions. Total resources mobilised by the Board amounted to RM8.6 billion at the end of 1999, representing an increase of RM1.3 billion or 17.3% (+RM1.2 billion or 18.9% in 1998). The increase in resources was due mainly to the expansion of its operations and the subsequent increase in the number of depositors by 8.9% to 3,748,208 at the end of 1999 compared with 3,440,971 in the previous year. At the same time, the number of Muslims registered with the Board to perform the pilgrimage was higher at 34,926 (29,404 in 1998).

Total depositors' balance, including bonuses credited, rose by RM1.2 billion or 18.1% (+RM1.1 billion or 18.5% in 1998) to RM8 billion, accounting for 93% of the total resources mobilised at the end of 1999 (92.4% at the end of 1998). During the year, new deposits placed with the Board was higher by 15.9%, at RM3.4 billion, while withdrawals rose by 16.2% to RM2.7 billion, resulting in a net increase of RM681 million in total deposits outstanding. The bonus rate remained at 8% per annum in 1999, while the value of bonuses credited to depositor's accounts was higher at RM539.8 million (1998: RM459.2 million).

As at end-1999, the bulk of the Board's funds were invested in corporate securities. Investments in corporate securities rose by RM384.4 million or 11% (+RM499.3 million or 16.8% in 1998) to RM3.9 billion, accounting for 45.1% of total assets in 1999. Of these investments, 73.5% was in quoted shares and 26.5% in unquoted shares. Investments in short-term instruments turned around to increase by RM443.7 million or 24.2% (–RM197 million or –9.7% in 1998) to RM2.3 billion at the end of 1999, accounting for a higher share of 26.6% of total assets. Despite the increase in investments in corporate securities, gross dividends received by the Board declined by 41% to RM147 million in 1999, reflective of lower dividend rates offered by the companies in which the Board had invested. During the year, income earned from other investments was slightly higher, amounting to RM471.1 million (RM466.6 million in 1998).

Industrial Finance Institutions

Total assets of the industrial finance institutions increased by RM2.5 billion or 16.7% in 1999 compared with RM4.5 billion or 43% in 1998. The stronger asset growth in 1998 was primarily due to the transfer of the Export Credit Refinancing Scheme from Bank Negara Malaysia to the Export-Import Bank of Malaysia Berhad in January 1998.

The growth in total assets in 1999 was mainly in the form of loans which accounted for 63.4% of the increase.

Table 4.21
Industrial Finance Institutions: Changes in Direction of Lending

Sector	Year					
	1997/96		1998/97		1999/98	
	RM million	%	RM million	%	RM million	%
Transport & storage	–25.96	–2.36	125.77	8.04	995.29	62.37
Real estate & construction	568.80	51.61	61.83	3.95	838.17	52.53
Mining & quarrying	7.73	0.70	3.82	0.24	9.69	0.61
Manufacturing	214.29	19.44	1,334.22	85.28	–0.77	–0.05
General commerce	19.00	1.72	29.06	1.86	–24.76	–1.55
Agriculture	22.75	2.06	–32.33	–2.07	–13.43	–0.84
Others	295.56	26.82	42.06	2.69	–208.47	–13.06
Total	**1,102.17**	**100.00**	**1,564.43**	**100.00**	**1,595.72**	**100.00**

The increase was funded mainly by capital funds and borrowings. Industrial finance institutions have traditionally relied heavily on capital funds and borrowings to fund their asset growth as they are not licensed to mobilise deposits from the public. Established primarily to promote development programmes in the agricultural, industrial and international trade and export sectors, these institutions are able to access low-cost resources from the Government and foreign institutions including the Japan Bank of International Cooperation (the merged entity of the Overseas Economic Cooperation Fund of Japan and the Japan Export-Import Bank) and the Islamic Development Bank, Jeddah.

Capital funds of the industrial finance institutions increased by 68.6% as at end-1999 to RM3.1 billion accounting for half of the total increase in liabilities in 1999. This was due mainly to the increase in capital funds of Bank Pembangunan dan Infrastruktur Malaysia Berhad from RM105.5 million to RM1 billion (+RM894.5 million) and Bank Industri Malaysia Berhad[1] from RM320.5 million to RM670.5 million (+RM350 million). Bank Pembangunan dan Infrastruktur Malaysia Berhad underwent capital restructuring at the end of 1998 in which 65% (RM488.6 million) of its total Government loans was converted into paid-up capital. Subsequently, in 1999, a bonus issue was declared based on the enlarged capital, increasing its paid-up capital to RM650 million. In addition, a cash injection of RM350 million by the Government had further increased its paid-up capital to RM1 billion as at end-1999. Similarly, Bank Industri Malaysia Berhad also converted its Government loans amounting to RM350 million into paid-up capital, raising the amount to RM670.5 million as at end-1999.

The other major source of funding of the industrial finance institutions in 1999 was borrowings which increased by 10.8% to account for 44.9% of the increase in total liabilities. Borrowings by these institutions included borrowings from related corporations (22.8%), the Government and Bank Negara Malaysia (40.2%) as well as foreign institutions such as the Japan Bank of International Cooperation and the Islamic Development Bank, Jeddah (24.6%). Borrowings from non-Government entities increased by 28% to RM8.8 billion in 1999, while borrowings from the Government fell by 22.5%. The decline in borrowing from Government was due to the partial conversion of the Government loans into share capital of the industrial finance institutions.

[1] Renamed “Bank Industri dan Teknologi Malaysia Berhad” as of 28 February 2000.

Loans extended by the industrial finance institutions increased by 20.8% (RM1.6 billion) in 1999. The increase was attributed solely to Bank Pembangunan dan Infrastruktur Malaysia Berhad’s building up of infrastructure loan portfolio since October 1998 when it was entrusted to finance the nation’s major infrastructure projects. Excluding Bank Pembangunan dan Infrastruktur Malaysia Berhad, loans extended by the industrial finance institutions declined by RM362.1 million in 1999.

In terms of distribution by economic sector, transport and storage accounted for the largest share (62.3%) of the increase in loans, compared with 8% in the previous year while the real estate and construction sector accounted for 52.5% of the increase in loans. In contrast, loans to the manufacturing sector declined by RM0.8 million in 1999. Despite the decline in loans to the manufacturing sector, the exposure of the industrial finance institutions to this sector remained high at 37%.

Overview of the Financial Markets

Developments in the financial markets were mixed in 1999. While trading volumes in the stock, bond and interest rate futures markets was higher, trading in the money, foreign exchange and stock index futures markets registered lower volumes.

Trading volume in the money market was lower by 24% in 1999, amounting to RM1.39 trillion. This reflected the lower trading volume in interbank deposits, which more than offset the higher trading in money market papers. The lower trading in interbank deposits was an outcome of the ample liquidity situation and the subdued loan growth, which led to the reduced reliance on the interbank market for funding needs. Meanwhile, trading volume in all money market papers was higher, except for bankers acceptances and negotiable instruments of deposits. This reflected the shift in investments from lower-yielding shorter-tenure papers to the higher-yielding longer-tenure papers. A notable amendment to the privileges given to the principal dealers (PDs) in 1999 was that PDs are now allowed to net off the actual holdings of excess specified securities from their eligible liabilities base.

In the interbank foreign exchange (forex) market, the average daily volume of interbank forex transactions was lower by 61.3% in 1999, amounting to RM1.4 billion. The sharp decline followed the imposition of the selective exchange controls along with the pegging of the ringgit exchange rate to the US dollar (US$) in September 1998. Following the controls, the offshore ringgit market, which previously contributed to the large volumes in the interbank forex market, was effectively eliminated. Trading activity in the ringgit was subsequently restricted to genuine trade-related transactions as well as for portfolio flows. This was evidenced by the shift in the composition of the major buyers of the US$ for the ringgit from offshore financial institutions to domestic enterprises. Activity continued to be dominated by transactions of the US$ against the ringgit, reflecting the importance of the US$ as a vehicle currency as well as the high US$ concentration of trade settlements and external debt.

Funds raised in the capital market were marginally lower in 1999 amounting to RM17.2 billion (1998: RM17.8 billion). This reflected the lower funds raised by the public sector, while funds raised by the private sector were higher. The amount raised by the public sector was lower because of the better-than-expected revenue collection and the availability of surplus funds from the preceding year. Meanwhile, the funds raised by the private sector were higher, following improved sentiment in the capital market as the economic recovery gained momentum. The higher funds raised by the private sector were driven mainly by the higher amount of funds raised through equity issues, which was more than three times the amount raised in 1998. Despite the marginally lower overall net funds raised, the capital market continued to be the main domestic source of financing for the economy in 1999.

In the equity market, sentiment on the Kuala Lumpur Stock Exchange (KLSE) was generally bullish in 1999, with the benchmark KLSE Composite Index (KLSE CI) rising by 38.6% to end the year at 812.33 points. Similarly, market capitalisation and trading volume was higher (47.6% and 46.1% respectively). The positive market sentiment was driven mainly by the strong economic performance and improved corporate earnings. The more favourable outlook on the Malaysian economy, as evidenced by a series of sovereign credit ratings upgrade and the impending reinstatement of Malaysia into the Morgan Stanley Capital International (MSCI) indices, further encouraged market confidence. The year also witnessed the commencement of trading operations on Malaysian Exchange of Securities Dealing and Automated Quotation (MESDAQ), Malaysia's exchange for growth and technology companies, with the listing of a technology hardware company.

The size of the ringgit bond market continued to expand in 1999 growing by 28.1% to RM201.5 billion. This was driven mainly by the higher issuance of private debt securities (PDS) for corporate debt restructuring schemes. As a result of the strong growth in PDS, the outstanding amount of PDS rose to a level that nearly matched that of Malaysian Government Securities. Trading activity for ringgit bonds was also sharply higher in 1999, amounting to RM155.9 billion or more than three times the amount traded in 1998. Consequently, the market's liquidity, as measured by the ratio of trading volume to amount outstanding, improved significantly, rising to 77.4% from 28.9% in 1998. These developments reflected the growing maturity of the domestic bond market which would augur well for the Government's aim of developing a deep and liquid ringgit bond market.

In the futures market, while trading in the KLSE CI Futures contracts declined significantly by 43%, the 3-month Kuala Lumpur Interbank Offered Rate (KLIBOR) futures contract was more actively traded. The decline in stock index futures trading was due mainly to the lack of foreign participation, while the higher trading in interest rate futures was attributed mainly to the improved liquidity situation in the underlying cash market and the revival of the market maker scheme.

As in previous years, efforts continued to be focused on developing the financial markets. Specifically, measures to improve corporate governance and minority shareholder protection were introduced, notably, the Finance Committee Report on Corporate Governance and the new Malaysian Code on Take-Overs and Mergers. Measures were taken to enhance transparency, such as the requirement for public limited companies (PLCs) to file financial statements on a quarterly basis. The year also marked the commencement of Phase 2 of a three-phase programme to move from merit-based regulation to disclosure-based regulation, with the amendments to the Guidelines on Issue/Offer of Securities.

A strategic initiative to develop a Capital Market Master Plan was also initiated in 1999, to chart the strategic positioning and future direction of the capital market for the next ten years. To provide the policy direction and to rationalise the regulatory framework for the development of the bond market, the National Bond Market Committee (NBMC) was established in June 1999. It was also announced that the Securities Commission (SC) would be the single

Table 4.22
Money Market*

	1998		1999	
	Volume (RM billion)	Annual change (%)	Volume (RM billion)	Annual change (%)
Total Money Market Transactions	**1,837.7**	**-1.2**	**1,412.6**	**-23.1**
Interbank Deposits	**1,650.7**	**-1.4**	**1,189.3**	**-28.0**
Money Market Papers	**187.0**	**0.0**	**223.3**	**19.4**
Bankers Acceptances (BAs)	79.3	–6.9	67.9	–14.4
Negotiable Instruments of Deposits (NIDs)	43.1	–23.6	27.2	–36.9
Malaysian Government Securities (MGS)	33.1	166.9	63.8	92.7
Khazanah Bonds	5.0	–	16.1	222.0
Treasury Bills	6.7	55.8	8.9	32.8
Bank Negara Bills	0.0	–	0.0	–
Cagamas Bonds	4.5	21.6	12.9	186.7
Cagamas Notes	15.3	21.4	26.5	73.2

* All data are sourced from money market brokers, except for MGS, Khazanah bonds and Cagamas papers which are sourced from Bond Information and Dissemination System (BIDS).

regulatory authority for the supervision and regulation of the corporate bond market to rationalise the regulatory framework.

Money Market

The volume of funds traded in the money market declined in 1999 by 23% to RM1,413 billion (see Table 4.22). Although, the volume of trade in money market papers increased by 19.4%, this was more than offset by the 28% decline in the volume of trade in interbank deposits. **Trading in interbank deposits** declined to RM1,189 billion in 1999 from RM1,651 billion in 1998, an outcome of the continued ample liquidity situation in the banking system which led to the reduced reliance on the interbank market for funding needs. The reduced recourse to the interbank market for funds was also a result of the subdued loan growth during the year. By tenure of deposits, the volume of trade declined across all tenures except for deposits of 2-month and 12-month maturities. As a significant proportion of the funds was placed at longer tenures, there was a dampening effect on the overall volume of transactions given that the pace of turnover of longer-term funds is slower thereby, leading to a lower volume of trade. In an environment of ample liquidity, a marked increase in the volume of trades in 12-month deposits reflected market perception that interest rates might have bottomed out. In 1999, the volume of trades in the 12-month tenure increased by RM550 million (36.7 times the volume in 1998).

Trading in money market instruments increased by 19.4% to RM223 billion in 1999 (RM187 billion in 1998) reflecting higher trading volumes in all papers except bankers acceptances (BAs) and negotiable instrument of deposits (NIDs). Lower trading volumes in the latter two instruments was due to the lower issuance of both papers. Total NIDs outstanding in 1999 fell by 51.2% to RM27.3 billion, while total BAs outstanding fell by 20% to RM14.8 billion. There was a notable increase in the trading volume of longer-tenured papers such as Malaysian Government Securities (MGS), Khazanah bonds, Cagamas bonds and notes. This was attributable to the shift in investments from the lower-yielding interbank money market deposits into the higher-yielding money market papers. In addition, the lower net issuance of bonds in 1999 as compared with the previous year also contributed to the increased demand for these instruments. The net issuance of MGS was only RM3.3 billion in 1999 (RM8.8 billion in 1998), while Cagamas bonds recorded a larger net redemption of RM2 billion (a net redemption of RM1.7 billion in 1998). There was only a marginally larger net nominal issuance of Khazanah bonds of RM4.1 billion in 1999 (RM3.9 billion in 1998).

A notable development in 1999 was the significantly higher trading volume in the **Islamic interbank money market** increasing from RM158 billion in 1998 to RM436 billion in 1999. Trading was higher for interbank deposits (+197%) which more than offset the reduction in the trading of Islamic papers (–14%). There was a marked increase in Skim Perbankan Islam (SPI) deposits, especially in the first half of the year, to take advantage of the higher rates offered by the Islamic deposits relative to the rates on conventional deposits. Although the relatively more favourable returns on Islamic fixed deposits declined in the second half-year, especially for 1-month deposits, which reversed its

Graph 4.15
Share of Total Volume Traded

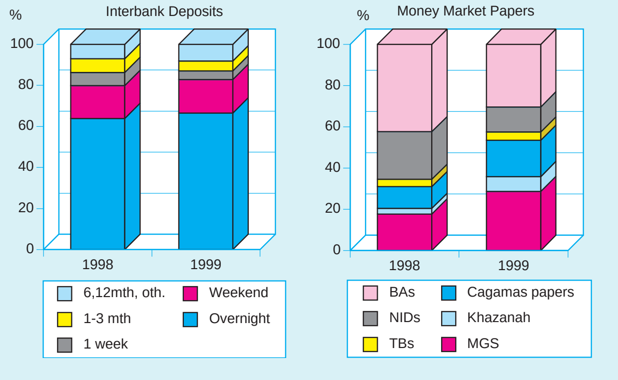


Table 4.23
Islamic Interbank Money Market*

	1998		1999	
	Volume (RM billion)	Annual change (%)	Volume (RM billion)	Annual change (%)
Total IIMM Transactions	**158.1**	**28.1**	**435.7**	**175.6**
Interbank Deposits	**142.0**	**36.9**	**421.9**	**197.1**
Islamic Papers	**16.1**	**-18.3**	**13.8**	**-14.3**
Green Bankers Acceptances (Green BAs)	9.7	–15.7	12.6	29.9
Islamic Acceptance Bills (IABs)	6.4	–22.0	1.2	–81.3

* Volume traded through money market brokers

trend, Islamic fixed deposits of other maturities continued to offer higher rates than conventional fixed deposits of similar maturities. Since the increase in deposits was required to be invested in other Islamic products, this resulted in a marked increase in the trading volume of Islamic interbank deposits. In addition, the increased trading volume of interbank deposits could also be attributed to the participation of discount houses in SPI. In 1999, discount houses were for the first time allowed to participate in the Islamic banking scheme. This is particularly significant as discount houses are active market makers specialising at the shorter-end of the money market. An analysis of the trading volume by maturity indicated that there was a significant increase of about 240% in the trading of overnight and weekend deposits. Meanwhile, trading in Islamic money market papers declined due to the large decline in the trading of Islamic Acceptance Bills (IABs), which was only partially offset by the increase in Green Bankers Acceptances (Green BAs). However, the overall decline in the trading of Islamic money market papers was in line with the decline in the total outstanding issues of all types of BAs.

As part of the annual review of principal dealers (PDs) system, 12 financial institutions (16 in 1999) have been appointed as principal dealers in the year 2000. One notable amendment was made to the privileges given to the PDs. Previously, for the purpose of calculation of their statutory reserve requirement, PDs were allowed to net off from their eligible liabilities (EL) base, 50% of their sales or purchases (whichever is lower) of specified instruments (MGS, Treasury Bills, Cagamas papers and Khazanah bonds) in the secondary market. With the recent amendment, PDs are now allowed to net off their actual holdings of excess specified securities from their EL base. In addition, as part of their new responsibility, each PD is now required to maintain a minimum market share of 2.5% of the total specified securities traded by the industry every month.

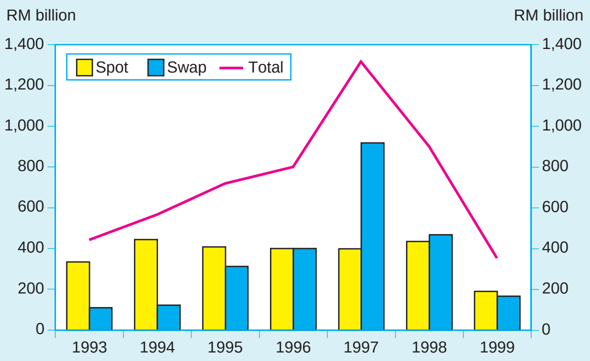
Foreign Exchange Market

The average daily volume of interbank foreign exchange transactions (spot and swap transactions) effected through the eight foreign exchange brokers in the Kuala Lumpur foreign exchange market declined by 61.3% during the year, from RM3.7 billion in 1998 to RM1.4 billion in 1999. The decline followed the imposition of the selective exchange controls and the pegging of the exchange rate to the United States dollar in September 1998.

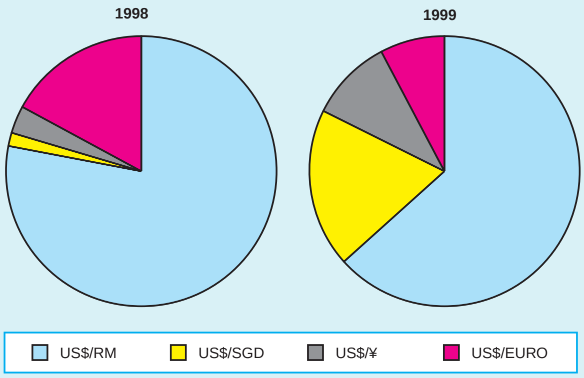
Following the controls, the offshore ringgit market, which previously contributed to the large volumes in the interbank foreign exchange market, had effectively been eliminated. The trading activity in the ringgit was essentially restricted to trade-related transactions as well as for portfolio flows. The larger volumes of trading in 1997 and 1998 were largely due to the significant growth of the swap market and the larger volume of big transactions, both of which reflected the speculative activity.

Activity in the foreign exchange market in 1999 continued to be dominated by transactions of the United States dollar against the ringgit, although its share of total transactions declined to 63.2% from 77.9% in 1998. The continued dominance of US$/RM trades reflected the significance of the US$ as a vehicle currency in the interbank foreign

Graph 4.16
Volume of Interbank Transactions in the Kuala Lumpur Foreign Exchange Market



Graph 4.17
Interbank Transactions in the Kuala Lumpur Foreign Exchange Market by Currency



exchange market as well as the high concentration of trade settlement and external debt in United States dollar. Most notably, trades involving the United States dollar against the Singapore dollar increased by about 3.6 times to account for 19% of the total volume of transactions.

With the introduction of the exchange controls, there has been a shift in the composition of the major buyers of the United States dollar for the ringgit, both in the spot and swap markets. In the past two years, offshore financial institutions dominated the US$/RM market. However, in 1999, the major buyers were domestic enterprises. Swap transactions accounted for 46.6% of total transactions in 1999 (1998: 51.8% and 1997: 69.7%). The lower volume of swap transactions in 1998 and 1999 compared to 1997 was primarily due to the August 1997 restrictions on non-trade related swaps.

Funds Raised in the Capital Market

Funds raised in the capital market were marginally lower in 1999 amounting to RM17.2 billion compared with RM17.8 billion in 1998. This reflected the lower funds raised by the public sector, as funds raised by the private sector were higher in 1999 compared with 1998. The amount of net funds raised by the **public sector** in 1999 was lower at RM6.3 billion, due to the better-than-expected outturn in revenue collection and the availability of surplus funds from the preceding year, when the public sector had raised gross funds of RM9.8 billion. Meanwhile, the net funds raised by the **private sector** was higher at RM10.9 billion (1998: RM8 billion), following improved sentiment in the capital market as the economic recovery gained momentum. Despite the lower overall net funds raised, the capital market continued to be the main domestic source of financing for the economy in 1999. The ratio of net funds raised in the capital market to the net loans extended by the banking system (excluding loans sold to Cagamas but including loans sold to Danaharta) rose from 3.18 in 1998 to 4.72 in 1999.

The lower net funds raised by the **public sector** (RM6.3 billion) was primarily due to the smaller issuance of Malaysian Government Securities (MGS). There were five new issues of MGS in 1999 totalling RM10 billion (compared with six issues totalling RM15 billion in 1998). Nevertheless, MGS continued to account for the bulk (67%) of the gross funds raised by the public sector during 1999. In addition to MGS, the Government also issued a single Government Investment Issue (GII) of RM2 billion to replace the last remaining GII issue in the market upon its maturity. There were also four new issues of zero-coupon Government-guaranteed Khazanah Murabahah bonds in 1999, which raised funds totalling RM2.6 billion (1998: RM2.7 billion). The issuance of these Khazanah bonds was a continuation of Khazanah Nasional Berhad's programme of providing a benchmark yield curve for the ringgit bond market since 1997. The year also saw the raising of RM377 million through the

Table 4.24
Funds Raised in the Capital Market

	1998	1999*p*
	RM million	
By Public Sector		
Government Securities, gross	14,950	10,000
Less Redemptions	6,200	6,676
Equals Net Federal Receipts	8,750	3,324
Khazanah Bonds	2,732	2,598
Govt. Investment Issues (net)	–750	0
Malaysia Savings Bond (net)	–928	375
Net Funds Raised by the Public Sector	9,804	6,297
By Private Sector		
Shares/Warrants	1,788	6,087
Private Debt Securities[1], gross	14,152	17,553
Less Redemptions	7,977	12,750
Equals Net Issues	6,175	4,804
Net Funds Raised by the Private Sector	7,963	10,891
Net Funds Raised in the Capital Market	17,767	17,188
Net Issues of Short-term Securities[2]	185	–607
Total	17,951	16,581

[1] Excludes debt securities issued by banking institutions.
[2] Refers to Commercial Papers and Cagamas Notes only.
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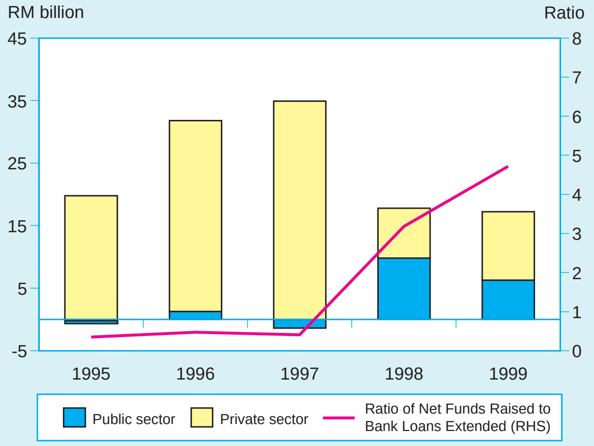
Graph 4.18
Total Net Funds Raised in the Capital Market By the Public and Private Sectors



issuance of the 2-year Malaysia Savings Bonds Series 2, which was aimed at ameliorating the adverse impact of the low interest rate environment on the income earned by retirees on their deposits with financial institutions.

In the case of the **private sector**, the higher net funds of RM10.9 billion raised by the private sector was driven mainly by the higher amount of funds raised through equity issues, which at RM6.1 billion, was more than three times the amount raised in 1998 (RM1.8 billion). The equity issues more than offset the lower amount of private debt securities (PDS) issued (RM4.8 billion; 1998: RM6.2 billion), emerging as the main mobiliser of funds for the private sector in the capital market in 1999. The share of funds raised by the private sector through the issuance of equity securities increased from 22.5% in 1998 to 55.9% in 1999.

In the **equity market**, the bulk of the RM6.1 billion raised was through rights issues (RM4.3 billion), which were significantly higher than the amount of RM0.7 billion raised in 1998. Of the total rights issues, RM2.4 billion, or more than half, was raised by a single firm for the purpose of financing acquisitions. Other forms of equity issuance, namely initial public offers (IPOs), special issues and private placements, also recorded higher amounts. Of significance, no IPO was undersubscribed in 1999 compared with a 56.8% undersubscription in 1998.

In the **PDS market**, the net funds raised of RM4.8 billion was marginally lower despite a higher value of new PDS issues of RM17.6 billion (1998: RM14.2 billion). This was due to the much larger amount of redemptions, which was at a record level of RM12.7 billion in 1999 (1998: RM8 billion). The significantly higher PDS redemptions in 1999 was due partly to the maturity of PDS issued in 1994 and 1996. Specifically, the bulk (57%) of the PDS which matured in 1999 were 5-year corporate bonds issued in 1994 (RM4.3 billion or 78% of corporate bonds issued in 1994) and 3-year Cagamas bonds issued in 1996 (RM3 billion or 63% of Cagamas bonds issued in 1996). In addition to the large scheduled redemptions, the PDS redemptions were also due to 11 early redemptions in 1999 by seven PDS issuers, totalling RM2.4 billion (1998: five early redemptions totalling RM805 million). Straight bonds accounted for 54.5% of the RM17.6 billion gross funds raised (1998: 72.3%), asset-backed Cagamas bonds, 25.2% (1998: 23.5%), Islamic bonds, 9.9% (1998: 2.4%), convertible bonds, 7.2% (1998: 0.7%), and bonds with warrants, 3.2% (1998: 1.1%).

The larger amount of PDS issued and the early PDS redemptions in 1999 were attributed partly to corporate debt restructuring. Indeed, the largest PDS issue in 1999 (accounting for 39.7% of the gross funds raised from PDS issues) was for a debt restructuring scheme. As for Cagamas bonds, there was a net redemption of RM2 billion (1998: –RM1.7 billion), reflecting the larger amount of redemption of RM6.5 billion during the year, compared with RM4.4 billion in new funds raised. In terms of utilisation, 41.7% of the gross PDS funds raised was channelled to the transport, storage and communications sector, while

Table 4.25
New Issues of Private Debt Securities by Sector (RM million)

	1998	1999*p*
Agriculture, hunting, forestry & fishing	0.0	0.0
Mining & quarrying	0.0	0.0
Manufacturing	125.0	524.5
Electricity, gas & water supply	529.0	523.8
Wholesale & retail trade, restaurants & hotels	0.0	170.0
Construction	0.0	1,729.0
Purchase of residential property	1,000.0	0.0
Purchase of non-residential property	0.0	0.0
Real estate	370.0	875.8
Transport, storage & communication	1,103.3	7,316.9
Financing, insurance & business services	11,024.5	5,169.6
Purchase of securities	0.0	1,238.4
Others	0.0	5.0
Total	**14,151.8**	**17,553.0**

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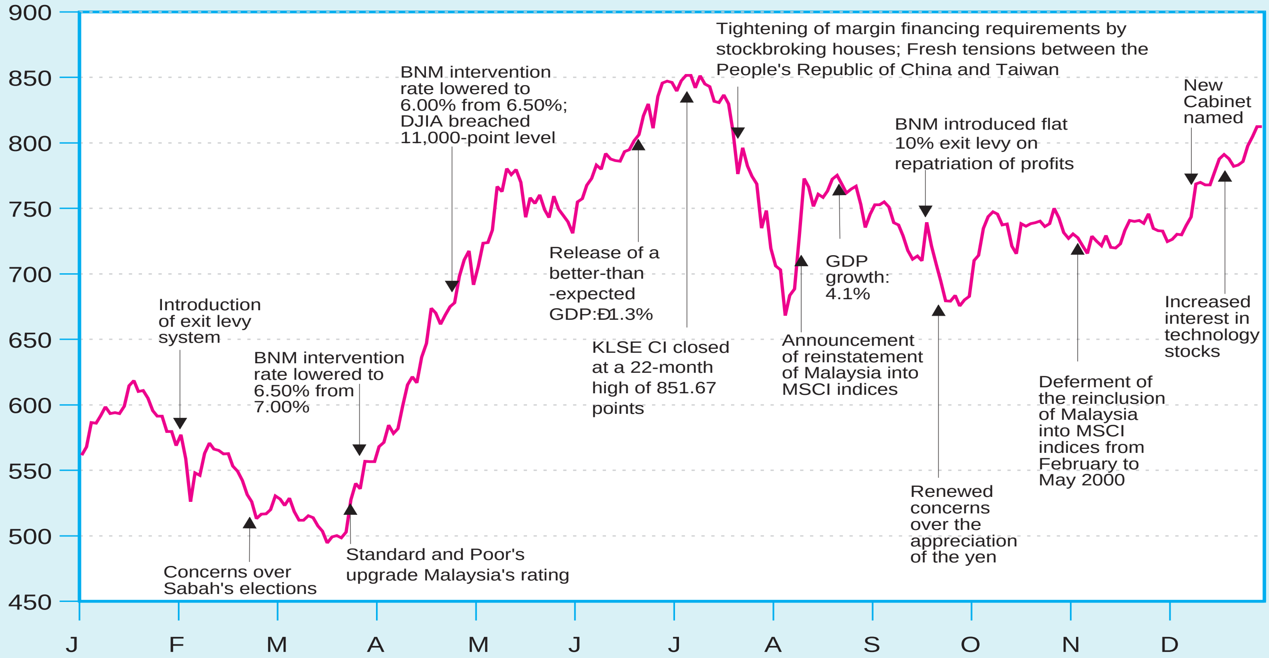
Graph 4.19
Performance of the KLSE CI in 1999



29.5% was channelled to the finance, insurance and business services sector.

Equity Market

Market sentiment on the Kuala Lumpur Stock Exchange (KLSE) was generally bullish in 1999, with the benchmark **KLSE Composite Index (KLSE CI)** ending the year higher at 812.33 points. This was an increase of 38.6% from a year ago. Similarly, market capitalisation increased by 47.6% to reach RM553 billion. The positive market sentiment was driven by the strong economic performance, improved corporate earnings, considerable progress in bank restructuring and the low interest rate environment. The mix of policies and measures introduced by the Government and the KLSE provided a conducive environment for businesses and investments. Market confidence was further encouraged by the more favourable outlook on the Malaysian economy, as evidenced by a series of upgrading of Malaysia's sovereign ratings by a number of international credit rating agencies, the possible reinstatement of Malaysia into the Morgan Stanley Capital International (MSCI) indices, as well as the economic and stock market recovery in the region.

Consistent with the performance of the KLSE CI, all other KLSE indices, except the Mining and Plantation indices, closed the year higher. The Finance index was the top performer, rising by 75.7%. The rise in the Finance index reflected investors' positive response to the significant progress in bank restructuring. In contrast, the Plantation and Mining indices declined by 8.4% and 4.5% respectively. The former was due mainly to the decline in crude palm oil prices (–29.6%) while the latter was in line with the negative growth of the mining industry (–4%). The Second Board index also underperformed the KLSE CI, rising by 14%. This reflected investors' interest in larger capitalised companies.

The KLSE CI in 1999 was on an uptrend for the most part of the year, interspersed by brief periods of decline. It went through four discernible phases. The KLSE CI began the year with a short period on the rise before pressures emerged in the last week of January to dampen the uptrend, and this continued into the end of March. It reached the lowest point of the year (494.57 points) on 24 March. Sentiment turned around in April, with the KLSE CI rising steadily for more than three months to reach a peak of 851.67 points on 9 July. The rising momentum was halted by a brief period of decline from mid-July to early-August, when the KLSE CI fell to 668.21 points. The KLSE CI subsequently recovered, turning bullish again to close the year at 812.33 points.

The KLSE CI started off the year on a positive note on news of a trade surplus for November 1998 and the exchange control relaxation which allowed the repatriation of profits arising from contra transactions. The price increases was shortlived, however, as market sentiment began to weaken by the end of January, and deteriorated further until the end of March. Following the announcement on 4 February 1999, on the introduction of the levy on the early repatriation of capital (previously repatriation of capital within the 12-month holding period was not allowed), the market fell as stocks were sold based on the misperception that only profits repatriated before 15 February would be exempted from levy. Further clarification on the exit levy, however, produced an almost immediate recovery. Nevertheless, the subsequent announcement of a further decline in the Industrial Production Index (IPI) and the concerns over the Sabah elections dampened market sentiment.

Table 4.26
Kuala Lumpur Stock Exchange: Selected Indicators

	1998	1999*p*
Price Indices		
Composite	586.13	812.33
EMAS	146.94	206.39
Second Board	158.37	180.57
Total Turnover		
Volume (billion units)	58.3	85.2
Value (RM billion)	115.2	185.3
Average Daily Turnover		
Volume (million units)	236.9	343.4
Value (RM million)	468.2	747.0
Market Capitalisation (RM billion)	374.5	552.7
Market Capitalisation/GDP (%)	131.7	184.4
Total No. of Companies Listed	736	757
Main Board	454	474
Second Board	282	283
Market Liquidity:		
Turnover Value/Average Market Capitalisation (%)	34.6	40.3
Turnover Volume/Number of Listed Securities (%)	37.1	49.4
Market Concentration:		
10 Most Highly Capitalised Stocks/ Market Capitalisation (%)	35.5	33.9
Average Paid-Up Capital of Stockbroking Firms (RM million)	91.9	103.2

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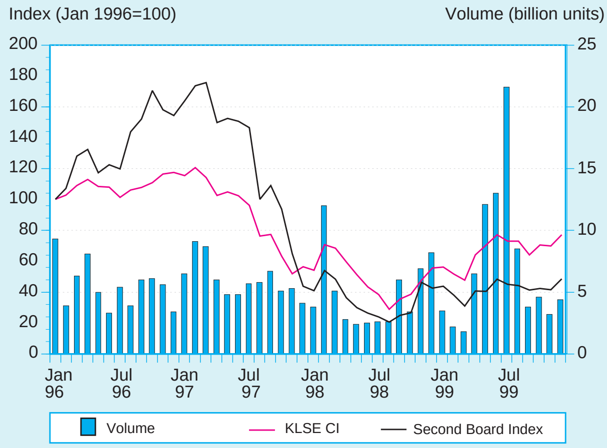
Source: Kuala Lumpur Stock Exchange

Graph 4.20
Kuala Lumpur Stock Exchange Composite Index, Second Board Index and KLSE Trading Volume



Source: Kuala Lumpur Stock Exchange

The KLSE CI rebounded strongly from April to mid-July against a backdrop of improving prospects for economic recovery. The Index rose continuously for three months from April to June by 34.2%, 10.1% and 9.2% respectively. The rise was due partly to the improved views on Malaysia, expressed by a number of major international credit rating agencies and security houses. In addition, market sentiment was also aided by the reduction in the BNM 3-month intervention rate, positive growth in the IPI (3.1% in February; the first upturn in 12 months), the moderation in the CPI (from 3.8% in February to 3% in March) and the smaller-than-expected GDP contraction for the first quarter 1999 (–1.3%). On the external front, the rise of the Dow Jones Industrial Average (DJIA) index, which breached the 11,000-point level on 4 May also helped to boost regional markets, including the KLSE.

The strong rally was interrupted in mid-July, as selling interest prevailed and pushed prices lower. Selling by foreign funds became more prominent as they locked in profits. The falling prices resulted in recurring margin calls by stockbrokers and financial institutions and prompted forced selling, thus reinforcing the sell down. Sentiment was also affected by concerns over the rise in US interest rates, tensions between The People's Republic of China and Taiwan and the strengthening of the Japanese yen.

The sharp decline of the KLSE CI reversed on 9 August amidst several positive developments. These included the MSCI's announcement that Malaysia would

Key Capital Market Measures in 1999

Capital market measures introduced in 1999 were aimed mainly at promoting a more efficient, transparent, innovative and competitive capital market that has the highest standards of integrity and systemic stability. The key measures were as follows:

Improving Corporate Governance and Minority Shareholder Protection

- The new Malaysian **Code on Take-Overs and Mergers** 1998 came into force on **1 January** to enhance transparency and to protect minority interests. The new Code contained, among others, provisions to ensure that minority shareholders were given relevant information necessary to make an informed decision and provisions imposing criminal liability on parties that provide false or misleading information.

- The Finance Committee **Report on Corporate Governance** was released on **25 March**. The Report contained 70 principal recommendations to enhance corporate governance standards and covered three broad areas, namely, the development of the Malaysian Code on Corporate Governance, reform of laws, regulations and rules, and training and education. An Implementation Project Team had been established and entrusted with the task to lead and oversee the implementation of the recommendations in the Report.

- Effective **1 April**, **restrictions** were placed **on the number of directorships** that may be held by directors of public listed companies (PLCs) to address the corporate governance issues arising from multiple directorships, e.g. insufficient time and effort devoted to the boards they represent. The restrictions stipulated that a director of a PLC should not hold more than 25 directorships in companies, of which the number of directorships held in PLCs should not be more than 10.

Enhancing Transparency

- Effective **18 June**, listed companies were required to present their financial statements in accordance with **accounting standards** issued by the Malaysian Accounting Standards Board (MASB). This was to enhance the quality of information disclosed in financial statements and to ensure that accounting standards issued by MASB were complied with.

- With effect from **31 July**, PLCs were required to **file financial statements** with the KLSE **on a quarterly basis**. The aim was to strengthen corporate accountability and disclosure as well as to aid investors in making informed investment decisions.

Strengthening the Stockbroking Industry

- Effective **28 May**, the **Capital Adequacy Requirements** (CAR) were introduced to ensure that the liquid capital of a stockbroking company (SBC) would be sufficient to cover its total measured risks. CAR is a risk-based financial monitoring tool with separately identifiable measures for the specific risks associated with a SBC's business.

- The KLSE issued standards for the **treatment of interest on non-performing accounts** and **provision for bad and doubtful debts** in the financial statements of SBCs, effective **1 July**. The objective was to ensure consistency in the recognition of interest income and the provision for bad and doubtful debts.

- The KLSE introduced **new Memorandum & Articles (M&A) and Rules**, with effect from **1 July**. The new M&A and Rules incorporated enhanced measures to strengthen the stockbroking industry and to achieve greater clarity and transparency in the business conduct of SBCs.

Strengthening the Financial Position of PLCs

- On **30 April**, the Securities Commission (SC) announced that **revisions** were made to the **requirements for KLSE Main and Second Board listings, reverse take-overs and back-door listings** to strengthen the financial position of PLCs. These revisions included more stringent profit track records, higher minimum issued and paid-up capital for companies seeking listing on the KLSE, a standard requirement for a moratorium on the disposal of shares by the promoters of all Second Board applicants and Main Board applicants involved in certain activities, as well as additional criteria for the listing of property development, construction and trading/retailing companies.

Facilitating Capital Raising

- On **30 April**, listed companies were allowed to issue and list **new equity warrants** with attractive exercise prices to replace existing equity warrants. This was to ease the capital raising problems of listed companies by enabling them to have access to more flexible avenues for capital raising.

Facilitating the Move Towards Disclosure-Based Regulation (DBR)

- On **30 December**, the SC announced that the "Policies and Guidelines on Issue/Offer of Securities" (Issues Guidelines) were amended to further facilitate the progressive move towards **DBR**[1]. It marked the commencement of Phase 2 of a three-phase implementation programme to move from merit-based regulation[2] to regulation based on disclosure. The focus of the revisions was generally on the liberalisation of the requirements on pricing of securities, valuation of assets and utilisation of proceeds.

Encouraging the Consolidation of Stockbroking Companies

- In the 2000 Budget proposals, **tax incentives** were granted to encourage the consolidation of SBCs. These were as follows:

  – SBCs engaged in merger exercises would be given stamp duty and real property gains tax exemptions on all instruments related to mergers completed between 30 October 1999 to 31 December 2000.

  – The acquiring SBCs would also be given tax credits (calculated as a sum equivalent to half of the losses suffered by the acquired entity multiplied by the income tax rate). The tax credit could only be claimed against tax payable for two years of assessment immediately following the year in which the merger was completed.

Enhancing Infrastructure and Other Measures

- The Institutional Settlement Service (ISS) was launched on 15 July to facilitate the settlement of trades of investors directly with the clearing house. The ISS allows resident custodian banks and institutional investors to participate directly in the clearing and settlement process.

- The integrated electronic system for share applications was inaugurated on 26 August for an initial public offering. The system marked the beginning of an easier share application process since it reduced the need for form-filling and queuing as it provided investors with the option to use automated teller machines.

- The KLSE Link, which is an internet-based electronic document management system, was launched on 8 October to enhance the content, consistency and timeliness of corporate announcements;

- The KLSE Syariah Index was launched on 17 April to cater to investors seeking to invest in instruments which were in line with Syariah principles;

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1 Under DBR, the SC regulates the quality of information disclosed in offerings of securities and investors determine the investment merits of the offerings.

2 Under merit-based regulation, the investment merits of offerings of securities are assessed and determined by the SC.

- KLSE strengthened its suspension policy in order to ensure continuous trading and proper functioning of the stock market. Effective 14 June, PLCs were no longer allowed to suspend trading by merely submitting requests without detailed justification and, the periods of suspension generally should not be longer than three market days.

- The regulation of depository receipts was put in place on 3 May to enhance foreign interest in Malaysian shares. Following that, sponsored American Depository Receipts (ADR)/Global Depository Receipts (GDR) programmes were allowed to continue to operate for Malaysian listed companies.

Further Developing the Capital Market

- A **Capital Market Master Plan** would be developed to chart the strategic positioning and future direction of the Malaysian capital market for the next 10 years. Among others, it would address the weaknesses in the capital market highlighted during the crisis, provide a strategic road map to facilitate future business development and assist in the creation of a resilient and competitive capital market.

- The **National Bond Market Committee (NBMC)** was established to provide the policy direction and to rationalise the regulatory framework for the development of the bond market as well as to recommend appropriate implementation strategies to address impediments to the development of the bond market. Chaired by the Secretary-General of Treasury, the NBMC included representatives from BNM, SC, Economic Planning Unit (EPU), Registrar of Companies (ROC) and KLSE. Three working groups were established, namely, the Legal and Regulatory Reform Committee, the Product and Institutional Development Committee and the Infrastructure and Operations Working Group. It was also announced that the SC would be the **single regulatory authority** for the supervision and regulation of the corporate bond market to rationalise the regulatory framework.

- To enhance the development of the bond market, it was proposed in the 2000 Budget that the transfer of assets for the purpose of **asset securitisation** would be **exempted from stamp duty and real property gains tax**, effective 30 October 1999 until 31 December 2000.

- In the 2000 Budget proposals, **unit trusts** sponsored by the Federal and State Governments were given income **tax exemptions** for 2000 and 2001 in order to assist the Government sponsored unit trusts to play a bigger role in mobilising savings and to enhance the stability of the stock market.

be reinstated into its MSCI indices in February 2000. The KLSE CI recovered by 15.7% in four days. This development was shortlived, however, as profit-taking and the non-committal attitude of investors ahead of 1 September led the KLSE CI to trend lower. Sentiment, nevertheless, recovered somewhat, following the announcements by BNM of the small amount of portfolio outflows (US$456 million for the period 1-3 September), allaying the earlier fears of a large outflow of portfolio funds from 1 September. The introduction of the flat 10% levy system by BNM on 21 September was also well received by investors. Sentiment, however, remained weak due to the strengthening of the Japanese yen and the re-emergence of fears over the possibility of an interest rate hike in the US.

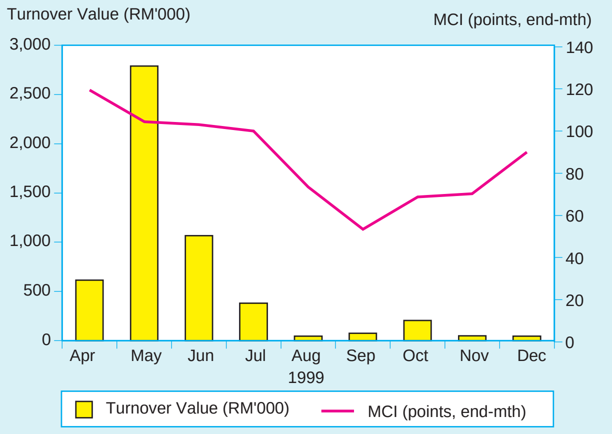
Sentiment began to improve from October, influenced mainly by expectations of a pro-growth Budget. The decision to delay the reinstatement of Malaysia into the MSCI indices from February to May 2000 did, however, dampen sentiment temporarily. Following the favourable response to the new Cabinet line up and the rising interest in technology stocks, sentiment turned bullish in December, with the KLSE CI rising by 10.6%.

In comparison with the performance of the other stock markets in the region, the increase in the KLSE CI (38.6%) was lower than the Korea Composite Index (82.8%), Singapore ST Index (74.8%) and Jakarta Official Index (70.1%), but was higher than the Thailand SET Index (35.4%). In terms of ranking, the KLSE ranked eighth in the Asia-Pacific region and second in ASEAN.

Reflecting the overall positive market sentiment, trading volume on the KLSE was 46.1% higher in

1999, amounting to 85.2 billion units or an average daily volume of 343 million units (1998: 58.3 billion units and 237 million units respectively). In terms of transacted value, the turnover was 60.8% higher at RM185.3 billion (1998: RM115.2 billion). The bulk of the trading (62.4%) was in April to July when market sentiment was most bullish. Trading remained centred on the trading/services (24.4% of total trade) and finance (12.9%) sectors on the Main Board. Of significance was the higher trading volume in the Loans/TSR sector (17.1% of total trade; 1998: 10.8%). This was attributed partly to the decision by the SC to allow the issuance and listing of new warrants to replace the existing warrants. Market liquidity (measured by the ratio of units traded to the number of units of securities listed) increased to 49.4% in 1999 from 37.1% in 1998. Similarly, the ratio of trading value to average market capitalisation rose to 40.3% in 1999 (1998: 34.6%).

Graph 4.22
Malaysian Exchange of Securities Dealing and Automated Quotation: Trading and MESDAQ Composite Index (MCI)

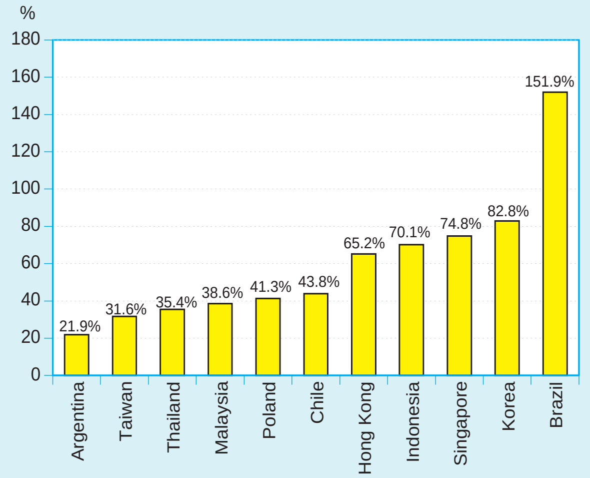


Source: Malaysian Exchange of Securities Dealing and Automated Quotation

Several **measures** were introduced during the year, to further develop the capital market. The key measures are contained in the box, *Key Capital Market Measures in 1999*.

The year 1999 was an important year for **MESDAQ**, Malaysia's exchange for growth and technology companies. The highlight of the year was the commencement of trading operations on 30 April 1999 with the listing of a technology hardware company on the exchange. The MESDAQ Composite Index (MCI) declined initially and rebounded in the last quarter of 1999, broadly in line with the KLSE CI, to close at 89.94 points at end-1999. Trading volume on MESDAQ amounted to RM5.3 million, with the bulk of the trading (53%) concentrated in May. In addition to the single listing, two companies applied for listing in 1999, one of which was involved in smart-card technology while the other was a pharmaceutical company.

Graph 4.21
Performance of Selected Regional & Emerging Stock Market Indices (% change from 1998 to 1999)



Source: International Federation of Stock Exchanges (FIBV)

During the year, MESDAQ also introduced Malaysia's first electronic prospectus and launched the Malaysian Enterprise Network (MEnet). The electronic prospectus was introduced with the first listing on 30 April, and was intended to reduce the cost of IPOs and at the same time extend the reach of prospectuses by leveraging on internet technology. As it turned out, the prospectus for the maiden listing at MESDAQ attracted 64,000 on-line hits with approximately 2,000 copies downloaded. Another development in financial information dissemination during the year was the launch of the MEnet on 16 April. The MEnet is an internet-based bulletin board sponsored by MESDAQ, where Malaysian private limited companies could efficiently and cost-effectively profile themselves to potential investors. As at end-1999, 20 companies and 16 investors had registered with MEnet.

As at end-1999, MESDAQ had 13 stockbroking companies as members, the same number as when trading commenced on 30 April. Seven of these stockbroking companies were market-makers. An open trading system is expected to be implemented by end-2000 to replace the existing trading system, the MESDAQ Quotation

Table 4.27
Outstanding Amount of Ringgit Bonds

	1998		1999p		Change (RM mil)
	RM mil	% Share	RM mil	% Share	
Malaysian Government Securities	75,012	47.7	78,336	38.9	3,324
Government Investment Issues	2,000	1.3	2,000	1.0	–
Khazanah Bonds	4,850	3.1	8,980	4.5	4,130
Malaysia Savings Bonds	4	0.0	379	0.2	375
Danaharta Bonds	2,601	1.7	10,344	5.1	7,743
Danamodal Bonds	11,000	7.0	11,000	5.5	–
Cagamas Bonds	15,064	9.6	13,019	6.5	–2,045
Other Private Debt Securities	46,737	29.7	77,413	38.4	30,676
Total	157,268	100.0	201,470	100.0	44,202

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System (MQS). The move, from the current proprietary platform and network to an open trading architecture which utilises internet-based technologies and standards, would increase the trading system's flexibility and would allow MESDAQ to respond rapidly to the impending borderless marketplace that is being opened up by electronic commerce and the increasing connectivity of issuers and investors worldwide. Meanwhile, as in past years, various roadshows and presentations were also organised for potential issuers, the investment community, the media and the general public, in an effort to market MESDAQ as well as the MEnet.

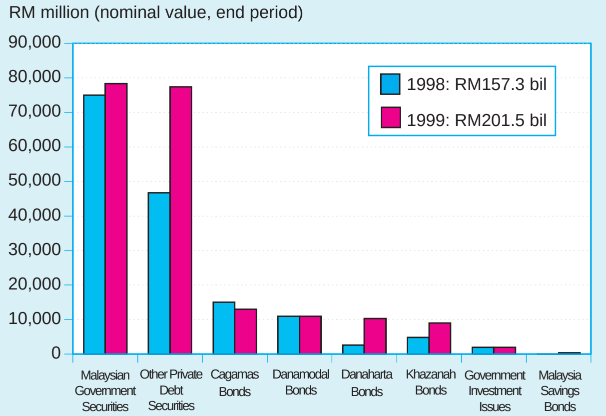
Bond Market

The **size** of the ringgit bond market, comprising public debt securities[2] and private debt securities[3] (PDS), increased by 28.1% during the year, from RM157.3 billion at the end of 1998 to RM201.5 billion at the end of 1999. The growth was driven mainly by the higher issuance of PDS for corporate debt restructuring and the purchase of non-performing loans.

The increase in the size of the bond market reflected mainly the rise in the outstanding amount of other PDS[4] (+RM30.7 billion or 65.6%) and bonds issued by the national asset management company, Pengurusan Danaharta Nasional Berhad (+RM7.7 billion or 298%). Malaysian Government Securities (MGS) continued to account for the largest portion of the total bonds outstanding, although its share fell significantly to 38.9% from 47.7% in the previous year. Most notably, the share of other PDS had risen to a level (38.4%) that nearly matched that of MGS, reflecting the considerable expansion of other PDS in 1999. This development is a positive step towards achieving the Government's aim of developing a deep and liquid PDS market.

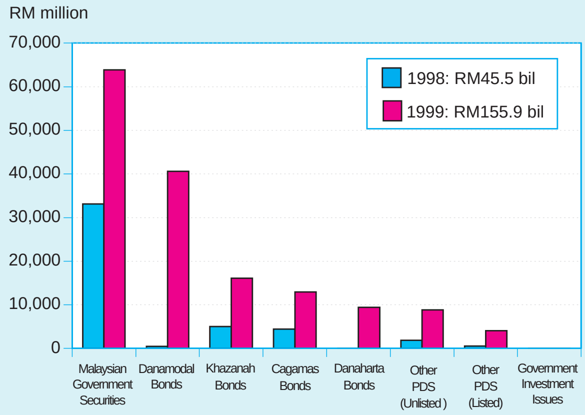
Trading activity in the secondary market for ringgit bonds was sharply higher in 1999. Trading volume amounted to RM155.9 billion, more than three times the amount traded in 1998 (RM45.5 billion). Similarly, the bond market's liquidity, as measured by the ratio of trading volume to amount outstanding, had also

Graph 4.23
Size of the Ringgit Bond Market: Amount Outstanding



[2] Public debt securities refers to Malaysian Government Securities, Government Investment Issues, Khazanah bonds and Malaysia Savings Bonds.
[3] Private debt securities refers to Cagamas bonds, Danamodal bonds, Danaharta bonds and other PDS.
[4] Listed and unlisted private bonds other than those issued by Cagamas, Danaharta and Danamodal.

Graph 4.24
Trading of Ringgit Bonds



Source: Bond Information and Dissemination System

improved significantly, rising from 28.9% in 1998 to 77.4% in 1999. This development reflects the growing maturity of the domestic bond market and augurs well for the development of a deep and liquid bond market. The ample liquidity situation in the banking system, the decline in interest rates, the improved credit risk profiles of corporate bonds, the higher yields offered relative to short-term interbank money market deposits and the recovery in economic activity, were among the contributory factors to the higher trading activity.

As in previous years, trading was focused on the over-the-counter segment of the bond market (97.4%), particularly MGS. Trading of MGS was higher at RM63.8 billion (1998: RM33.1 billion) and continued to account for the largest share of total trading volume. Nevertheless, its share of total transactions at 41% was significantly lower than the 72.8% recorded in 1998. This decline in the share of MGS, reflected the significantly higher trading of the bonds issued by the special purpose vehicle established to recapitalise banking institutions, Danamodal Nasional Berhad (Danamodal). The trading volume of Danamodal bonds amounted to RM40.6 billion in 1999 compared with RM476 million traded in the last three months of 1998[5]. As a result, its share of total trading volume rose from a mere 1% in 1998 to 26.1% in 1999, making it the second most actively traded bond after MGS, taking the place of Khazanah bonds. Danamodal bonds were also the most liquid instrument in the bond market in 1999 (liquidity ratio: 369.4%).

[5] Danamodal bonds were issued on 21 October 1998.

The number of **ratings** of new issues (including short-term debt securities) conducted by the two domestic rating agencies, Rating Agency Malaysia Berhad (RAM) and Malaysia Rating Corporation Berhad (MARC), was significantly higher in 1999. During the year, RAM completed 46 rating exercises valued at RM35.2 billion (1998: six exercises totalling RM934 million). Of these, 42 were long-term issues while four were short-term. Similarly for MARC, new issue ratings numbered 22 compared with seven issues in the preceding year, while the total value of debt rated was RM8.3 billion (RM2.5 billion in 1998). Thirteen of the ratings were long-term issues and nine were short-term issues.

Several measures were introduced during the year, to further develop the ringgit bond market. The key measures are contained in the box, *Key Capital Market Measures in 1999*.

Unit Trust Industry

The **unit trust industry** continued to expand in 1999, as reflected in the growth of five indicators of the unit trust industry (Table 4.29), namely the number of unit trust management companies, number of funds launched, number of units in circulation, number of accounts, as well as the net asset value (NAV). Contributing to the expansion of the industry in 1999 was the 13.5% increase in the number of funds, with the launching of 12 funds during the year (six and nine funds launched in 1997 and 1998 respectively), bringing the number of unit trust funds to 101. One unit trust management company was also established in 1999 (the same number as in 1997 and 1998), bringing the number of such

Table 4.28
Trading of Ringgit Bonds

	1998		1999	
	RM mil	% Share	RM mil	% Share
Malaysian Government Securities	33,085	72.8	63,838	41.0
Government Investment Issues	3	0.0	0	0.0
Khazanah Bonds	5,013	11.0	16,098	10.3
Danaharta Bonds	15	0.0	9,410	6.0
Danamodal Bonds	476	1.0	40,635	26.1
Cagamas Bonds	4,463	9.8	12,944	8.3
Other PDS (Unlisted)	1,886	4.1	8,856	5.7
Other PDS (Listed)	536	1.2	4,094	2.6
Total	**45,475**	**100.0**	**155,876**	**100.0**

Source: Bond Information & Dissemination System

Table 4.29
Unit Trust Industry: Selected Indicators

	1998			1999			1998	1999
	Govt. Sponsored Funds	Private Funds	Total	Govt. Sponsored Funds	Private Funds	Total	Growth (%)	
No. of Unit Trust Management Companies	10	22	32	10	23	33	3.2	3.1
No. of Unit Trust Funds*	28	61	89	29	72	101	11.3	13.5
Units in Circulation (billion)	35.5	11.0	46.5	37.1	15.5	52.6	3.0	13.0
No. of Accounts (million)	7.7	0.8	8.6	7.9	1.0	8.9	3.5	3.5
Net Asset Value (NAV) (RM billion)	32.3	6.4	38.7	32.2	11.1	43.3	15.3	11.8
Ratio of NAV to KLSE Market Capitalisation (%)	8.6	1.7	10.3	5.8	2.0	7.8		

* Refers to funds already launched.

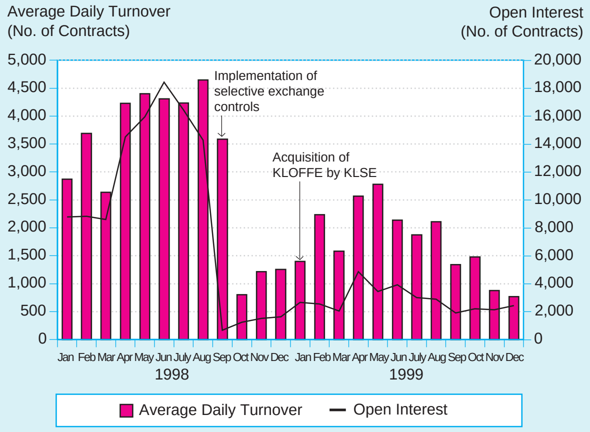
Source: Securities Commission Malaysia

companies to 33. The increase in the number of funds launched and the units in circulation, as well as the strong performance of the KLSE during the year, were among the factors contributing to the 11.8% growth (1998: +15.3%) in the NAV of the unit trust industry, to total RM43.3 billion at end-1999. However, due to the faster growth of the KLSE market capitalisation in 1999 (+47.6%; –0.3% in 1998), the ratio of the unit trust industry's NAV to the KLSE market capitalisation was lower at 7.8% in 1999 (1998: 10.3%).

Futures Market

On 4 January 1999, the KLSE acquired KLOFFE Capital Sdn. Bhd., in line with the global trend towards the consolidation of domestic exchanges. The acquisition would enable the **Kuala Lumpur Options and Financial Futures Exchange (KLOFFE)** to gain access to the infrastructure and operation system of the KLSE, thus providing a comprehensive base to enhance the development of the products offered by KLOFFE. The performance of the **Kuala Lumpur Stock Exchange Composite Index Futures (KLSE CI Futures)**, the only futures product on KLOFFE, was somewhat discouraging in 1999. Trading in the KLSE CI Futures contracts declined significantly by 43% to 436,678 contracts (771,244 contracts in 1998). The lack of interest in the KLSE CI Futures contracts was due mainly to the lower foreign participation since the implementation of the selective exchange controls in September 1998.

Graph 4.25
Kuala Lumpur Options and Financial Futures Exchange: Average Daily Turnover and Open Interest

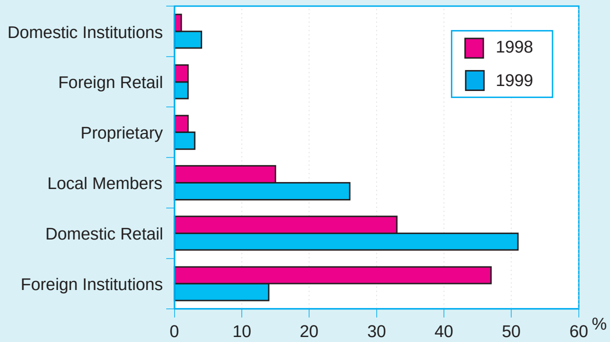


Source: Kuala Lumpur Options and Financial Futures Exchange

During the year, the KLSE CI Futures **prices** tracked the movement of the underlying KLSE CI closely. The KLSE CI Futures started off the year at 582 points, then dipped to a low of 490 points in March, before rebounding to an intraday high of 908.5 points in July. It ended the year at 810 points. The volatility of the KLSE CI Futures reduced markedly, as compared to a year ago. The 20-day moving volatility of the KLSE CI Futures was within a band of 18% to 55% (25% to 215% in 1998) while the underlying KLSE CI was traded within a lower range of 16% to 48%.

In terms of **trading** activities, however, the recovery and the improved market sentiment of the KLSE did not spill over to the futures market. Total trading activity was lower, amounting to 436,678 contracts (1998: 771,224 contracts). On average, trading volume amounted to 1,761 contracts per day (1998: 3,135 contracts) or 43.8% lower than in the previous year. The decline in trading activity was due mainly to the lack of foreign participation. Nevertheless, the open

Graph 4.26
Kuala Lumpur Options and Financial Futures Exchange: Market Demography



Source: Kuala Lumpur Options and Financial Futures Exchange

interest, which is the number of unsettled positions, increased from 1,650 contracts at the end of 1998 to 2,432 contracts at the end of 1999. The Derivatives Liquidity Ratio (DLR), representing the ratio of the turnover value of the futures contracts to the turnover value of the component stocks, stood at 27.9% at the end of the year (24.3% in the previous year). The DLR of less than 100% implied that investors' exposures in the underlying market were not fully covered by its futures contracts, leaving room for further improvement in the turnover value of the KLSE CI Futures contracts.

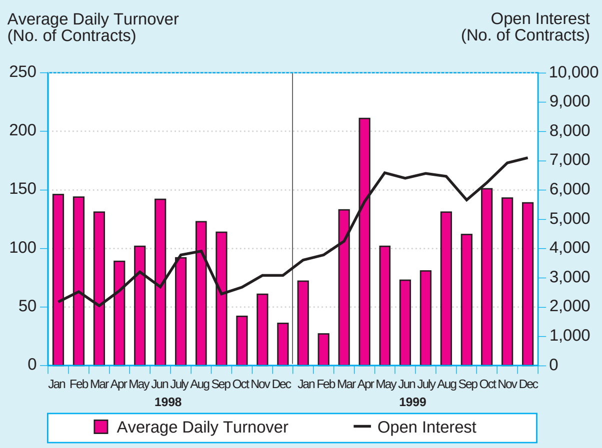
In terms of monthly activity, trading was most active in April and May, with the daily trading volume averaging 2,570 contracts in April and 2,780 contracts in May. In addition, month-end open interest was at its highest in April at 4,878 contracts. This was the period when the market sentiment in the underlying KLSE CI turned bullish, responding to a series of positive news, such as the reduction of the BNM intervention rate, the upgrading of Malaysia's outlook by international credit rating agencies and the overall positive sentiment in the region. In contrast, trading activity declined noticeably in the last quarter, averaging 879 contracts per day in November and 767 contracts per day in December. The lower trading activity reflected market concerns surrounding the general elections and the Y2K issue.

Market **demography** of KLOFFE changed markedly in 1999. Domestic retailers emerged as the major players, accounting for 51% of the total trade (1998: 33%), followed by local members (26%; 1998: 15%). The number of local members increased in 1999 to 61 (1998: 49), reflecting the growing awareness in futures trading. In the past, the market demography of futures trading had been characterised by the dominance of foreign institutions, which accounted for more than 45% of the total trade in the period from 1996 to August 1998. In 1999, the participation of foreign institutions fell significantly to 14% of the total trade (47% in 1998), following their reduced interest in KLOFFE since the selective exchange controls were introduced. However, there was renewed foreign interest in the second half of 1999 when stock market developments reflected the stronger-than-expected recovery in economic growth. The participation of foreign institutions increased from 8% of total trade in the fourth quarter of 1998 to 14% in the third quarter of 1999 and rose further to 18% in the last quarter of 1999. Recognising the need to increase the participation of domestic institutions so that KLOFFE would have a more balanced participation among domestic players, the Futures Industry Act (FIA) was amended to allow domestic fund managers to participate in the futures industry. Consequently, the share of domestic institutions, although small, improved from 1% in 1998 to 4% in 1999.

In 1999, the **3-month Kuala Lumpur Interbank Offered Rate (KLIBOR) futures** contract was more actively traded on the Commodity and Monetary Exchange of Malaysia (COMMEX). KLIBOR futures recorded both a higher turnover during the year (daily average of 115 contracts; 102 in 1998) and a record high open interest position at the end of the year (7,107 contracts; 3,092 in 1998).

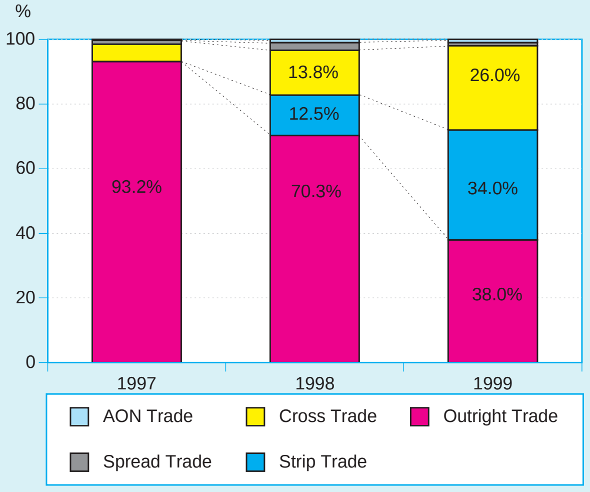
The higher **trading activity** was due mainly to the improved liquidity situation in the underlying cash market and the revival of the market maker

Graph 4.27
KLIBOR Futures: Average Daily Turnover & Open Interest



Source: Commodity and Monetary Exchange of Malaysia

Graph 4.28
KLIBOR Futures: Types of Trade



Source: Commodity and Monetary Exchange of Malaysia

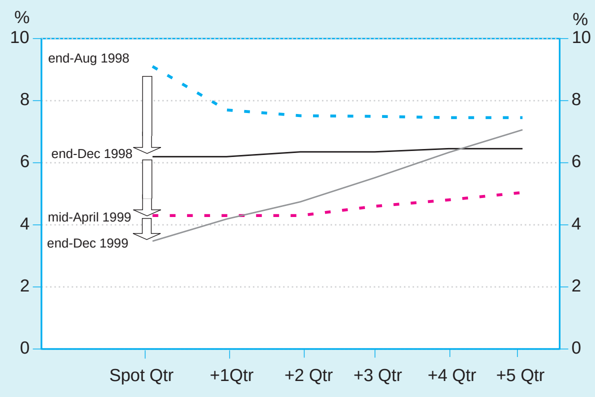
scheme in August 1999. The decline in interest rates during the year could also have increased the demand for hedging against interest rate movements, especially in April when the 3-month KLIBOR declined from 6.3% to 4%. This was reflected in the surge of the average daily turnover to 211 contracts in April (highest monthly turnover during the year) and the increase in open interest position by 1,348 contracts (the highest monthly increase in open interest position ever recorded). The year ended with 7,107 open interest contracts, more than double the number of contracts at the end of 1998. In terms of the types of trades, interest continued to shift from outright trades to strip and cross trades. The share of outright trades fell sharply from 70.3% of total transactions in 1998 to 38% in 1999, while the share of strip and cross trades rose to 34% (1998: 12.5%) and 26% (1998: 13.8%) respectively.

The implied yield curve in 1999, changed from a flat line at the end of 1998 to an upward sloping curve at the end of 1999, with lower implied yields on shorter-term contracts and higher implied yields on longer-term contracts. The implied yield on the spot-month contract declined to 3.48% at the end of 1999 (end-1998: 6.2%), while implied yields on longer-dated contracts were on a declining trend in the first five months, before trending upwards until the end of the year. The implied yield on the 18-month contract, for example, ended the year higher at 7.06% (end-1998: 6.46%). The steepening of the yield curve reflected the market's expectation of higher interest rates in the future. This was partly due to the anticipation of a pick-up in economic activity and loan demand in year 2000 and beyond.

In an effort to boost trading in the KLIBOR futures market, a market maker scheme was re-introduced on 16 August 1999. The revival of the scheme came one year after it was terminated in July 1998 as a result of the financial crisis. Essentially, a market maker scheme requires market makers to make two-way quotes so as to provide liquidity to the market. The scheme started with five market makers but ended the year with four, due to an impending merger of two market makers. Since the launch of the market maker scheme, there was an increase in market turnover, the bulk of which was contributed by the market makers (49–69% of total turnover in the last four months of 1999). Meanwhile, the number of local members of COMMEX increased in 1999 to 52 (1998: 47), reflecting the increased awareness and interest in futures trading following promotional and educational campaigns by COMMEX.

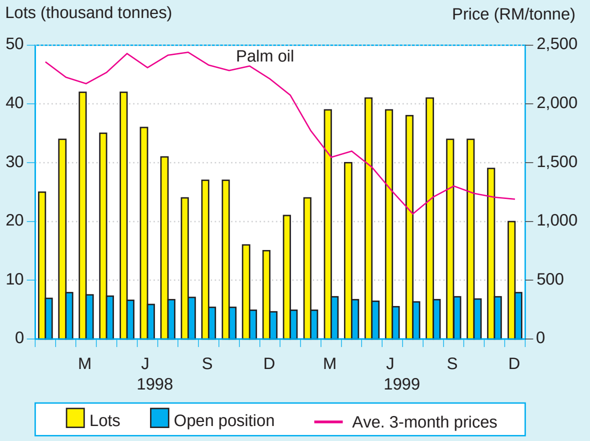
Trading of crude palm oil (CPO) futures contracts on the Commodity and Monetary Exchange of Malaysia turned around to increase by 10.2% to 389,933 contracts or equivalent to 9.7 million tonnes in 1999 (1998: –27% or 353,680 contracts or equivalent to 8.8 million tonnes), primarily on account of the marked increase in Malaysia's CPO production. On a daily basis, the average volume traded was 1,559 lots, compared with 1,443 lots in 1998. Total open positions also increased during the year, from 4,597 lots at end-

Graph 4.29
KLIBOR Futures: Implied Yield



Source: Commodity and Monetary Exchange of Malaysia

Graph 4.30
Futures Trading on the COMMEX



December 1998 to 7,854 lots at the end of December 1999. Foreign participation remained low during the year, although non-residents were allowed since mid-September 1998 to trade in any Malaysian futures market without any restriction on the repatriation of funds as it was exempted from the 12-month holding period and the payment of levy. Foreign participants accounted for 12% of the total volume traded in 1999, compared with 25% in recent years prior to the crisis.

The strong CPO futures prices in 1998 continued briefly in early 1999 with the 3-month price for the commodity staying above the RM2,000 per tonne level in January and trading at a premium over its major competitor, soyabean oil. However, prices fell below the RM2,000 level in February and declined further thereafter, to close at RM1,190 per tonne in December. The downtrend in prices was on account of the sharp increase in Malaysia's CPO production during the year as well as strong competition from the bumper soyabean harvests in the United States and Latin America. With the price decline, CPO was traded at a discount against soyabean oil from May onwards. During the year, the price range for the 3-month futures contract widened to RM1,240 from RM500 in 1998, with the highest price recorded at RM2,203 per tonne.