The Financial Sector

The Financial Sector

SOURCES AND USES OF FUNDS OF THE FINANCIAL SYSTEM

The total assets of the financial system expanded at a slower pace in 2001, in line with the more moderate economic growth. The bulk of its funds was sourced through deposits placed with financial institutions and contributions to the provident, pension and insurance funds. As in previous years, the resources were mainly invested in loans and advances and securities.

The moderate increase in the total assets of the financial system of 3.5% to RM1,295.2 billion reflected the increases in assets of both the banking system and the non-bank financial intermediaries (NBFIs). As a percentage of GDP, the total assets of the financial system rose to 389.4% of GDP from 367.1% in 2000. Given the higher growth of the assets of the NBFIs (6.7%), relative to that experienced by the banking system (2.1%), the latter's share of the total assets of the Malaysian financial system declined from 67.8% at the end of 2000, to 66.9% at the end of 2001.

Within the banking system, the bulk of the increase in assets was due to the growth in assets of the commercial banks (including Islamic banks), finance companies and merchant banks. This reflected mainly the increase in loans and advances and investment in securities as well as deposits with other financial institutions. Meanwhile, assets of the NBFIs accounted for a higher share of 33.1% of total financial system assets at the end of 2001 (32.2% in 2000). The growth in assets of the NBFIs was driven principally by an expansion in the assets of the provident, pension and insurance funds (+RM25 billion), which accounted for 92.7% of the increase in the total assets of this group.

During the year, the bulk of new resources was contributed by deposits placed with financial institutions and contributions to the provident, pension and insurance funds. Though recording a slower growth of 2.9% in 2001 (4.3% in 2000), deposits mobilised by the financial institutions continued to account for the largest share (45.8%) of the total sources of funds at the end of 2001 (46% in 2000). Similarly, the banking institutions (comprising commercial banks, finance companies, merchant banks, and discount houses) continued to be the largest mobiliser of deposits, accounting for 83.4% of total deposits of the financial system (84.1% in 2000).

Graph 4.1
Assets of the Financial System as at end 2001*p* (% share)

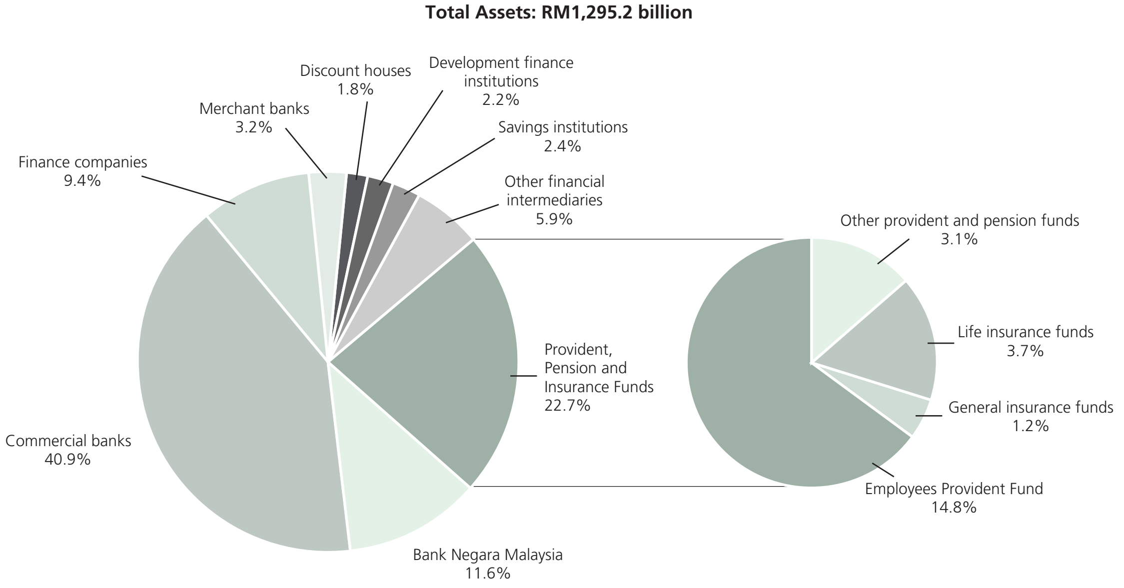

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Table 4.1
Assets of the Financial System

	Annual change		As at end 2001*p*
	2000	2001*p*	
	RM billion		
Banking system	**27.5**	**17.5**	**865.9**
Bank Negara Malaysia	1.9	0.8	149.7
Commercial banks[1]	29.8	5.6	529.5
Finance companies	-4.4	4.2	121.7
Merchant banks	-2.3	4.2	41.1
Discount houses	2.6	2.7	23.8
Non-bank financial intermediaries	**42.6**	**26.9**	**429.3**
Provident, pension and insurance funds	27.8	25.0	294.3
Employees Provident Fund	*18.1*	*6.0*	*191.1*
Other provident & pension funds	*3.1*	*8.6*	*40.3*
Life insurance funds	*6.1*	*9.2*	*47.6*
General insurance funds	*0.6*	*1.2*	*15.3*
Development finance institutions[2]	3.4	2.8	27.9
Savings institutions[3]	7.0	-1.5	30.7
Other financial intermediaries[4]	4.4	0.7	76.3
Total	**70.1**	**44.4**	**1295.2**

[1] Includes Bank Islam Malaysia Berhad and Bank Muamalat Malaysia Berhad (since 1999).
[2] Includes Malaysian Industrial Development Finance Berhad (MIDF), Bank Pertanian Malaysia, Borneo Development Corporation, Sabah Development Bank Berhad, Sabah Credit Corporation, Export-Import Bank Malaysia Berhad, Bank Pembangunan dan Infrastruktur Malaysia Berhad and Bank Industri dan Teknologi Malaysia Berhad.
[3] Includes National Savings Bank, Bank Kerjasama Rakyat and co-operative societies.
[4] Includes unit trust (ASN, ASB, ASW2020, ASN2, ASM (Malaysia) and ASM Mara), building societies, Credit Guarantee Corporation, Cagamas Berhad, leasing companies, factoring companies and venture capital companies.
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Table 4.2
Sources and Uses of Funds of the Financial System

	Annual change		As at end 2001*p*
	2000	2001*p*	
	RM billion		
Sources:			
Capital and reserves	7.1	4.7	126.7
Currency	-3.8	-1.3	25.4
Deposits[1]	23.9	16.8	592.6
Borrowings	-0.4	-0.2	7.3
Funds from other financial institutions[1]	-3.3	0.5	68.9
Insurance and provident funds	23.1	20.0	257.1
Other liabilities	23.5	3.9	217.2
Total	**70.1**	**44.4**	**1295.2**
Uses:			
Currency	-2.4	-2.1	4.5
Deposits with other financial institutions	5.3	-6.3	178.0
Bills	0.1	-0.3	16.3
Treasury	*0.6*	*-0.2*	*4.0*
Commercial	*-0.4*	*-0.1*	*12.2*
Loans and advances[2]	24.6	20.5	534.7
Securities	35.4	36.7	306.8
Malaysian government	*12.6*	*14.1*	*101.6*
Foreign	*0.3*	*0.9*	*2.7*
Corporate	*19.9*	*22.3*	*195.7*
Others	*2.6*	*-0.7*	*6.9*
Gold and foreign exchange reserves	-3.9	3.7	113.5
Other assets	11.2	-7.9	141.3

[1] Effective 1998, the statutory reserves of banking institutions have been reclassified as "Funds from other financial institutions" rather than "Deposits". In this regard, data from prior years have also been revised accordingly.
[2] Excludes loans sold to Danaharta.
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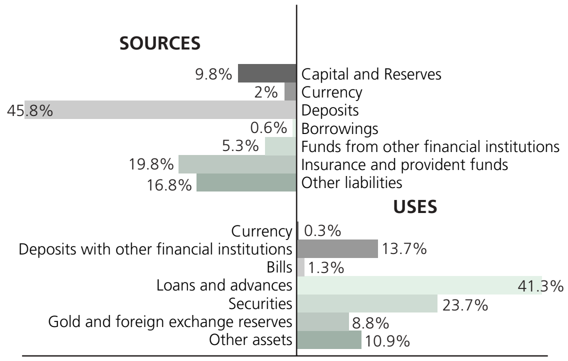
In terms of holders, deposits were mainly held by the non-financial private sector (comprising individuals and business enterprises), which accounted for 68.6% of the outstanding deposits at the end of 2001. The deposits of this group grew by 4.4% in 2001, mainly as a result of an increase in deposits by individuals. As in previous years, fixed deposits continued to account for the bulk of the increase in deposits placed by the non-financial private sector. By maturity, fixed deposits continued to be concentrated at the shorter-end.

Graph 4.2
Sources and Uses of Funds of the Financial System as at end 2001*p* (% share)

Total: RM1,295.2 billion



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Contractual savings with provident and pension funds as well as contributions to insurance funds continued to be the major sources of funds for the financial system, expanding by 8.4% to account for 19.8% of the total funds mobilised by the financial system in 2001. Meanwhile, capital and reserves of the financial system increased by 3.9% (+6.1% in 2000), reflecting mainly the strengthened capital position of the banking institutions.

The increase in the total resources of the financial system in 2001 was mainly invested in loans and advances and securities. The growth of total loans and

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

	Annual change 2000	Annual change 2001*p*	As at end 2001*p*
	RM billion		
Deposits[3] with:			
Commercial banks	37.5	14.3	301.8
Finance companies	-0.9	2.6	60.8
Merchant banks	2.9	-2.4	11.3
Discount houses	1.3	0.0	5.3
National Savings Bank	3.4	0.1	10.6
Others	3.1	2.3	16.6
Total	**47.3**	**17.0**	**406.5**
Demand deposits	14.8	2.1	58.1
Fixed deposits	21.9	9.2	269.1
Savings deposits	10.2	4.0	58.6
NIDs[4]	0.0	-1.1	1.8
Repos[5]	0.4	2.8	18.8
Fixed deposits			
of which:			
Up to 1 year	*10.6*	*6.6*	*237.0*
More than 1 year	*11.4*	*2.6*	*32.2*

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

	Annual change 2000	Annual change 2001*p*	As at end 2001*p*
	RM billion		
Loans and advances	**22.9**	**21.6**	**501.1**
Agriculture	2.7	0.3	13.7
Mining and quarrying	0.0	-0.1	1.3
Manufacturing	1.6	-1.2	55.8
Housing	13.2	12.8	111.1
Construction[2]	-3.3	1.8	84.1
Business services	-0.9	1.4	21.8
General commerce	0.9	0.8	19.4
Transport and storage	0.1	-0.9	13.4
Purchase of shares	0.0	-2.4	20.5
Consumption credit	7.4	9.6	68.3
Others	1.0	-0.4	91.7
Investments in corporate securities	**16.0**	**22.3**	**195.7**
Total	**38.9**	**44.0**	**696.8**

[1] Excludes credit to non-financial public enterprises.
[2] Includes loans for real estate.
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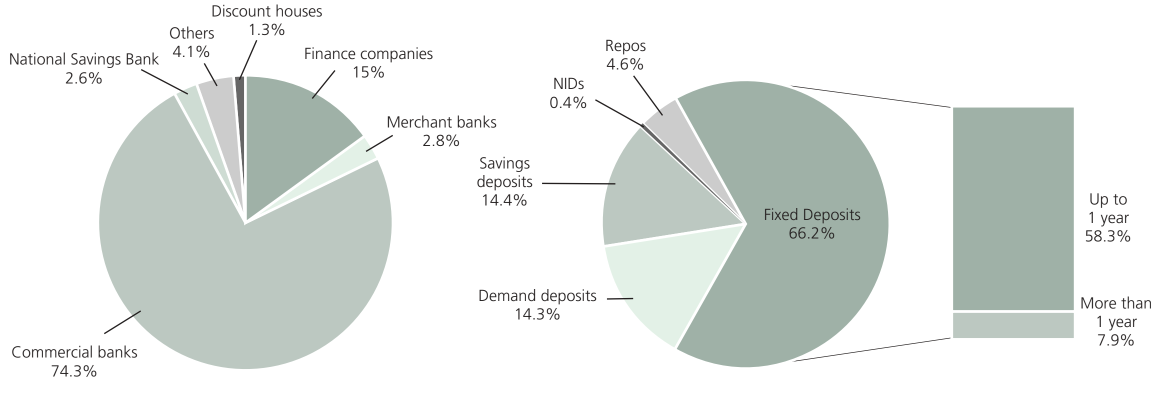
advances was sustained at RM20.5 billion or 4% in 2001 (+RM24.6 billion or 5% in 2000) despite the lower real GDP growth. The sustained loan growth was due mainly to increased demand from the household sector. This was reflected in the higher loans extended for the purchase of residential property and passenger cars.

Investment in securities by the financial system continued to expand in 2001, recording an increase of 13.6%. In particular, there were marked increases in investments in corporate (+RM22.3 billion) and government securities (+RM14.1 billion), in line with the increase in the issuance of both PDS and MGS as well as market expectations of lower interest rates which encouraged investors to acquire debt securities.

Graph 4.3
Non-Financial Private Sector Deposits with the Financial System as at end 2001*p* (% share)

By Institutions
Total Deposits: RM406.5 billion

By Types of Deposits
Total Deposits: RM406.5 billion



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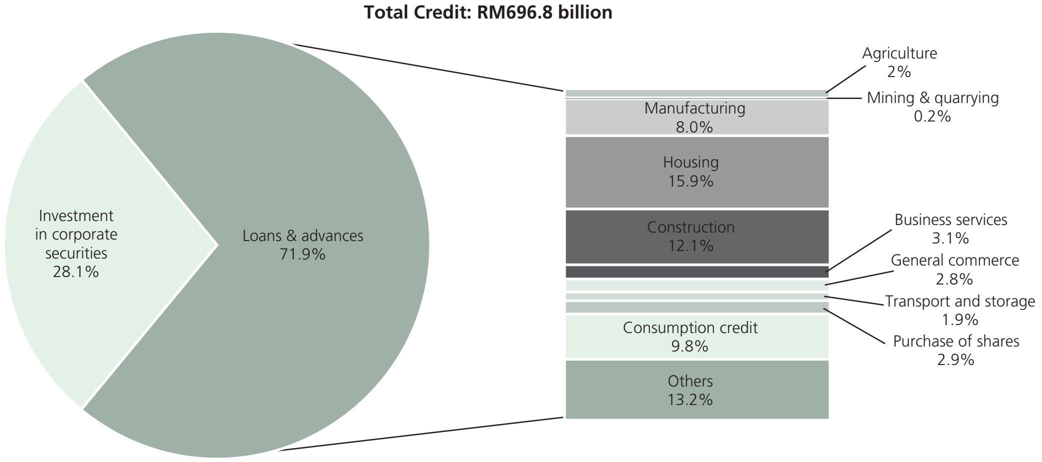
Graph 4.4
Direction of Credit to the Non-Financial Private Sector as at end 2001*p* (% share)



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Provident and pension funds continued to be the main investors in securities, accounting for 41% of the increase in investments in securities. Having declined in the previous year (-RM3.9 billion), gross holdings of gold and foreign exchange reserves turned around to record a marginal increase of RM3.7 billion in 2001, mainly on account of the repatriation of export proceeds from abroad and inflows of foreign direct investment.

MANAGEMENT OF BANKING SYSTEM

The strategies implemented in 1999 and 2000 to strengthen the banking sector continued to be pursued in 2001 aimed at strengthening the ability of the banking sector to operate in a more competitive and increasingly difficult economic environment. In particular, efforts to restructure the large corporate sector debts were intensified during the year. The positive results achieved through the institutional arrangements put in place by the Government during the financial crisis have also succeeded in minimising the impact of the economic slowdown on the overall health of the banking system. Despite the adverse impact of the events on September 11 on the world economy and its consequent impact on the Malaysian economy, the Malaysian banking sector remained resilient and was able to play its intermediation role efficiently and effectively throughout the year. Total outstanding loans of the banking system continued to record positive growth of 3.4%, whilst the preliminary unaudited pre-tax profit of RM7.5 billion for the calendar year 2001 can be expected to further strengthen the capital base of the banking system, thus enhancing further its capacity to meet future challenges. The thrust of the banking policies throughout the year were therefore aimed at preserving the integrity and maintaining the resilience of the banking system amidst a more challenging environment as well as building the necessary foundations for the long term development of the banking system to effectively meet the needs of a changing economy as envisaged in the Financial Sector Masterplan. With the increased resilience of the banking sector, BNM has shifted its focus from managing banking sector problems to medium and longer term efforts towards developing a more robust financial system.

Despite the adverse impact of the events on September 11 on the world economy and its consequent impact on the Malaysian economy, the Malaysian banking sector remained resilient and was able to play its intermediation role efficiently and effectively throughout the year.

Developments in 2001

The restructuring efforts undertaken since the financial crisis have placed the banking sector on a stronger footing to withstand further pressures and to contribute towards macroeconomic stability. The various prudential and developmental measures introduced earlier have also helped to enhance the business and risk management practices within banking institutions. Close regulatory and supervisory oversight on the banking institutions will nevertheless continue to be maintained. Banking institutions are now subjected to more rigorous stress testing and are required to submit more detailed statistics to identify areas of potential vulnerabilities. BNM also conducts regular dialogues with banking institutions to facilitate the formulation of pre-emptive policies that would contribute towards minimising the impact of the economic slowdown on the banking system and to preserve the soundness of the banking sector. One potential area of vulnerability that needed to be addressed was the resolution of the large corporate debts and its impact on the health of the banking sector. To facilitate this process, the corporate debt restructuring framework under the Corporate Debt Restructuring Committee (CDRC) was revamped to accelerate the pace of corporate debt restructuring in Malaysia. Borrowers and creditors were subject to more stringent and definitive timelines in the debt restructuring process to ensure that they complete the resolution process within the shortest timeframe. The membership of the Steering Committee was also expanded to include representatives from Pengurusan Danaharta Nasional Berhad and the Federation of Public Listed Companies. Operational restructuring was undertaken together with financial restructuring to ensure the viability of the debt restructuring scheme. Significant progress has been achieved following this revised framework, with the resolution of a number of debt restructuring cases, including the debts of three large corporates. CDRC had targeted to resolve 10 cases with total debts of RM10.2 billion between 1 August 2001 and 31 December 2001. As at 31 December 2001, CDRC has successfully resolved eight of these cases, with debts accounting for 83.5% of the total targeted amount of debts to be addressed. In total, CDRC has successfully resolved 11 cases in the year 2001, involving debts amounting to RM11.9 billion. With stronger economic recovery envisaged in 2002, CDRC is well placed to meet its target to complete the restructuring of the remaining cases by July 2002.

The merger programme for domestic banking institutions that was initiated in 1999 and concluded in 2000 succeeded in consolidating the fragmented domestic banking sector without causing disruptions to the provision of banking services. In 2001, the focus of the domestic banking groups was to complete the business integration processes and rationalisation exercises. This formed the most critical aspect of the mergers. The banking groups would not be able to reap the benefits of mergers and attain higher levels of economies of scale, synergies and efficiency without rationalising their business operations and removing duplications in resources. Therefore, all banking groups capitalised on the opportunity to reorganise, rationalise and restructure their business operations, including their branch network and staff requirements, in line with their future business strategies. By the end of 2001, all banking groups had conducted their branch rationalisation exercise and five banking groups had rationalised their workforce. All the staff rationalisation exercises were conducted on a voluntary basis. Affected staff were granted the opportunity for various options of redeployment to other suitable business divisions, or to opt for the voluntary separation schemes. For those who opted for the latter, they were adequately compensated. The compensation schemes were relatively consistent across banking groups. Staff were also given the opportunity to participate in a re-skilling programme, aimed towards enhancing their skills in alternative areas of businesses, thereby facilitating their smooth transition into other segments of the economy. As a result of the rationalisation exercises during the year, 187 branches were closed, whilst 55 branches were relocated and a total of 4,240 staff left the banking industry.

All banking groups completed their business system integration during the year with minimal disruption to the provision of banking services to customers, thus enabling customers to enjoy seamless services from the merged institutions. Customers now have access to a wider scope of banking services through cross-selling of banking products between institutions within the same banking groups. The merged banking groups are now more well-capitalised to meet future calls for capital expenditure as well as able to undertake higher levels of risk arising from wider scope of business activities. Domestic banking institutions have already started on aggressive branding campaigns to establish themselves as key players within the Malaysian banking industry.

The merger programme and the structural reforms undertaken by the banking sector since 1998 have enhanced the ability of the banking sector to adjust and cope with a more difficult environment. As an important enabler of the economic transformation and growth process in Malaysia, it was important that the development of the financial sector is aligned

Table 4.5
Merger Programme for Domestic Banking Institutions

Original Anchor Banking Group	Merged with	Resultant Entity After Merger
1 Affin Bank Berhad Group Perwira Affin Bank Berhad Asia Commercial Finance Berhad Perwira Affin Merchant Bank Berhad	BSN Commercial Bank (M) Berhad BSN Finance Berhad BSN Merchant Bankers Berhad	Affin Bank Berhad AFFIN ACF Finance Berhad Affin Merchant Bank Berhad
2 Alliance Bank Berhad Group Multi-Purpose Bank Berhad	International Bank Malaysia Berhad Sabah Bank Berhad Sabah Finance Berhad Bolton Finance Berhad Amanah Merchant Bank Berhad Bumiputra Merchant Bankers Berhad	Alliance Bank Berhad Alliance Finance Berhad Alliance Merchant Bank Berhad
3 Arab-Malaysian Bank Berhad Group Arab-Malaysian Bank Berhad Arab-Malaysian Finance Berhad Arab-Malaysian Merchant Bank Berhad	MBf Finance Berhad	Arab-Malaysian Bank Berhad Arab-Malaysian Finance Berhad[1] Arab-Malaysian Merchant Bank Berhad
4 Bumiputra Commerce Bank Berhad Group Bumiputra Commerce Bank Berhad Bumiputra Commerce Finance Berhad Commerce International Merchant Bankers Berhad		Bumiputra Commerce Bank Berhad Bumiputra Commerce Finance Berhad Commerce International Merchant Bankers Berhad
5 EON Bank Berhad Group EON Bank Berhad EON Finance Berhad	Oriental Bank Berhad City Finance Berhad Perkasa Finance Berhad Malaysian International Merchant Bankers Berhad	EON Bank Berhad EON Finance Berhad Malaysian International Merchant Bankers Berhad
6 Hong Leong Bank Berhad Group Hong Leong Bank Berhad Hong Leong Finance Berhad	Wah Tat Bank Berhad Credit Corporation (Malaysia) Berhad	Hong Leong Bank Berhad Hong Leong Finance Berhad
7 Malayan Banking Berhad Group Malayan Banking Berhad Mayban Finance Berhad Aseambankers Malaysia Berhad	The Pacific Bank Berhad PhileoAllied Bank (M) Berhad Sime Finance Berhad Kewangan Bersatu Berhad[2]	Malayan Banking Berhad Mayban Finance Berhad Aseambankers Malaysia Berhad
8 Public Bank Berhad Group Public Bank Berhad Public Finance Berhad	Hock Hua Bank Berhad Advance Finance Berhad Sime Merchant Bankers Berhad	Public Bank Berhad Public Finance Berhad Public Merchant Bank Berhad
9 RHB Bank Berhad Group RHB Bank Berhad RHB Sakura Merchant Bankers Berhad	Delta Finance Berhad Interfinance Berhad	RHB Bank Berhad RHB Delta Finance Berhad RHB Sakura Merchant Bankers Berhad
10 Southern Bank Berhad Group Southern Bank Berhad	Ban Hin Lee Bank Berhad United Merchant Finance Berhad Perdana Finance Berhad Cempaka Finance Berhad Perdana Merchant Bankers Berhad	Southern Bank Berhad Southern Finance Berhad Southern Investment Bank Berhad

Note: [1] Pending completion of business merger with MBf Finance Berhad.
[2] To be absorbed into Mayban Finance Berhad.

with the envisaged direction for the development of the economy. This is an important element behind the formulation of the Financial Sector Masterplan (FSMP) by BNM that was launched in March 2001, which outlines the broad strategies for the development of the Malaysian financial sector over the next 10 years.

The FSMP outlines the medium and longer term agenda to build a financial sector that is responsive to the changing economic requirements and that is resilient, efficient and competitive. In achieving the end-game, the respective building blocks needs to be put in place to form the foundation on which further progress can be built upon. The recommendations that were outlined in the FSMP were therefore focused on enhancing domestic capacity and capability before progressing towards a more competitive environment in the second phase and finally towards greater international integration. The FSMP identified three key objectives in its implementation phases: firstly, to ***enhance domestic capacity*** by building the capabilities of domestic banking institutions and increased deregulation in certain areas to increase competition; secondly, to ***promote financial stability*** through strong, risk-adjusted prudential regulations and supervision; and finally, to ***meet the socio-economic objectives*** of Malaysia, which includes increasing the level of consumer activism. The thrust of the policy measures and initiatives undertaken during 2001 were therefore aimed towards meeting the objectives in these areas.

Enhancing Domestic Capacity

One of the most significant developments during the year was the introduction of internet banking by domestic banking institutions. Eight domestic banking groups are now offering the full range of banking services through the internet. This is a significant milestone for the Malaysian banking sector, not only in terms of a new delivery channel but also marked the beginning of the liberalisation process. It is planned under the FSMP that the liberalisation of the operating environment for the incumbent foreign-owned banking institutions would start in Phase 2, that is after 2003. However, given the progress that has been achieved by the domestic banking institutions to compete, foreign-owned commercial banks have been allowed to offer transactional internet banking services with effect from 1 January 2002. As at 1 March 2002, three foreign-owned commercial banks have taken advantage of this and are offering transactional internet banking services.

The completion of the consolidation programme for the domestic banking sector represented the initial step towards enhancing the capacity of the domestic players to compete in the new business environment. Following this, the domestic banking groups would need to continuously assess their positions, not only within the domestic market but also within the presence of other regional and international players, and develop strategies to enhance their competitive presence in their targeted market segment. Benchmarking their position vis-à-vis their peers within the domestic banking sector as well as the foreign banks operating in Malaysia, would be an important step for the domestic players to gain this competitive edge, whilst setting realistic targets for improvement.

The benchmarking programme that started in 2000 continued to be one of the main agenda pursued by BNM to enhance the capacity of banking institutions. The benchmarking programme provides a powerful tool for banking institutions to see where their strengths lie and identify the opportunities that can be capitalised in enhancing returns in areas in which they have comparative advantage. As consumers grow in sophistication, the ability for banking institutions to provide wide range of financial services at competitive prices becomes increasingly important. Financial products would need to be personalised and customised to the individual needs of corporate and retail clients. Banking institutions would therefore need to be more proactive and innovative in identifying their niche areas and packaging and marketing their products to cater for the needs of their niche markets. Recognising these challenges ahead, it is important for banking institutions to formulate their plans with clearly defined milestones and the necessary resources required to achieve these goals. Baselines for future comparison would need to be established. Therefore, banking institutions must allocate adequate resources and implement capacity building measures to achieve this strategic objective.

In this regard, BNM has developed a set of general benchmarks in consultation with the banking industry, that has served as an initial framework to measure the position of banking institutions vis-à-vis their peers and help drive performance improvement within each banking institution. These benchmarks include indicators on operating and financing ratios, broad indicators on customer service and ratios to gauge operational efficiency within banking institutions. BNM will continue to provide statistics on industry averages to banking institutions on a quarterly basis to facilitate their internal monitoring process. Efforts are currently ongoing to further refine the general performance indicators to allow banking institutions to better assess their competitive position, particularly in identifying gaps and opportunities relating to different customer and product segments. By monitoring detailed ratios on cost and returns of different products, transactions, customer segments and delivery channels, banking institutions would be in a position to evaluate their key strengths and capabilities. This understanding will help banking institutions to re-examine existing business models, define future focus and leverage on their respective strengths to enhance shareholders' value.

Tracking the progress is an important part of the process. Board of directors of banking institutions are certainly expected to show commitment to drive this process. Towards this end, BNM has implemented the first of a series of awareness programmes for directors and senior management of banking institutions to raise their awareness of best practices on core areas of banking and emerging issues facing the banking industry. The first seminar was on benchmarking aimed to enhance the understanding of the board of directors and senior management of banking institutions on the related issues. Strategies to be undertaken in implementing a benchmarking exercise, how benchmarking could aid an institution in formulating their business plans and drive performance, as well as how benchmarking could be incorporated in risk management practices were discussed. In line with the strategy of the FSMP, further seminars would be conducted, emphasising on areas relating to the capacity enhancement of banking institutions.

As recommended in the FSMP, BNM has also developed a broad framework for the establishment of full-fledged investment banks in Malaysia. The functions of an investment bank are currently performed by different entities within a banking group: that is the merchant bank, stockbroking firm and discount house. The more competitive and challenging environment has made it imperative for these different entities to attain higher levels of efficiency and economies of scale, by facilitating mergers between these different entities. With the creation of investment banks, the consumers would benefit by being able to obtain a wide range of banking and securities related products and services from the merged entity. Towards this end, BNM has undertaken a study to determine the scope of business, desired structure and regulatory framework for the investment banks. As the scope of activities of investment banks would focus on banking-related as well as capital market and securities-related activities, the merged entity would need to be supervised by both BNM and the Securities Commission (SC). As part of this process, efforts are therefore being directed towards harmonising the legal and regulatory framework for the merchant banks and stockbroking companies. This would be essential to minimise regulatory gaps and to ensure that there would not be excessive regulatory burden on investment banks arising from the dual regulatory environment. Efforts are also being undertaken to streamline guidelines, best practices and examination requirements imposed on the stockbroking companies and the exempt dealers, which are the commercial banks and merchant banks. With the standardisation of the operational requirements and continuous collaboration between BNM and the SC, the banking sector and capital market would stand to benefit from the efforts to develop a more robust capital market as envisaged by the Capital Market Masterplan.

BNM continued to place emphasis on preserving the strength and resilience of the banking sector, whilst promoting an environment where innovation and competition amongst players in the financial market were encouraged. The challenge was therefore, to balance the trade-offs between encouraging innovation between players in the financial system and preserving overall financial stability.

Promoting Financial Stability

The initiatives to strengthen the capacity of domestic banking institutions were complemented with continuous enhancements to the prudential regulations in order to maintain stability in the banking sector and to enable the banking sector to adapt to the changes evolving within the industry. BNM continued to place emphasis on preserving the strength and resilience of the banking sector, whilst promoting an environment where innovation and competition amongst players in the financial market were encouraged. The challenge was therefore, to balance the trade-offs between encouraging innovation between players in the financial system and preserving overall financial stability.

Banking institutions are very much involved in the business of managing risks. To ensure that the safety and soundness of the banking system is preserved at all times and to safeguard the interest of depositors, it is critical to have an effective risk-focused and risk-adjusted prudential regulation and supervisory framework in place to govern the conduct of banking institutions. In the past, guidelines relating to the management of risk on derivatives trading were issued to inculcate the practice of sound risk management among banking institutions in the area of derivatives trading. Recognising the need to enhance the overall risk management framework and to align the practices of banking institutions with international best practices, BNM has issued a guideline on best practices for credit risk management and is currently developing a more comprehensive market risk management framework to address the risk exposures that are inherent in the banking business.

The continued emphasis on sound credit risk management clearly strengthens the point that credit risk forms the largest source of risk faced by banking institutions as their core business is in lending activities. The recent Asian financial crisis has highlighted that poor credit risk management is a source of vulnerability in banking institutions and the absence of sound credit risk practices and strong credit culture may result in significant or even crippling losses. Therefore, the Guidelines on Best Practices for the Management of Credit Risk formed the foundation towards upgrading the practices by banking institutions with regard to credit management and administration. The guidelines prescribed the specific requirements that banking institutions have to comply with, as well as best practices which banking institutions are encouraged to observe. The establishment of sound credit risk management practices and culture as envisaged in the guidelines rests on four pillars: enhanced responsibility on the part of the board of directors and management of banking institutions in the credit risk management process, having in place adequate infrastructure for effective credit risk management, the development of an integrated risk management process and the establishment of comprehensive internal controls and audit procedures for credit risk management.

The responsibilities of the board of directors of banking institutions to be aware and ensure that proper oversight on credit risk management is established within banking institutions is one of the key requirements emphasised in the guidelines. Board members are expected to focus on supervisory oversight to ensure that adequate credit risk management processes are put in place and that the credit risk policy is consistent with the banking institutions' capital strength, management expertise and risk appetite. The board of directors need to be kept informed in a timely manner on the performance of the credit portfolio and banking institutions are required to set up an independent credit risk management committee, which does not have any credit approval authority, to assist the board in overseeing the overall credit risk management process. The functions of the credit risk management committee would include, among others, evaluating and assessing the adequacy of strategies and policies to manage the overall credit risk associated with their activities; monitor, assess and advise on credit risk portfolio composition; and evaluate risks under stress scenarios and the capacity of the banking institution to sustain such risk.

The level of risk exposure that a banking institution assumes on a credit facility is determined when the decision is made to grant the facility. Thus, it is important for the credit assessment and evaluation process to be properly conducted by competent personnel using all relevant information and appropriate risk assessment tools to perform the evaluation process. The credit management process should include regular reviews on the financial position and the repayment capacity of the borrower, as well as taking into account the developments facing the economic sector in which the borrower operates. As such, having competent personnel in the credit granting and review process is essential towards enhancing the quality of credit. Recognising this, the guidelines require that all personnel involved in the credit appraisal, approval and review process to undergo an accreditation programme. This programme would enhance the understanding on the risks associated and the factors and market conditions that may subsequently affect the quality of the credit granted.

The upgrading in the level of skills amongst credit personnel alone would not be sufficient. It has to be complemented with an effective credit risk management information system to help banking institutions identify potential areas of vulnerabilities among borrowers, thus enabling them to take

Banking Measures Issued in 2001

The regulatory framework was further strengthened in 2001 with the introduction of several new policy measures and further refinement to the existing prudential guidelines. In addition, liberalisation measures were also instituted as part of the continuing effort to improve the competitiveness and efficiency of the financial sector. Several recommendations outlined in the Financial Sector Masterplan (FSMP) were also implemented during the year.

Enhancing Resilience and Capacity of Banking Industry

Revision of Corporate Debt Restructuring Committee (CDRC) Framework

In previous years, the size and complexity of the cases referred to the Corporate Debt Restructuring Committee (CDRC) contributed to the slow progress of debt restructuring efforts. The unfavourable market conditions and sentiments have also affected the smooth implementation of some of the restructured schemes which had obtained all the necessary approvals from the authorities, including those involving disposal of assets and raising of new equity capital. In certain instances, several cases had to be revised to review aspects of the previously agreed and approved terms and conditions, thus delaying the implementation of the restructuring process.

To expedite efforts to strengthen the corporate sector and to enable the restructuring exercises to be conducted effectively to place the corporate sector in a position to continue to participate in the economic growth process, a number of changes were introduced to the CDRC framework to facilitate and expedite the restructuring efforts under its purview. These initiatives are as follows:

(i) Inclusion of representatives from Danaharta and the Federation of Public Listed Companies in the CDRC Steering Committee;
(ii) Revision to the CDRC framework and approach with a specific timeline set to ensure effective implementation of the restructuring schemes (CDRC has set a timeline of one year for the completion of the restructuring of key corporate groups);
(iii) Enhance greater discipline among borrowers and creditors where borrowers would be required to undertake operational restructuring, where necessary, and for creditor banking institutions to be more realistic in their recovery expectations; and
(iv) Enhance disclosure and reporting through the issuance of a quarterly update on the progress of debt restructuring to ensure a more comprehensive reporting of the corporate borrowers and the progress of the restructuring to allow for greater transparency of the restructuring process.

The criteria for acceptance of loans to participate in a restructuring exercise under the CDRC was also changed to be eligible only to cases which involved an aggregate borrowing of RM100 million by the borrower as compared to RM50 million previously, and for the borrower to have exposure to at least five creditor banks as opposed to two creditor banks previously. The guiding principles to be adhered by all parties concerned, the formulation and implementation of workout proposal for the CDRC cases and the conditions to be abided during standstill periods remain unchanged.

Industry Wide Benchmarking Project

One of the key recommendations outlined in the FSMP to drive improvements and enhance the capacity of the banking industry is the benchmarking exercise. BNM in discussions with the Association of Banks in Malaysia has embarked on an industry wide benchmarking project to provide banking institutions with a means to elevate the performance of the banking sector. This is essential in equipping banking institutions with the necessary knowledge to leverage and reap the potential opportunities and to effectively address emerging challenges.

While indicators and benchmarks have been used previously, this is the first time that a wide ranging set of indicators has been formulated to form a basis for a periodical and systematic assessment.
A committee comprising a number of industry players, the Association of Banks in Malaysia and BNM

was set up to drive the benchmarking project. The group is responsible for developing the quantitative and qualitative benchmarks that would serve as 'drivers' of performance improvement. To initiate this process, BNM has begun to disseminate reports to banking institutions, benchmarking each bank's performance against that of the industry. Currently, there is a proposed set of minimum general benchmarks that are being adopted by all the banking institutions. These include benchmarks for capital adequacy, profitability, asset quality, liquidity, loan performance, productivity, customer service and operational efficiency. This set of indicators will be further refined with additional and more detailed indicators so as to enhance understanding of the factors driving the banking institutions' performance. The results from the benchmarking exercise will provide valuable input to banking institutions to guide them in implementing capacity building initiatives. The monitoring of comprehensive ratios and indicators will facilitate banking institutions to better evaluate their key strengths and capabilities and use this understanding to examine existing business models and strategies, and define future focus in the face of a constantly changing financial landscape.

Prudential Measures

Guidelines on Directorship in Banking Institutions

As part of the overall effort to improve the quality of corporate governance in the banking sector, the Guidelines on Directorship in Banking Institutions (BNM/GP1) was revised on 24 July 2001.

The main revisions cover:

- *Restricting directorships by the CEOs of banking institutions to the holding company, sister company or subsidiary of the sister company, all of which must be financial institutions and limiting the number of directorships held by a CEO at any one time to five.*
  This aims to ensure that CEOs of banking institutions are able to concentrate and dedicate their full attention on the management of the respective banking institution. Directorship in related companies would allow the CEOs to streamline the activities of the banking institutions with the financial companies in the group, thus enabling the group to maximise both its synergistic value and profitability. Directorships in organisations that represent the interests of the banking industry, non-profit organisations and statutory bodies or Government-owned companies, are however permitted and would not be part of the limit.

- *Accord full discretion and responsibility to the Board of Directors of individual banking institutions in determining the remuneration of CEOs.*
  The bonus, salary, increment and remuneration package of CEOs would be determined by the Board based on objective, measurable and transparent criteria. The total remuneration of the directors and the CEOs must be disclosed in the annual financial statements of the banking institutions.

Best Practices for the Management of Credit Risk

Following a series of discussions with the banking industry, the Best Practices for the Management of Credit Risk (Best Practices) was implemented on 1 September 2001. The Best Practices stipulates the minimum standards on best practices and mandatory requirements to be observed by all banking institutions in all aspects of their credit activities. The issuance of the Best Practices is one of the recommendations outlined in the FSMP.

Reflecting the nature of banking business, credit risk remains the largest source of risk for banking institutions. Effective credit risk management is therefore vital to minimise the risk of insolvency emanating from poor and weak credit processes and risk management. In tandem with this objective, the Best Practices aims to lay the foundation for the progressive development of higher standards in the management of credit risk and to inculcate strong credit culture in banking institutions.

Among the major requirements stipulated in the Best Practices are:

(i) *Appropriate overview by the Board of Directors and management*

- The Board of Directors is entrusted with the supervisory role and is responsible for ensuring that adequate risk management processes are in place. Therefore, the Board of Directors will no longer approve loans so as to enable them to undertake their supervisory role more effectively. However, the Board of Directors can reject loans or modify the terms of the loan that have been approved by the banking institution's executive body/credit personnel, should the majority of the Board be of the opinion that the loan would expose the banking institution to undue excessive risk.

(ii) *Existence of adequate infrastructure for credit risk management*

- An independent committee comprising of personnel experienced in credit and risk management must be formed and be chaired by a director (without the executive powers to approve credit) to assist the Board in overseeing the credit risk management processes;
- Personnel involved in credit-granting activities must be accreditated by reputable bodies or individuals acknowledged by the Board, after undergoing a common training programme and passing a common test, before being eligible to approve a credit proposal;
- A product evaluation programme must be carried out where all new credit products must be signed off by all relevant departments affected by the product and approved by the committee/the Board before its introduction; and
- An effective management information system must be put in place to enable management to be aware of, measure, monitor and control the credit risk inherent in its activities.

(iii) *Existence of an integrated risk management process*

- The credit approving function must be performed by full-time executive personnel or a committee comprising of such personnel;
- An internal credit grading system must be developed to systematically grade the credit risk of the banking institution's loan accounts;
- Credit assessment must be based on repayment capacity rather than on collateral, with specific reference and comprehensive assessment of the identified source of repayment;
- An independent credit review department or unit to review (audit) the quality of loan appraisals done by the mainstream credit officers and the approval process in accordance with standards set; and
- Biannual stress analysis, or at more frequent intervals as may be prescribed by BNM, must be performed, the results of which must be tabled to the Board.

(iv) *Comprehensive internal controls and audit procedures*

- An audit evaluation must be performed to assess the independence, adequacy and overall effectiveness of the credit risk management systems.

Accounting Treatment for Loans Sold to Cagamas with Recourse

With effect from 1 September 2001, the accounting treatment for loans sold to Cagamas on a recourse basis was revised to reflect the essence of the transaction (including under the back-to-back arrangement). Following the revision:

- loans sold to Cagamas on a recourse basis will no longer be deducted from gross loans. Proceeds from the "sale" transaction is reclassified to the "liability side" of the balance sheet; and
- interest income received from the loans and subsequently paid to Cagamas would be recognised on a gross basis as "interest income" and "interest expense" respectively, instead of on a net basis as "non-interest income".

The sale of loans to Cagamas Berhad on a recourse basis effectively entails a secured financing as any defaulted loans would be returned and replaced by the selling banking institutions. Thus, from a risk point of view, the credit exposure remains with the selling institutions, even after the loans have been "sold". The revision attempts to ensure that the books of a reporting entity reflect the substance of the transaction, rather than its form, the main principle underlying the generally accepted accounting principle.

Anti-Money Laundering Act 2001

The Anti-Money Laundering Act 2001 (AMLA) was gazetted on 5 July 2001. The enactment of AMLA signifies a concerted and comprehensive effort to combat illegal transfer of financial resources as a mean to legitimise such assets. AMLA provides comprehensive new laws for the prevention, detection and prosecution of money laundering, the forfeiture of property derived from, or involvement in money laundering and the requirements for record keeping and reporting of suspicious transactions for reporting institutions.

In recognition of the importance of a co-ordinated national effort in the fight against money laundering, the National Co-ordination Committee to Counter Money Laundering (NCC) was formed involving the various ministries and government agencies as its members. One of the major outcomes of the various initiatives undertaken by the NCC is the enactment of AMLA in 2001.

AMLA addresses the following broad issues:

(i) *Money Laundering Offences*

Stipulates monetary penalty of up to RM5 million or imprisonment not exceeding five years, or both, on any person found to be engaged or abetted in money laundering. The Second Schedule sets out the criminal activities that are illegal activities for the purpose of money laundering which include among others, serious crimes of drug trafficking, corruption and certain offences under the Penal Code such as kidnapping, robbery, human trafficking, gambling, vice and fraud.

In the civil or criminal proceedings ensuing the offence, no witness shall reveal the identity of the person who discloses the offence unless required by the court. No publications or broadcasting of the proceedings are allowed on the disclosure, or person who does the disclosure, except if the person is charged with the offence.

(ii) *Financial Intelligence Unit (FIU)*

Empowers the Minister of Finance (MoF) to appoint a competent authority, who will be empowered to act in accordance with this Act. In this regard, the MoF has appointed BNM as the competent authority and a 'Financial Intelligence Unit' (FIU) has been set up in BNM. Its responsibilities include:

- receiving and analysing reports issued by the reporting institutions;
- sending any report received or information derived from any such report to an enforcement agency;
- sending any information derived from an examination to an enforcement agency;
- compiling statistics and records;
- making recommendations to the relevant supervisory authority, enforcement agency and reporting institutions;
- developing training requirements and providing training for any reporting institutions; and
- communicating relevant information to a corresponding authority of a foreign state.

(iii) *Reporting Obligations*

The obligations of the reporting institutions cover:

- record keeping by the reporting institutions;
- immediate reporting on transactions exceeding an amount specified by the FIU or any suspicious transaction, either to the FIU or the supervisory authority;
- maintenance of records for a period of not less than six years, even after the closure of the account;
- verification of the identity of the account holder using official or private documents for any banking service to be offered. In the case of an account opened on behalf of another person, reasonable measures must be undertaken to obtain the true identity of the person; and

- adoption, development and implementation of internal programmes, policies, procedures and controls in order to guard against and detect any offence. The aforesaid programme needs to address the integrity of employees; conduct training programmes to enable the employees to disclose their responsibilities effectively, designate compliance officers at the management level and develop audit functions to test compliance. Compliance shall cover all branches and subsidiaries inside and outside Malaysia.

Provisions stipulated under AMLA overrides the secrecy obligation imposed by any written law.

(iv) *Powers of investigation, search and seizure*
This is to be undertaken by a competent authority and enforcement agencies (EA) upon having reason to suspect an offence under AMLA. The powers include:
- power to enter and search the premises for any property, record, report or document;
- make copies of, take extracts from, take possession of or remove from the premises, any of the records, reports or documents that were seized; and
- power to search and detain any person found on such premises until the search is completed.

(v) *Powers of freezing, seizure and forfeiture of property*
The EA may issue an order to freeze any property and seize any movable property suspected to be the subject matter of an offence or evidence relating to such an offence, except those in the possession, custody or control of a financial institution. Where the movable property seized comprising money, shares, securities, stocks, debentures etc, belonging to a person other than the person being prosecuted, the seizure shall prohibit the using, transferring or dealing with such property; or require the surrender of the property.

Liberalisation Measures
Negotiable Instruments of Deposits
With effect from 22 January 2001, the maximum tenor for the issuance of negotiable instruments of deposit (NIDs) was lengthened to ten years from five years.

The NIDs were first introduced in 1979 as an alternative avenue for banking institutions to source funds. When the NIDs were first issued, the maximum tenor was restricted to three years. Over the years, the maximum tenor was lengthened to five years in tandem with developments in the local debt market. Reflecting the need to further deepen the capital market, efforts were intensified in recent years to expand the range and tenor of debt instruments. Consistent with this effort, the current extension of the maximum tenor to up to 10 years would increase the supply of longer dated debt papers as well as lengthening the yield curve in the pricing of long-term bonds, thus contributing positively towards the development of the longer end of the debt market. In addition, it also adds variety and diversity to the longer dated papers available in the debt market to cater to the specific needs of the various groups of investors and permit the banking institutions to source longer term funds for hedging purposes.

Upliftment of the RM150,000 Limit on Sale of Housing Loans with Recourse Basis to Cagamas Berhad
The restriction on sale of housing loans costing more than RM150,000 on a recourse basis to Cagamas Berhad (Cagamas) was uplifted on 29 May 2001. The liberalisation took place after a temporary relaxation of the selling restriction during the period 17 April 2000 to end-March 2001.

The securitisation market in Malaysia began in late 1980s with the establishment of Cagamas which purchases housing loans of RM150,000 and below from banking institutions on a recourse basis. As the market at that time lacked the infrastructure required for a full-fledged securitisation activity, sale of housing loans to Cagamas were made on a full recourse basis, with a longer-term objective of developing a full-fledged securitisation market through outright sale of loans to Cagamas, i.e. on a non-recourse basis. Bearing in mind this long-term agenda, the range of housing loans eligible for sale on a recourse basis to Cagamas has been restricted to those costing less than RM150,000.

In 2001, Cagamas expanded its operations to include the purchase of housing loans on a non-recourse basis. Nevertheless, the volume of loans sold by banking institutions under the scheme remains low as the financial institutions are flooded with liquidity under prevailing market conditions and hence do not see the need to seek refinancing from Cagamas. Furthermore, the yield spread of banking loans has increased in view of the low interest rate environment. Even though the response to this new facility is not encouraging in view of the present liquidity situation, this new avenue provides the financial institutions with greater flexibility in managing their assets and liabilities more efficiently and effectively. Once market conditions return to normal, financial institutions would use this avenue as an effective tool to reduce their credit exposure and hence, increase their ability to grant credit facilities. Therefore, in the meantime, banking institutions were permitted to sell housing loans above RM150,000 on a recourse basis for a temporary period. However, as at end-March 2001, the market remained liquid whilst compliance with the data requirement by Cagamas for the non-recourse sale remained insufficient. In view of these developments, banking institutions are now allowed to sell all types of housing loans to Cagamas including those for the purchase of houses costing above RM150,000. This would give Cagamas greater flexibility to extend its business scope, thus providing a catalyst to the further development of the securitisation industry. Notwithstanding this, the role of Cagamas in developing a true securitisation market would continue to be pursued.

Upliftment of Restriction on the Provision of Bridging Finance for Residential Property Development Exceeding RM250,000 Per Unit

With effect from 27 November 2001, the restriction on the provision of bridging finance facility for the development of residential properties priced above RM250,000 per unit as well as the development of shop houses exceeding RM250,000 per unit located within residential areas was uplifted as the stock of unsold residential units had declined. The bridging finance restriction for the development of shop houses priced above RM250,000 per unit, which are not located within residential areas as well as for the development of commercial properties, remains unchanged. Details of this measure can be found in the *Monetary Measures in 2001* section in *Chapter 2: Monetary and Fiscal Developments* of the BNM Annual Report.

Consumer-related Measures

Guidelines for Lending Institutions Accepting Guarantee for a Credit Facility

With effect from 1 June 2001, the Guideline for Lending Institutions Accepting Guarantee for a Credit Facility was amended to further safeguard the interest of guarantors. Under the revised framework, banking institutions may no longer obtain a waiver of guarantor's rights whether voluntarily or involuntarily. In addition, the maximum coverage of credit facility secured by a guarantor was raised to RM250,000 from RM200,000.

In the course of their lending activities, banking institutions often require a guarantor, who in the event of default by the borrower, is equally and severally liable to the lending banking institution. The issuance of this guideline, back in 1995, aims to provide certain safeguards to the guarantor of a credit facility. This includes the requirement for banking institutions to ensure that the guarantor is fully aware of his liability beforehand and is prepared to undertake it, and that he is kept informed of the latest status of the credit facility to enable him to monitor the repayment by the borrower. In dealing with defaults, the lending institutions are required to use their best endeavour to execute the judgement to recover the sum in default from the borrower first, before any action can be taken against the guarantor. These safeguards are however, not applicable in cases where the guarantor voluntarily waives his rights, thus reducing the effectiveness of the safeguards stipulated in the guideline. With the revision, banking institutions would still be required to perform the steps as stipulated in the guideline, hence ensuring that the rights of the guarantors remain protected.

Establishment of Complaints Unit in Banking Institutions
In order to promote greater customer awareness of the existence of a structured and formal mechanism for banking institutions to address public enquiries, all commercial banks and finance companies have been required to set up a dedicated Complaints Unit within their organisation by end-2001. Banking institutions are also encouraged to establish complaints booth within their branch premises. The Unit will function as the focal point for managing all complaints received by the banking institutions (via correspondence, e-mails, telephones etc) consistent with the long-term objective to improve the services provided by the banking institutions to the banking public.

To ensure that all complaints are being attended to, banking institutions are required to put in place a central tracking system to record and monitor the status of each complaint received by the institution. In addition, all complaints lodged must be processed and responded to within a period of two weeks from its receipt, with the exception of complex cases whereby complainants would be informed of the timeframe to resolve the matter. For certain cases, if the complainant is unsatisfied with the response given or the cases remain unresolved, the complainant may subsequently forward his/her dissatisfaction or complaints to the Banking Mediation Bureau (BMB) or BNM.

The BMB was established to provide an avenue for consumers aggrieved with the services provided by the banking institutions to seek redress. The present scope of BMB operations is limited to claims involving monetary losses not exceeding RM250,000 arising from unfair practices relating to charges and fees as well as against guarantors, ATM-related matters and unauthorised use of credit cards. In order to foster a more market-oriented banking system as envisaged in the FSMP, the power and scope of operations of BMB would be expanded to cover the full range of retail banking-related consumer complaints. This would ensure that BMB would be effective and proactive in protecting the rights of the banking consumers. The setting up of the Unit is therefore an initial step towards the achievement of this vision.

Improving Access to Financing for Priority Sector
Measures implemented in 2001 were also focused at enhancing the accessibility of the small- and medium-sized enterprises (SMEs) and specific industries to financing at reasonable cost to fund their working capital needs in order to meet demands of the domestic economy.

Reduction of Interest Rates and Financing of Loans under Special Funds
With effect from 16 April 2001, the funding rates (rates charged by the Government on lending institutions) and lending rates (maximum rates charged by lending institutions on borrowers) for the Fund for Food (3F), New Entrepreneurs Fund (NEF) and Fund for Small and Medium Industries 2 (FSMI2) were reduced. The reduction in funding rates ranged between 0.75 and 2.0 percentage points, whilst the lending rates were reduced within the range of 0.25 and 1.0 percentage points. In addition, the allocation for these funds was also increased, which in aggregate amounted to RM0.75 billion. Details of this measure can be found in the *Monetary Measures in 2001* section in *Chapter 2: Monetary and Fiscal Developments* of the BNM Annual Report.

Reduction in Lending Rates and Liberalisation of Eligibility Criteria of Special Funds
Effective 15 October 2001, the funding and lending rates for the Rehabilitation Fund for Small and Medium Industries (RFSMI), FSMI2 and NEF2 were further reduced by 0.5 percentage points. The revision in the rates was aimed at further lowering the cost of doing business, thus promoting higher domestic economic activities as impetus for growth in investment.

The eligibility criteria and conditions of 3F, RFSMI, Fund for Small and Medium Industries, Bumiputera Entrepreneur Project Fund and Entrepreneur Rehabilitation and Development Fund were also liberalised to further enhance access to such financing schemes. Details of this measure can be found in the *Monetary Measures in 2001* section in *Chapter 2: Monetary and Fiscal Developments* of the BNM Annual Report.

The Entrepreneur Rehabilitation and Development Fund

The Entrepreneur Rehabilitation and Development Fund (ERDF) was established on 3 July 2001 with a total allocation of RM500 million. It has two objectives, namely to assist the resolution of existing non-performing loans (NPLs) and to provide working capital to Bumiputera SMEs. Out of the RM500 million allocation, RM120 million is allocated to assist the SMEs in resolving their existing NPLs, whilst the remaining RM380 million is allocated to provide working capital support to enable the SMEs to continue in their business operations. The ERF Sdn Bhd (ERF) has been entrusted to act as the administrator and secretariat of the ERDF.

The primary objective of the ERDF is to provide distressed companies that are still fundamentally viable and being capably run, with financial assistance in the form of working capital to eligible borrowers with existing NPLs not exceeding RM1 million. Features of the financing terms include:

- amount of financing sought is limited to the borrower's actual working capital requirement or RM3 million, whichever is lower. The new financing would be extended by the ERF and financial institutions in the ratio of 80%:20%;
- maximum lending rate of 5% per annum for a maximum tenure of 5 years; and
- all conduct of the new financing is made through non-checking accounts with close monitoring on the disbursements by the financial institutions and ERF.

The new financing would be complemented by a scheme to restructure the existing NPLs through debt reduction and moratorium as follows:

- Unsecured loans: all outstanding and penalty interests would be waived, whilst the unsecured principal amount would be reduced by 40%. The Government will contribute financial assistance on 30% of the principal amount, while the entrepreneur must settle the remaining 30% of the NPLs by not more than 18 monthly instalments; and
- Secured loans: haircuts of between 50%-100% on outstanding interest including penalty interests and a 2-year moratorium on the repayment of the remaining balance would be granted. In the event that the borrower defaults on the instalment payments, the financial institutions would reinstate any haircuts provided prior to the default and the Government would withdraw the financial assistance that was given to help the distressed companies.

An added unique feature to the financing scheme under the ERDF is the mandatory requirement for the approved applicant to undergo structured training programmes and the existence of advisory services. This added feature attempts to equip Bumiputera SMEs with current business expertise and skills required to succeed in the present business environment through the various training and awareness programmes that are conducted by Institut Bank-Bank Malaysia (IBBM). The training is organised to cover topics such as financial cash flow management, computerised accounting, financing tools and motivational talks. The programmes also help to ensure optimal and prudent usage of the disbursed funds to maximise business opportunities that are available at any given time.

To ensure that only qualified SMEs are given access to the ERDF, the applicants to the ERDF must meet the following eligibility criteria:

- The Bumiputera SMEs total outstanding NPLs must not exceed RM1 million;
- The SMEs must be at least 60% owned by Bumiputera;
- The NPLs must be for business related loans only;
- The financial duress suffered by the SMEs must be due to the economic crisis and not due to mismanagement or fraud;
- The loans turned non-performing between 1 January 1998 and 30 June 2001; and
- The borrower must have an ongoing business or potential viable business venture.

Eligible SMEs are expected to use the combination of working capital assistance, NPLs restructuring and training programmes to both rehabilitate and develop existing businesses that would otherwise have been forced to cease operations due to the economic downturn.

pre-emptive actions, such as loan rescheduling or restructuring, to ensure that borrowers will be able to continue their business activities and thus mitigate any potential losses. To facilitate the monitoring and review process, banking institutions are required to develop an internal credit risk rating system which would cover all the credit exposures of the banking institution to the borrowers, including off-balance sheet exposures. With a better understanding of the behavioural patterns that are inherent in certain types of loans or industries, banking institutions would then be able to price their loans correctly to match the level of risk inherent in the credit facility.

In addition to the new requirements that were introduced in the guideline, existing practices such as the setting of credit authority limits, limits on particular sectors, single customer credit limit and rules regarding the provision of credit facilities to related entities, would continue to be a significant part to the overall management of credit risk. The guidelines that have been issued are by no means conclusive and exhaustive. The framework would be continually reviewed to be in line with international best practices and to be reflective of the credit practices of the banking industry.

The availability of a comprehensive and up-to-date centralised database that houses credit information of previous and present borrowers can assist banking institutions in their credit assessment and monitoring process, by expediting the credit evaluation process whilst enabling banking institutions to have more comprehensive information on a particular borrower on a real time basis. To enhance the existing centralised credit bureau that was established in the early 1980s, BNM has developed a sophisticated and comprehensive electronic-based system, known as the Central Credit Reference Information System (CCRIS) which became operational in October 2001. The CCRIS would capture information of all borrowers in the banking system, thereby enabling banking institutions to conduct background checks on prospective borrowers and the level of indebtedness of the borrower in the banking system on a real time basis. From a broader perspective, CCRIS would help to develop sound credit culture in the financial system by enabling personnel engaged in credit approval process to make informed decisions based on centrally available and comprehensive information.

In addition to credit risk, another area of risk that needs to be properly managed by banking institutions is market risk. BNM is currently developing minimum standards for the management of market risk for banking institutions. These guidelines would focus on three main components of market risk, namely: interest rate risk, exchange rate risk and equity risk. The issuance of this guidelines envisaged in 2002 would enhance the overall risk management practices of banking institutions in both credit and market risks.

The raising of standards of risk management practices among banking institutions, in particular with respect to market and credit risks would not only help banking institutions to better understand the risk-return relationship in their own business, but also help them to prepare for the new capital regulatory requirements to be introduced by the Bank for International Settlements, known as 'Basel II'. While the new capital adequacy rules will allow greater flexibility in the use of internal systems to determine regulatory capital requirements, this would be subject to banking institutions having the ability and capacity to maintain high standards of risk management practices. To attain the flexibility, banking institutions would not only be required to meet the technical requirements with respect to their risk management systems for instance, covering the structure of the internal loan rating system and the minimum historical data requirement, but they would also be required to conduct comprehensive evaluation on the use of such systems in the decision making process within the institutions. The issuance of minimum standards on risk management would therefore be consistent with the developments in the international arena and would help domestic banking institutions in particular lay the foundation for stronger business culture to cope with changing market structure and regulatory framework.

Since the financial crisis, various efforts have been channelled towards strengthening the supervisory framework over banking institutions. With the completion of the consolidation programme for domestic banking institutions, it is imperative that closer monitoring and supervision over banking groups be conducted to maintain the overall stability of the banking sector. To achieve this, BNM has intensified its supervisory focus on bank holding companies and their subsidiaries in the supervision process. Previously, the examination focus has mainly been on the banking institutions and their subsidiaries. As the financial system evolves and becomes increasingly complex, supervisory oversight needs to be extended to the group as a whole, to provide a better understanding on the linkages and interdependencies between the respective entities within each banking group. The extension of the supervisory net to include bank holding companies would place BNM in a better position to assess the overall condition of the banking group and act upon the areas of vulnerabilities that may threaten the solvency of the banking group, and ultimately the stability of the financial sector. The expansion of the examination process to include the bank holding company of banking institutions and their subsidiaries is also consistent with the overall move towards consolidated supervision. Close monitoring of the activities of the bank holding companies, as well as other entities within a particular banking group would only be possible with the availability of key information such as capital strength and leverage position of the bank holding company and the group as a whole. The framework for regular reporting by the bank holding company would therefore be finalised to enable BNM to assess the risk profile of each banking group on a consolidated basis and to extend the prudential regulatory framework to include bank holding companies. The prudential framework aims to ensure that bank holding companies are well capitalised and able to lend financial support to its subsidiaries should the need arise. At the same time, an assessment of the group structure would also be undertaken. While group structures would naturally take into account the need for business synergy, regulatory principles would ensure that such structures do not hamper the effective conduct of consolidated supervision. The framework for consolidated supervision would need to continuously evolve as the market develops and continuously enhanced to provide a comprehensive framework that will culminate into a specific legislation to regulate the holding companies of banking groups.

As the banking system undergoes the transition towards a more deregulated and a market-oriented financial system, strong corporate governance becomes a key pre-requisite. Good corporate governance practices such as transparency, efficient internal controls and having an effective board of directors would contribute positively towards ensuring that banking institutions are well-run and well-managed, with the ultimate objective of enhancing efficiency, productivity and shareholders' value. As banking institutions grow larger and undertake more complex business activities, it would be increasingly important for members of the board and senior management to comprehend the factors that may affect the financial position of their banking institution so that appropriate measures can be implemented to safeguard the soundness of their banking institution. Directors and senior management are also expected to continuously upgrade their knowledge on emerging issues such as trends emerging in the market, new technology and techniques that can enhance their performance and efficiency, as well as new challenges facing the banking business in order for them to exercise their duties effectively. Given the critical role played by the CEOs in managing the daily operations of the banking institutions, it would be vital for CEOs to accord their full attention to the running of their banking institution. Therefore, BNM has restricted the number of directorships that a CEO may hold at any one time to five directorships. To ensure that the positions that they hold will not be in conflict or adversely affect the objectivity of the CEOs, they are also not permitted to become a director, chairman or hold any executive powers in other entities, other than as a director in a subsidiary or a holding company of their banking institution.

It has been a practice previously for banking institutions to request for approval for the remuneration rewarded to their CEOs and directors. This was necessary at the time to ensure that the compensation packages of senior management commensurate with increases in the level of productivity of the banking institutions. However, moving forward, to enable banking institutions to attract the best talents and for the remuneration to be market driven, BNM has removed the requirement for banking institutions to obtain the prior approval of BNM on the remuneration of their CEOs and directors. The responsibility of determining the appropriate amount of remuneration now lies with the board of directors and shareholders of banking institutions, who are primarily responsible for ensuring that the remuneration packages of their senior management are based on transparent, measurable and objective criteria. In line with the move towards promoting greater market discipline, this liberalisation is accompanied by the requirement for banking institutions to disclose the aggregate amount of remuneration paid to their CEOs, executive directors and non-executive directors in their annual accounts.

Taking into account the increasing demand for greater public disclosure and the enhancement of financial reporting by standard setters, BNM has recently issued a consultative paper to the banking industry on the proposed amendments to the Guidelines on the

Specimen Financial Statements for the Banking Industry (GP8). The revised GP8 has been drawn up with greater focus on the role of the board of directors. Directors are placed in a position of trust by shareholders while the law places the responsibility for managing the affairs of the banking institutions on the board. The board therefore carries the ultimate responsibility for proper stewardship of company resources and the achievement of corporate objectives. In line with this, the primary responsibility for the preparation of the financial statements is placed on the board of directors and the board is expected to develop a sound financial reporting structure to ensure the integrity and credibility of its accounts. A less prescriptive stance has been adopted in the reporting of several items in the revised GP8. This is intended to give banking institutions the flexibility in disclosing their policies and reporting of financial performance and business operations according to the specific circumstances pertaining to the institution.

The shift towards fair value accounting framework with the adoption of International Accounting Standard 39 (IAS 39) is another area of challenge to financial institutions in terms of financial reporting. While the fair value model is yet to be fully implemented in Malaysia, banking institutions must stand ready and make preparations for compliance with the new requirements. Policies on investments in financial assets as well as hedging activities for example, would need to be re-examined to be consistent with the new recognition and measurement rules. The new framework would also require banking institutions to reassess the capability of their management information systems to cope with the new measurement rules. Similarly, the board and management of banking institutions would need to be informed of the overall impact of the fair value accounting framework on the institution's balance sheet and profitability, in particular with respect to potential increase in income volatility.

Banking is a business which is founded on the basis of integrity and is dependent upon the confidence level that is placed by the public on the banking system. Therefore, it is important that the integrity of the financial system is preserved to maintain confidence of the public on the financial sector. The board of directors therefore, have an equally important role to ensure that the reputation of their banking institution is preserved. The board of directors must ensure that there is an appropriate mechanism to monitor and manage reputational risks, as even though a banking institution may have strong fundamentals, certain issues if not managed, may have destabilising effects on the banking institution. It has been a practice for banking institutions to have adequate controls and procedures in place to verify the authenticity of their customers before establishing a banking relationship with them. These requirements have been put in place since the introduction of the guidelines on "Know Your Customer Policy" in 1993 to ensure that the banking system is not used as a conduit for criminal activities.

However, in light of the higher degree of innovation and greater use of technology in the banking sector, efforts were directed towards strengthening the overall regulatory framework on anti-money laundering. In June 2001, the Government passed a new legislation, Anti-Money Laundering Act 2001 (AMLA), to combat money laundering activities in Malaysia. Prior to the enactment of this legislation, legal provisions on money laundering activities focused mainly on drug and corruption activities and these provisions were incorporated in various specific legislations. Legal statutes on money laundering were therefore fragmented. The AMLA also aims to address the gaps in the various legislations by ensuring that all activities relating to money laundering are curbed in a cohesive manner. The AMLA enhances the overall anti-money laundering framework by making it more comprehensive. Firstly, money laundering itself would now be treated as a separate criminal offence. Secondly, the scope of AMLA would cover laundering of proceeds from 122 offences. Thirdly, existing administrative requirements in relation with customer identification, record keeping and suspicious transaction reporting would now be made legally binding. The AMLA also requires the establishment of a financial intelligence unit to receive suspicious transaction reports and conduct intelligence. The Government has appointed BNM as the competent authority to collect, process and conduct intelligence gathered relating to suspected money laundering activities from reporting entities. The AMLA which came into force on 15 January 2002 has identified at the initial stage, commercial banks, finance companies, merchant banks and Islamic banks as reporting entities. Other entities such as stockbroking companies, discount houses, insurance companies and money changers will be included as reporting entities at a later stage. Fourthly, the AMLA enhances the powers of law enforcement agencies to seize and freeze properties to enable them to detect, monitor and prosecute money laundering offences.

Following the enactment of the AMLA, BNM will revise the guidelines on "Know Your Customer Policy" to be in line with the provisions in the AMLA and to incorporate international best practices prescribed by the Bank for International Settlements and the Financial Action Task Force. At the initial stage, the reporting mechanisms on cases of money laundering would be based on suspicious transactions reporting only. The requirement to report all transactions exceeding a certain prescribed amount would be imposed at a later stage when banking institutions have put in place the necessary systems to record and track information of individual customers in a more comprehensive manner. Procedures and controls to address the integrity of their employees, training programmes including "know-your-customer" programmes, designate compliance officers at management level and develop audit functions to test compliance would also form part of the compliance requirements, to be complied by all branches and subsidiaries of banking institutions.

Meeting Socio-economic Needs

One of the important objectives highlighted in the FSMP is to promote greater consumer awareness and activism. BNM continued to pursue efforts towards achieving this objective whilst building the safeguards to protect the interests of consumers of banking services. Consumer activism has been identified as an important element that would help to drive performance in banking institutions and the desired efficiency and effectiveness in a market driven environment. The need to ensure adequate and effective consumer education and protection is also becoming more crucial. The prevention of any disruptions in the level or reliability of service to bank customers and also their protection from potential unfair practices reflects positively on the ability of the financial system to absorb increasing competition. Active and structured consumer education programmes are needed to increase consumer understanding of banking institutions' products and services, which will in turn give rise to more active consumerism. The objectives of the consumer awareness initiative are threefold: to educate and enhance consumer knowledge on personal financial issues; to improve legal protection for consumers and customer redress avenues; and to increase product transparency and disclosure. To achieve these objectives, BNM has taken several measures in 2001 to lay the necessary foundation towards building a more active consumerism movement in Malaysia.

As part of the ongoing efforts to educate consumers on financial issues, BNM has also undertaken an extensive education and public announcement programme to curb the activities of illegal deposit taking entities. This effort was conducted through media advertisements, distribution of pamphlets and placement of posters to reach a wide spectrum of the population and to enhance consumer knowledge on such illegal activities. Due to the lack of information and understanding by the public, illegal deposit taking businesses were able to develop particularly amongst the less informed segment of the population. With the extensive education campaign, it is hoped that greater awareness would help towards preventing the activities of illegal deposit taking from taking place in the future.

Towards further improving legal protection for consumers, the guidelines on the acceptance of guarantee for credit facility were amended to further safeguard the interests of guarantors in May 2001. The level of protection accorded to guarantors was emphasised by prohibiting banking institutions from obtaining a waiver of guarantor's rights voluntarily or involuntarily. This was to ensure that guarantors were aware of their rights and would not be caught off-guard by the fine prints in the guarantee agreement. Greater emphasis was also placed on ensuring that banking institutions educate the guarantors on their obligations before committing to the loan agreement, and to keep the guarantors updated on the status of the loan at all times. Actions against guarantors should only be taken after banking institutions have exhausted all means available to recover the amount owed to them from the borrower.

In a move towards providing avenues of redress for customers and to enhance the level of service provided by banking institutions, all commercial banks and finance companies are required to set up a dedicated Complaints Unit as a channel for customers to raise their problems with their respective banking institutions and to enable banking institutions to record and monitor the progress of complaints received from consumers in order to improve the services that are provided. The Complaints Unit is the focal point for managing complaints received by banking institutions and is responsible to take the necessary actions so that similar grievances would not reoccur in the future. Previously, BNM had actively mediated to resolve grievances raised by consumers. With the setting up of the Complaints Unit, banking institutions would now be the first point of reference for dissatisfied customers. Banking institutions should endeavour to act upon and respond to the complainant as soon as possible. In the event that the customer remained dissatisfied with the decisions made by the banking institution, the matter could be forwarded to the Banking Mediation Bureau.

BNM also continued to accord priority to the development of Bumiputera entrepreneurs. In particular, to improve the accessibility of banking services for Bumiputera entrepreneurs, banking institutions have been required to set up a designated Bumiputera Development Unit (BDU) within each organisation to address specific issues related to the Bumiputera entrepreneurs. The role to be played by the BDU included acting as a one-stop centre to coordinate all financing and advisory services for Bumiputera entrepreneurs, to be responsible for handling loan applications received from Bumiputera businesses, to undertake functions of marketing and promoting banking related products to the Bumiputera entrepreneurs, and to undertake and coordinate training programmes in areas such as product familiarisation and financial management for Bumiputera entrepreneurs. With the established point of reference within each banking institution, the mechanism for Bumiputera entrepreneurs to gain access to banking credit will be more efficient and effective.

BNM also established a special fund, Entrepreneur Rehabilitation and Development Fund or "Tabung Pemulihan dan Pembangunan Usahawan" to provide financial assistance to small and medium Bumiputera enterprises (Bumiputera SMEs). The objectives of the fund was to provide financing to help affected Bumiputera SMEs to resolve their NPL problems by providing working capital to enable them to continue with their business. Although the funds were provided by the Government, banking institutions were required to assess the viability and repayment capacity of the SMEs. The Fund is aimed at providing assistance to Bumiputera SMEs that faced difficulties in obtaining new financing and thus helped to preserve their businesses that were still viable.

Moving Ahead

The FSMP has outlined the direction for the development of the banking sector in the next 8-10 years. The implementation of the recommendations of the FSMP needs to be carefully sequenced in order to minimise disruption to the overall economy.

The developments during the next few years would be vital towards achieving the end-game envisaged in the FSMP. They would form the building blocks on which further developments of the banking sector would take place. With the global financial industry continuing to evolve and the acceleration in the rate of change, the Malaysian banking sector, particularly the domestic banking institutions would be faced with mounting pressure to become more efficient and competitive, innovative, technology-driven and strategically more focused. Therefore, greater emphasis would continue to be given towards strengthening the resilience and competitive position of banking institutions to enable them to remain relevant in a more globalised and liberalised environment.

SUPERVISORY ACTIVITIES

BNM continues to adopt a two-pronged supervisory approach for banking institutions, focusing on both on-site examination and off-site surveillance. In line with the philosophy of creating a framework for a strong, risk-adjusted prudential regulation and supervision of the banking sector, emphasis continued to be placed on high risk areas that could affect the safety and soundness of banking institutions. The risk profile and business activities of the banking institution and its related companies are taken into account in determining the areas of supervisory focus to enable appropriate assessment of the overall health of the banking group and to ensure that activities undertaken by the group would not result in an adverse impact on the banking institutions and the banking system as a whole. The supervisory process therefore covers not only the banking institutions, but also the bank holding companies and related companies.

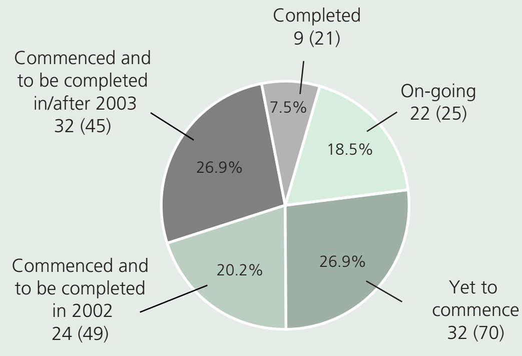
In 2001, BNM conducted 85 examinations on banking institutions, of which, 35 examinations were conducted on the local and overseas branches of the banking institutions and another 7 examinations on bank holding companies and related companies of banking institutions. In addition, there were 5 examinations of non-bank financial institutions. The on-site examination continues to focus primarily on the assessment of the financial and operating conditions of banking institutions, reinforced with emphasis on the assessment of risk profiles and adequacy of risk management systems of banking institutions. The off-site supervisory function complements on-site examination through dynamic ongoing surveillance of the financial health of banking institutions. It includes the review and approval of financial statements of banking

PROGRESS OF IMPLEMENTATION OF FINANCIAL SECTOR MASTERPLAN

The Financial Sector Masterplan (FSMP), launched in March 2001, outlines the medium and long-term strategies for the development of the financial sector. In the context of the plans and strategies that have been put in place, it is important for the development to be monitored and managed. Towards this end, a FSMP Secretariat and a FSMP Steering Committee (FSMP SC) have both been set up in BNM to monitor the implementation of the FSMP recommendations. The FSMP Secretariat has drawn a framework to monitor the progress in the implementation of the recommendations. It will also review the relevance of the recommendations against current and future developments, especially in the international markets and to monitor the progress of the domestic financial institutions and financial system in the context of attaining the specified milestones. The FSMP SC reviews on a monthly basis the progress of the FSMP recommendations, provides strategic directions to the FSMP Secretariat as well as discuss policy issues that have emerged in taking the FSMP recommendations forward for implementation.

To facilitate monitoring the progress in the development of the financial system, the recommendations are divided into five categories based on objectives that are being envisioned for the financial system. This will include building efficiency and capacity, enhancing competition, providing an efficient payment system, strengthening the regulatory framework and enhancing consumer awareness. With regard to the recommendations under the Islamic Banking and Takaful sector, its progress is being monitored in accordance with four objectives, namely, to strengthen regulatory framework development, to promote product and market development, to strengthen the legal and Shariah framework and to enhance knowledge and expertise to promote human capital development. In line with the consultative and iterative approach that has been adopted in the implementation of the FSMP recommendations, a number of working groups with participation and representations from the industry, the private sector and related Government agencies have been and will be established in the development of the financial sector as outlined in the FSMP. This is to ensure that the implementation of the FSMP recommendations are being carried out in a manner where the desired results are achieved without disruptions to the financial sector.

Graph I.1
Progress of Implementation of FSMP Recommendations



Total recommendations : 119
Total projects : 210
( ) No. of projects

As at end-2001, out of the total 119 recommendations, 22 recommendations are being implemented on an on-going basis, where its implementation is on a continuous basis and runs throughout the FSMP's 10-year period, while nine or 9% of the remaining 97 recommendations have been fully implemented. The associated work in the implementation of each recommendation involves several related projects. The recommendation for the "Development of a Comprehensive Framework for Consolidated Supervision" for example encompasses eight projects. The projects under the recommendation include developing a framework for consolidated supervision of financial conglomerates relating to information/statistical reporting by bank holding companies to BNM as well as putting in place the legal framework and regulations relating to group structures, intra-group transactions, corporate governance, liquidity, capital adequacy and other prudential requirements. The recommendation would only be considered complete when all projects under it have been fully completed. To achieve the implementation of the remaining 88 recommendations, a total of 164 projects will need to be completed.

Consistent with the focus under Phase 1 of the FSMP on building domestic capacity, current efforts are focused on implementing measures to enhance the capability and capacity of financial institutions to improve their level of efficiency, competitiveness and effectiveness, measures to promote stability in terms of strengthening the regulatory and institutional framework as well as measures to put in place an efficient and market driven consumer protection framework.

The recommendations to enhance domestic capacity and enhance competition include the benchmarking exercise to enable banking institutions to benchmark their performance against international standards and

Table I.1
Status of Implementation of Recommendations

Banking Sector	
Completed	**On-Going**
R3.5 Uplift restriction on employment of expatriates to attract best international talents to meet the demand for expertise in specific areas of banking R3.12 Encourage outsourcing of non-core functions to gain greater strategic focus and efficiency R3.14 Encourage the development of new delivery channels to increase the range of product and services at more effective rates	R3.2 Improve awareness of best practices and conduct focused training to raise the level of awareness of best practices and enhance understanding of chief executive officers and directors of banking institutions on emerging trends and issues facing the banking industry R3.3 Enhance credit skills and monitor the requirement for accreditation of credit officers and managers to strengthen credit skills of credit officers and managers and ensure effectiveness of the accreditation requirement R3.13 Require management of banking institutions to give greater attention to the development of ICT to ensure the formulation of appropriate ICT strategies R3.15 Adopt 'what is not prohibited is allowed' regulatory philosophy and phase-out product pre-approval requirements to remove impediment to innovation R3.19 Facilitate the development of a conducive tax regime to provide incentives to encourage financial prudence and innovation R3.34 Initiate an active and structured consumer education programme to develop active consumerism R3.36 Encourage consumers to pursue formal administrative and legal redress to protect customers from possibilities of unfair practices by banking institutions
Insurance Sector	
Completed	**On-Going**
R4.2 Allow all players in the market to operate via the internet to enhance competitiveness and efficiency of the insurance industry R4.16 Increase the statutory minimum paid-up capital of insurers to accelerate consolidation process that will enable domestic insurers to capture the size and scale needed to compete effectively in a more deregulated and liberalised market	R4.5 Open up the pension industry to insurers to increase the market share of domestic life insurers R4.8 Allow insurers to distribute other personal financial service products to enable insurers to make more effective use of the agency force and other distribution channels
Islamic Banking and Takaful	
Completed	**On-Going**
R5.6 Increase the number of takaful operators to accelerate the expansion of takaful industry	R5.11 Create a favourable tax regime to avoid barriers in adopting Islamic banking concepts and takaful products

Alternate Modes of Financing	
Completed	**On-Going**
R7.2 Establish a RM500 million VC Fund to increase the availability of VC financing and stimulate new ventures	R7.13 Establish a one-stop agriculture research and development centre as well as a comprehensive and integrated information database to facilitate banking institutions in their assessment of specialised risks involved in agriculture financing
R7.3 Introduce further tax incentives for the VC industry to promote the growth of VCs	R7.14 Develop structured and systematic training programme for borrowers to ensure the orderly development of players in the agriculture sector
R7.4 Liberalise the MESDAQ listing requirements to facilitate the exit of VCs from their investments	R7.15 Establish risk-distribution mechanism that will reduce risks to the financial institutions and at the same time, reduce borrowing costs through a guarantee and insurance protection scheme
	R7.16 Provide subsidies to agriculture industry to help reduce insurance costs especially for small scale farmers
	R7.17 Grant tax exemptions to provide greater financial assistance to the sector

Labuan International Offshore Financial Centre	
Completed	**On-Going**
	R8.1 Develop an active International Offshore Financial Centre (IOFC) for Malaysia to support the increasing demands of the domestic economy
	R8.2 Review existing rules and regulations to facilitate expansion in the scope of core business to facilitate new offshore businesses and allow offshore service providers to maximise capabilities and expertise to expand their businesses
	R8.3 Adopt a consultative and market driven approach to create a conducive tax and business environment to enhance the competitiveness and attractiveness of Labuan
	R8.6 Strengthen Islamic banking and finance as well as Islamic insurance (takaful) to develop Labuan with a strategic focus on Islamic products and services
	R8.7 Enhance the Labuan International Financial Exchange (LFX) to be a one stop financial exchange for residents and global companies
	R8.8 Enhance the e-commerce gateway to encourage global e-commerce operators to set up domicile in Labuan
	R8.9 Maximise potentials of Labuan IOFC by developing other complementary economic measures

to use it as a strategic tool to drive performance. BNM has disseminated reports to banking institutions, benchmarking each bank's performance against that of the industry and that of their peers on the basic indicators. In order to enhance awareness and garner the support and commitment of board members and senior management of banking institutions on the importance of benchmarking, BNM had conducted a "Seminar on Benchmarking". The seminar was part of a series of seminars planned for the directors and chief executive officers of banking institutions and insurance companies to enhance awareness on important areas which are vital prerequisite for taking the development of financial services sector forward. In addition to quantitative indicators, market research will be conducted on customers' needs and satisfaction levels to drive customer segment strategies, particularly in the areas of retail and small business banking.

Internal benchmarking will also be established to determine the pace of implementation of the FSMP. To gauge the extent of progress achieved in relation to the specific objectives set out under the various phases of the FSMP, the performance and development will be periodically measured against specific milestones set at the various stages of implementation. The results of the periodic reviews will serve both to determine the sequence and pace of subsequent implementation, as well as prompt remedial actions or adjustments that may be needed to ensure that the measures implemented achieve their intended objectives.

Given the crucial importance of developing expertise and skilled personnel to manage and control credit risk within banking institutions, a recommendation relating to the accreditation of credit personnel programme has also been introduced. The accreditation programme is aimed at ensuring that all credit personnel have a complete understanding of the risks associated with lending activities, which in turn would help to enhance the credit culture and credit standards of banking institutions. The recommendation relating to removal of salary restrictions has also been implemented whereby banking institutions are now given flexibility to determine the salaries, allowances and bonuses of their employees based on their productivity and efficiency levels. This has enhanced the ability of banking institutions to mobilise, attract and retain the best talents into the industry.

To allow greater operational flexibility, banking institutions have also been allowed to outsource their non-core business activities to third party service providers and engage in cross-selling activities. To date, 22 banking institutions have outsourced some of their non-core functions to third party service providers and 6 banking institutions are engaged in cross-selling financial products and services of entities within the same group, including those belonging to their related non-bank financial institutions. The ability of banking institutions to offer a broad range of financial services through different distribution channels also become increasingly important to maintain their competitive edge. To date, eight domestic banking institutions and three foreign-owned banking institutions offer internet banking facilities. Various efforts have also been put in place to enhance the efficiency and competition in the payments system. This includes enhancements to the RENTAS system, introduction of a real time surveillance system to enhance transaction monitoring and liquidity management, and a Repurchase Agreement Enhancement Module to enhance liquidity in the secondary bond market and facilitate the settlement of repurchase agreement transactions. In order to allow market forces to shape developments in the payments system, a National Payments Advisory Council (NPAC) was established in mid-2001 to perform an advisory function and provide market input in the development of payment systems policies. Members of the NPAC comprise of officials from the Ministry of Energy, Communications and Multimedia of Malaysia, BNM, Securities Commission, Hong Kong Monetary Authority, Bank of Japan, Malaysian Administrative Modernisation and Management Planning Unit (MAMPU), Malaysian Electronic Payment System Sdn. Bhd. (MEPS), the Association of Banks in Malaysia, the Association of Finance Companies of Malaysia, the Association of Merchant Banks in Malaysia and the General Insurance Association of Malaysia.

To further strengthen the regulatory framework, three consultative papers on the banking sector have been issued namely, the prompt corrective measures which recommend a set of regulatory actions that would be automatically instituted on banking institutions found to be operating in a manner detrimental to depositors' interest; the consultative paper on single customer credit limit which is intended to refine the existing guidelines; the consultative paper on the revised Guidelines on the Specimen Financial Statements for the Banking Industry (BNM/GP8), which is intended to cater for the rapid pace of development in the financial markets; and the increasing demand for greater public disclosure to foster market discipline and strengthen financial stability.

In the insurance sector, the consolidation of the industry was further advanced with the implementation of the recommendation to increase the statutory minimum paid-up capital for direct insurers to RM100 million with effect from 30 September 2001. To date, a total of eight mergers and acquisitions (M&As) involving 16 insurers have been completed, while M&As involving another 13 insurers are at various stages of implementation.

The FSMP also contained a set of recommendations to enhance the effectiveness of financial institutions that are not licensed under the Banking and Financial Institutions Act 1989. The recommendations were directed at improving the regulatory framework for Development Financial Institutions (DFIs) and building capacity and increase efficiency of DFIs in utilising their financial resources in meeting the Government's objectives. The Development Financial Institutions Act 2002, which came into force effective 15 February 2002 has accorded BNM powers to enforce the Act. Following the enforcement of the Act, six DFIs have been placed under the purview of the Act. In order to further enhance the development of alternative modes of financing, the listing requirements by venture companies on the MESDAQ have been liberalised and the Government has established a RM500 million Venture Capital (VC) Fund to increase the availability of VC financing in the economy and in the process, stimulate more new ventures, particularly in the ICT industry. In addition, tax incentives in the form of tax deductions equivalent to the amount of investments made in approved venture companies at start-up, seed capital and early stage financing have also been given to the industry.

In promoting consumer awareness and initiating a structured consumer education programme, BNM and the banking institutions have initiated a comprehensive plan for an active and structured Consumer Education Programme. The Association of Banks in Malaysia in consultation with The Product Transparency and Disclosure Working Group had published the first series of information pamphlets namely, on areas such as protecting your credit card, protecting your ATM card, investing in unit trusts and prepayment charges on housing loans. An information pamphlet on "Illegal Deposit Taking/Get Rich-Quick Schemes" was also published to highlight and promote public awareness of the dangers of participating in get rich-quick schemes involving illegal deposit-taking. In addition, BNM, together with the banking institutions have established a committee for consumer education to enhance consumer knowledge on personal financial issues including awareness on consumers' rights and liabilities; and to improve legal protection for consumers and customer redress avenues. In moving towards a standard full disclosure model for products, the committee will develop guidelines on the minimum level of product transparency to ensure that consumers are well informed of all risks and liabilities associated with particular banking products and services.

In the same vein, consultative papers were also issued on a proposed framework for the development of independent financial advisers (IFAs) in the insurance industry and 'best advice' practices in the sale of life insurance products. These recommendations under the FSMP, which are currently being finalised for implementation in 2002, will enable consumers to obtain professional independent advice on their financial planning and management from certified IFAs who can provide advice on a broader range of insurance products. The 'best advice' practices regulation would ensure that proper advice, based on the specific financial circumstances and needs of individuals, is rendered by intermediaries in the sale of life insurance products.

With regard to Islamic banking, a standard framework has been formulated for the computation of the rate of return for Islamic banking institutions aimed at providing a level playing field and terms of reference for the Islamic banking players in deriving the rate of return. The framework would allow BNM to assess the efficiency, profitability, prudent management and fairness of Islamic banking institutions more effectively. Two committees had been formed namely, the Consultative Committee on Services (CCS) and Consultative Committee on Product and Market Development (CCPMD). The CCS was formed with the objective of setting the minimum best practice standard for Islamic banking in customer service, establishing image building as well as promoting public awareness and knowledge on Islamic banking and finance. The CCPMD was formed to drive the innovation and development of Islamic banking products. Both CCS and CCPMD have members comprising of BNM officials and representatives of the Islamic banking institutions and takaful companies.

A total of 24 recommendations or 27% of the 88 recommendations are targeted to be fully implemented in 2002. With the implementation of the recommendations under Phase 1, the foundations for developing stronger domestic banking and financial institutions would have been established. The expected outcome, by the end of Phase 1 should be the emergence of domestic players that are stronger, more efficient and innovative, besides being increasingly more competitive and resilient, as well as effective DFIs that play a significant role in addressing the development strategies of the nation by complementing the established banking institutions to meet financing requirements of the changing economy. BNM would continue to closely monitor the progress of the implementation of the recommendations under the FSMP to ensure a smooth transition from one phase to another, based on the achievement of specified milestones and to ensure measures implemented are timely and the desired strategic direction and objectives are achieved.

institutions. Financial statements are reviewed to ascertain if the statements are prepared in compliance with accounting standards and BNM guidelines, as well as to ensure adequate provisioning for bad and doubtful debts. In addition to the review of audited accounts on an annual basis, the review of semi-annual and quarterly (for listed companies) accounts are also performed.

In addition to examination conducted on banking-related activities, emphasis was also placed on the information systems within banking institutions to ensure that they were adequately maintained with high data integrity. With the introduction of internet banking as a new delivery channel and the increased usage of technology in banking activities, additional attention was given to the information systems of banking institutions in order to mitigate the potential risks associated with the widespread adoption of electronic banking delivery channels. The maintenance of data integrity in these delivery channels, especially where it involves payment services, becomes increasingly critical and warrants supervisory focus. BNM has therefore increased its information system examinations throughout the year to ensure that the information systems of banking institutions form a foundation for the safe and sound operation of banking institutions. A rigorous monitoring of the performance of banking institutions, compliance with regulatory requirements and occurrence of fraud, complements the stress tests. These would enable BNM and the banking institutions to undertake pre-emptive and remedial actions in areas of supervisory concern. Special surveillance programs were also conducted to curb the rise in ATM related frauds.

Moving forward, developmental efforts will continue to be taken to further strengthen the supervision of the banking institutions. In line with the increasing complexity of risks undertaken by banking institutions, the CAMEL framework is being expanded to include a separate component on Sensitivity to Market Risk. In addition (following the enactment of the Development Financial Institutions Act 2001), the scope of banking supervision was expanded to include the supervision of Development Financial Institutions.

PROGRESS OF BANKING SECTOR RESTRUCTURING

The institutional arrangements put in place to preserve the stability of the banking sector during the Asian crisis, namely, Pengurusan Danaharta Nasional Berhad (Danaharta) the asset management company; Danamodal Nasional Berhad (Danamodal) a special purpose recapitalisation agency; and the Corporate Debt Restructuring Committee (CDRC) achieved significant progress in their respective operations during the year 2001.

As at 31 December 2001, total loan rights acquired and managed by Danaharta amounted to RM47.7 billion, of which RM39.8 billion were from the banking system. This accounted for approximately 40% of the total non-performing loans of the banking sector. Danaharta completed its loan acquisition phase in 2000 and did not make any direct purchases from the banking institutions in 2001. The increase in loans managed by Danaharta in 2001 was mainly due to the exercise of the put option agreement between Danaharta, Commerce-Asset Holdings Berhad and Bank Bumiputra Malaysia Berhad (BBMB) Group arising from the merger between BBMB and Bank of Commerce (M) Berhad. The put option has since expired on 31 August 2001.

In 2001, Danaharta focused on the management of loans and assets within its administration. With the objective of maximising recovery values, Danaharta adopted various techniques in the management process, including active restructuring and rescheduling for viable loans, foreclosure, appointment of Special Administrators and Schemes of Arrangement for non-viable loans.

As at 31 December 2001, Danaharta has dealt with RM47.7 billion (99.9%) of the total loan rights acquired and managed under its portfolio. Of these loans, Danaharta expects a recovery rate of 56% over the

Table 4.6
Danaharta: Loan Recovery as at 31 December 2001

	Adjusted loan outstanding[1] (RM billion)	Adjusted expected recovery[2] (RM billion)	Expected recovery (%)
Plain loan restructuring	11.6	8.0	69
Settlement	6.9	5.2	76
Scheme of arrangement	9.2	6.9	76
Special Administrators - scheme approved	5.5	2.5	44
Foreclosure	11.6	3.4	29
Others (including partial resolutions)	4.1	2.5	60
Legal action	2.0	-	-
Total	**50.9**	**28.5**	**56**

[1] Comprising loan rights acquired of RM47.7 billion and accrued interest of RM3.2 billion.
[2] Assuming zero recovery on defaulted cases as at 31 December 2001.

outstanding amount of loans acquired (inclusive of accrued interest). The expected recovery rate has been adjusted after applying an assumption of zero recovery for defaulted accounts (average default rate as at 31 December 2001 is approximately 11%).

From the total adjusted loan outstanding already dealt with, Danaharta expects to receive total recovery of RM28.5 billion as at 31 December 2001. Of this, Danaharta has received recovery proceeds totalling RM15.2 billion, of which RM9.7 billion were realised in the form of cash and the remaining in the form of non-cash assets, namely restructured loans, securities and properties. The remaining expected recoveries totalling RM13.3 billion are at various stages of recovery.

Danaharta has distributed net recoveries amounting to RM8 billion in cash and 36,559,542 units of securities at par value. The cash distribution, amounting to RM7.7 billion, was distributed for the recovery on BBMB and Sime Bank Group NPLs and the remaining RM312.6 million and 36,559,542 units of securities at par value were distributed back to 24 financial institutions under the 80 (selling financial institution): 20 (Danaharta) surplus recovery sharing agreement.

Danaharta continued to sell foreclosed property collateral via open tenders during the year. Properties that remained unsold during the tenders were transferred to Danaharta Hartanah, which continues to sell the properties via its "secondary sales" programmes. In 2001, Danaharta conducted a fifth property tender involving 269 properties, of which 49% received successful bids for a total consideration of RM283.4 million, representing a 17% surplus over their total indicative value of RM242.3 million. The fifth tender saw the highest participation of property buyers amongst all the tenders that had been conducted by Danaharta. It also further exemplified the strong trend of successful sales via real estate agents (REAs), during which the REAs were responsible for selling 126 or 96% of the 131 properties that received successful bids. On 22 January 2002, Danaharta launched a specific property tender involving 30 units of six-storey shopoffices in one location only with a total indicative value of RM31.9 million. The closing date for the tender was 28 February 2002. Danaharta expects to launch its sixth property tender in the second quarter of 2002. As at 31 December 2001, Danaharta has sold 498 of the 614 properties offered since the first open tender held in 1999, for a total consideration of RM843.5 million. These included 357 properties sold in primary sales (RM593.3 million) and 141 properties sold in secondary sales (RM250.2 million).

Danaharta also embarked on its first asset-backed securitisation (ABS) exercise through Securita ABS One Berhad (Securita), a special purpose vehicle. The ABS exercise was the first collateralised loan obligation securities in Malaysia, to provide Danaharta with a more efficient method of divestment as it helped to overcome the operational difficulties faced in outright sales or auctioning a large number of accounts and avoided the risk of "cherry picking" by investors. It also enabled a wider investor base to be addressed. Funds raised from this and future issues will help to enhance Danaharta's cash collection in meeting bond redemption and operational requirements.

The first Danaharta ABS exercise, which will mature on 20 December 2005, involved the issuance of RM310 million triple-A rated Senior Notes with a coupon rate of 3.875% per annum that were backed by approximately RM595 million worth of performing loans. The successful exercise garnered a subscription rate of 3.5 times above the nominal amount of the issue.

In the case of Danamodal, no further capital injection was made since December 1999 as the capital position of banking institutions has continued to strengthen. In August 2001, Danamodal concluded the Sales and Purchase agreement on the disposal of its investment in one finance company. With the completion of the sale, Danamodal's outstanding investment in the banking sector has reduced to RM2.1 billion, from RM7.1 billion since its inception. Danamodal expects to recover the entire remaining investment over time.

> Noting that debt restructuring on its own may not bring about long term solution for the problems faced by the large corporates, borrowers were also required to undertake operational restructuring, over and above the financial restructuring, to ensure the viability of the company over the longer term.

Table 4.7
Status of CDRC cases as at 8 March 2002

	Total debt outstanding* (RM million)	Number of accounts
Total referred to CDRC	67,644	87
Cases withdrawn / rejected / transferred to Danaharta	13,076	36
Cases accepted	54,568	51
Resolved	35,773	39
Outstanding	18,795	12
Being restructured by CDRC	*17,770*	*11*
Revised	*1,025*	*1*

* Including non-banking and offshore institutions.

Changes were made to the CDRC debt restructuring framework during the year. The changes which were made to accelerate the pace of corporate debt restructuring in Malaysia included the setting of specific timeline to ensure effective implementation of the restructuring and enhanced disclosure and reporting requirements. Noting that debt restructuring on its own may not bring about long term solution for the problems faced by the large corporates, borrowers were also required to undertake operational restructuring, over and above the financial restructuring, to ensure the viability of the company over the longer term. The criteria for the acceptance of loans under CDRC was also amended to borrowers with aggregate borrowing of RM100 million with exposure to at least five creditor banks. (The details of the revision in the framework can be found in the section on Banking Measures 2001).

As at 8 March 2002, 12 cases with debts totalling RM18.8 billion remained outstanding. This included one case which was previously resolved but had to be revised. For cases in which the creditors and borrowers are unable to reach a consensus on the terms of the restructuring exercise, the cases would be removed from the purview of CDRC. Any further negotiations between the creditors and borrowers will be conducted outside the auspices of CDRC. To date, CDRC has rejected or discharged 12 cases from its purview. CDRC is on course in its target to ensure that all workout proposals of borrowers under its purview are approved and implemented by end-July 2002.

PERFORMANCE OF THE BANKING SYSTEM

Profitability

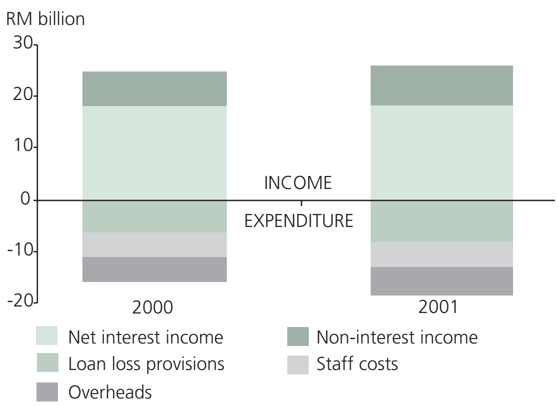
For the third consecutive year since the Asian crisis, the Malaysian banking sector continued to record profits, albeit at a lower level. Profits for the calendar year 2001 amounted to RM7.5 billion. Higher provisioning accounted for the lower profits in 2001. Analysed by institution type, the lower profits were attributed to the commercial and merchant banks. The decline in the profits recorded by the banks was however mitigated by the higher profits recorded by

Table 4.8
Banking System[1]: Income and Expenditure

	For the calendar year			
	2000	2001*p*	Annual change	
	RM million			%
Interest income net of interest -in-suspense	38,217	37,601	-616	–1.6
(Interest-in-suspense)	5,139	5,787	648	12.6
Less: Interest expense	19,575	19,330	–244	–1.2
Net interest income	18,642	18,271	–371	–2.0
Add: Non-interest income	6,700	7,917	1,218	18.2
Less: Staff cost	4,597	4,841	245	5.3
Overheads	4,706	5,321	615	13.1
Profit before provisions	16,039	16,026	–13	–0.1
Less: Loan loss provisions	6,716	8,552	1,836	27.3
Pre-tax profit	9,324	7,474	–1,849	–19.8
Of which:				
Commercial banks	6,848	5,112	–1,737	–25.4
Finance companies	1,889	2,060	171	9.0
Merchant banks	586	302	–283	–48.4
Return on assets (%)	1.5	1.1		
Return on equity (%)	19.5	14.5		
Cost to income (%)	36.7	38.8		

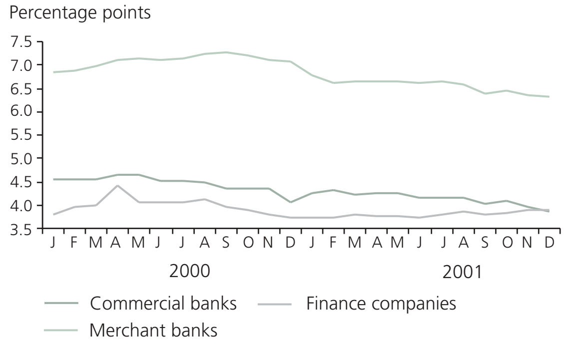
[1] Excludes Islamic banks.
p Preliminary.

Graph 4.5
Banking System [1] : Profitability



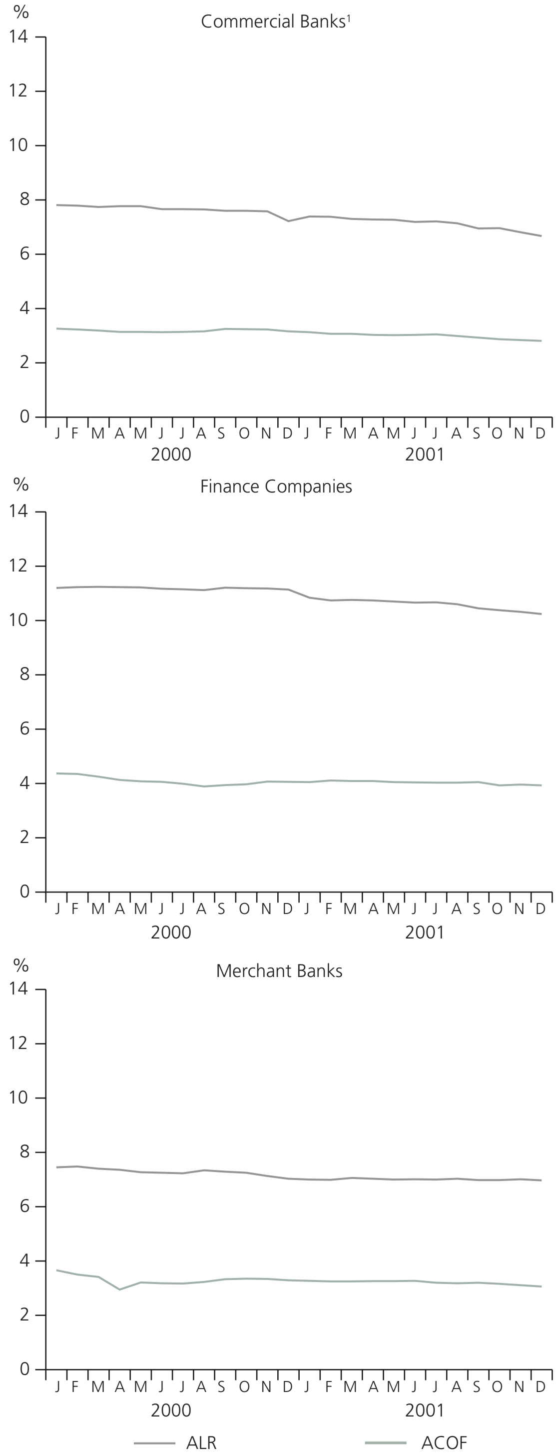
[1] Excludes Islamic banks

Graph 4.6
Net Interest Rate Margins



[1] Exclude Islamic banks
Note: Net interest margin = Average lending rate for all loans - Average cost of funds

Graph 4.7
Average Lending Rates and Average Costs of Funds



[1] Exclude Islamic banks
Note: ALR includes interest which have been suspended and penalty interest on NPLs
ACOF excludes the costs of overheads, statutory reserves and liquid asset requirements

the finance companies. While the banks' profits were eroded by the higher provisions for loan losses, the strong loan growth of the finance companies especially for the purchase of passenger cars, coupled with a decline in loan loss provisions, had contributed to their higher profitability.

The higher loan loss provisions charged by the banking system in 2001 was the result of the increase in the NPL (6-month classification) to RM60 billion as at end-December 2001. The increase in loan loss provisioning expenses was due partly to anchor banks having to realign the policies on loan loss provision of the acquired loan portfolios to be in line with their more stringent standards. These were, however, one-off adjustments which in effect would place the banking system on a stronger footing as the adjustments were from minimum to more prudent standards.

Net interest income remained at about the same level as in the previous year, recording only a marginal decline of 2% during the year. The reduction in net interest income was due to a larger decline in gross interest income compared to the decline in interest expense. Lower interest income from interbank placements and investment securities contributed largely to the decline in gross interest income. As the banking system remained flushed with liquidity in 2001 and interest rates continued to be low, banking institutions switched their asset mix from lower yielding investment securities to loan assets. This change in strategy to maximise yields led to intense competition in the retail and mortgage loans sectors. The competitive interest rate environment and lower lending rates were compensated by a healthy growth in loan base which resulted in total income received from lending activities recording an increase of 3.5%.

The lower lending rates were also compensated by a decline in interest expense due to lower interest paid on deposits (-RM0.3 billion or -1.9%) although total deposits mobilised by the banking system increased.

The non-interest income (excluding recoveries) of the banking system increased by 18.2% in 2001. This was due mainly to extraordinary gains from disposal of investments and dividends received which rose by RM0.9 billion (+73.9%) and trading income of RM0.5 billion (+28.4%). Fee-based income, which accounted for 26.3% of the non-interest income, registered an increase of RM17.9 million to RM3 billion, reflecting the greater attention by banking institutions on the provision of fee-based services to complement traditional fund-based income.

The rationalisation and systems integration efforts undertaken consequent to the merger exercise resulted in an increase in overhead costs of RM0.6 billion or 13.1%. These are, however, one-off costs and banking institutions are expected to be able to reap the benefits of the rationalisation and integration process in the future years.

Table 4.9
Banking System[1] : Financing Activities

	For the year		Annual growth (%)
	2000	2001	
	RM billion		
Loan approvals	133.3	124.7	–6.5
Loan disbursements	357.3	365.5	2.3
Loan repayments	345.0	358.2	3.8
	As at end		Annual growth (%)
	2000	2001	
	RM billion		
Outstanding loans[2]	447.4	462.7	3.4
Adjusted outstanding loans[3]	454.5	473.3	4.1
Adjusted total financing for the economy[4]	551.4	586.6	6.4

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

Loan Activity

The lending activities of the banking system moderated in 2001 following a modest economic growth during the year. The slowdown, which was primarily a consequence of the global economic downturn, had affected the domestic economy through lower exports, unfavourable business sentiment and short-term prospects. Against these developments, demand for loans and financing declined, resulting in a lower number and amount of loan applications received by banking institutions in 2001. In view of the lower number of loan applications received, loan approvals declined by 6.5% during the year. However, loan repayments increased marginally by 3.8% as many borrowers repaid and refinanced their loans to take advantage of the low interest rate environment. Loan disbursements also recorded a marginal increase of 2.3%.

Consumer credit extended by the banking system which rose by 11.9% was supported by the strong consumer spending. Similarly, loans for purchase of transport vehicles (primarily for purchase of passenger cars) recorded a strong growth of 27.4%, while loans for purchase of residential properties expanded by 9.3%. The strong demand for loans by the retail sector reflected mainly the positive response of the public to the current low interest rate environment as well as the Government's pump-priming expenditure to spur the domestic economy. The demand for housing loans was also augmented by the competitive housing loan packages offered by banking institutions and the home ownership promotion campaigns initiated by the private sector to boost sales. In addition, several incentives were accorded during the promotion period such as stamp duty exemption for buyers, waiver of processing fees and a higher margin of financing.

Demand for loans from the corporate sector, however, remained weak throughout 2001 due to the decline in exports and the domestic economic slowdown. The low demand for loans from the construction and real estate sector was attributable to the overhang situation and the Government's directive to the local authorities to defer approval for new construction of office and commercial space to combat the property overhang situation. As a result, approximately 50% of the new loans approved during the year were to individuals, with loans for residential properties accounting for a significant share of 22%.

As the time lag between approval and disbursement of loans for credit cards and purchase of passenger cars is short, loan disbursements to the two sectors in 2001 recorded strong growth at 59.2% and 40.1% respectively. This was followed by loans for purchase of residential properties at 10.6% and loans for the manufacturing sector at 9%. Disbursements of loans to finance the purchase of residential properties were slower due to the legal documentation process whilst for properties under construction, drawdowns are progressive according to the stage of completion. Loan disbursements in other sectors declined following the downward trend in loan approvals. As in the previous year, the manufacturing sector accounted for a significant proportion of loan disbursements, totaling RM101.4 billion or 27.7% of total disbursements. Funds disbursed to the wholesale, retail, restaurant and hotel sector amounted to RM65.4 billion, a marginal increase of 4.6% from RM62.5 billion as at end-2000. The manufacturing sector also contributed the largest share in loan repayments, accounting for 28.1% or RM100.7 billion, which was 10.8% higher than the amount of repayments last year (RM90.9 billion). The wholesale, retail, restaurant and hotel sector also recorded a significant amount of repayments, accounting for 17.9% or RM64.1 billion.

Compared with the previous year, total undrawn loans edged up by 8.1% in 2001. With higher undrawn loans and repayments marginally lower than disbursements, total outstanding loans of the banking system, including loans sold to Cagamas and Danaharta, registered an annual growth of 3.4% in 2001, compared with 5.4% the previous year. Taking into account loans written-off and loans converted into equity and bonds in the course of restructuring, as well as the repayment of the loans of the two LRT companies, the total outstanding loans grew at an annual rate of 4.1%, compared with 7.1% in 2000.

As interest rates continued its downtrend to a record low in 2001, new private debt securities (PDS) issued increased sharply by 23.8%, raising a total of RM33.3 billion from the market. Total redemption amounted to RM16.9 billion, which was mainly due to the redemption and maturity of several medium-term PDS that were issued in 1996/97. Subsequently, outstanding PDS rose by 16.9% to RM113.3 billion and total outstanding loans, adjusted for loans written-off and loan conversion, as well as the repayment of the loans of the two LRT companies and taking into account outstanding PDS in 2001, amounted to RM586.6 billion. This translated into an annual growth of 6.4%, relatively lower than 9.6% achieved in 2000.

Moderating demand for financing throughout 2001 had resulted in a slower pace in lending activities of the banking institutions during the year. However, further drawdown of existing approved credit facilities, as well as the various measures introduced in 2001, are expected to translate into improved loan activity in 2002. The upliftment of the restriction on the provision of bridging finance for residential property development exceeding RM250,000 per unit in November 2001 is envisaged to spur further the growth in the property sector. A further impetus for growth in the property sector would be the extension of ringgit credit facilities to non-residents for the purchase of immovable properties in Malaysia. Effective July 2001, resident financial institutions are allowed to provide loans to non-residents to finance the purchase or construction of any property in Malaysia. Various incentives were also introduced to enhance access of small- and medium-sized enterprises (SMEs) to financing under the existing special funds, as well as to promote domestic economic activity and investment growth. These included a reduction in lending rates and liberalisation of eligibility criteria of special funds, as well as additional allocations for certain funds. For example, the Fund for Food (3F) was increased from RM1 billion to RM1.3 billion and the lending rates reduced to 3.75% per annum from 4% per annum. The allocation for the New Entrepreneur Fund (NEF) rose from RM1.25 billion to RM1.5 billion, with a reduction in lending rates to 5% per annum. A new Entrepreneur Rehabilitation and Development Fund (ERDF) was established and incorporates rehabilitation measures such as advisory services, new contracts and financial support. In addition, on 20 September 2001, given the increased risks biased towards further economic weakness following the 11 September incident, the 3-month BNM intervention rate was reduced by 50 basis points to 5% per annum. This resulted in a corresponding fall in the base lending rates (BLR) of commercial banks and finance companies to 6.39% per annum and 7.45% per annum, respectively. This reduction, in part, has provided an impetus for consumer lending, as well as enhance domestic business and consumer confidence to support domestic economic activity. These measures are expected to continue to translate into an improved outlook in loan activities in 2002.

Asset Quality

Amidst the economic slowdown in 2001, the asset quality of the banking system deteriorated marginally during the year. Net NPLs on a 6-month classification increased by RM8 billion to RM32.1 billion as at end-

December 2001. Similarly, net NPLs on a 3-month classification increased by RM8.4 billion to RM45.2 billion as at end-December 2001. The asset quality during the year was largely affected by two factors; the expiry of the borrowers to repay their debts. Towards the first half of 2001, loans amounting to RM4.3 billion or 34.7% of the increase in gross NPLs were classified as NPLs due to the expiry of the indulgence period. The reclassification of

Despite the build-up of NPLs over the year, the institutional and regulatory framework put in place by BNM over the years and the prudent provisioning policies of banking institutions had positioned the banking sector on a sound footing to adjust and respond positively to these pressures. The banking system continued to maintain a strong capital position, with RWCR well above 12% throughout the year.

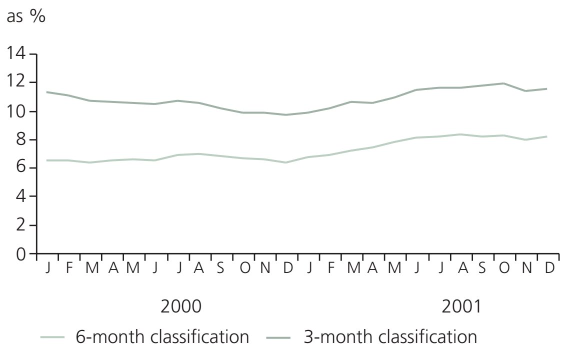
NPL indulgence period granted to borrowers participating in the debt restructuring process under the auspices of the CDRC and the economic slowdown that had hampered the ability of corporations and retail these loans however did not adversely affect the profitability of banking institutions on account of the requirement that interest on these loans be recognised on a cash basis and specific provisions be set aside. In

Table 4.10
Banking System[1]: Non-performing Loans and Loan Loss Provisions

	As at end					
	2000			2001		
	Actual[2]	Classification		Actual[2]	Classification	
		3-month	6-month		3-month	6-month
	RM million					
Commercial banks						
General provisions	6,399.8	6,365.9	5,241.9	6,125.6	6,134.3	5,416.9
Interest-in-suspense	5,576.2	5,672.7	5,263.1	6,632.0	6,661.8	6,435.7
Specific provisions	11,360.8	11,726.5	10,721.5	14,134.0	13,975.7	13,188.7
Non-performing loans	35,660.6	41,107.3	31,607.3	46,934.8	51,578.9	41,682.7
Net NPL ratio (%)[3]	6.4	8.1	5.3	8.8	10.4	7.4
Total provisions/NPL (%)	65.4	57.8	67.2	57.3	51.9	60.1
Finance companies						
General provisions	1,647.1	1,640.4	1,656.7	1,822.5	1,802.6	1,802.5
Interest-in-suspense	2,343.3	2,435.3	2,211.6	2,640.6	2,849.3	2,579.8
Specific provisions	4,809.0	5,055.4	4,514.3	4,971.2	5,095.2	4,840.2
Non-performing loans	14,255.4	17,627.0	13,338.3	15,266.0	18,781.8	14,602.9
Net NPL ratio (%)[3]	9.2	13.2	8.5	9.0	12.8	8.4
Total provisions/NPL (%)	61.7	51.8	62.8	61.8	51.9	63.2
Merchant banks						
General provisions	377.1	336.3	336.9	379.0	340.5	374.6
Interest-in-suspense	513.5	568.5	524.0	523.1	540.0	522.8
Specific provisions	816.3	827.2	806.4	1,056.8	1,073.9	1,017.0
Non-performing loans	3,084.2	4,387.4	3,211.1	4,415.8	5,029.3	4,373.9
Net NPL ratio (%)[3]	10.9	18.7	11.7	21.7	26.2	21.6
Total provisions/NPL (%)	55.3	39.5	51.9	44.4	38.9	43.8
Banking system						
General provisions	8,423.9	8,342.6	7,235.4	8,327.0	8,277.4	7,594.0
Interest-in-suspense	8,433.0	8,676.6	7,998.7	9,795.7	10,051.2	9,538.4
Specific provisions	16,986.0	17,609.0	16,042.3	20,162.0	20,144.9	19,045.9
Non-performing loans	53,000.3	63,121.7	48,156.7	66,616.6	75,390.0	60,659.5
Net NPL ratio (%)[3]	7.2	9.6	6.3	9.3	11.5	8.1
Total provisions/NPL (%)	63.9	54.9	64.9	57.5	51.0	59.6

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

Graph 4.8
Banking System[1]: Net Non-performing Loans Ratio



[1] Excludes Islamic banks

addition, a number of loan accounts that had previously been restructured were reclassified as NPL as the economic slowdown and weak capital market impeded the ability of corporations to raise funds to improve their leverage position.

Despite the increase in NPLs over the year, the institutional and regulatory framework put in place by BNM over the years and the prudent provisioning policies of the banking institutions had positioned the sector on a sound footing to respond positively to these pressures. The banking system continued to maintain a strong capital position, with RWCR well above 12% throughout the year. The specific provisions set aside by banking institutions increased by RM3 billion or 18.7% during the year. As a result, the net NPL ratio of the banking system was sustained within the range of 7.9% to 8.3% throughout the second half of the year. In terms of loan loss coverage, the level of provisioning outstanding remained high at 59.6% of total NPLs as at 31 December 2001. Including the value of collateral, the total loan loss coverage of the banking sector strengthened to 148.1% of NPLs as at end-December 2001. The stress tests conducted on banking institutions on a quarterly basis have also indicated that the banking sector as a whole would continue to remain strong and well capitalised under adverse economic conditions and depressed asset prices, with the RWCR of the banking sector remaining above 8%, and some banking institutions recording RWCR well above 8%.

Table 4.11
Banking System[1]: Non-performing Loans by Sector

	As at end				
	NPL by sector		Change	As percentage of total loans to sector	
	2000	2001	2000/2001	2000	2001
	RM million		%		
Agriculture, hunting, forestry and fishing	702.5	924.0	31.5	6.4	8.1
Mining and quarrying	210.3	244.5	16.3	14.7	19.4
Manufacturing	8,865.9	12,409.6	40.0	14.4	20.3
Electricity, gas and water supply	252.9	358.8	41.9	3.3	7.3
Wholesale and retail trade, restaurants and hotels	4,729.5	4,983.4	5.4	13.3	13.8
Wholesale trade	*2,058.6*	*2,126.5*	*3.3*	*10.7*	*10.7*
Retail trade	*1,300.5*	*1,364.5*	*4.9*	*11.8*	*12.0*
Restaurants and *hotels*	*1,370.4*	*1,492.4*	*8.9*	*26.0*	*30.1*
Broad property sector	20,874.0	27,346.3	31.0	15.8	17.1
Construction	*8,021.2*	*10,526.0*	*31.2*	*23.2*	*31.6*
Purchase of residential property	*5,055.3*	*6,727.9*	*33.1*	*9.0*	*8.0*
Purchase of non-residential property	*4,159.7*	*4,918.7*	*18.2*	*15.8*	*18.2*
Real estate	*3,637.7*	*5,173.7*	*42.2*	*24.5*	*33.2*
Transport, storage and communication	1,920.5	1,595.0	-17.0	16.3	15.5
Finance, insurance and business services	2,990.4	4,633.8	55.0	9.6	14.5
Consumption credit	6,260.7	5,803.3	-7.3	11.1	8.3
Personal uses	*1,885.2*	*1,873.5*	*-0.6*	*14.6*	*14.2*
Credit cards	*377.8*	*409.4*	*8.4*	*5.1*	*4.6*
Purchase of consumer durable goods	*80.3*	*70.1*	*-12.7*	*10.1*	*14.8*
Purchase of transport vehicles[2]	*3,917.4*	*3,450.3*	*-11.9*	*11.1*	*7.3*
Purchase of securities	4,438.5	5,206.6	17.3	18.2	24.6
Community, social and personal services	783.8	1,237.3	57.9	13.1	21.1
Others	971.3	1,874.0	92.9	8.4	17.9
Total	**53,000.3**	**66,616.6**	**25.7**		

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

The global economic downturn and the slump in the global electronics industry in 2001 adversely impacted exports during the year and consequently, the volume of production and sales of the manufacturing sector. Against this backdrop, the sector recorded the largest increase in NPL over the year, from RM8.9 billion as at end-2000 to RM12.4 billion as at end-2001. In terms of distribution of gross NPLs by economic sectors, the manufacturing sector continued to account for a large portion of total NPLs in the banking system. As at 31 December 2001, gross NPLs to the manufacturing sector accounted for 18.6% of total NPLs of the banking system and 20.3% of total loans granted to this sector. However, towards the last quarter of 2001, the NPLs of this sector stabilised as both external and domestic demand improved during the quarter.

The construction sector was also adversely affected by the economic slowdown. As at end-December 2001, the NPLs for this sector accounted for 15.8% of total NPLs of the banking sector and 31.6% of total loans to this sector. As the construction sector has been a major beneficiary of the Government's fiscal stimulus measures, the NPLs in this sector is expected to improve in 2002. NPLs for the purchase of residential properties remained manageable at 8% of total loans extended for this purpose. Within the finance, insurance and business services sector, NPLs increased by 55% during the year. The bulk of the NPLs to this sector were attributed to investment holding companies which had difficulties servicing their debts due to lower dividends from subsidiary companies.

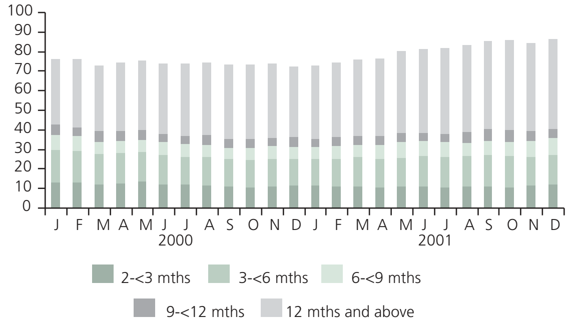
Despite the relatively stronger performance of the stock market in 2001, NPLs for the purchase of securities increased by RM0.8 billion or 17.3%. Although the NPL ratio to this sector accounted for 24.6% of total loans to the sector as at 31 December 2001, the total exposure of the banking sector to the sector remained small at 5% of total loans extended by the banking sector.

In terms of potential risk to the banking sector, total outstanding loans in arrears have stabilised and continued to remain at manageable levels throughout the year. Despite a more difficult economic environment, total outstanding loans in arrears net of NPLs in the 2 to less than 6 months buckets increased only marginally by 1.4% or RM280.8 million in the year 2001. These were mainly due to increases in loans in arrears in the 2 to less than 3 months buckets, whilst total outstanding loans in arrears in the 4 to less than 6 months buckets declined by 4.5% during the year. New loans classified as NPLs have also started to moderate over the second half of the year, recording a decline from RM20.1 billion in the first half of the year to RM11.2 billion in the second half of the year 2001. The banking system has also recorded a 27.8% increase in recoveries in the second half of the year.

The pre-emptive initiatives that have been taken to accelerate the pace of corporate debt restructuring have started to yield positive results in enhancing the asset quality of banking institutions and significantly reduced risks to the banking system. During the year, the successful restructuring of the debts of two large corporate borrowers had reduced the NPLs of the banking system by RM2.9 billion or 0.7% of total NPLs. The satisfactory progress of corporate debt restructuring under the new CDRC framework is expected to further alleviate a significant portion of the NPL problems from the banking sector. With the completion of the debt restructuring process under CDRC envisaged by July 2002, the asset quality of banking institutions can be expected to improve by approximately 3 percentage points. Therefore, the banking institutions are well placed to support the economic recovery in 2002.

It is therefore envisaged that the level of NPLs in the banking system will continue to remain manageable as the banking system has emerged stronger following the restructuring efforts as well as the various measures introduced to improve the risk management practices of banking institutions. As the economy is expected to record stronger performance in the year 2002, the asset quality of banking institutions will also improve in tandem with the positive economic outlook.

Graph 4.9
Banking System[1]: Ageing Profile of Loans in Arrears



[1] Excludes Islamic banks

Liquidity Management

The international reserves declined during the first half of the year to RM98.9 billion as at end-June 2001. To stabilise liquidity conditions, BNM liquidity operations was expansionary, releasing liquidity that was absorbed from the banking system in the previous year. The total intervention by BNM in the form of outstanding net interbank borrowing and issuance of Bank Negara Bills (both conventional and Islamic) declined from RM49.6 billion as at end-2000 to RM34.1 billion as at end-June 2001.

Liquidity in the banking system however increased in the second half of the year as international reserves rose by RM18.4 billion, from RM98.9 billion as at end-June 2001 to RM117.2 billion as at end-December 2001. The significant current account surplus, the steady inflow of foreign direct investment and the interest rate differential in Malaysia's favour during the period following coordinated interest rate cuts in the major economies during the year accounted for the increase in inflows, thereby contributing to the increase in the level of liquidity in the banking system. To absorb the impact of the additional liquidity, BNM increased its intervention and sterilised the inflows during the second half of the year through additional interbank borrowing (including Islamic borrowing) of RM12 billion, increasing the total intervention by BNM to RM46.1 billion as at end-December 2001. This has ensured that interbank rates remained stable, with the three-month weighted average interbank rate ranging from 2.85% to 3.06% per annum during the year.

Graph 4.10
Liquidity in the Banking System in 2001

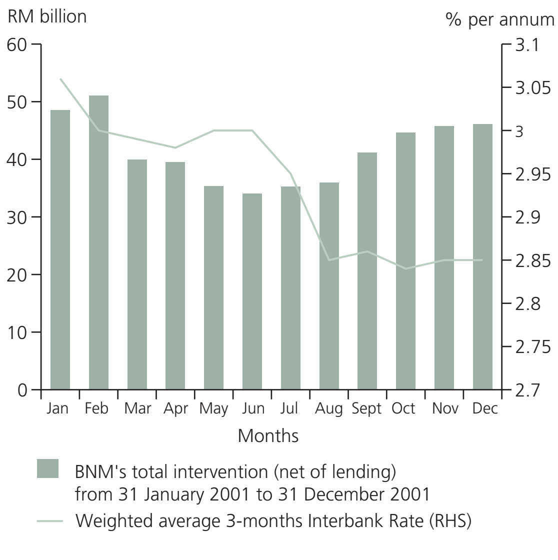


Table 4.12
Banking System[1]: Liquidity Projection as at 31 December 2001

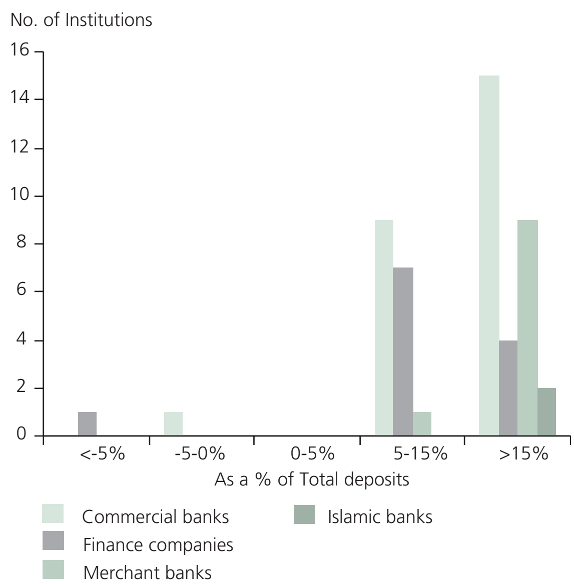
	Cumulative Mismatch (RM billion)		Buffer as % of total deposits	
	1 wk.	**1 mth.**	**1 wk.**	**1 mth.**
Commercial banks[1]	37.1	51.8	11.5	16.1
Finance companies	8.0	11.4	9.9	14.1
Merchant banks	6.6	6.4	46.1	44.1
Banking system[1]	**51.7**	**69.6**	**67.5**	**74.3**

[1] Excludes Islamic banks.

The liquidity management of the banking institutions showed an overall improvement as the adoption of the new liquidity framework become mandatory from January 2001. As at end-December 2001, the cumulative liquidity surplus of the banking system (excluding two Islamic banks) was projected at RM51.7 billion in the very short-term bucket of up to 1-week and RM69.6 billion in the 1-month bucket. As a group, commercial banks, finance companies and merchant banks projected large surpluses in the 1-month bucket amounting to 16%, 14% and 44% of their total deposit base respectively.

On an individual basis, the majority of the banking institutions have projected surpluses, well above the regulatory requirement in the 1-week and 1-month

Graph 4.11
Banking System: Profile of Potential Liquidity Surplus/Shortfall up to One Month Ahead as at 31 December 2001

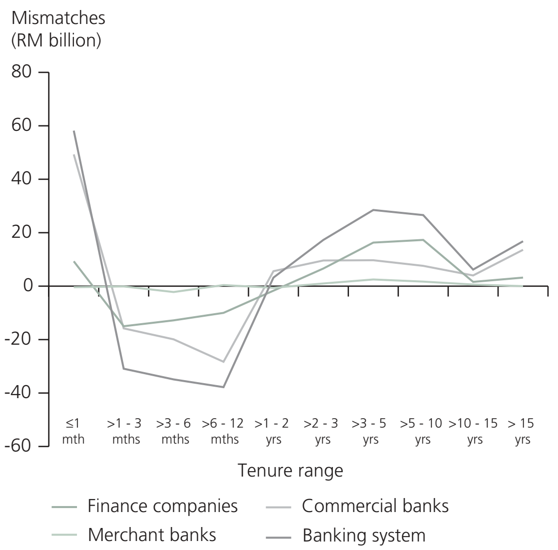


buckets and only one finance company and one commercial bank projected a shortfall of between -5% and 0% for the 1-month bucket as compared to 12 banks as at end-December 2001. With the proportion of assets that were liquid also remaining high at RM59.4 billion (in terms of forced sale value) as at end-December 2001, the ability of the banking system to withstand potential liquidity shocks has significantly improved. The ample liquidity in the banking system would then enable banking institutions to conduct increased intermediation activities to support the economic growth momentum.

Interest Rate Risk

As activities in the debt market increased in tandem with the low interest rate environment, and significant growth in fixed rate loans, particularly loans for the purchase of transport vehicles, the level of interest rate risk in the banking system remained manageable. Nevertheless, the overall interest rate mismatch profile of the banking system as at end-2001 remained structurally similar, with negative interest rate mismatch positions concentrated in the shorter term maturities and positive interest rate mismatches in the longer term maturities. This reflects the nature of domestic banking activities and the lack of long-term hedging instruments, where assets with longer tenure interest rate repricing are not funded by liabilities of similar interest rate repricing tenure.

Graph 4.12
Banking System[1]: Net Interest Rate Position Mismatches as at 31 December 2001



[1] Excludes Islamic banks

Table 4.13
Banking System[1]: Impact of 1% Rise in Interest Rate on Solvency and Balance Sheet

	Duration weighted net position					
			As a percentage of			
	RM million		Capital base (%)		Total assets (%)	
	2000	2001	2000	2001	2000	2001
Commercial banks	-1,842	-2,281	-4.3	-5.2	-0.4	-0.4
Finance companies	-1,323	-1,846	-14.2	-19.3	-1.2	-1.5
Merchant banks	-216	-224	-4.7	-4.9	-0.6	-0.6
Banking system	-3,381	-4,351	-6.0	-7.5	-0.5	-0.6

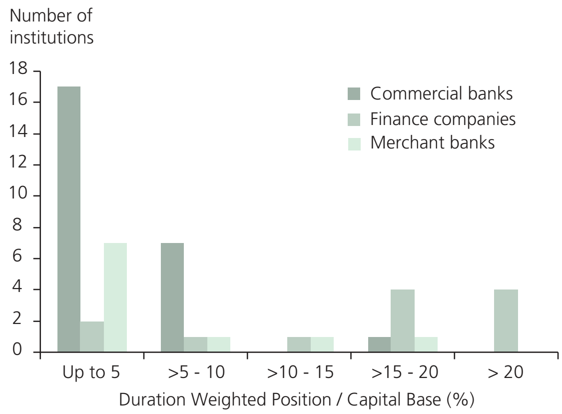
[1] Excludes Islamic banks.

Focusing on the shorter term tenure of the interest rate mismatch profile, the net positive gap position in the less than 1-month repricing bucket is driven by significant concentration in floating rate BLR type loans that mature or are repriced within 1-month, accounting for over 40% of banking institutions' interest sensitive assets. Nevertheless, with short-term deposits being predominantly repriced between the 1 to 12 months buckets, the negative gap position within these repricing buckets have offset the positive gap position in the less than 1-month bucket. As at 31 December 2001, over 83.3% of interest rate sensitive liabilities were concentrated in the less than one year repricing buckets.

On the other hand, across the medium- to long-term spectrum of banking institutions' interest rate maturity profile, the depth in funding is still relatively shallow generally due to the lack of long-term hedging instruments and partly to the preference of depositors towards shorter term deposits in view of the present low interest rate environment. This has resulted in the positive interest rate mismatch. As a percentage of interest rate sensitive assets with repricing maturity above one year, fixed rate loans accounted for 67% whilst fixed rate debt securities accounted for 30%.

Adopting the duration weighted position concept in the analysis of banking institutions' interest rate risk which ascertains the potential loss in economic value of banking institutions' on- and off-balance sheet position given a one percentage point shift in interest rates, as at end-2001, the duration weighted net position of the banking system amounted to RM4.4 billion. Reflective of the interest rate mismatch profile, most of the exposure to interest rate risk was concentrated in the maturity buckets exceeding three

Graph 4.13
Banking System[1]: Distribution by Duration Weighted Net Position as a Percentage of Capital Base as at 31 December 2001



[1] Excludes Islamic banks

years. The duration weighted position of the banking system in the 3 to 10 years and the more than 15 years repricing buckets amounted to RM2.4 billion and RM1.5 billion respectively, representing 54% and 35% of the total duration weighted position of the banking system. This was largely due to fixed rate financing granted by the finance companies, particularly hire purchase financing, block discounting and lease financing, and the commercial banks and merchant banks long-term fixed rate loans and holdings of fixed rate securities for liquidity and investment purposes.

On an industry-type basis, the majority of the exposure to interest rate risk has been from commercial banks and finance companies, which have respectively accumulated a duration weighted position of RM2.3 billion and RM1.8 billion or a 52.4% and 42.4% share from the total duration weighted position of the banking system as at end-2001. The rise in interest rate risk of finance companies can be explained by the significant growth in fixed rate loans in the 3 to 5 years and 5 to 10 years bucket by 56.1% and 89% to RM8 billion and RM17.4 billion respectively. On the other hand, the commercial banks' growth in interest rate risk is due to their increased activities in fixed rate debt securities in the medium-term tenures and the long-term fixed rate loan activities of two commercial banks, predominantly in the form of Islamic type financing and staff loans with maturity exceeding 15 years amounting to over RM9 billion. The duration weighted position of merchant banks remain relatively small with a total amount of RM224 million as compared to RM216 million as at end-2000.

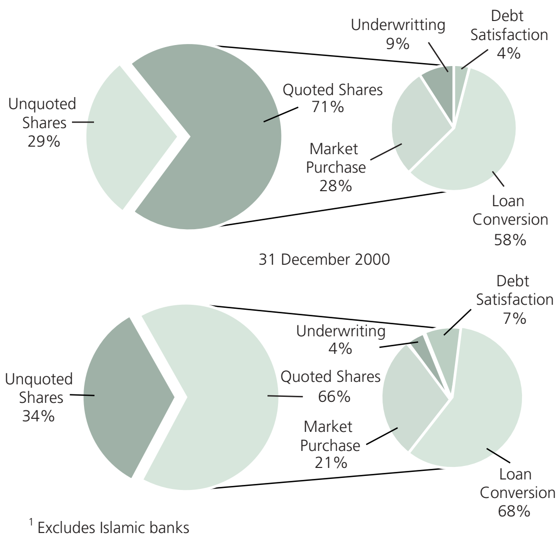
In relating the impact of interest rate risk to the stability of the banking system, the duration weighted position can be used to measure against the potential erosion of the value of banking institutions' capital base and assets. In terms of assets, as at 31 December 2001, the exposure of the banking system towards interest rate risk was rather insignificant with a potential loss of only 0.6% in the value of the banking system's total assets for a one percentage point rise in interest rates. Nevertheless, this would translate to an erosion of 7.5% in the value of the banking system's capital base compared to 6% as at end-2000. This was due to the increased exposure of finance companies to interest rate risk in relation to their fixed rate loan activities. The potential loss to the value of finance companies' capital base amounts to 19.3%, higher than 14.2% recorded in the previous year. On the other hand, merchant banks and commercial banks experienced a marginal increase in the erosion in capital base for a one percentage point rise in interest rates, recording 4.9% and 5.2%, respectively. On an individual institution basis, 12 institutions were exposed to interest rate risk exceeding 10% of their capital base, nine of which were finance companies reflecting the high interest rate risk nature of their activities. The other institutions were one commercial bank and two merchant banks whose activities in the debt market increased significantly. Most of the remaining commercial banks and merchant banks had a potential loss in capital base of less than 5% for a one percentage point shift in interest rates.

Equity Risk

The banking system's exposure to equity investments remained insignificant as at end-2001, with the overall outstanding equity holdings representing only 0.2% of the system's total assets. Investments in quoted shares during the year declined from RM1.8 billion to RM1.5 billion due mainly to the lacklustre performance of the Kuala Lumpur Composite Index (KLCI) as a result of global economic slowdown. The KLCI peaked just above 700 points in the first quarter of 2001, but remained below 700 points for the remaining part of the year, resulting in lower debt-to-equity conversions which declined by 25% during the year.

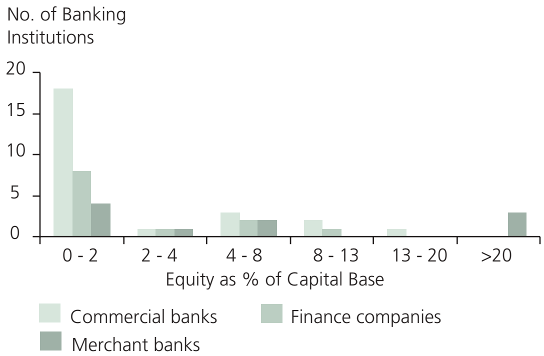
The relative uncertainty and weak sentiment in the stock market throughout the year, led to a larger proportion of equity held by banking institutions due to underwriting, which increased by 5% from RM64.5 million as at end-2000 to RM143.7 million as at end-2001. The holdings of unquoted shares, which represented 0.1% of the system's total assets also registered a decline.

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



[1] Excludes Islamic banks

Graph 4.15
Banking System[1]: Distribution by Equity as a Percentage of Capital Base as at 31 December 2001



[1] Excludes Islamic banks

Reflective of the weak stock market, both the commercial banks and finance companies reduced their equity holdings by 25% and 15% respectively in 2001. The merchant banks however registered an increase in their equity holdings by 30.2%, mainly from underwriting activities as a result of lacklustre initial public offers in the first half of the year. Consequently, merchant banks had the highest equity exposure as their holdings of quoted shares accounted for more than 8% of their capital base, while equity exposure of commercial banks and finance companies accounted for only 1.8% and 3.7% of their capital base respectively. In terms of individual banking institutions, most banks had less than 2% of the capital base exposed to equity risk. However, three merchant banks had an equity exposure in excess of 20% of capital base.

In the face of a more volatile market, the estimated potential loss in equity value based on a 10-day volatility of the KLCI, was higher at 17% in the year 2001 as compared to only 10% in 2000. Despite the higher volatility, potential loss to the banking system in the event of a decline in the stock market was estimated to be only 0.4% of the total capital base in 2001, as compared to 0.5% in 2000. This marginal loss is due to the overall reduction in the equity holdings of the banking institutions.

While the equity potential loss of commercial banks and finance companies was reduced to 0.3% and 0.6% of their respective capital base, merchant banks, on the other hand, had the highest potential loss from equity risk of 1.5%, which is 40 basis points higher compared to the year 2000, due to higher equity holdings coupled with the merchant banks' relatively smaller capital base. However, this exposure remained insignificant and did not pose any threat to the stability of the banking system.

Table 4.14
Banking System[1]: Equity Exposure

	Equity[2] holdings (RM million)		Equity[2] / Capital base (%)		Potential equity[2] loss / Capital base (%)	
	2000	2001	2000	2001	2000	2001
Commercial banks	1,031.2	768.5	2.4	1.8	0.4	0.3
Finance companies	417.3	354.9	4.6	3.7	0.8	0.6
Merchant banks	305.8	398.1	6.6	8.7	1.1	1.5
Banking system[1]	1,754.3	1,521.6	3.1	2.6	0.5	0.4

[1] Excludes Islamic banks.
[2] Amount of investment in quoted shares.

Foreign Exchange Risk

Although the interest rate differential between the USD and Ringgit narrowed in the first half of 2001 causing the forward discount in the foreign currency forward market to reduce considerably, there was strong demand for foreign currency forward contracts by importers during this period. Foreign currency forwards sold by banking institutions increased by RM10 billion during the period of heightened speculation by the market that the Ringgit would be repegged downwards against the USD. As a hedge against these forward contracts, holdings of foreign currency assets by banking institutions rose to peak at RM21.3 billion as at end-May 2001. Consequently, the net open foreign currency position of the banking system rose to RM3.1 billion as at end-June 2001 before easing off in the second half of the year to RM2.3 billion at the end of 2001.

In the second half of 2001, the continued fall in USD interest rates further narrowed the interest rate differential between the USD and Ringgit, and subsequent rate cuts by the US Federal Reserve resulted in USD interest rates falling below the domestic interest rate from September 2001 onwards. This dampened the demand for foreign currency forwards by importers which resulted in foreign currency forward sales by banking institutions declining from RM25.9 billion as at end-May 2001 to RM13.6 billion as at end-2001. Subsequently, the holdings of foreign currency denominated assets by banking institutions contracted in response to reduced hedging requirements. By year end, net foreign currency assets of the banking system declined to RM8.4 billion as against RM9.8 billion as at end-2000.

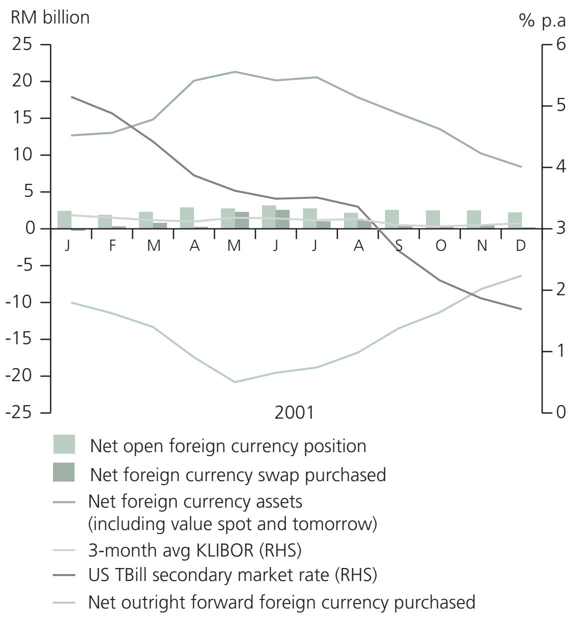
The foreign currency risk undertaken by the banking institutions remained within prudential levels as there was only a marginal increase in foreign currency exposure compared to end-2000. The commercial banks' net open foreign currency position as a percentage of capital base increased by 0.9 percentage points to 5.1% and by 0.8 percentage points to 1% for the merchant banks. On an individual banking institution basis, only six commercial banks and one merchant bank out of the total 35 commercial and merchant banks had net open foreign currency position as a percentage of capital base above 5%. Of the seven, four had a net exposure beyond 10%. The high exposure of these institutions were generally attributable to increased forward purchases as well as off-balance sheet funding of domestic activities through the swap market.

Table 4.15
Banking System[1]: Foreign Currency Exposure

	NOP (RM million)		NOP/Capital Base (%)	
	end-2000	end-2001	end-2000	end-2001
Commercial banks	1,824	2,221	4.2	5.1
Merchant banks	-8	47	0.2	1.0
Banking system	1,816	2,268	3.8	4.7

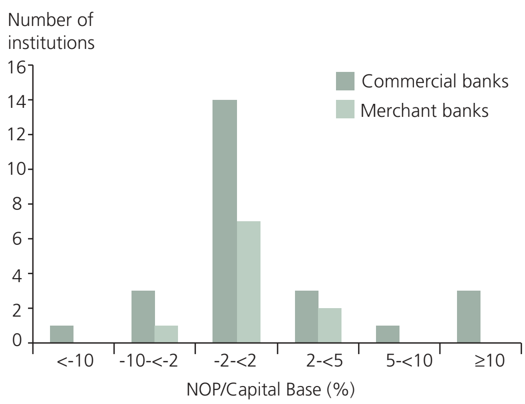
[1] Excludes Islamic banks.

Graph 4.16
Banking System[1]: Foreign Currency Exposure



[1] Excludes Islamic banks

Graph 4.17
Banking System[1]: Distribution of Net Open Foreign Currency Position as at 31 December 2001



[1] Excludes Islamic banks

Capital Strength

The capital position of the banking system strengthened during the year to 12.8% as at end-2001 on the back of continued profitability and capital injections into the banking institutions to support their enlarged operations following the conclusion of the mergers as well as to meet the 31 December 2001 deadline of a higher minimum capital funds requirement. Profits (excluding unaudited profits for the year 2001) accounted for RM2.8 billion of the increase whilst new capital injections contributed another RM3.7 billion. On a net basis, capital base of the banking system has increased by RM1.6 billion on a year-on-year basis. This is largely due to the exclusion of the capital base of 16 banking institutions amounting to RM4.1 billion, which were merged or absorbed as a result of the consolidation process during the first quarter of the year.

Concurrent with the profits earned and increase in capital funds, total Tier-1 capital of the banking system increased by RM2.6 billion or 5.2% to RM53.4 billion as at end-2001. Total Tier-2 capital however recorded a marginal increase of RM0.2 billion. Reflective of the stronger capital position of the banking system in 2001, its risk-weighted capital ratio (RWCR) increased to 12.8% in December 2001 from 12.5% as at end-2000 while core capital ratio (CCR) increased by 10 basis points to 10.8%. Both the RWCR and CCR far exceeded the internationally prescribed ratios of 8% and 4%. Overall, the RWCR of the banking system was consistently above 12% throughout 2001 except for January 2001 when it dipped to 11.8% while the CCR was sustained above 10% throughout 2001.

Table 4.16
Banking System[1]: Constituents of Capital

	As at end		Annual change	
	2000	2001		
	RM million		RM million	%
Tier-1 capital	50,786.9	53,419.5	2,632.6	5.2
Tier-2 capital	14,753.6	14,960.2	206.6	1.4
Total capital	65,540.5	68,379.7	2,839.2	4.3
Less:				
Investment in subsidiaries and holdings of other banking institutions' capital	7,662.6	8,923.6	1,261.0	16.5
Capital base	57,877.9	59,456.1	1,578.2	2.7
Risk assets:				
0%	121,482.3	124,822.2	3,339.9	2.7
10%	17,864.5	15,985.5	-1,879.0	-10.5
20%	104,355.8	97,728.5	-6,627.3	-6.4
50%	80,985.4	92,666.9	11,681.5	14.4
100%	401,143.3	397,872.7	-3,270.6	-0.8
Total risk-weighted assets	464,293.6	465,350.4	1,056.8	0.2
Risk-weighted capital ratio (%)				
Banking system[1]	**12.4**	**12.8**	**0.4**	**3.2**
Commercial banks	12.2	12.6	0.4	3.3
Finance companies	11.5	11.4	-0.1	-0.9
Merchant banks	17.1	19.0	1.9	11.1

[1] Excludes Islamic banks.

Although the capital base of the commercial banks and finance companies improved from their end-2000 position, only the commercial banks registered an improvement in their RWCR from 12.2% as at end-2000 to 12.6% as at end-2001. The increase in the capital base of the finance companies was moderated by higher investments in subsidiaries following the takeover of a finance company in conjunction with the merger exercise. This, coupled with strong demand for hire purchase financing in 2001, resulted in the RWCR of the finance companies declining by 10 basis points to 11.4% as at end-2001. The capital base of merchant banks has declined after deducting investments in subsidiaries which has increased by 658% in 2001 following the acquisition/establishment of two new subsidiaries by a merchant bank. However, the RWCR of merchant banks increased to 19.1% from 17.1% as at end-2000 due to the reduction in the risk-weighted assets caused by a decline in the loan base, in line with the trend to shift the focus of activity from lending to advisory services.

The total risk-weighted assets of the banking system increased marginally by 0.2% or RM1.1 billion to RM465.4 billion as at end-2001 in line with a moderate loan growth. Of the various categories of risk-weighted assets, the risk-weighted assets of 0% and 50% risk-weight categories had increased due to the increase in investments in low risk assets and housing loans secured by first charge. Assets in the 10% risk-weight category continued to shrink as banking institutions reduced their holding of Cagamas papers whilst assets in the 20% risk-weight category shrank due to the reduction in investments in corporate papers that are guaranteed by domestic BIs following the maturity of such papers. Assets in the 100% risk-weight category fell mainly due to the write-off of the amount recoverable from Danaharta.

With the strong capital base of the banking system following the higher revised minimum capital funds, the conclusion of the merger programme and the profits recorded in 2001, the banking system is well positioned to meet the loan demands which would augur well for the growth of the economy in 2002.

ISLAMIC BANKING

The Islamic banking industry sustained its expansion despite slower economic growth during the year. In terms of the market share relative to the banking system, the share of Islamic banking assets and deposits increased to 8.2% and 9.5% respectively, surpassing the 8% targets set for the year 2001 (6.9% and 7.4% respectively in 2000). Total financing registered an increase to 6.5% compared with 5.3% in 2000. The continued expansion of the Islamic banking sector was mainly attributable to the various measures undertaken by BNM and continuous efforts by the industry players in introducing new instruments as well as measures to enhance the Islamic banking industry in areas that were outlined in the Financial Sector Masterplan (FSMP) on Islamic banking and takaful.

Table 4.17
Islamic Banking: Key Data

	As at end		Change (%)
	2000	2001	2001
Number of financial institutions	**49**	**38**	**–22.4**
Commercial banks	21	14	–33.3
Finance companies	14	10	–28.6
Merchant banks	5	5	0.0
Islamic banks	2	2	0.0
Discount houses	7	7	0.0
Total assets (RM million)	**47,068**	**58,929**	**25.2**
Commercial banks	20,094	26,750	33.1
Finance companies	7,150	9,749	36.3
Merchant banks	1,507	1,353	–10.2
Islamic banks	14,029	17,328	23.5
Discount houses	4,288	3,749	–12.6
Total deposits (RM million)	**35,923**	**47,106**	**31.1**
Commercial banks	16,091	22,031	36.9
Finance companies	5,393	7,664	42.1
Merchant banks	867	673	–22.4
Islamic banks	11,304	14,375	27.2
Discount houses	2,268	2,363	4.2
Total financing (RM million)	**20,891**	**28,201**	**35.0**
Commercial banks	8,606	12,256	42.4
Finance companies	5,090	7,613	49.6
Merchant banks	769	771	0.3
Islamic banks	6,426	7,561	17.7
Discount houses	–	–	0.0
Financing-deposits ratio (%)	**58.2**	**59.9**	**1.7**
Commercial banks	53.5	55.6	2.1
Finance companies	94.4	99.3	5.0
Merchant banks	88.7	114.6	25.9
Islamic banks	56.8	52.6	–4.2
Discount houses	–	–	0.0
Number of branches	**131**	**132**	**0.8**
Commercial banks	7	8	14.3
Finance companies	2	2	0.0
Islamic banks	122	122	0.0
Number of counters	**2,087**	**2,065**	**–1.1**
Commercial banks	1,338	1,335	–0.2
Finance companies	745	730	–2.0
Merchant banks	4	0	–100.0

The FSMP has set a 20% target to be achieved by 2010, in terms of the market share of Islamic banking assets relative to the total banking system. The development of a well-established and comprehensive regulatory framework that preserves the integrity of the Islamic banking operations is an integral component of the work being undertaken to set up an appropriate prudential standard for the Islamic banking industry. To further strengthen the regulatory framework of Islamic banking and to improve the operational efficiency of Islamic banking institutions, BNM introduced the following measures in 2001:

- **Requirement to observe the minimum risk weighted capital adequacy ratio framework for the Islamic banking portfolios of conventional banking institutions participating in the Islamic Banking Scheme (IBS banks)**
  With effect from 2 January 2002, in order to steer the development of Islamic banking, BNM set a series of targets to be achieved by the IBS banks. IBS banks are required to observe a minimum core capital ratio of 4% and risk-weighted capital ratio of 8% for their Islamic banking portfolios. The new requirement is expected to promote a more efficient utilisation of Islamic banking capital funds and enhance the level playing field among IBS banks. This is an initial effort to prepare the regulatory platform that is sensitive and tailored specifically to address the distinct risk characteristics of Islamic banking. To ensure full disclosure and transparency, the IBS banks are required to maintain a separate disclosure on the capital adequacy of their Islamic banking portfolios in the financial statement.

- **Standard framework for the computation of the rate of return for Islamic banking institutions**
  BNM formulated a standard framework for the computation of the rate of return for Islamic banking institutions, aimed at providing a level playing field and terms of reference for the Islamic banking players in deriving the rate of return. The framework would allow BNM to assess the efficiency, profitability, prudent management and

fairness of Islamic banking institutions more effectively. Furthermore, the standardisation of the calculation of the rate of return would serve to address the information asymmetry between the bank and its depositors, by enhancing transparency and ensuring that depositors receive their fair share of the return on investment, in conformity with the Shariah principles.

To provide greater strategic focus to Islamic banking operations and facilitate greater economies of scale, BNM has encouraged the IBS banks to rationalise their Islamic banking operations within their respective banking groups. Consolidation would result in a wider range of Islamic banking facilities, better synergies within the group, enhanced cost effectiveness and efficiency, thereby, placing the IBS banks in a better position to expand their Islamic banking operations. One domestic banking group established the first domestic one-stop Islamic financial centre, providing a wide range of facilities to meet customer requirements.

As part of the activities to promote Kuala Lumpur as a regional Islamic financial centre, the Kuala Lumpur International Summit was held from 19 to 21 February 2001. The Summit provided an avenue for regulators, practitioners and academicians to deliberate on the issues and challenges confronting Islamic banking and finance. In conjunction with the Summit, the Islamic Banking and Finance Institute Malaysia (IBFIM) was launched as an industry-owned research and training institute. IBFIM would be a one-stop centre for providing education, training and research on Islamic financial services, covering Islamic banking, takaful and Islamic capital market at both the domestic and the international levels.

As part of the initiatives to enhance the effectiveness in disseminating information on Islamic banking and takaful, the Islamic Banking and Takaful Week (IBTW) was held from 26 October to 2 November 2001. The primary objective was to promote greater public awareness and knowledge on Islamic banking and takaful, as well as to build a high impact campaign on Islamic banking and takaful at the Islamic financial institutions. Apart from the Islamic banking institutions (comprising the Islamic banks and IBS banks) and takaful companies, the development finance institutions offering Islamic products and services also participated in the campaign.

In conjunction with the IBTW, was the launch of the Islamic banking logo. The main objective of the logo is to increase the visibility of Islamic banking, particularly in conventional banking institutions offering both conventional and Islamic banking products and services. The Islamic banking institutions are required to display the logo at their premises to indicate the availability of Islamic banking products and services offered. The logo would also be used by the Islamic banking institutions in their documents and brochures related to Islamic banking transactions. In conjunction with the IBTW, the Association of Islamic Banking Institutions Malaysia (AIBIM) introduced two awards, the 'Islamic Banker Award' for individual contribution and 'Best Performance Institution Award' for individual institution contribution, to acknowledge meaningful contributions made for the development of the Islamic banking industry in Malaysia.

The Islamic banking logo provides the branding of Islamic financial products and services and reflects the commitment of the Islamic banking institutions in developing Islamic banking and finance as envisioned by the FSMP.

In line with the recommendations of the FSMP to increase the market penetration level and to deepen the Islamic financial market, BNM formed two consultative committees, the Consultative Committee on Services (CCS) and Consultative Committee on Product and Market Development (CCPMD), comprising BNM and representatives of the Islamic banking institutions and takaful companies. The CCS was formed with the objective of setting the minimum best practice standard for Islamic banking in customer service, establishing image building as well as promoting public awareness and knowledge on Islamic banking and finance. The CCPMD was formed to drive the innovation and development of Islamic banking products.

Consequent to the continuous efforts to enhance the savings avenue for senior citizens and charity organisations, half of the Bon Simpanan Malaysia Siri 03 issuance was based on the Islamic principle of Bai'

Al-Inah (sell and buy back) where the bank identifies the assets and sells them to the customers. The customers will then sell back the assets at a higher price and in return, the bank issues the bond to the customers. The Islamic bonds have a maturity period of two years and a rate of return of 5% per annum. During the year, BNM issued specific operational guidelines to govern the administration of three government funds disbursed under the Islamic concept, namely the New Entrepreneurs Fund 2 (NEF 2), Entrepreneurs Rehabilitation and Development Fund (ERDF) and Fund for Food (3F).

During the year, the Malaysian Accounting Standards Board (MASB) issued MASB Standard *i*-1 (Presentation of Financial Statements of Islamic Financial Institutions). The objective of the standard is to lay down the basis for the presentation and disclosure of financial statements of Islamic financial institutions that conduct Islamic banking activities.

Table 4.18
Islamic Banking: Sources and Uses of Funds

	As at end			
	2000		2001	
	RM million	% share	RM million	% share
Sources:				
Capital and reserves	2,526	5.4	3,434	5.9
Debentures and notes				
Deposits	35,923	76.3	47,106	79.9
of which	–	...	–	...
INI issued	*500*	*1.1*	*1,222*	*2.1*
Repos	*431*	*0.9*	*1,655*	*2.8*
Amount due to financial institutions	4,796	10.2	4,173	7.1
Domestic	*4,796*	*10.2*	*4,173*	*7.1*
Foreign	–	...	–	...
Bankers acceptances	597	1.3	728	1.2
Others	3,227	6.9	3,488	5.9
Total	**47,069**	**100.0**	**58,929**	**100.0**
Uses:				
Cash	348	0.7	201	0.3
Reserve with BNM	724	1.5	878	1.5
Amount due from financial institutions	8,743	18.6	11,502	19.5
Domestic	*8,743*	*18.6*	*11,062*	*18.8*
Foreign	–	...	*440*	*0.7*
Investments	3,135	6.7	10,148	17.2
of which:				
Stock and shares	*82*	*0.2*	*45*	*0.1*
Debentures	*2,808*	*6.0*	*9,909*	*16.8*
Fixed Assets	*245*	*0.5*	*194*	*0.3*
Foreign investments	–	...	–	*0.0*
Placement with discount houses	–	–	–	...
Marketable securities	12,877	27.4	5,309	9.0
of which:				
Treasury bills	-	-	-	-
GII	*357*	*0.8*	*908*	*1.5*
INI held	*212*	*0.5*	*184*	*0.3*
Cagamas bonds	*134*	*0.3*	*84*	*0.1*
Financing	20,891	44.4	28,201	47.9
Others	351	0.7	2,690	4.6
Total	**47,069**	**100.0**	**58,929**	**100.0**

Sources and Uses of Funds

In 2001, the total assets of the Islamic banking sector increased by RM11.9 billion or 25.2%, to RM58.9 billion as at end-2001. A significant portion of the increase in the total assets (RM7.3 billion or 61.3%) was contributed by the financing disbursed during the period. As in the previous years, the largest portion of the Islamic banking assets remained with the IBS commercial banks with a market share of 45.4%, followed by the Islamic banks (29.4%) and the IBS finance companies (16.5%). Both the IBS commercial banks and finance companies recorded moderate growth in their assets of 33.1% and 36.3%, respectively. The increase in assets was attributable to the growth in total financing of IBS commercial banks (42.4%) and finance companies (49.6%), constituting 70.5% of the total financing.

A major portion of funds in the Islamic banking sector continued to be sourced from deposits, which accounted for 79.9% of the total resources. Total deposits recorded a moderate growth of 31.1% or RM11.2 billion to reach RM47.1 billion as at end-2001, capturing a market share of 9.5% (7.4% in 2000) of the total banking industry. While the deposits of the IBS finance companies recorded the highest growth (42.1%), the bulk of Islamic banking deposits (46.8%) remained with the IBS

Table 4.19
Islamic Banking: Deposits by Type and Institutions

	Annual change				As at end
	2000		2001		2001
	RM million	%	RM million	%	RM million
Demand deposits	**1,190**	**22.1**	**–107**	**–1.6**	**6,457**
Commercial banks	580	18.1	55	1.5	3,841
Islamic banks	610	28.1	–162	-5.8	2,616
Savings deposits	**817**	**32.5**	**822**	**24.7**	**4,149**
Commercial banks	567	56.0	553	35.0	2,133
Finance companies	145	50.7	131	30.4	562
Islamic banks	105	8.7	138	10.5	1,454
Investment deposits	**9,405**	**62.5**	**9,041**	**37.0**	**33,505**
Commercial banks	3,917	66.6	3,808	38.8	13,610
Finance companies	2,214	87.3	2,237	47.1	6,986
Merchant banks	129	32.2	-160	-30.2	370
Islamic banks	877	14.1	3,066	43.1	10,181
Discount houses	1,159	104.5	90	4.0	2,358
Other deposits	**814**	**108.1**	**1,428**	**91.1**	**2,995**
Commercial banks	451	95.6	1,524	165.1	2,447
Finance companies	–	–	–96	–45.3	116
Merchant banks	337		–34	–10.1	303
Islamic banks	26	37.7	29	30.5	124
Discount houses	–	–	5	–	5

commercial banks. The growth in deposits reflected public confidence and acceptance of Islamic banking as well as the competitive rate of return on deposits.

In terms of types of customers, deposits from business enterprises accounted for 30.5% of the total deposits, followed by Government (23.7%) and the domestic non-bank financial institutions (20.2%). Investment deposits continued to capture a major portion of the Islamic banking deposits (71.1%), registering a strong growth of 37% to reach RM33.5 billion as at end-2001. The savings deposits recorded a growth of 24.7%, while the demand deposits recorded a slight decline of 1.6% during the period.

In terms of the maturity profile of the investment deposits, 61.1% of the deposits (65.3% in 2000) continued to be concentrated at the shorter end of the yield curve, mainly one to three months maturity. The one to three months maturity captured 59.4% of the general investment deposits and 72% of the specific investment deposits (63.6% and 80.8% respectively in 2000). The trend is relatively similar to the fixed deposits of the conventional banking system for which the shorter end of the yield curve represented a share of 49.3% of the deposits placement (53.4% in 2000). The average rates of return for the investment deposits with placement of less than three months maturity were in the range of 2.6% to 3.6% and for placement of one year and above, the range was 3.3% to 4.5%. The small incremental return between the shorter and longer placement tenures and the uncertainty of future rates of return led to the continued concentration at the shorter end of the yield curve by depositors.

As at end-2001, shareholders' fund of the Islamic banks and the Islamic banking capital fund of the IBS banking institutions saw a significant increase of RM908 million to RM3.4 billion. This increase was mainly attributable to higher retained profits during the year. The profitability of the Islamic banking sector recorded a total pre-tax profit of RM905.9 million during the year compared with RM533.3 million in 2000.

Total financing extended by the Islamic banking sector expanded by RM7.3 billion or 35% (RM7.2 billion or 52.2% in 2000). The financing-deposits ratio increased to 59.9% at end-2001 from 58.2% at end-2000. As in the previous years, financing to the broad property sector and consumption credit remained significant, increasing by 38.2% and 24.2% respectively. The higher demand for property sector financing was attributed to the growth in the end-financing for residential properties (72.2%), benefiting from the Property-Ownership Campaign backed by the Government during the year. Meanwhile, financing for the purchase of passenger vehicles also recorded an increase of

Graph 4.18
Islamic Financing Concepts as at December 2001

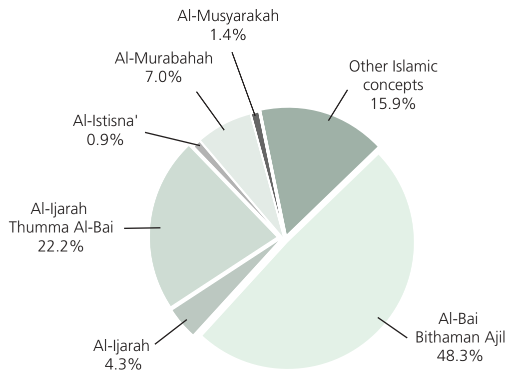


Table 4.20
Islamic Banking: Direction of Financing

	As at end			
	2000		2001	
	RM million	% share	RM million	% share
Agriculture, hunting, forestry and fishing	1,577.7	7.6	1,639.6	5.8
Mining and quarrying	78.5	0.4	64.0	0.2
Manufacturing	2,044.3	9.8	3,073.4	10.9
Electricity, gas and water	855.6	4.1	543.6	1.9
Community, social and personal services	292.7	1.4	353.1	1.3
Broad property sector	7,506.3	35.9	10,782.5	38.2
Real estate	*363.1*	*1.7*	*565.8*	*2.0*
Construction	*1,572.0*	*7.5*	*1,698.3*	*6.0*
Purchase of residential property	*3,974.4*	*19.0*	*6,845.9*	*24.3*
Purchase of non-residential property	*1,596.8*	*7.6*	*1,672.4*	*5.9*
Wholesale, retail, restaurants and hotels	854.7	4.1	1,135.2	4.0
Transport, storage and communications	787.9	3.8	763.0	2.7
Finance, insurance and business services	595.7	2.9	1,229.5	4.4
Purchase of securities	705.0	3.4	872.6	3.1
Consumption credit	4,043.1	19.4	6,812.7	24.2
Credit cards	*1.4*	*…*	*3.0*	*…*
Personal uses	*340.2*	*1.6*	*686.9*	*2.4*
Purchase of consumer durables	*43.1*	*0.2*	*55.2*	*0.2*
Purchase of transport vehicles	*3,658.4*	*17.5*	*6,067.7*	*21.5*
Others	1,549.7	7.4	932.1	3.3
Total	**20,891.2**	**100.0**	**28,201.3**	**100.0**

65.9% to RM6.1 billion in 2001 from RM3.7 billion in 2000, duly caused by the relatively lower profit-taking ratio charged for financing which averaged 4.5% per annum in 2001 (averaged 6% per annum in 2000).

In tandem with the continued exposure of Islamic financing to the broad property sector, financing based on Bai Bithaman Ajil (BBA) constituted the bulk of total financing (48.3%), amounting to RM13.6 billion as at end-2001. This was followed by Ijarah Thumma Al-Bai (AITAB) financing that recorded a significant increase of 68.3%, reflecting the tremendous demand for the Islamic hire purchase financing during the year.

Profitability

As in the previous year, the Islamic banking sector continued to record a significant increase in profits. Pre-tax profit rose by 69.9% to RM905.9 million for the calendar year 2001 (RM533.3 million in 2000). With the improvement in profitability, the Islamic banking sector was able to provide a positive rate of return on assets of 1.5% (1.1% in 2000) and a return on equity of 26.4% (21.2% in 2000).

The higher profitability recorded in 2001 was largely due to the increase in total finance income of RM2.9 billion, where income from financing constituted 67% of the total finance income. Investment income also increased by 206.8% or RM89.1 million in 2001 (RM29 million in 2000) due to gains from the sale of investment securities, while trading income increased by 60.4% to RM108.1 million in year 2001 (RM67.4 million in year 2000).

Asset Quality

The asset quality of Islamic financing deteriorated moderately during the year 2001, with net non-performing financing (NPF) ratio increasing to 7.2% from 7% in 2000. The financing loss provisions (income-in-suspense, specific provisions and general provisions) increased slightly to RM1.4 billion from RM1 billion in 2000. The increase in financing loss provisions was mainly due to the increase in general provisions by 49.4%, and specific provisions by 49%.

The bulk of the NPF was concentrated in the broad property sector, where NPF expanded by 57.4% or RM609.8 million in 2001 to account for the largest share of 56.7% of total NPF (50.2% in 2000). The high NPF in the broad property sector reflected the significant increase of NPF in the residential and non-residential property sectors of RM371.1 million and RM128.3 million respectively.

Table 4.21
Islamic Banking: Non-performing Financing and Financing Loss Provision

	As at end	
	2000	2001
	RM million	
Islamic Banking		
General provisions	314	469
Income-in-suspense	163	182
Specific provisions	535	797
Non-performing financing (NPF)	**2,119**	**2,949**
Net NPF ratio (%)	7.04	7.24
Total provisions/NPF (%)	47.76	49.10

Islamic Interbank Money Market (IIMM)

The outstanding amount of liquidity absorbed from the IIMM through BNM operations increased by 51.3% to RM5.9 billion, mainly due to the concentration of BNM's liquidity operation on medium-term tenure investment via the Mudharabah Money Market Tender. This was evidenced by the increase of 46.3% in the volume of the one-month maturity profile of Mudharabah Interbank Investments. However, this had led to a decline in the volume of Mudharabah funds in the overnight (-17.8%) and 1-week (-26.4%) tenures, which subsequently resulted in a reduction in the overall trading volume of Mudharabah interbank investments of 14.9% from RM283.6 billion in the year 2000. This reduction was also due to the shift of Mudharabah funds to investment activities in other Islamic instruments.

The total trading volume of Islamic instruments increased by 42.5% to reach RM12.2 billion in the year 2001 (RM8.6 billion in 2000). An important

Table 4.22
Islamic Interbank Money Market (IIMM) *

	2000		2001	
	Volume (RM billion)	Annual change (%)	Volume (RM billion)	Annual change (%)
Mudharabah Interbank Investments	283.6	-32.8	241.2	-14.9
Green Bankers Acceptances	13.6	7.9	19.5	43.4
Islamic Acceptance Bill	4.7	291.7	3.9	-17.0

*Volume transacted through brokers.

Table 4.23
Islamic Interbank Money Market (IIMM) - Maturity Profile *

	2000 Volume (RM billion)	2001 Volume (RM billion)	Change (%)
Overnight and weekends	**223.8**	**184**	**-17.8**
1 week	**66.3**	**48.8**	**-26.4**
1 month	**13.4**	**19.6**	**46.3**

* Volume transacted through brokers and Mudharabah money market tender.

development in the trading of short-term Islamic instruments was the marked growth in the volume of trading of Bank Negara Negotiable Notes (BNNN), which amounted to RM1.2 billion (RM70 million in 2000). The increase in the trading volume of BNNN was associated with the higher issuance of BNNN of RM1 billion (RM250 million in 2000) and high demand for short-term Islamic instruments. The total trading volume of green bankers acceptance also recorded a significant growth of 43.4% (RM19.5 billion). However, the trading volume of the Islamic acceptance bills was lower, totalling RM3.9 billion compared with RM4.7 billion in the year 2000.

The trading of long-term Islamic instruments continued to improve in 2001. During the year, the total trading volume was RM11 billion compared with RM8.5 billion in 2000. This was mainly attributable to the increase in trading of Khazanah bonds amounting to RM5.9 billion (RM5.4 billion in 2000). The total trading volume of Government Investment Issue (GII) amounting to RM2.4 billion, also contributed to the increase in the total trading volume of long-term Islamic instruments. Prior to June 2001, GII was not a tradable instrument as it was issued under the Islamic principle of Qardhul Hasan (benevolent loan), which did not permit secondary trading. As part of BNM's efforts to develop and promote the secondary trading of Islamic instruments, the issuance concept of GII was changed from Qardhul Hasan to Bai' Al Inah (sell and buy back) concept as to allow GII to become one of the tradable instruments in the IIMM. As at the end of 2001, the outstanding amount of GII amounted to RM4 billion.

The average gross rates of return of the Islamic banking institutions for the year 2001 were in the range of 2.9% to 8.7%, with an average of 5.3%. Meanwhile, the average Mudharabah interbank rates concluded in the IIMM were in the range of 2.8% to 3.1% with the tenure ranging from overnight to 6 months. There were no activities concluded above the 6 months tenure, as market participants were uncertain of the return on investment and also due to the lack of hedging instruments available for market participants to hedge their longer-term exposure.

National Shariah Advisory Council

In 2001, the bank re-appointed all the seven members of the National Shariah Advisory Council for Islamic Banking and Takaful (the Council) for the 2001-2003 term. The Council held four meetings during the year of 2001 and deliberated more than 15 Shariah issues. Among the major issues discussed and decided by the Council were:-

(i) Financing obtained through the New Entrepreneurs Fund (NEF) should be based on *Bai' Al-Inah* (sell and buy back arrangement) concept instead of *Bai' Ad-Dayn* (sale of debt). This is to avoid the possibility of sale and purchase of non-existence debt which may occur in the previous financing mechanism of the NEF based on *Bai' Ad-Dayn*;

(ii) Islamic banking institutions are allowed to sell debt arising from vehicle financing based on *Ijarah Thumma Al-Bai'* concept to Cagamas Berhad, following which, Cagamas will issue *Cagamas Mudharabah bonds* to finance the transaction. This will facilitate the securitisation of Islamic financing and provide additional investment opportunities to the market players; and

(iii) Islamic money market players are allowed to participate in intra-day transactions to manage their short-term liquidity needs. The mechanism for the intra-day transaction is similar to the inter-bank *Mudharabah* investment which is currently being practised. The shortened maturity period in intra-day transaction would ease liquidity constraints and allow market players to manage liquidity positions more efficiently.

International Developments

While the FSMP primarily focused on the development of the Islamic banking industry on the domestic front, BNM also participated actively in the global development of Islamic banking and finance. With the rapid development in the global Islamic financial industry, there was recognition for the need of a standard-setting body to adapt, develop and harmonise standards for Islamic financial products and services that would foster the development of the industry. Against this background, meetings on the Risk Management and Regulatory Standards for Islamic Financial Institutions among the central banks of the Muslim countries, the Islamic Development Bank, Accounting and Auditing of Islamic Financial Institutions, and the IMF agreed that an international standard-setting entity, preliminarily known as the Islamic Financial Services Board (IFSB), be established. The objectives of IFSB, among others, would be to promote the development of Islamic financial services industry as well as effective supervision and regulation of institutions offering Islamic financial products through adaptation of new or existing standards, based on the recognition of the unique risks of Islamic financial products and practices. IFSB would also liaise and cooperate with relevant standard setters and facilitate training and capacity development of personnel in relevant areas to ensure effective oversight of the industry. In addition, it would enhance and coordinate initiatives to develop instruments and procedures for efficient operations and risk management as well as undertake research on the Islamic financial industry. The IFSB is expected to be established in 2002 and Malaysia has been chosen to be the headquarter for the Secretariat of the IFSB.

The year 2001 also witnessed a significant development in the International Islamic Financial Market (IIFM). Bahrain, Indonesia, Islamic Development Bank, Iran, Malaysia and Sudan signed the Article of Agreement on the establishment of an IIFM Board on 13 November 2001. This signified the global commitment and support for the initiative to create and structure an international financial market which accords and embraces Islamic principles. The IIFM Board is entrusted to develop and supervise the orderly development of the IIFM. The Board is supported by two committees, the Market and Product Development Committee (MPDC) and the Shariah Supervisory Committee (SSC). The MPDC would undertake research and development on universally accepted financial products which comply with the Shariah principles, and the SSC would endorse and approve the new products before they are traded in the market. For this purpose, Shariah scholars from several regions would be appointed to become the SSC members to ensure the harmonisation of the Shariah interpretations. Meanwhile, the IIFM Secretariat is located in Bahrain. The Labuan Offshore Financial Services Authority and Labuan offshore players are expected to capitalise on this development in promoting Labuan IOFC as one of the active centres for Islamic money and capital markets, particularly in this region.

On 1 November 2001, Malaysia entered into a Memorandum of Understanding (MoU) with Bahrain to jointly promote the development of Islamic banking and finance on the international front. The MoU outlined the co-operative framework between Malaysia and Bahrain for the development of the IIFM, the development of prudential standards to govern the operations of Islamic financial institutions, the convergence of the accounting, auditing and Shariah standards for international harmonisation as well as training and research in the field of Islamic banking and finance.

DEVELOPMENT FINANCIAL INSTITUTIONS

Background

Development Financial Institutions (DFIs) are institutions that have been established and largely funded by the Government to promote the development of certain identified priority sectors and sub sectors of the economy, such as agriculture sector, infrastructure development, shipping, capital-intensive and high-technology industries as well as to achieve certain social goals, by providing financial services and support to complement the banking institutions. These DFIs are generally specialised in the provision of medium and long-term financing of projects that may carry higher credit or market risks due to the longer investment tenures. DFIs have played a significant role in the socio-economic development of the country. It is envisaged that in the next decade, DFIs will continue to progress and assume a more significant role in pursuing the Government policy goals for strategic, social and economic development. The realisation of this vision is supported by the recommendations for DFIs in the Financial Sector Masterplan (FSMP) that aims to improve supervisory framework for DFIs and to enhance DFIs' effectiveness and efficiency in providing specialised financial services.

Supervisory and Regulatory Framework for the DFIs

DFIs were regulated and supervised by several Ministries and State Agencies. The Development Financial Institutions Act 2002 (DFIA) came into force with effect from 15 February 2002 to provide a comprehensive regulatory framework to ensure safe and sound financial management of the DFIs. DFIA takes into consideration the unique roles, functions and objectives of each DFI, the relevant provisions in the existing statutes, the current supervisory standards that are provided in the Banking and

Financial Institutions Act 1989 (BAFIA) and the Insurance Act 1996. It aims to ensure that the policies and objectives of DFIs are consistent with the Government initiatives. Under the DFIA, BNM would be the single regulatory and supervisory body for the DFIs. In performing its role, BNM's focus will be to promote effective and efficient DFIs which will eventually minimise the Government cost in meeting its policy objectives. This will contribute towards realisation of the vision and objectives for DFIs in the FSMP.

The important aspects of DFIA include: -

(a) Selective application of the Act
Recognising the unique characteristics of each DFI, DFIA is structured to allow flexible application of the Act on selected DFI or on specific role, function and operating structure of each selected DFI.

(b) Centralised supervisory body
Efforts to develop effective and efficient DFIs require effective and dynamic supervision by a centralised regulatory authority which would play a strong coordination role in the overall supervision of DFIs. The appointment of BNM as the centralised supervisory body for the DFIs is aimed at meeting this requirement.

(c) Monitoring role and objectives of DFIs
There is strong emphasis on the assessment of the efficiency and effectiveness of DFIs in performing their roles and objectives to ensure consistency with the Government policies. The performance measurement of DFIs will encompass quantitative and qualitative indicators that evaluate the economic and social contribution as well as financial performance.

(d) Efficient management and effective corporate governance
DFIA emphasises on efficient management and effective corporate governance in the DFIs through the appointment of qualified board of directors and senior management. Additionally, this will be augmented by credible external auditor and transparent disclosure of information. The aim is to harness sufficient check and balance and greater accountability by the management.

(e) Comprehensive supervision mechanism
A formal and comprehensive supervision framework is required to ensure the safety and soundness of the DFIs so as to minimise the need for financial assistance from the Government. The legislation incorporates prudential rules, on-site and off-site supervision, reporting requirement, disclosure standard and powers to the regulator to deal with any mismanagement and malpractices in the DFIs.

(f) Strengthen financial position and improve efficiency of asset and liability management
DFIA provides the mechanism to strengthen the financial position of DFIs. Prudential requirements are imposed with the aim to ensure safe and sound financial operations of DFIs, so as to be in line with the best practices of insurance companies and banking institutions.

OTHER FINANCIAL INSTITUTIONS

Discount Houses

Total resources of discount houses continued to rise in 2001 by RM2.7 billion or 12.8% (RM2.6 billion or 13.8% in 2000). The increase mainly reflected higher interbank borrowings and deposits. With deposits increasing at a slower rate (8%; 38.2% in 2000), discount houses resorted to other sources of funds to finance their investment. As a result, there was greater reliance on interbank borrowings, which increased by 23.8% in 2001 (-25.3% in 2000). Furthermore, recognising the tendency for customers to make withdrawals towards the end of the year, discount houses increased their interbank borrowings to safeguard their year-end trading

Table 4.24
Discount Houses: Sources and Uses of Funds

	Annual Change		At end
	2000	2001	2001
	RM million		
Sources:			
Approved capital funds	191	277	2,065
Deposits	3,858	1,117	15,070
Interbank borrowings	-1,670	1,173	6,099
Others	181	129	582
Total	**2,561**	**2,696**	**23,816**
Uses:			
Investment in securities:	2,337	1,657	20,382
Government debt securities	*46*	*1,111*	*1,788*
MGS held	*-122*	*993*	*1,462*
Khazanah bonds	*163*	*222*	*655*
BNM bills	*709*	*-590*	*120*
Private debt securities	*342*	*942*	*11,647*
Bankers acceptances	*990*	*-941*	*3,234*
Negotiable instruments of deposit	*-603*	*-124*	*220*
Cagamas debt securities	*858*	*-224*	*1,087*
Others[1]	*-169*	*1,259*	*1,631*
Interbank placements	313	724	2,856
Others	-90	315	578
	1999	2000	2001
Number of discount houses	7	7	7

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

positions. Deposits accepted grew at a slower rate during the year because of the non-rollover in Sistem Perbankan Islam (SPI) deposits upon maturity and the less competitive interest rates offered by discount houses.

The increase in total resources continued to be invested mainly in securities, which expanded by RM1.7 billion or 8.9% in 2001 (RM2.3 billion or 14.3% in 2000). In particular, there was a shift of investment into longer-dated bonds, particularly MGS, Danaharta and Danamodal bonds, as well as bonds issued by the private sector (PDS). The shift reflected the declining interest rate environment which enhanced the attractiveness of longer-dated papers as compared to shorter-term instruments.

During the year, discount houses also expanded their fee-based activities. The industry arranged, lead-managed and co-managed the issuance of PDS worth RM4.4 billion (RM2.8 billion in 2000). The total amount underwritten by the discount houses was RM1.6 billion (RM2.5 billion in 2000), for 16 PDS issues (58 issuance in 2000). Following the annual review of the Principal Dealer System by BNM in early 2001, only one discount house was appointed as a principal dealer (two in 2000).

Table 4.25
National Savings Bank

	Annual change		At end
	2000	2001*p*	2001*p*
	RM million		
Deposits [1]	3,299	243	10,307
Savings	-69	-84	1,230
Fixed	3,092	-317	5,400
GIRO	384	427	3,300
Islamic banking	-108	216	360
Others	1	1	17
Premium Savings Certificates	40	97	700
Investments (book value)	1,212	1,687	6,053
Malaysian Government Securities	178	18	1,111
Shares	32	913	2,045
Government guaranteed bonds	544	458	1,587
Other investments	458	298	1,310
Deposits with financial institutions	2,793	-986	2,700
Gross loans	310	-69	2,302
Net loans (less provision for doubtful debt, bad debts, and interest in suspense)	312	-74	2,164
Number of NSB branches [2]	-3	-9	414
Number of post offices with NSB facilities [3]	-18	-180	443
Number of account holders ('000)	600	390	9,500
Number of Automated Teller Machines	14	-5	606

[1] Includes interest credited
[2] Includes mini-branches and sub-branches
[3] Includes permanent and mobile offices
p Preliminary

National Savings Bank

Total resources of the National Savings Bank (NSB) continued to expand, increasing by RM451 million or 4% to RM11.8 billion as at end-2001. The increase was due mainly to higher GIRO and Islamic banking deposits, which more than offset the decline in fixed and savings deposits. GIRO deposits grew by RM427 million or 14.9%. The increase in GIRO deposits was due mainly to attractive product enhancements that offered additional advantages to depositors. Islamic banking deposit schemes, which were introduced in 1994 have gained popularity, with Islamic banking deposits rising by RM216 million in 2001. Although fixed deposits decreased marginally, due mainly to redemptions by corporations, it nevertheless remained the major source of deposit funds, accounting for 52.4% of total deposits outstanding as at end-2001, followed by GIRO deposits with a share of 32%.

In terms of the composition of its assets, there was a shift from placements of deposits with financial institutions to investments in shares and Government guaranteed bonds. Investments in shares and Government guaranteed bonds increased by RM913 million (+80.7%) and RM458 million (+40.6%) respectively. Meanwhile, deposits placed with financial institutions declined by RM986 million, reflecting the low interest rates environment. As at end-2001, the bulk of NSB's assets was in the form of investments in securities (51.1%), deposits with financial institutions (22.8%) and loans (18.3%).

Provident and Pension Funds

Total resources of the 14 provident and pension funds (PPF) surveyed by BNM expanded by 6.7% in 2001 to RM231.5 billion. The bulk of the increase were new contributions to the Employees Provident Fund (EPF). Accumulated contributions, however, grew at a slower rate of 6% or RM11.7 billion during the year, reflecting lower net contributions and dividends credited during this year. At the same time, withdrawals were also higher (RM6.6 billion to RM17.3 billion), resulting in the PPF recording lower net contributions of RM3.4 billion during the year (2000: RM9.5 billion).

Higher withdrawals were mainly under the four EPF schemes, for which withdrawal procedures had been made more flexible during the year. Withdrawal of EPF

Table 4.26
Provident and Pension Funds: Selected Indicators

	2000	2001*p*
	RM million	
As at end		
Number of contributors ('000)	19,075	19,058
of which: EPF	*9,966*	*10,074*
SOCSO	*8,877*	*8,769*
Accumulated contributions	196,290	208,023
Assets	216,936	231,479
of which: Investments in MGS	65,810	72,512
During the year		
Gross contributions	20,178	20,701
Withdrawals	10,689	17,314
Net contributions	9,489	3,387
Dividends credited	10,237	9,366
Investment income	12,150	11,113

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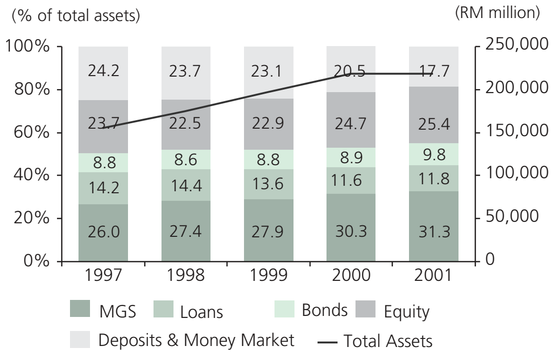
Source: Employees Provident Fund, Pension Trust Fund, Social Security Organisation, Armed Forces Fund, Malaysian Estates Staff Provident Fund, Teachers Provident Fund and eight other private provident and pension funds.

Graph 4.19
Provident and Pension Funds: Major Asset Composition



contributions were made more flexible for pensionable employees as well as retirees who took optional retirement; for all contributors for the purchase of a second house on condition that the first house is sold; the purchase of computer for own use; and for payment of fees for tertiary education. Withdrawals under the annuity scheme were also higher during the year before the scheme was discontinued on 5 October 2001. Improved efficiency which led to shorter processing time for withdrawal applications also contributed to higher withdrawals during the year.

During the year, gross contributions to PPF expanded at a slower rate of 2.6% (2000: 15.1%) reflecting mainly the more moderate increase in gross contributions to the EPF. In April, EPF contributors were given an option to reduce their monthly contributions from 11% to 9% in line with the Government efforts to stimulate domestic demand. About 75% of the active contributors opted for the reduction in their contribution. The number of contributors to the PPF also fell marginally by 0.1% to 19.1 million as a result of the decline in the number of non-active members of the Social Security Organisation. Meanwhile, total dividends credited during the year were lower, at RM9.4 billion, reflecting lower investment income amid a low interest rate environment.

In terms of the composition of assets of the PPF, there was some shift from the holdings of deposits and money market papers to MGS and corporate bonds. The share of MGS and corporate bonds increased to 31.3% and 9.8% respectively, while the share of deposits and money market papers declined to 17.7% at the end of 2001. The shift reflected the preference for assets with higher returns and also the larger issuance of MGS and corporate bonds during the year. Meanwhile, investment in equities recorded a higher share of 25.4% while the share of loans declined to 11.8%, reflecting some shift in the investment strategy of PPF in 2001.

Several recommendations affecting the PPF industry were contained in the Capital Market Masterplan, which was launched in February 2001. These included recommendations for PPF to participate in venture capital funds in order to diversify their holdings and enhance returns on portfolio; deregulation of restrictions on participation in exchange-traded derivatives; and liberalising the restrictions on the management of funds by foreign fund management companies. Specifically for EPF, the recommendations included a review of the investment restrictions imposed on EPF in order to allow for a greater free float of MGS; and diversification of the management of funds by placing out a greater portion of its funds with external fund managers. In January 2002, the EPF's Annuity Scheme was replaced by the Withdrawal Payment Scheme. Under this new scheme, contributors can transfer not more than 50% of their savings from Account 1 to a new account, Account 4. The scheme allows contributors to make monthly withdrawals from Account 4 over a 20-year period on reaching the age of 55.

Industrial Finance Institutions

Industrial finance institutions constitute Bank Pembangunan dan Infrastruktur Malaysia Berhad (BPIMB), Bank Industri dan Teknologi Malaysia

Table 4.27
Industrial Finance Institutions : Changes in the Direction of Lending

Sector	Annual Change					
	1999		2000		2001	
	RM million	% change	RM million	% change	RM million	% change
Transport & storage	995.3	291.6	1,612.7	120.7	862.7	29.3
Agriculture	-13.4	-13.1	38.3	42.9	-3.9	-3.0
Manufacturing	-0.8	…	-96.8	-2.8	128.5	3.9
General commerce	-24.8	-7.9	-212.9	-73.6	8.0	10.4
Real estate & construction	838.2	37.9	-372.7	-12.2	315.0	11.8
Others	-198.8	-15.7	541.7	50.7	-2.7	-0.2
Total	1,595.7	20.8	1,510.4	16.3	1,307.6	12.2

Berhad (BITMB), Sabah Development Bank Berhad (SDB), Export-Import Bank of Malaysia Berhad (EXIM Bank), Malaysian Industrial Development Finance Berhad (MIDF), Malaysian Industrial Estates Berhad (MIEL), Borneo Development Corporation (Sabah) Sendirian Berhad (BDC Sabah), and Borneo Development Corporation (Sarawak) Sendirian Berhad (BDC Sarawak).

Total assets of the industrial finance institutions continued to increase in 2001 by RM3.4 billion or 16.7% compared with RM2.5 billion or 14.1% in 2000. The growth in total assets was mainly attributed to the increase in deposits placed with financial institutions and loans and advances which accounted for 53.9% (+RM1.8 billion) and 38.9% (+RM1.3 billion) of the increase respectively.

Loans extended by the industrial finance institutions registered a lower growth of 12.1% in 2001 compared with 16.3% in 2000. The growth was largely influenced by the loans extended by BPIMB and SDB which registered increases of 28.9% (+RM1.5 billion) and 18.5% (+RM178.7 million) respectively. However, excluding the two institutions, the total loans extended by industrial finance institutions recorded a decline of 6.9% (-RM329.9 million) in 2001.

Total loans extended by BPIMB and SDB accounted for 63.3% (RM7.6 billion) of total loans of industrial finance institutions. The growth was driven by the expansion in development and infrastructure loans of BPIMB as reflected in the growth rate of 29.2% (RM862.7 million) in loans to the transport and storage sector (especially infrastructure sub-sector). In the case of SDB, the increase was triggered by the implementation of loan expansion strategy in 2001. The decrease in total loans extended by other industrial finance institutions was largely attributed to early repayment of loans by borrowers of BITMB and MIDF and conversion of loans to loan stocks by borrowers of MIDF.

Deposits placed with financial institutions by industrial finance institutions increased by 40.4% (+RM1.8 billion) in 2001 compared with 46.4% (+RM1.4 billion) in 2000. The large increase was partly the result of lower demand for loans experienced by many of the industrial finance institutions relative to increase in borrowings.

Industrial finance institutions have traditionally relied heavily on funding from the Government and government-related institutions in the form of equity, grants, loans and placement of deposits to fund their operations as they are not licensed to mobilise deposits from the public. The industrial finance institutions also relied, to a lesser extent, on external funding at preferential terms under special bilateral agreements with international multilateral development finance institutions. More recently, however, some industrial finance institutions have raised funds from the capital market to better match the long investment tenure of the projects financed by them and to be less dependent on government funding.

Total borrowings of industrial finance institutions increased by 16.9% (+RM2.4 billion) in 2001 compared with 23.8% (+RM2.8 billion) in 2000. Borrowings from the Government by the industrial finance institutions registered a substantial increase of 44.5% to RM10.7 billion in 2001 and accounted for 63.8% of total borrowings. The increase was mainly contributed by a significant increase in borrowings (131.3% or +RM3.4 billion) by BPIMB from the Government to support its development and infrastructure projects. Borrowings from the non-Government entities however, declined by 12.4% to RM6.1 billion in 2001.

Table 4.28
Venture Capital Funds/Companies

	At End	
	2000	2001*p*
No. of venture capital funds/companies	31	36
No. of investee companies	159	180
	RM million	
Sources		
Shareholders' funds	972.6	983.2
Liabilities	543.4	993.8
Total	**1,516.0**	**1,976.9**
Uses		
Investments in investee companies	718.2	652.9
Other assets	797.8	1,324.0
Total	**1,516.0**	**1,976.9**

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Table 4.29
Venture Capital Funds/Companies: Investments During the Year

	2000	2001p
No. of investee companies	35	42
	RM million	
Investments during the year	**131.3**	**109.3**
By sector		
Manufacturing	*25.4*	*16.8*
of which:		
- IT based products	*0.3*	*1.9*
- Electrical and electronic products	*7.5*	*–*
- Advance electronics technology	*8.9*	*11.3*
Information communication technology	*53.1*	*76.0*
Life sciences	*3.5*	*3.2*
Others	*49.4*	*13.4*

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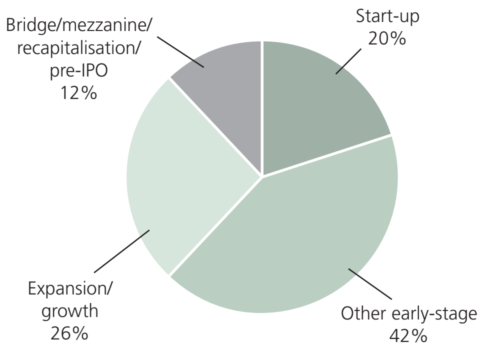
Venture Capital

The venture capital (VC) industry continued to expand in 2001 as an alternative source of financing. Total resources increased by 30.4% to RM2 billion as at end-2001, due mainly to the establishment of two Government-owned venture capital companies (VCCs). The number of VC funds/companies also rose to 36 as at end-2001. Similarly, the total number of investee companies backed by VC investments increased to 180, from 159 in the previous year.

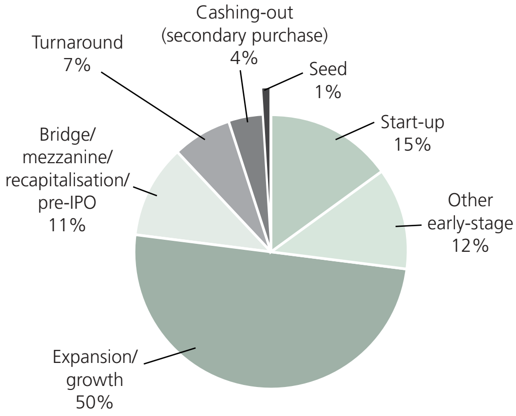
During the year, VCC investments were placed with 42 companies (35 companies in 2000) for a total value of RM109.3 million. The bulk of investments (70%) continued to be placed in the information communication technology (ICT) sector, in line with Government policy to develop the ICT industry. Investments in the life sciences sector, albeit small, were sustained at 2.9% of total investments. Another encouraging development in 2001 was the higher share of investments in companies at the start-up and early stages, which accounted for 62% of total investments (27% in 2000). The higher investments in these stages indicated an increased risk tolerance of the VC industry in supporting companies during the more risky period of their lifespan.

The Government continued its efforts in supporting the VC industry by providing adequate liquidity to meet the industry needs. Following the announcement of the establishment of the RM500 million VC fund, a Government-owned company, Malaysia Venture Capital Management Berhad (MAVCAP) was set up to manage this VC fund. To date, MAVCAP has committed to invest RM20 million into one investee company and appointed three VCCs to manage a total of RM75 million of its total fund. In addition, another Government-owned

Graph 4.20
Investments by stages in 2001



Investments by stages in 2000



company, Kumpulan Modal Perdana Sdn. Bhd. was established to manage the Venture Capital Fund for Technology Acquisition amounting to RM190 million. The objective of this VC fund is to assist entrepreneurs in technology acquisition by investing into foreign technology-based companies which would lead to technology transfer to Malaysia. The fund would also be used for the implementation of the Advanced Microchip Design and Training Centre. In a move to improve the quality of Malaysian technopreneurs, the Government launched the Technopreneur Development Flagship spearheaded by the Multimedia Development Corporation. The Flagship is aimed at developing a sizable number of SMEs in the ICT sector and nurturing them into world-class companies. Several measures were introduced to increase the usage and deployment of ICT, including sales tax exemption on smart cards and related equipment, tax reduction on income derived from trading via websites in Malaysia and income tax deduction on costs incurred in developing business websites.

During the year, there were also new private sector initiatives which contributed to the development of the VC industry. The first business plan competition, Venture 2001, which was launched in November 2000 with the objectives of converting potential ideas into actual businesses and fostering an entrepreneurial environment in Malaysia successfully received 447 business plans, significantly higher than its initial target of 250. Venture 2002 was subsequently launched in January 2002 to build on earlier efforts to develop an entrepreneurial culture in Malaysia.

FINANCIAL MARKETS

Overview

In 2001, trading volume in the money market and capital markets, comprising bond and equity markets, and futures market were higher, while the foreign exchange market recorded a lower trading volume. The financial markets remained effective in their role as financial intermediaries for mobilisation and allocation of funds in 2001. During the course of 2001, relevant authorities continued to undertake new initiatives in order to improve market infrastructure to better meet the financing needs of the economy.

Total volume of funds traded in the money market increased moderately, reflecting mainly the higher trading of money market papers, amidst lower trading of interbank deposits. The higher trading in the money market papers reflected the significant increase in trading of Malaysian Government Securities (MGS) as well as the shift in investments from lower-yielding papers to the high-yielding papers in view of ample liquidity and the low interest rates environment. Meanwhile, the lower trading in interbank deposits was an outcome of the ample liquidity situation, which led to the reduced reliance on the interbank market for funding needs.

New initiatives to further improve infrastructure of the financial markets resulted in improved efficiency of market as financial intermediaries, as reflected in generally higher trading volumes.

In the interbank foreign exchange market, the average daily volume of interbank foreign exchange transactions was lower during the year. Trading activity in the ringgit was concentrated mainly in trade-related transactions following the non-internationalisation of ringgit. Activities continued to

Table 4.30
Funds Raised in the Capital Market

	2000	2001*p*
	RM million	
By Public Sector		
Government Securities, gross	16,413	23,087
Less Redemptions	5,286	7,100
Less Government holdings	-	-
Equals Net Federal receipts	11,127	15,987
Khazanah Bonds (net)	551	-220
Govt. Investment Issues (net)	2,000	-195
Malaysia Savings Bond (net)	-19	-359
Net funds raised by public sector	13,659	15,213
By Private Sector		
Shares	6,013	6,123
Debt securities[1]	30,953	37,220
Less Redemptions	10,459	20,890
Equals Net Issues	20,494	16,330
Net funds raised by private sector	**26,507**	**22,453**
Total Net Funds Raised	**40,166**	**37,666**
Short-term papers and notes (net)[2]	-1,482	-2,288
Total	**38,684**	**35,378**

[1] Exclude debt securities issued by banking institutions.
[2] Refers to Commercial Papers and Cagamas Notes only.
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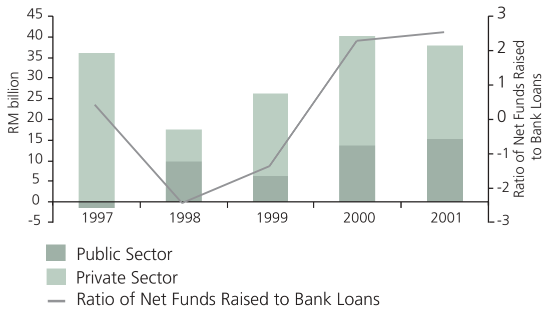
Graph 4.21
Net Funds Raised in the Capital Market by the Public and the Private Sectors



be dominated by transactions in the US dollar against the ringgit, reflecting the importance of the dollar as a vehicle currency and the high dollar concentration in trade settlements and other capital account transactions.

The capital market, comprising the equity and bond markets, remained important as a source of financing, although net funds raised in the capital market was slightly lower at RM37.7 billion. The bulk of funds was raised in the bond market by both the private and public sectors (RM31.6 billion), while the balance (RM6.1 billion) was raised in the equity market by the private sector. The public sector raised a total amount of RM15.2 billion mainly through new issuances and reopening of MGS to meet the higher financing needs of the Government.

In the private sector, total funds raised in both the PDS and equity markets amounted to RM22.5 billion, of which the PDS market accounted for 72.7%. Although funds raised in the equity market remained relatively unchanged at RM6.1 billion, they remained an important source of financing. Funds were raised largely through rights issues, initial public offerings (IPOs) and private placements. Improved sentiment on the Kuala Lumpur Stock Exchange (KLSE) as a source of financing was evidenced by oversubscription in many of the IPOs. These IPOs were also traded at a premium over their offer prices at the end of their first day of trading. In a challenging environment in 2001, the KLSE performed relatively well, with its composite index rising marginally by 2.4% to 696.09 points at the end of 2001. Market capitalisation also increased by 4.6% to RM465 billion. Besides the low interest rates and ample liquidity situation coupled with the expansionary fiscal policy, factors such as positive corporate restructuring and strengthened macroeconomic fundamentals contributed positively to the performance of the KLSE.

In the PDS market, total gross funds raised during the year was higher at RM37.2 billion (2000: RM31 billion) as companies resorted to issuing PDS to take advantage of low interest rates, ample liquidity and investor preference for more stable investment options. Nevertheless, high redemptions, in particular by a major corporation under the debt-restructuring scheme resulted in lower total net funds raised during the year. In contrast to the year 2000, the bulk of the funds raised during the year were utilized to finance new activities and for refinancing purposes. During the year, there was a steady decline in the yields of bonds due to market expectations of lower interest rates and continued ample liquidity in the market. Meanwhile, trading activity in the secondary market increased sharply during the year following the higher supply of MGS.

In the derivatives market, trading in the KLIBOR Futures and Crude Palm Oil (CPO) Futures was higher during the year while trading activities in the KLSE CI Futures remained thin. The decline in turnover volume of KLSE CI Futures was due mainly to the lack of volatility of the KLSE CI. Trading in KLIBOR Futures, on the other hand, was active due to the ample liquidity situation in the interbank cash market and improved interests in the local bond and interest-rate swap markets. Meanwhile, higher production of crude palm oil and favourable developments on the price fronts contributed to the higher trading in the CPO Futures Contract.

During the year, several measures and initiatives were implemented to strengthen market practices and build a stronger financial infrastructure. A notable development in the capital market during the year was the launching of the Capital Market Masterplan in February with the objective of setting out the strategic position and future direction for the Malaysian capital market. At the same time, in the equity market, measures introduced during the year emphasized efforts to improve corporate governance and efficiency in market activity. The introduction of the guidelines on offering of asset-back securities was the major development in the bond market. Meanwhile, the Malaysia Derivatives Exchange (MDEX) was established in June 2001 as an integrated derivatives exchange following the merger of two exchanges, the Kuala Lumpur Options and Financial Futures Exchange and the Commodity and Monetary Exchange of Malaysia, aimed at facilitating economies of scale and depth of market through improved operating efficiencies and the trading of more derivative products.

Money Market

Volume of transactions in the money market rose moderately in 2001. A notable development was the significant expansion in trading of Malaysian Government Securities (MGS) and the shift of trading into the longer-dated papers. These developments were influenced by interest rates developments, the underlying liquidity in the system and supply factors. During the year, trading in the money market instruments was concentrated in the MGS. The higher trading volume (148.2%) reflected mainly market expectations that the domestic interest rates would remain low, following the aggressive interest rate cuts by the US. The September 11 incident compounded these expectations, precipitating a significant rise in trading of MGS in the months of September and October to account for one-fifth of total volume of transactions during the year. These developments, together with the sustained inflows of funds amid the ample liquidity situation, as well as the larger issuance of MGS to finance the Government's fiscal deficit, prompted market participants to lock in their funds in higher-yielding MGS. In addition, longer-dated papers such as MGS tended to exhibit wider range of price movements, thereby providing the market with arbitrage opportunities particularly in a declining interest rate environment. In 2001, the average yield to maturity (YTM) of the 5-year MGS fluctuated within a wide range of 136 basis points, compared with 72 basis points in 2000. Furthermore, there was also greater participation of non-bank players, notably insurance companies and large corporations. The heightened interest in the MGS resulted in lower yields, particularly for the longer-dated MGS.

Graph 4.22
Money Market Instruments

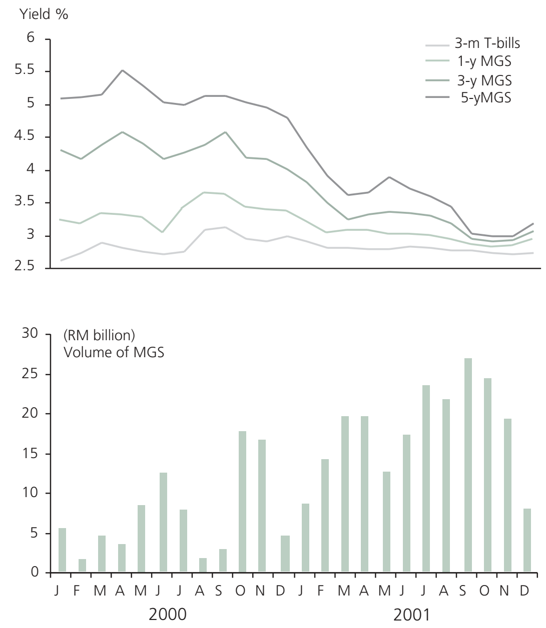


Table 4.31
Money Market[1]

	2000		2001	
	Volume (RM bilion)	Annual Change (%)	Volume (RM bilion)	Annual Change (%)
Total money market transactions	**1425.4**	**0.7**	**1500.8**	**5.3**
Interbank deposits	**1091.7**	**-8.2**	**1055.3**	**-3.3**
Money market papers	**333.7**	**47.7**	**445.5**	**33.5**
Bankers Acceptances (BAs)	63.6	-6.3	60.5	-4.9
Negotiable instrument of deposits (NIDs)	21.0	-22.8	34.3	63.3
Malaysian Government Securities (MGS)	88.6	38.9	219.9	148.2
Khazanah bonds	15.5	-3.7	17.9	15.5
Treasury bills	15	30.4	13.4	-10.7
Bank Negara Bills	50.9		55.2	8.4
Cagamas bonds	29.3	127.1	25.9	-11.6
Cagamas notes	49.8	87.9	18.4	-63.1

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

Graph 4.23
Share of Total Volume Traded

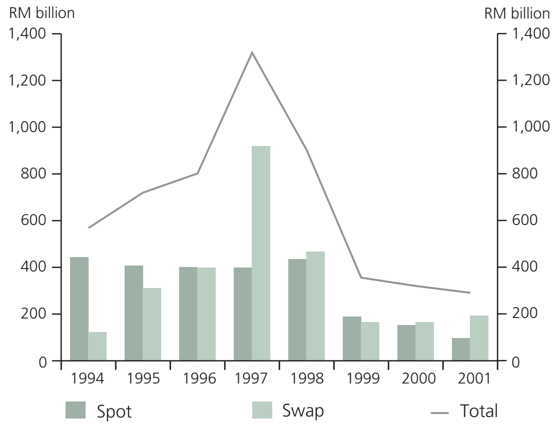
Consequently, the yield curve shifted downwards from the position at end-2000, before edging upwards since November when sentiments on the prospects for global economic recovery improved towards the end of the year. To some extent, the higher MGS yield in December also reflected the liquidation of papers by some market players following the large accumulation of MGS in their portfolio in September and October.

In contrast, trading in the shorter-dated papers, notably the Cagamas notes, Treasury bills and Bankers Acceptances was lower during the year (-28.1%). Similarly, the interbank deposits also recorded a lower transactions volume (-3.3%), due to the preference among banks to invest in the higher-yielding papers, while the ample liquidity in the system has reduced recourse to interbank funding. Overnight deposits remained the most actively traded tenure in the interbank market, accounting for 70% of interbank deposit trades.

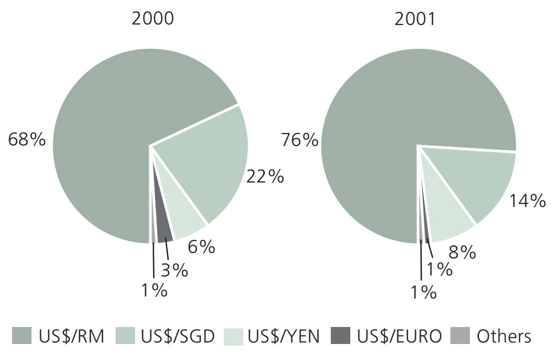
Foreign Exchange Market

In the KL interbank foreign exchange market, the average daily volume of interbank foreign exchange transactions (spot and swap transactions) done through the eight foreign exchange brokers declined by 9.5% compared to the volume traded in 2000. Trading activity reflect mainly trade-related transactions. Position-taking activity on the ringgit has been contained through the elimination of the offshore ringgit market as well as through guidelines governing the operating framework of banking institutions. As a result of these measures, the volume of transactions conducted has stabilised following the significant decline at end-1998.

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



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



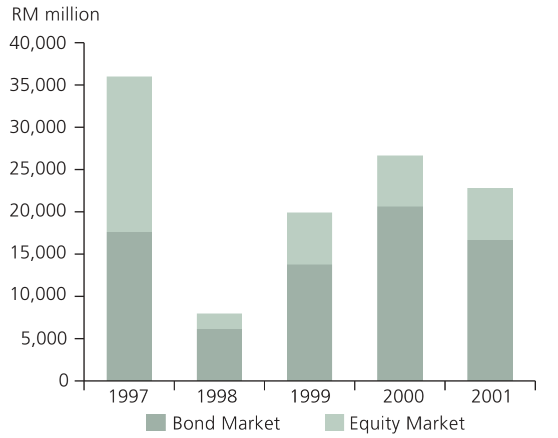
The majority of trades transacted in 2001 occurred in the first half, before subsiding towards the end of the year. The increased activity in the first half of the year reflected mainly forward purchases of foreign exchange for imports of goods and services, and loan repayments in view of the discount on the ringgit swap rate. By composition, transactions in the Kuala Lumpur foreign exchange market continued to be dominated by transactions in the US dollar against the ringgit, with the share of such transactions increasing to 76% in 2001 from 68% of total transactions in 2000. This development reflects the increasing significance of the US dollar in the KL interbank foreign exchange market as well as the high usage of the US dollar in the settlement of trade, services and capital account transactions.

Equity Market

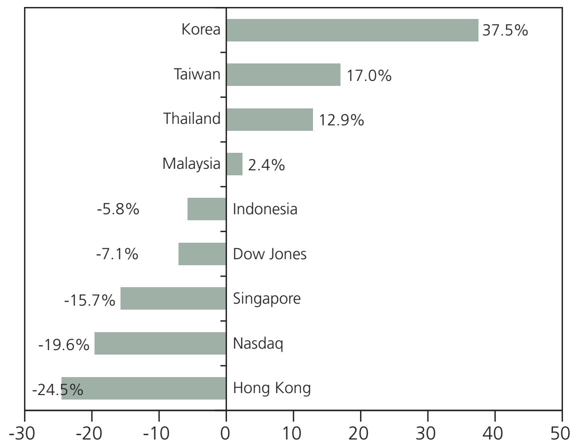
Notwithstanding a more challenging global environment in 2001, the Kuala Lumpur Stock Exchange Composite Index (KLSE CI) ended the year slightly higher (2.4%). Market capitalization also rose by 4.6% to RM465 billion (RM444.4 billion in 2000). Compared to the regional bourses, which include Hong Kong, Singapore, Indonesia and the Philippines, the KLSE also performed quite favourably. During the year, strong economic fundamentals, the completion of restructuring of large corporations and positive changes in corporate governance issues became factors that have increasingly influenced the performance of the KLSE CI. Meanwhile, the KLSE as well as the Securities Commission continued to further enhance regulations and their enforcement to address issues of concern to investors, particularly minority shareholders.

The equity market remained an important source of financing for the private sector in 2001. Funds raised through the equity market amounted to RM6.1 billion

Graph 4.26
Funds Raised by the Private Sector in the Capital Market



Graph 4.27
Performance of Selected Regional & Emerging Stock Market Indices (% change from 2000 to 2001)



Source: International Federation of Stock Exchanges (FIBV)

or 27.3% of the total funds raised by the private sector in the capital market (RM6 billion or 22.7% in 2000). The new funds were mainly raised through rights issues (31%), initial public offerings (IPOs) (27.4%) and private placements (27.4%). In 2001, there was a total of 20 IPOs, of which six were listed on the Main Board and the other 14 on the Second Board. The amount raised through IPOs was higher, at RM1.7 billion during the year. Compared with 2000, using IPOs to raise funds were exercised by companies in a broader range of industries and sectors, including telecommunications, trading and services, industrial and consumer products, and information technology. Improved confidence in the equity market was evident in the oversubscription for about 70% of the total number of IPOs raised during the year. Furthermore, the bulk of the IPOs was traded at a premium over the offer prices at the end of the first day of trading, influenced mainly by the issuers' prospects and investor interest in specific sectors.

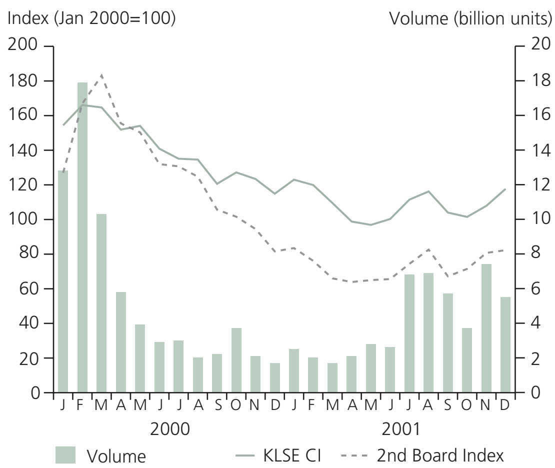
Table 4.32
Kuala Lumpur Stock Exchange: Selected Indicators

	2000	2001*p*
Price indices		
Composite	679.64	696.09
EMAS	159.77	165.23
Second Board	132.98	134.13
Total turnover		
Volume (billion units)	75.4	54.9
Value (RM billion)	244.1	96.0
Average daily turnover		
Volume (million units)	208.1	204.4
Value (RM million)	911.1	349.8
Market Capitalisation (RM billion)	444.4	465.0
Market Capitalisation / GDP (%)	130.4	134.6
Total number of companies listed	795	812
Main Board	499	520
Second Board	296	292
Market liquidity:		
Turnover value / Average market capitalisation (%)	42.3	22.2
Turnover Volume / Number of listed securities (%)	39.5	27.4
Market concentration:		
*10 Most Highly Capitalised Stocks/ Market Capitalisation (%)	38.9	36.7
Average paid-up capital of stockbroking firms (RM million)	129.6	138.2

p Preliminary
* based on market transaction only

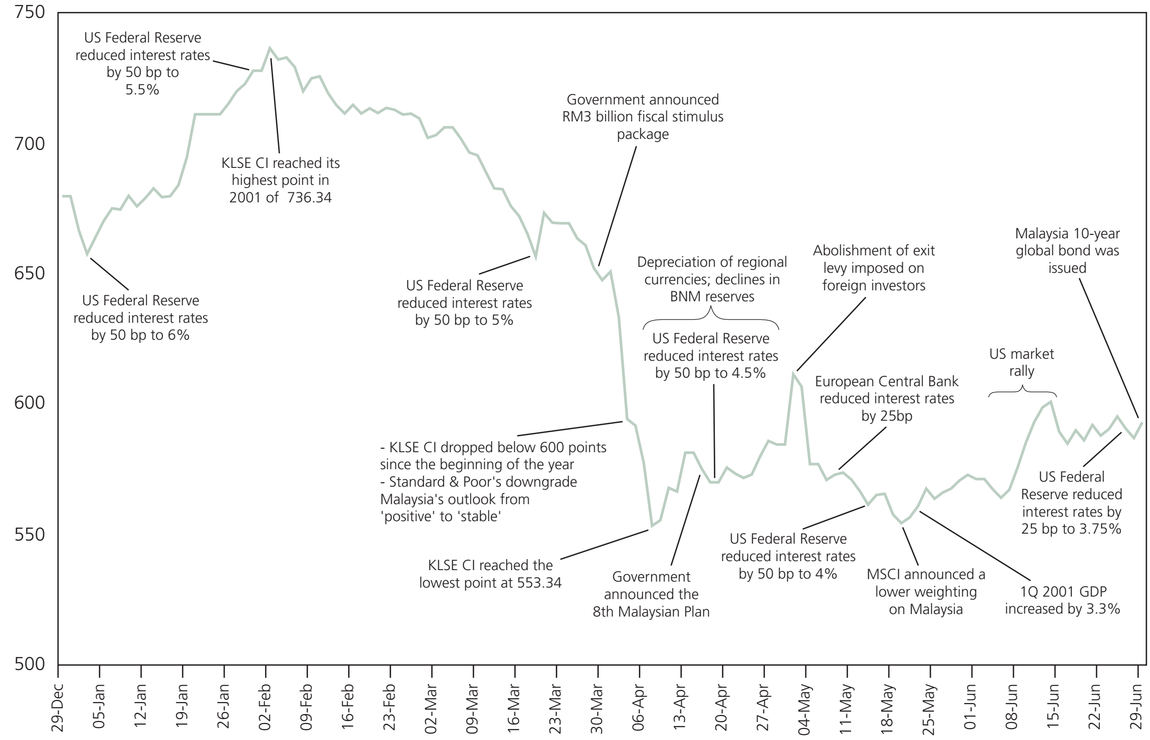
Source: Kuala Lumpur Stock Exchange

Graph 4.28
Kuala Lumpur Stock Exchange Composite Index, (KLSE CI) Second Board Index and KLSE Trading Volume

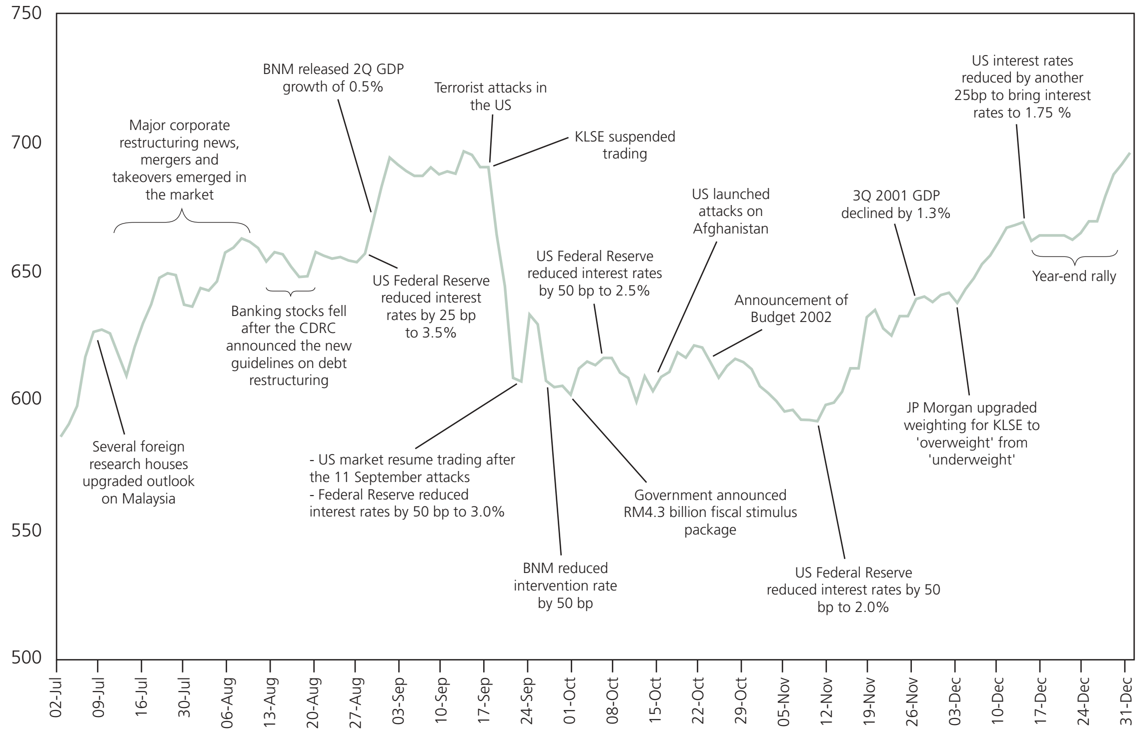


Source: Kuala Lumpur Stock Exchange

Graph 4.29
Performance of the KLSE CI (31 December 2000 - 30 June 2001)

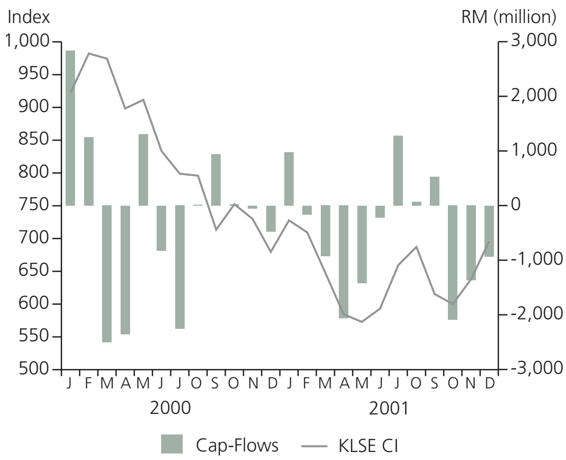


Graph 4.30
Performance of the KLSE CI (1 July - 31 December 2001)



In the first half of 2001, the decline of 11% in the KLSE CI was influenced mainly by poorer-than-expected corporate earnings as well as concerns over the slowdown in the global economy. Other factors included concerns over the impact of the depreciation of yen on regional currencies, and the revision of the Malaysian economic outlook from positive to stable by an international rating agency. Some other factors, however, mitigated the decline in the KLSE CI. These included the fact that other major international

Graph 4.31
KLSE CI vs Flows through External Accounts (Jan 2000 - Dec 2001)



rating agencies maintained their favourable ratings on the outlook for the Malaysian economy, as well as the abolishment of the exit levy on profits from portfolio investment repatriated within one year, effective May 2001.

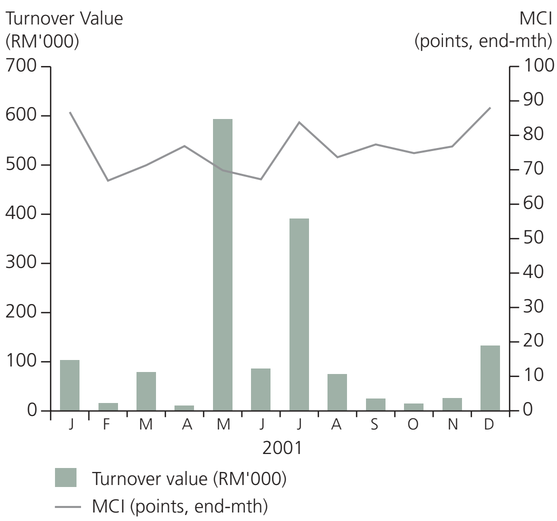
The KLSE CI rebounded strongly by 17.4% in the second half of 2001 against the backdrop of improving prospects for the domestic economy and positive reception of the institutional changes made to accelerate corporate debt restructuring. Prior to the September 11 incident, the better market performance was due partly to more favourable views on the Malaysian economy following positive GDP growth in the second quarter. Recovery in the US market and other markets also aided sentiment. The September 11 incident had temporarily disrupted the market. The KLSE was suspended on 12 September in order to maintain the orderly functioning of the market and to provide investors with sufficient time to fully assess the situation. After a brief bearish performance, market sentiment improved in October following better prospects for the Malaysian economy and positive developments in corporate restructuring. Market sentiment improved further towards year-end, supported by announcements of corporate restructuring of big enterprises, further fiscal spending to support growth as well as the Government's success in raising the US$1 billion 10-year global bond.

During the year, the performance of the KLSE was to a large extent, influenced by movements in foreign portfolio investment funds. It was evident that the KLSE CI performance tracked the trend in the flow of funds through the external accounts. These are the ringgit accounts maintained by non-residents, indicating that activities in the KLSE were to some extent, influenced by foreign participation.

In the Malaysian Exchange of Securities Dealing & Automated Quotation (MESDAQ), the MESDAQ Composite Index (MCI) declined by 5.4% to close the year at 88.08 points. The total trading volume was lower, valued at RM1.6 billion (2000: RM4.7 billion). Trading activities also remained thin with trades concentrated in May and July. Market capitalisation, nevertheless, increased to RM177.6 million at the end of the year (2000: RM141.4 million). This was due to one new listing on MESDAQ in 2001. By end-2001, four companies were listed on MESDAQ. The increasing underwriting risks amidst a weak market made it difficult for companies to secure underwriting commitments. As at end-2001, MESDAQ's total membership rose to 20 (2000: 19), of which 16 were stockbroking companies while the remaining were merchant banks.

In line with the recommendations of the Capital Market Masterplan to establish a single Malaysian exchange, MESDAQ signed a Merger Agreement with the KLSE on 31 December 2001. The consolidation of the exchanges would streamline the regulatory and market development functions of KLSE and MESDAQ, enabling the offering of a wider range of products and

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



Source: Malaysian Exchange of Securities services to market participants. As a result of the proposed merger, certain projects were aborted or put on hold. These included the enhancement of the MESDAQ Order Routing and Execution Surveillance System, the on-line registration of registered representatives and the on-line Capital Adequacy reporting by members.

In 2001, further measures were introduced to bring practices in the equity market in line with international standards. At the same time, the KLSE strengthened their monitoring and enforcement of compliance to existing and new regulations. In ensuring that investors would continue to have confidence in investing on the KLSE and in the Malaysian economy, emphasis continued to be given to improving the level of corporate governance. The new Listing Requirements introduced in January achieved the objectives of enhancing corporate governance and transparency, and efficiency in capital market activities, thereby strengthening investor protection and promoting investor confidence. At the same time, there was some relaxation of rules affecting the issue, offer and listing of securities in an effort to make the Malaysian capital market the preferred fund-raising venue for Malaysian companies.
Other measures included steps to enhance investor protection, especially minority shareholders.
The details of the measures introduced during the year are contained in the box "Key Capital Market Measures in 2001."

Bond Market

The ringgit bond market expanded further in 2001 and has increased in importance as a source of financing. The growth of the bond market was due to the low interest rate environment and ample liquidity situation, increased recourse to the bond market for longer-term financing and intensified debt restructuring exercise. In addition, the expansionary fiscal stance of the Federal Government resulted in significantly higher issuance of Malaysian Government Securities (MGS) to finance the fiscal deficit. Such a development continued to provide a benchmark yield curve for the ringgit bond market.

Total net funds raised in the bond market remained high at RM31.5 billion, accounting for 83.7% of the total funds raised in the capital market. As at end-2001, outstanding ringgit bonds rose by 13.3% to RM275.8 billion from RM243.6 billion as at end-2000.

In the primary market, the public sector raised net funds of RM15.2 billion. During the year, the Government issued and reopened a total of four MGS issues. New issues were raised to finance the Government's fiscal stimulus programmes. These new issues were also the rollover of maturing issues and as a means to enhance secondary

The ringgit bond market expanded further in 2001 and has increased in importance as a source of financing. A larger number of companies issued PDS in order to "lock-in" financing at low interest rates.

Table 4.33
Funds Raised in the Bond Market

	2000	2001*p*
	RM million	
By Public Sector		
Government Securities, gross	16,413	23,087
Less Redemptions	5,286	7,100
Equals Net Federal Receipts	11,128	15,987
Khazanah Bonds (net)	551	-220
Govt. Investment Issues (net)	2,000	-195
Malaysia Savings Bond (net)	-19	-359
Net Funds Raised by the Public Sector	**13,659**	**15,213**
By Private Sector		
Private Debt Securities, gross	**30,953**	**37,220**
Straight bonds	12,940	13,813
Bonds with Warrants	0	913
Convertible Bonds	1,944	1,328
Islamic Bonds	7,666	13,501
Asset Backed Securities	0	1,235
Cagamas Bonds	8,403	6,430
Less Redemptions	**10,459**	**20,890**
Private Debt Securities	6,205	15,575
Cagamas Bonds	4,254	5,315
Net Funds Raised by the Private Sector	**20,494**	**16,330**
Net Funds Raised in the Bond Market	**34,153**	**31,544**
Net Issues of Short-term Securities [1]	–1,482	–2,093
Total	**32,671**	**29,451**

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

market liquidity. As announced in the MGS auction calendar, the MGS were issued regularly on a quarterly basis, with a relatively large size of RM5 billion each in the first three quarters and RM6.5 billion in the fourth quarter of the year. Of the four MGS issues, three were reopening of existing MGS.

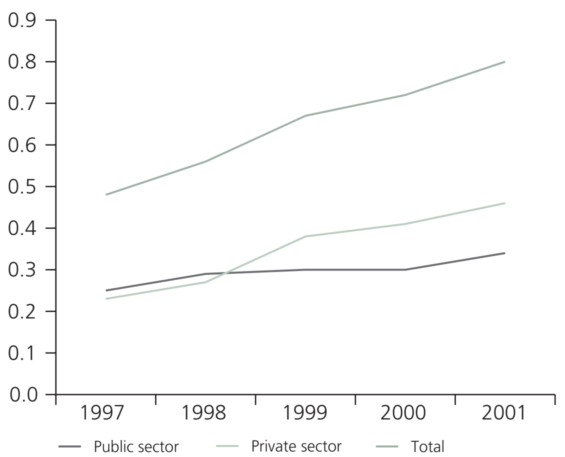
During the year, Government Investment Issues (GII) and Khazanah bonds were issued in order to rollover existing issues. In November, the Malaysia Savings Bonds Series 02 (BSM02) issued in November 1999 matured. The Government announced in the 2002 Budget that BNM would issue the third series of the savings bond, BSM03, for subscription by senior citizens and charitable organizations. The purpose was to mitigate the impact of the low interest rate environment on incomes of senior citizens and charitable organizations that were primarily dependent on income from deposits placed with banking institutions. BSM03 was offered for sale in January 2002.

The private sector also turned to the bond market to raise funds for its medium and long-term financing needs. A larger number of companies issued PDS in order to "lock-in" financing at low interest rates. In an environment of ample liquidity and uncertainties in the equity markets, there was also investor preference for more stable investment options. In 2001, the value of new PDS issues increased to RM37.2 billion. After netting off redemptions of RM20.9 billion, however, total net funds raised were lower at RM16.3 billion (2000: RM20.5 billion). The high redemptions were due partly to the early redemptions by a major corporation under a debt-restructuring scheme. In aggregate, total PDS outstanding increased by 13.1% to RM158.4 billion, or equivalent to 47.6% of GDP (41.1% at end-2000). Compared to the equity market which raised RM6.1 billion, the PDS market remained the main source of financing in the capital market for the private sector.

In terms of types of instruments, straight bonds and Islamic PDS were the most popular forms of funding during the year. Of the total proposed PDS issues rated by Rating Agency Malaysia (RAM), 35% were medium-term (5-7 years) while 60% were long-term (more than 7 years) bonds. Meanwhile, the higher issuance of Islamic PDS was due to the higher demand for Islamic instruments, partly due to the increased number of Islamic unit trust funds that were launched during the year. In addition, privatised projects such as water and power projects have been successfully funded by Islamic PDS. On the other hand, the issuance of bonds with warrants and convertible bonds remained small.

A notable development in the PDS market during the year was the introduction of the Guidelines on the Issuance of Asset-backed Debt Securities (ABS) by the Securities Commission. Total issuance of ABS amounted to RM1.2 billion in 2001. The interest in issuance of ABS reflected the benefits accruing to both originators and investors. From the originators' perspective, securitisation provides a vehicle for transforming relatively illiquid financial assets into liquid assets. In addition, it enables the originator to achieve a more efficient and cheaper cost of financing as ABS generally carry a higher rating compared with the long-term credit rating of the originator. This is because payments

Graph 4.33
Ratio of Bonds Outstanding to GDP



Graph 4.34
PDS Issues in 2001 by Type of Instrument

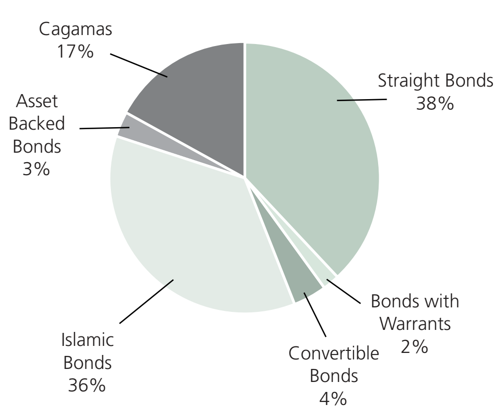


Table 4.34
New Issues of Private Debt Securities by Sector [1]

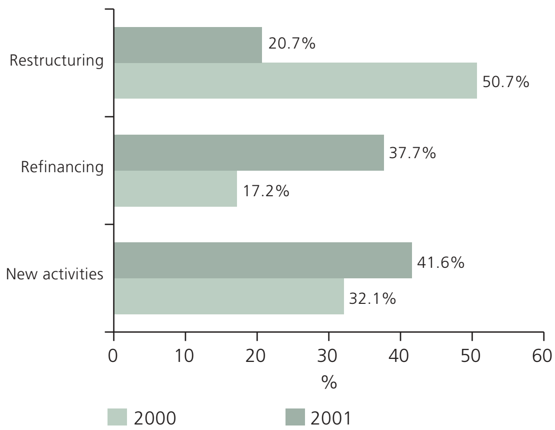
Sector	2000		2001*p*	
	RM million	% share	RM million	% share
Agriculture, hunting, forestry and fishing	42.5	0.2	26.6	0.1
Mining and quarrying	0.0	0.0	0.0	0.0
Manufacturing	1,354.6	6.0	2,512.0	7.5
Electricity, gas & water supply	4,564.1	20.2	10,006.9	30.0
Wholesale & retail trade, restaurants and hotels	1,853.9	8.2	420.0	1.3
Construction	2,006.3	8.9	3,299.9	9.9
Transport, storage and communication	7,320.3	32.5	5,374.5	16.1
Financing, insurance, real estate and business services	5,108.3	22.7	5,103.2	15.3
Government and others	300.0	1.3	6,598.2	19.8
Total	**22,550.0**	**100.0**	**33,341.3**	**100.0**

[1] Excluding Cagamas Bonds
p Priliminary

to investors in respect of such debt securities are principally derived, directly or indirectly, from the cash flows on these assets. Thus, the credit rating of such debt securities is derived from the quality of the underlying assets and not the credit standing of the originator of the assets, as is the case in debt securities issued by the corporation itself. From the investors' perspective, ABS widens the selection of fixed income products in the Malaysian bond market.

During the year, Cagamas has maintained its position as an active issuer in the PDS market, accounting for 17.3% of total issues. Cagamas re-opened seven of its existing fixed rate bonds in order to enlarge the size of existing issues, thereby

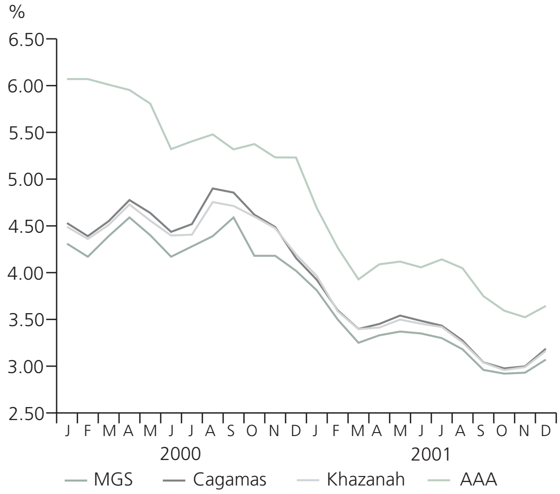
Graph 4.35
Utilisation of Proceeds



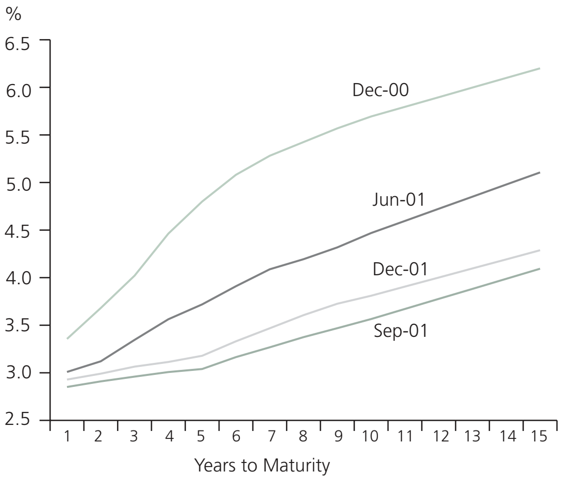
enhancing the liquidity of Cagamas bonds in the secondary market. For the first time, Cagamas issued 10-year fixed rate bonds in December 2001 to fund its purchases of housing loans for a 10-year tenure. The issuance of these bonds enabled Cagamas to develop a longer-term yield curve for its debt securities. This, in turn, would enable Cagamas to price its purchases of loans, particularly for the longer tenures, at market rates.

Companies from the utilities and infrastructure sectors were among the largest issuers of PDS, accounting for 30% and 16.1% of the total new issues respectively. Major issuers within this sector were independent power producers and toll road concessionaires which required long-term financing of more than 10 years for their projects. There was also increased recourse to the PDS market by companies in the manufacturing sector which accounted for about 7.5% of the total PDS issues in 2001. The debt restructuring of a few large and strategic corporations was reflected in higher new issues of PDS in the Government and other services sector. Issues were made by the special purpose vehicles, which were set up during the year, as part of the Government's commitment to accelerate the corporate restructuring process to strengthen investor confidence. The maturity of bonds issued by these special purpose vehicles have been appropriately sequenced. The issuance of bonds was accompanied by other debt and operational restructuring in order to improve the financial and operational capacities of the corporation to generate the cash flows to redeem the bonds.

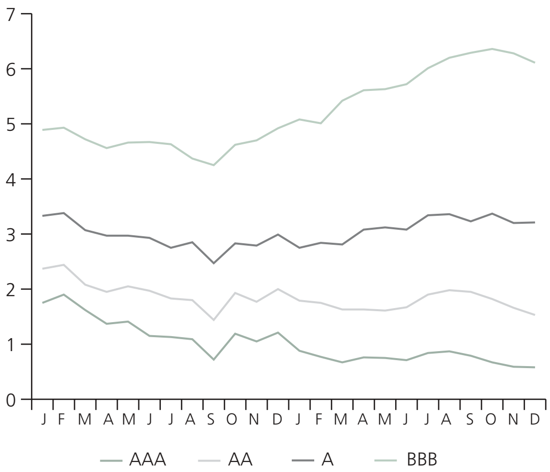
Graph 4.36
Indicative Yields of Selected Three-Year Bonds



Graph 4.37
MGS Yield Curves



Graph 4.38
Yield Differentials for 3-Year Bonds vis-a-vis the 3-Year MGS



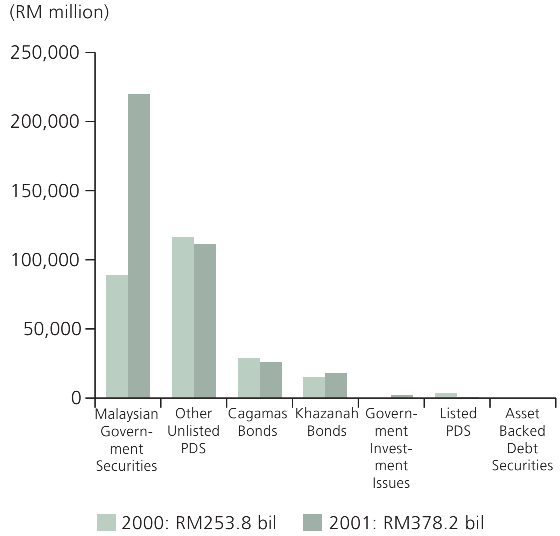
Of the total PDS issued, 41.6% were for new activities, 37.7% for refinancing and 20.7% were for restructuring purposes. This marked a positive development in the economy as a significant share of the funds would be used to generate new economic activities. In 2000, the bulk of the PDS issued had been for restructuring purposes.

There was a steady decline in the yields of bonds in all tenures, with the yield curves continuing to shift downwards throughout the year. The three-year MGS fell from 4.02% at end-1999 to 3.07% at end-2000. The same trend was observed for the 10-year MGS which had fallen by 188 basis points during the same period. Yields for other papers such as three-year Khazanah and Cagamas bonds also trended lower with narrowing yields differentials vis-à-vis the MGS papers. The yield differentials between three-year Cagamas bonds and three-year MGS in the secondary market were about six to 18 basis points. The narrow spreads enabled Cagamas to continue to play its role in providing low cost funds to financial institutions. The declining yield trend was due to market expectations of further reduction in interest rates, continued ample liquidity in the market and the shift of investments from equities to bonds in an environment of greater volatility in the global stock markets. The yields fell further in September following further interest rates cut in the United States and the reduction in the 3-month BNM Intervention Rate. In December, however, some upward shifting of yields occurred due to the expectations of interest rates bottoming out, in line with the shifting of yield curves in the regional markets, following indications of US economic recovery.

The MGS yields curves flattened throughout the year as the spread between the 10-year and the three-year papers narrowed from 167 basis points to 75 basis points, reflecting market expectations that interest rates would remain low for the medium term. The yields of PDS trended lower since early 1999 and the spreads against MGS narrowed notably. The narrowing of spreads of the AAA-rated PDS against the MGS was significant, indicating a trend towards lower risk premiums required by investors. In 2001, the spreads for A- and BBB-rated bonds, however, widened from 275 - 508 basis points in January to 321 - 611 basis points in December due to concerns over deteriorating global and local economic performance. This resulted in investors shifting their investments to the more secured Government and quasi-Government papers as well as highly rated and good quality corporate bonds.

Trading activities in the secondary market for ringgit bonds was sharply higher in 2001, which augured well for the deepening of the bond market. Trading volume increased by 49% and was valued at RM378.2 billion in 2001 (2000: RM253.8 billion). Similarly, liquidity in the bond market, as measured by the ratio of trading volume to total outstanding, also rose to 137.1% (2000: 104.2%). The higher trading activity was mainly due to the higher supply of MGS during the year. MGS were the most actively traded papers, rising by 148.2% and accounting for 58.2% of total trading activities (2000: 34.9%). The volume traded was highest in the third quarter. Expectations of a possible

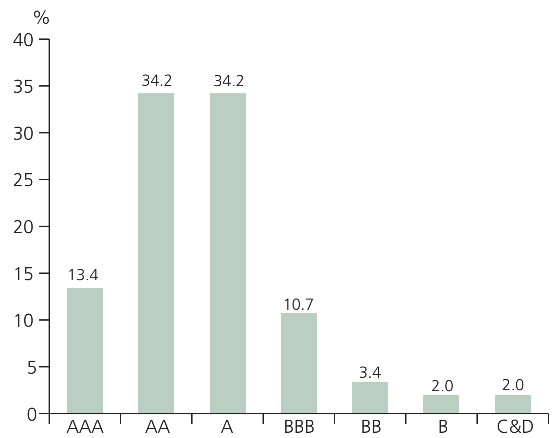
Graph 4.39
Trading of Ringgit Bonds



reduction in interest rates prompted investors to take longer positions in the bond market, especially in risk-free papers. During this period, bond investors were also switching to Government and quasi-Government papers due to the more stable returns from Government issues.

In contrast, secondary trading for Cagamas bonds declined sharply by 11.4% during the year, accounting for 6.9% of total trading activities (2000: 11.5%). In the low interest rate environment, trading interest was skewed towards longer-maturity papers such as MGS. Most Cagamas bonds were issued for tenures of two to three years. In addition, the size of Cagamas bonds was relatively small (RM200 million

Graph 4.40
Rating Distributions of Outstanding PDS*
(As at end December 2001)



* In terms of number of issues
Source: RAM and MARC

to RM400 million per issue), hence affecting liquidity for Cagamas papers. Despite investor interest being centered on MGS, demand for PDS with high ratings and good quality remained high. Nevertheless, the share of PDS turnover moderated to 29.4% of total trades compared with 45.9% in the previous year.

During the year, requests for ratings remained high as corporations, especially those with strong credit ratings, shifted to bonds as a cheaper funding option. In 2001, RAM completed 88 new ratings with the proposed gross issue valued at RM27.1 billion. Long-term issues represented 76% and 87% of the total number and gross issue value respectively. Meanwhile, the Malaysian Rating Corporation Berhad (MARC) completed 29 new corporate debt ratings with a total rated value of RM9.5 billion. The rated issues generally concentrated on the AA and A categories, as companies with good credit quality took advantage of their relatively easy access to the bond market.

During the year, of the total 192 rating reviews of the existing long-term debt securities conducted by RAM and MARC, 153 were affirmations/reaffirmations, 14 issues were upgrades while 25 issues were downgrades. As at the end of 2001, the bulk of the long-term bonds was in the AA and A categories.

During the year, several measures were introduced to further develop the bond market. The key measures are contained in the box "Key Capital Market Measures in 2001". These measures included the introduction of guidelines on offering of asset-backed securities, relaxation of the restrictions on the use of proceeds from the issuance of PDS and guidelines on the securities borrowing and lending programme under the Real Time Electronic Transfer of Funds and Securities System.

Unit Trust Industry

The unit trust industry expanded further in 2001, as evidenced by the growth in the number of unit trust management companies and unit trust funds as well as the increased units in circulation and number of accounts. Gross sales of the unit trust funds also exceeded repurchases during the year, resulting in net sales of RM6.1 billion. While net sales in 2001 were marginally lower than in 2000, it nevertheless remained high, relative to the average net sales of RM0.5 billion during the period 1995-99.

Growth of the industry was stimulated by increased investor demand for unit trust funds to suit their risk-return profiles and the continued availability of the EPF Member's Investment Scheme. Following

Key Capital Market Measures in 2001

Capital market measures introduced in 2001 were aimed at promoting a more efficient, transparent, innovative and competitive capital market which would attract increased participation among market players. Overall, the measures were aimed at enhancing investor confidence by addressing areas of concern, including issues of corporate governance. The key capital market measures introduced in 2001 were as follows:

Setting A Clear Direction for Capital Market Development

- A notable development in the year 2001 was the launching of the Capital Market Masterplan (CMP) in February with the objectives of setting the strategic position and future direction for the Malaysian capital market. There were six key objectives:
  i) To be the preferred fund-raising centre for Malaysian companies;
  ii) To promote an effective investment management industry and a more conducive environment for investors;
  iii) To enhance the competitive position and efficiency of market institutions;
  iv) To develop a strong and competitive environment for intermediation services;
  v) To ensure a stronger and more facilitative regulatory regime; and
  vi) To establish Malaysia as an international Islamic capital market centre.

  Of the 152 recommendations, 14 recommendations have been fully implemented, 24 partially completed while another 48 were ongoing. Progress has been made in the areas of exchange consolidation, stockbroking consolidation, disclosure-based regulation and the corporate bond market.

Strengthening the Stockbroking Industry by Enhancing Transparency and Governance

- On 22 January, the Kuala Lumpur Stock Exchange (KLSE) issued its **New Listing Requirements** to further strengthen the capital market and securities industry. The New Listing Requirements strengthened provisions in areas relating to disclosure, corporate governance, continuing listing obligations, financial reporting and enforcement. It codified unwritten rules and procedures relating to listed companies, simplified procedural requirements and processes, clarified requirements by removing ambiguities, and adopted international best practices and standards in listing rules.

- On 10 May, the Securities Commission (SC) **introduced several flexibilities to facilitate the issue, offer and listing of securities** by Malaysian companies. These flexibilities were in line with the CMP objective of making the Malaysian capital market the preferred fund-raising centre for Malaysian companies by enhancing the efficiency of the overall fund-raising process. The flexibilities introduced were:
  i) Revision of the historical profit-performance requirement for initial public offerings and reverse take-overs/backdoor listing on the KLSE;
  ii) Allowing the issuance and listing of irredeemable convertible unsecured loan stock (ICULS) as part of the floatation scheme on the KLSE;
  iii) Abolishing the preferential allocation limit of 10 lots per person for directors, employees and other persons in relation to a floatation scheme on the KLSE. However, the 5% overall limit of the preferential allocation scheme was retained;
  iv) Removal of the merit-based criteria for bonus issues arising from capitalisation of share premium and other reserves. Listed companies are now allowed to undertake bonus issues of securities through the capitalisation of share premium as long as the availability of the share premium is verified by the external auditors to the company; and
  v) Revision of the guidelines on employee share option schemes.

- On 3 September, further flexibilities were introduced by the SC to complement the previous flexibilities given on **Initial Public Offering** (IPOs) issuance and **fund-raising and restructuring.** For the issuance of IPOs, the SC amended the requirements for public offers, placements, underwriting, shareholding spread, retention of reserves and limitations on capital structure. Amendments to the Issues Guidelines relating to the use of proforma accounts were also introduced. With respect to flexibilities for fund-raising and restructuring exercise, flexibilities previously granted to rescue cases were extended. The post-restructuring net-tangibleasset position requirement for distressed listed companies, on the other hand, was reduced to 35% from 50% of the par value of their ordinary shares. In addition, all distressed listed companies were allowed to issue convertible securities with nominal values below RM1.00.

- On 25 April, the SC issued the **Guidelines on Offer Documents** for take-overs with the objective of enhancing disclosure in offer documentation, in line with the move towards a full disclosure-based regulation. The Guidelines would facilitate a take-over exercise by ensuring the clarity of the process, protecting the interests of minority shareholders of companies and providing timely and adequate information to shareholders.

Promotion of the Bond Market

- The SC released the **Guidelines on the Offering of Asset-Backed Securities** (ABS) on 10 April, marking an important milestone in the development of the corporate bond market. The Guidelines served to set out clear and transparent criteria to facilitate market participants in the offering of asset-backed debt securities. In accordance with the 2001 Budget announcement, asset securitisation transactions that are in full compliance with the SC's ABS Guidelines would be eligible for real property gains tax and stamp duty exemption, where applicable.

- On 3 December, **the restrictions on the use of proceeds from the issuance of PDS were further relaxed**. Proceeds from PDS issues can now be used to finance the development of residential properties and shop houses priced above RM250,000 per unit on condition that the proceeds of the bond issues should only be drawn upon achieving break-even sales (in value terms). In addition, such development of shop houses should be located within residential areas. This relaxation was in line with the relaxation of lending restrictions by BNM.

- BNM issued the Guidelines on Securities Borrowing and Lending (SBL) Programme under the Real Time Electronic Transfer of Funds and Securities System. The Guidelines, which took effect on 10 December, were part of the measures implemented during the year to promote the development of the bond market. A SBL transaction involves an exchange of securities between two parties for a period of time to meet the temporary needs of either or both parties. The objective of implementing of the SBL programme was to enhance the liquidity in the secondary bond market by providing a new mechanism to support trading strategies for dealers as well as to enhance the returns on bond portfolio investment for investors.

Enhancing Market Mechanism and Competitiveness

- On 1 July, the SC reduced the SCANS clearing fee, the SCORE fee, and SC levy as part of continuous efforts to enhance industry competitiveness. The SCANS clearing fee was reduced to 0.04% from 0.05%, subject to a maximum of RM200 per contract. The SCORE fee was reduced to 0.0025% from 0.005%. The SC levy, which was derived from the brokerage commission and the SCANS clearing fee, was reduced to 0.015% from 0.02%.

- Effective 18 July, the KLSE through its clearing house, SCANS, commenced the **Institutional Settlement Service (ISS) for direct business transaction**. The implementation of the ISS for direct business transaction would reduce the settlement risk exposure of international investors and enhance the delivery versus payment environment in line with international settlement best practices and requirements.

- On 29 August, the SC released the **Guidelines on the Establishment of Electronic Access Facilities by Universal Brokers** in line with the effort to create a framework for the orderly and effective implementation of electronic commerce in the capital market. "Electronic access facility" refers to a range of physical sites, locations or premises which contain facilities that enable clients to initiate orders or obtain investment advisory information electronically. Universal Brokers are free to determine the type, size, number and location of these facilities. However, they must ensure that the facility is reasonably secure against unauthorised tampering and intrusion. In addition, as a further step towards developing a more facilitative electronic commerce framework, particularly with regard to online trading, Universal Brokers were given the flexibility to provide discounts of up to 25% of the current commission rates applicable to trades with contract values of RM100,000 and below, for all electronically-routed trades executed by them.

- In the Budget 2002 presentation in October 2001, the Government announced the implementation of the **circuit breaker** mechanism in the stock market exchange. The mechanism has the capacity to halt trading activities temporarily when large declines are experienced during a trading day. The mechanism is expected to be in operation in the first quarter of 2002. It aims to provide investors some "breathing space" and opportunity for greater information dissemination during excessive market volatility by allowing closure or cessation of trading for a specific period, before resuming stock market trading activities. In this event, maintaining investor and market confidence can be ensured, especially when the trading environment becomes extremely uncertain.

Enhancing Investor Protection

- On 17 September, the SC released the **Guidelines on Trustees for Debenture Holders**, which would provide the check and balance to ensure that the interest of debenture holders are protected. Under these guidelines, the SC would grant a blanket approval to any trustee seeking to be appointed or to act as trustee under subsection 69(2) of the Securities Commission Act, provided that the requirements of these guidelines were met. A condition of approval by the SC was that the trustee must continue to meet these requirements while acting as a trustee in respect of a particular debenture issue.

- On 26 November, the **SC announced that companies listed on both the main and second boards of the KLSE which have yet to increase their paid-up capital to at least RM60 million and RM40 million respectively, were required to inform investors of their non-compliance and their plans to achieve compliance through updates in their quarterly financial reports**. The deadline for compliance with the requirement was extended from 30 April 2002 to 31 December 2002. Companies that failed to meet the minimum paid-up capital requirement by the extended deadline would be subjected to trading restrictions.

Improving Corporate Governance and Minority Shareholder Protection

- Effective 15 February, directors of public listed companies were required to attend **Mandatory Accreditation Programme (MAP) and Continuing Education Programme (CEP)** pursuant to the revamped Listing Requirement, which was issued on 22 January. The objectives of these training programmes were to better equip directors to discharge their duties and to enhance the overall calibre of directors of listed companies.

- Effective 1 June, public listed companies were required to comply with the **revamped Listing Requirements** (except for a few provisions), which came into effect on 15 February. Among others, the revamped Listing Requirements has brought into effect recommendations of the Finance Committee, in relation to the Malaysian Code on Corporate Governance. These recommendations were to create an environment that demands higher standards of conduct and higher quality disclosures from companies, board of directors and management. The new Listing Requirements has encouraged compliance with the Malaysian Code on Corporate Governance. The amendments made to the previous Listing Requirements include:
  i) Requirements on reporting the extent of compliance with the Malaysian Code of Corporate Governance by public listed companies;
  ii) Rules on disclosure requirements by directors when reporting on the state of internal controls;
  iii) Rules on non-executive directors and the requirement for one third of the board to be independent; and
  iv) Rules requiring the mandatory accreditation of directors of public listed companies.

- Effective 1 June, public listed companies were required to comply with the **'Statement on Internal Control: Guidance for Directors of Public Listed Companies'** issued by the Taskforce on Internal Control of the KLSE. The objective is to provide guidance to directors of listed companies in making disclosures on the state of internal control of their companies in their annual reports. In particular, explanation was provided on the key areas that directors must focus on before making any statements about the state of the company's internal control. These key areas were the system of internal control, responsibilities of various parties in the maintenance of the system of internal control, the process of review of the adequacy and integrity of the system of internal control and the minimum disclosures on the state of internal control to be made by the Board of Directors.

- The **Minority Shareholder Watchdog Group (MSWG)**, which was established in August 2000, commenced operations in July 2001. Its founding members are the Employees Provident Fund, Permodalan Nasional Berhad, Armed Forces Fund, Pilgrims Fund Board and Social Security Organisation (SOCSO). The role of the MSWG is to promote awareness among minority shareholders, particularly institutional investors, of their rights and responsibilities, to protect minority shareholders from exploitation by public listed companies and to deter and if necessary, to combat abuses by public listed companies on minority shareholders.

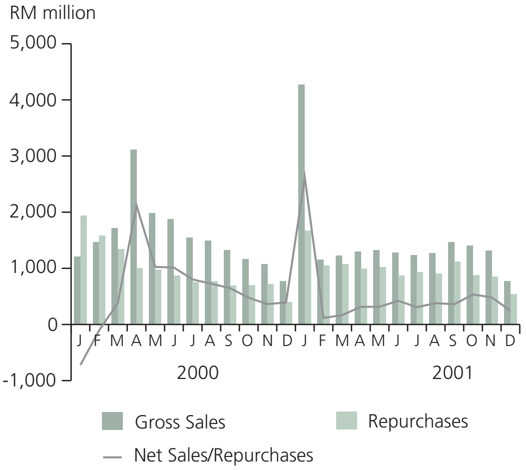
Table 4.35
Unit Trust Industry (Includes Islamic Unit Trust Funds) - Selected Indicators

	2000	2001	2000	2001
			Growth (%)	
Number of Unit Trust Management Companies	34	37	3.0	8.8
Number of Unit Trust Funds*	119	149	17.8	25.2
Units in Circulation (billion)	63.8	71.4	21.3	11.9
Number of accounts (million)	9.6	10	7.9	4.2
Net Asset Value (RM billion)	43.3	47.3	0.5	9.2
Net Sales (RM billion)	7.0	6.1		
Ratio of NAV to KLSE market capitalisation (%)	9.8	10.2		

* Refers to funds already launched

Source: Securities Commission

Graph 4.41
Unit Trust Industry - Gross Sales, Repurchases and Net Sales



marketing efforts by the industry, there was also greater awareness of the benefits of unit trust schemes for the smaller retail investors. The number of institutional unit trust agents also increased to 27 from 17 in the previous year. Together, these factors contributed to the 9.2% growth (2000: +0.5%) in the net asset value (NAV) of the unit trust industry. Consequently, the ratio of the industry's NAV to KLSE market capitalisation increased to 10.2% as at end-2001, from 9.8% at the end of the previous year.

Exchange Traded Derivatives Market

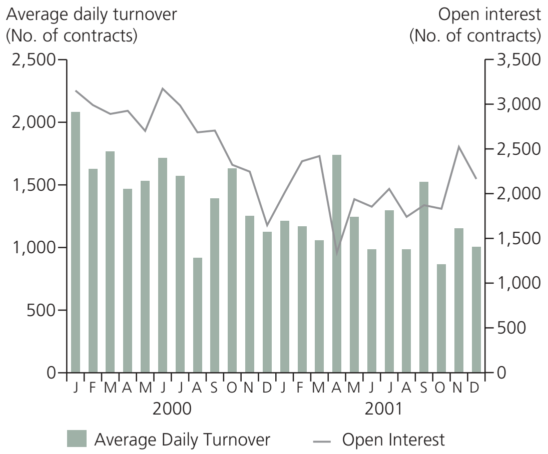
In line with the recommendation of the Capital Market Masterplan, the Malaysia Derivatives Exchange (MDEX) was established on 11 June 2001 as an integrated derivatives exchange, following the merger of two exchanges, the Kuala Lumpur Options and Financial Futures Exchange and the Commodity and Monetary Exchange of Malaysia. The establishment of the MDEX was aimed at facilitating economies of scale and depth of market through improved operating efficiencies and the trading of more derivative products. In 2001, the MDEX offered four products, namely the KLSE CI Futures, KLSE CI Options, 3-Month KLIBOR Futures and Crude Palm Oil (CPO) Futures Contracts.

Table 4.36
MDEX
Turnover: Number of Contracts

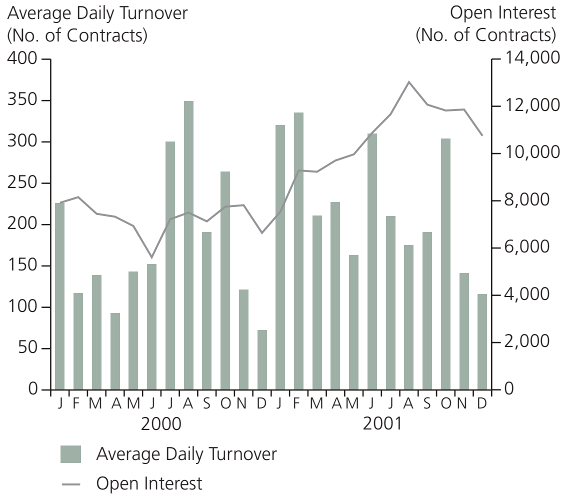
	2000	2001	% change
KLSE CI Futures	366,942	287,528	-21.6
KLSE CI Options	349	565	61.9
KLIBOR Futures	44,812	54,914	22.5
CPO Futures	308,622	479,799	55.5

Source: Malaysia Derivatives Exchange

Graph 4.42
KLSE Composite Index Futures and Option

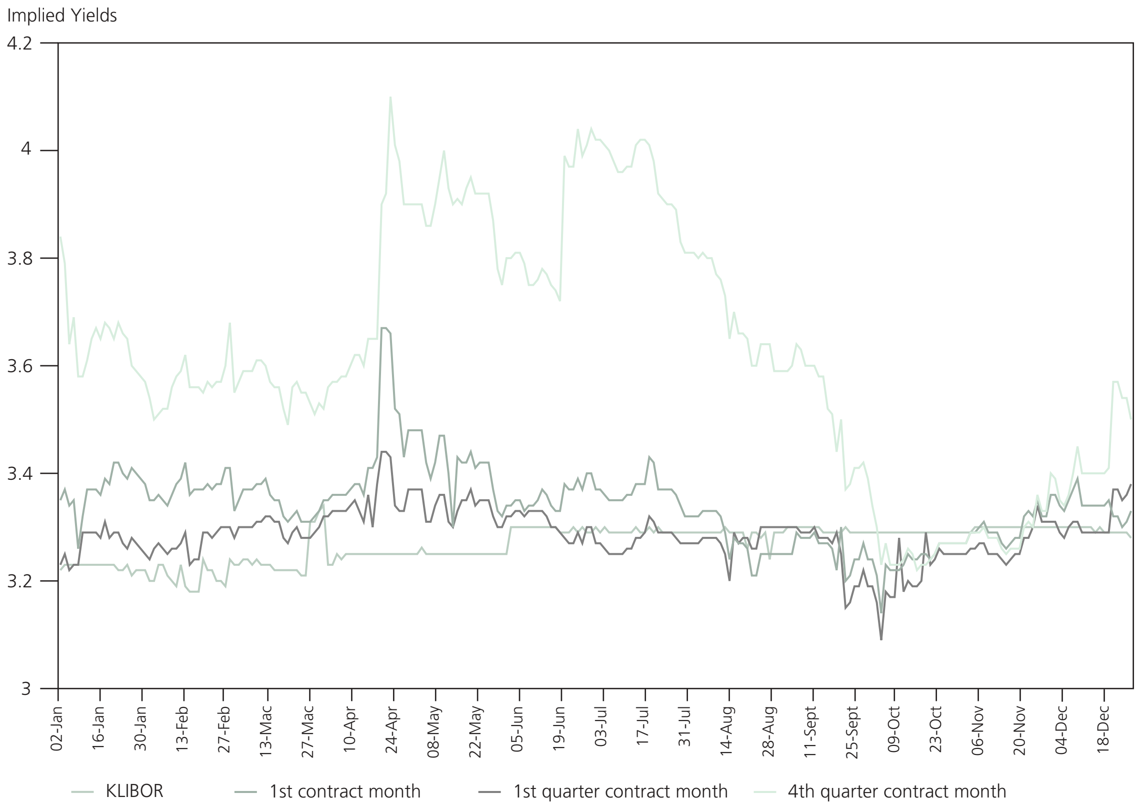


Graph 4.43
KLIBOR Futures

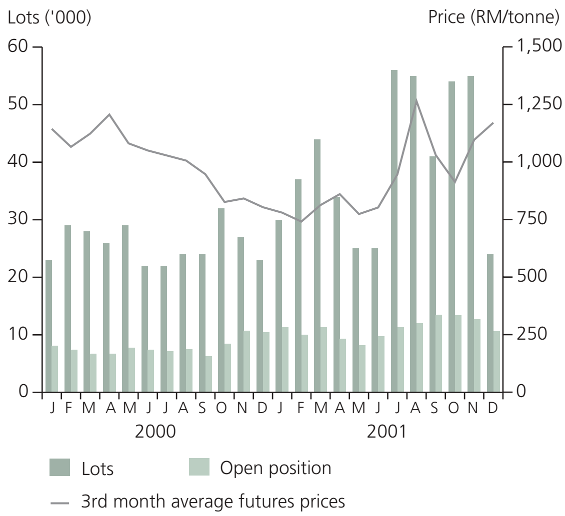


The performance of products traded over the MDEX was mixed in 2001. Trading activities in the **KLSE CI Futures** were weak with trading volume declining by 21.6%. The month-end open position, which is the number of unsettled positions was also low. The lower trading volume was due mainly to the lack of volatility of the KLSE CI that resulted in less participation by local and foreign investors. This was reflected in the low Derivatives Liquidity Ratio (DLR), which represented the ratio between the turnover value of futures against the turnover value of the component stocks. The DLR remained below the 100 mark throughout the year, implying that investors' exposure in the underlying market was not fully covered by their futures contracts. On the

Graph 4.44
KLIBOR Futures Implied Yields and Spot Yields



Graph 4.45
Crude Palm Oil Futures



price front, the KLSE CI Futures prices, which tracked the movement of the underlying KLSE CI closely, increased marginally by 1.4% in 2001. Similarly, total trading volume of the **KLSE CI Option**, which was introduced in 2000, remained low at 565 contracts and there was no open position. The weak trading activities were due to the lack of understanding of the product and high margin requirements.

Meanwhile, the annual turnover for **3-Month KLIBOR** Futures increased by 22.5%. In addition, the month-end open position was generally on a rising trend during the year, with the highest level recorded in August at 13,023 contracts, before closing at 10,751 contracts at year-end (end-2000: 6,642 contracts). The higher turnover was due to the ample liquidity situation in the interbank cash market and improved interest in the local bond and interest rate swap (IRS) markets. Banking institutions were the major players and accounted for the bulk of the trading activities. KLIBOR Futures prices were mixed during the year. The implied yields (4th quarter month contracts) increased from 3.84% in January to a peak of 4.10% in April before declining to the lowest level at 3.22% in October. The implied yields rose subsequently to close at 3.50% at the end of the year.

In 2001, the total trading volume for **CPO Futures Contracts** on the MDEX was higher, reflecting mainly higher crude palm oil production, which grew by 8.9% as well as developments on the physical palm oil markets, which began to show stronger prices since July. Reflective of the favourable development on the price front, total lots traded on the MDEX were significantly higher in the second half year, compared to the first half-year. During the year, the price range for the benchmark 3rd month futures contract widened to RM622 (2000: RM492), with the highest daily price trading at RM1,315 per tonne on 8 August 2001. Analysis on a bi-annual basis showed that average monthly CPO futures prices were lower in the first half-year, ranging between RM741-RM860 per tonne before surging to a higher price range of RM913-RM1,264 per tonne in the second half-year. The price rally during the second half of 2001 was mainly on account of increasingly tight global supplies of vegetable oils, as production of several major vegetable oils, including palm oil, rapeseed and sunflower oils declined, while demand continued to increase.

DEVELOPMENTS IN PAYMENT AND SETTLEMENT SYSTEMS

In 2001, BNM undertook several measures and enhancements to improve the efficiency of the payment systems operated by BNM as well as other domestic payment systems in co-operation with participating banks and the payment consortium. These efforts were important to ensure that the country's payment systems remain efficient, stable and reliable, while keeping abreast with technological developments.

RENTAS

During the year, several measures were introduced to further enhance the efficiency and flexibility of RENTAS. This included the introduction of a real time surveillance system to enhance transaction monitoring and liquidity management, as well as a Repurchase Agreement (REPO) Enhancement

Table 4.37
Payment and Settlement Systems

	2001			
	Value		Volume	
	(RM billion)	Annual change (%)	('000)	Annual change (%)
RENTAS				
IFTS transactions	10,436	-4.8	1,511	4.9
SSTS transactions	559.8	33	68	30.8
SPICK				
Cheques cleared	996	7.4	165,473	0.4
GIRO (IBG)				
IBG instructions	1.08	1,250[1]	125	1,150[1]

[1] The Interbank Giro system was introduced in October 2000

Malaysian Payment Systems

RENTAS

- RENTAS is the Real Time Gross Settlement System (RTGS) that was developed to reduce the financial risks associated with high value payments. The RENTAS system was launched in July 1999 and consisted of an inter-bank funds transfer system (IFTS) and a scripless securities trading, processing and settlement system (SSTS). The introduction of RENTAS has facilitated the attainment of the real time Delivery versus Payment (DVP) Model 1 for the sale and purchase of designated scripless securities.

SPICK

- SPICK (or Sistem Penjelasan Imej Cek Kebangsaan) is an image-based cheque clearing system, which provides for imaging of inward cheques for the purpose of examination and verification of signatures by the paying banks. With SPICK, banks are able to process and verify the cheques based on the data and compact disc received from the SPICK centres without having to sight the physical cheques. This enables a larger area of the country to enjoy same day clearing facilities and reduces the day-hold of outstation cheques as well as minimises the handling and movement of physical cheques. The system, which has centres located in Pulau Pinang, Kuala Lumpur and Johor Bahru, processes about 90 percent of the nation's cheques. SPICK retained its ISO 9002 certification in November 2001.

Automated Teller Machines (ATMs)

- Following the integration of the three ATM networks in 1996, the domestic banks now have a fully integrated ATM network of more than 3,800 ATMs. The payment consortium, Malaysian Electronic Payment System (1997) Sdn. Bhd. (MEPS) provides the switching, clearing and settlement services for the shared ATM network. This collaboration amongst the domestic banks has enabled customers to use all ATMs within the MEPS network and reduced the need for further expansion of each individual bank's ATM network.

Interbank GIRO

- The Interbank GIRO (IBG) service operated by MEPS since October 2000 involves an exchange of digitised transactions to transmit payment orders. The IBG system, which is capable of processing large volumes of individual payments electronically, has shortened the clearing cycle for payment transfers, especially for outstation payment transactions. The IBG payments include standing instructions for loan repayment, as well as payments of insurance premiums, salaries, income tax and contributions to the Employees Provident Fund. The IBG facility is currently provided by 11 banking institutions (including an Islamic bank). Plans are underway to enhance the IBG system to a browser-based system to facilitate e-commerce payment transactions. Graph 4.49 shows the performance of IBG system.

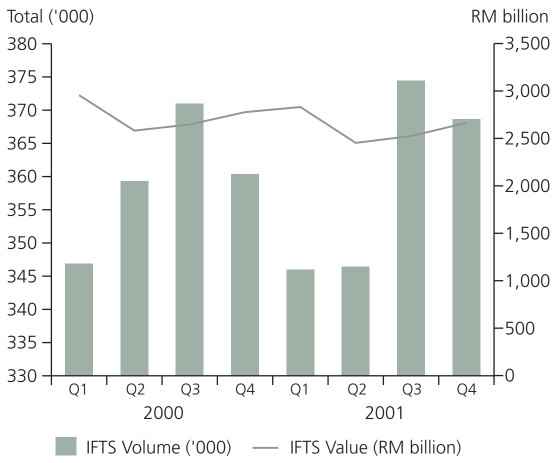
SET Payment Gateway

- In supporting the development of e-commerce, MEPS launched an internet payment gateway in March 1999 to process card-based payments for its member banks. The payment gateway accepts both Secure Sockets Layer (SSL) and Secured Electronic Transaction (SET) transactions. Currently, a total of eight banking institutions are participating in this system. Graph 4.50 shows the performance of the SET Payment Gateway.

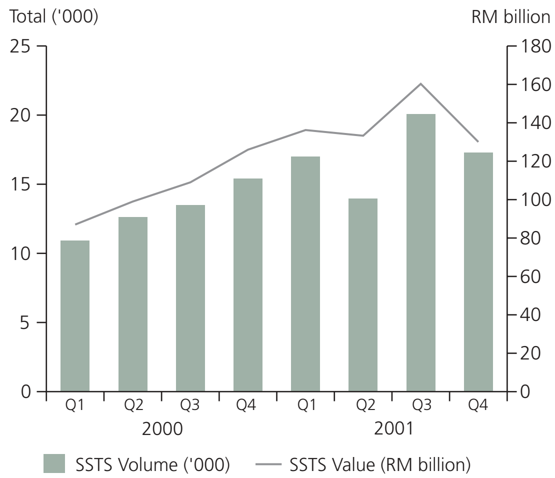
Debit Card System

- MEPS launched an interbank debit ePOS (electronic point of sale) service with three domestic banks in early February 2002. In this system, MEPS would operate the switching network for domestic debit cards, such that ATM cardholders of participating banks would be able to pay for purchases using their ATM cards at participating merchants, regardless of the acquiring bank. A debit card system allows cardholders to have their purchase transactions charged directly to funds in accounts with the issuing banks.

Graph 4.46
RENTAS IFTS Turnover



Graph 4.47
RENTAS SSTS Turnover



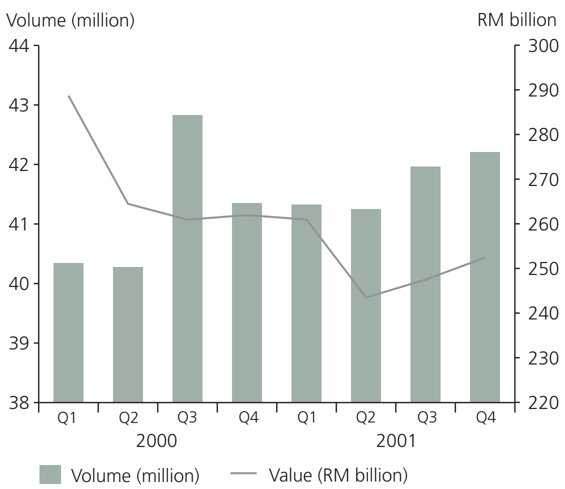
Module (REM) and securities borrowing and lending (SBL). The objectives of REM and SBL are to enhance the liquidity in the secondary bond market by providing a new framework or mechanism to support the trading strategy of dealers and to enhance returns on investment in bond portfolio for investors. The implementation of REM and SBL is also to facilitate greater flexibility in the settlement of REPO and SBL transactions among RENTAS members. At the same time, discussions are on-going to establish linkages with other domestic clearing systems such as the equities clearing and settlement system to enhance the current equities Delivery versus Payment model.

SPICK

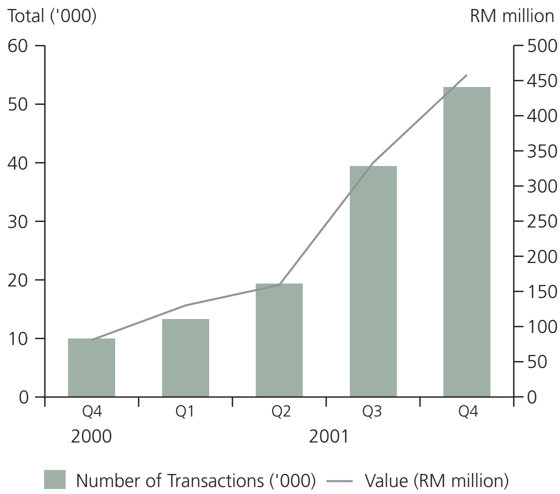
BNM introduced new day-hold periods for the clearing of outstation cheques deposited at and drawn on the respective SPICK and non-SPICK areas, which are cleared at SPICK-KL. With effect from 1 December 2001, the day-hold for cheques deposited at SPICK-KL, which are drawn on all towns, would be three days, whilst cheques deposited at Pulau Pinang, Johor Bahru, Kelantan, Terengganu, Sabah and Sarawak would be between three to eight days. The cut-off time of 2.00 p.m. for same day clearing, which was introduced as a temporary measure by BNM, was also removed. Hence, all local cheques deposited during the day would be cleared on the same day.

Cheque clearing for the non-SPICK areas in the states of Kelantan and Terengganu in the East Coast of Peninsular Malaysia and in Sabah and Sarawak in East Malaysia is currently done manually.

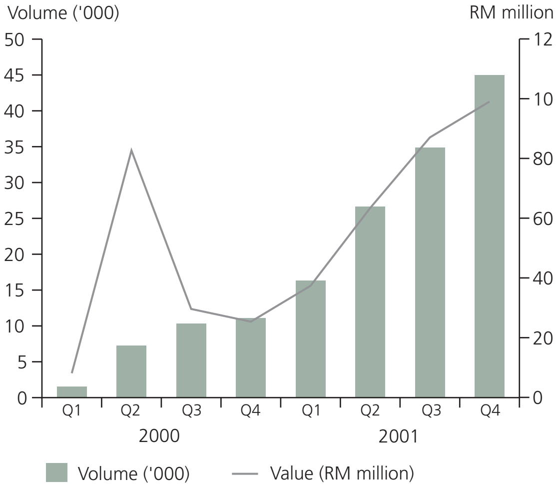
Graph 4.48
Value and Volume of Cheques Cleared by SPICK Centres



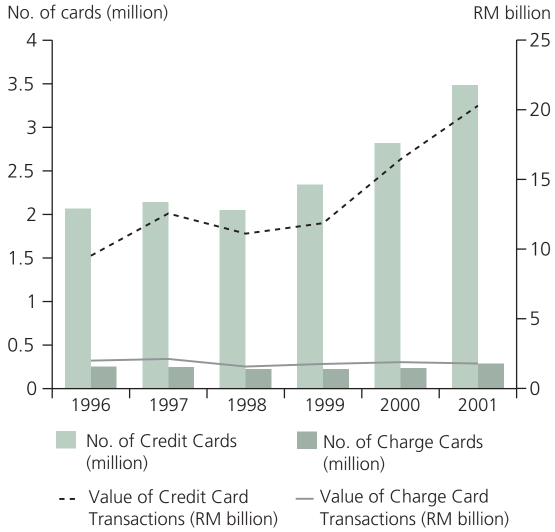
Graph 4.49
Inter-Bank GIRO Transactions



Graph 4.50
SET Payment Gateway Transactions



Graph 4.51
Credit and Charge Card Operations in Malaysia



BNM is exploring ways to improve the cheque clearing services in these areas, particularly in reducing further the number of day-holds.

Automated Teller Machines (ATMs)

During the year, the banking institutions continued to enhance their ATM services to provide additional facilities for customers to perform various banking transactions, including requests for new cheque books, fixed deposit placements, unit trust purchases, bill payments, electronic ticketing, share issue applications, loan repayments and the reloading of prepaid cards. Plans are also underway to migrate the current set of magnetic stripe ATM cards to chip-based ATM cards by January 2003 as part of the nation's efforts to encourage the ulitisation of multipurpose smart cards (MPC) and the banking industry's drive to counter fraud. As such, the ATM machines would be upgraded to read chip-based cards.

The Internet and Other Payment Services

At the end of 2001, eight domestic banks have introduced transactional internet banking services. The services offered allow customers to, among others, remit payments and transfer funds between accounts and banks, conduct account balance inquiries and statement requests, request for stop cheque payments and new cheque books, and access up-to-date account information. In some cases, it is also possible to submit loan applications and perform online share trading. Several banks have also provided online bill payment services using credit cards.

Table 4.38
Payment Media : Credit and Charge Cards

	2000		2001	
	No. of cards ('000)	Value of transactions (RM billion)	No. of cards ('000)	Value of transactions (RM billion)
Credit Cards	2,818	16.4	3,485	20.3
Charge Cards	235.7	1.9	286.9	1.8
Debit Cards	n/a	0.04	n/a	0.04

In 2001, a private sector operator had also introduced an electronic bill payment service via kiosks. The services provided at these kiosks include payment of utility bills as well as prepaid uploading and payments via credit cards, MEPS Cash and ATM cards of participating banks.

Developments in Payment Media

While cash is still the most common retail payment instrument used in Malaysia, the usage of credit cards, charge cards, debit cards and electronic money has been on an increasing trend. To some extent, this reflected the growing sophistication of Malaysian consumers as well as aggressive promotions by the card issuers.

BNM together with banks and credit card associations have implemented various measures to address the problem of credit card fraud. These measures included close monitoring of credit card activities through the issuance of guidelines and supervision, formation of a Risk Management Coordination Unit by the industry to coordinate fraud data collection, increasing the awareness of credit card fraud activities among merchants and cardholders, promoting cooperation and enhancing the investigative capabilities of banks in combating credit card fraud, and upgrading the banks' card surveillance system.

Progress has also been made in the implementation of the electronic money scheme, MEPS Cash, which was first introduced in 1998 during the Commonwealth Games. To increase its usage, the MEPS Cash card was piloted in September 1999 at selected areas in Kuala Lumpur, with six banking institutions participating and a total of 187 merchants accepting the MEPS Cash card. The banking institutions are now in the final stages of implementing a nationwide roll out of the MEPS Cash application. Besides being introduced as a stand-alone card, MEPS Cash will also be issued as an application in MyKad and the Payment Multi-Purpose Card (PMPC), which will contain ATM and debit applications.

Co-operation Initiatives

In 2001, BNM had established the National Payments Advisory Council (NPAC), which was set up in 1993. The roles of the NPAC are:-

- To provide input to address the short and long-term payment systems infrastructural needs;
- To monitor and keep abreast of developments in payment systems locally and abroad;
- To help co-ordinate various initiatives on payment systems to maximise utilisation of resources and avoid duplication of efforts;
- To provide inputs on the formulation of standards where necessary, for application of new technology in payment systems; and
- To provide their respective agency perspective on payment systems matters.

Currently, members of the Council include representatives from the Bank of Japan and the Hong Kong Monetary Authority, as well as the Ministry of Energy, Communications and Multimedia, the Malaysian Administrative Modernisation and Management Planning Unit (MAMPU) of the Prime Minister's Department, the Securities Commission, MEPS, the Association of Banks in Malaysia, the Association of Finance Companies of Malaysia, the Association of Merchant Banks in Malaysia, and the General Insurance Association of Malaysia.