The Financial System

The Financial System

Sources and Uses of Funds of the Financial System

The continued expansion in economic activity during the year was reflected in the growth of total assets of the financial system, which grew by 8.1% or RM143.6 billion to RM1.9 trillion as at end-2005. As at end-2005, the total assets of the financial system were equivalent to 386% of GDP (2004: 392.5%).

Assets of the banking system and the non-bank financial intermediaries (NBFIs) expanded in 2005, albeit at a slower rate at 7.7% (2004: 13.6%) and 9% (2004: 11.6%) respectively. The Central Bank's assets recorded a more moderate growth in 2005 due to a smaller increase in the holdings of gold and foreign exchange reserves. A moderate growth in assets was also registered by commercial banks and discount houses, while merchant banks and Islamic banks recorded a higher increase in assets.

The contribution of assets by type of institutions changed during the year, reflecting the continued transformation of the Malaysian financial system. Firstly, following the completion of the merger exercises of five finance companies with their respective parent commercial banks, the assets of the commercial banks rose by 14.4% to account for a larger share of 44.1% share of total financial system assets (2004: 41.7%), while the share of finance companies declined to 1.4% (2004: 3.9%). Secondly, with the greater emphasis on developing Islamic financial services, the share of Islamic banks' assets in

Table 4.1
Assets of the Financial System

	Annual change		As at end-2005*p*
	2004	2005*p*	
	RM billion		
Banking system	**142.1**	**91.7**	**1,280.8**
Bank Negara Malaysia	84.0	10.6	295.4
Commercial banks	127.3	106.1	842.4
Finance companies	-73.5	-41.5	26.9
Merchant banks	-1.4	3.9	46.6
Islamic banks	3.9	18.6	43.5
Discount houses	1.7	-5.9	26.0
Non-bank financial intermediaries	**59.7**	**51.9**	**627.7**
Provident, pension and insurance funds	35.6	39.8	423.2
Employees Provident Fund	*20.2*	*23.5*	*263.9*
Other provident & pension funds	*4.8*	*5.6*	*56.8*
Life insurance funds	*10.0*	*9.6*	*83.7*
General insurance funds	*0.6*	*1.0*	*18.8*
Development financial institutions[1]	12.4	8.7	100.1
Other financial intermediaries[2]	11.7	3.5	104.4
Total	**201.8**	**143.6**	**1,908.5**

[1] Refers to Bank Pembangunan Malaysia Berhad, Bank Kerjasama Rakyat Malaysia Berhad, Bank Simpanan Nasional, Export-Import Bank of Malaysia Berhad, Bank Pertanian Malaysia, Bank Perusahaan Kecil dan Sederhana Malaysia Berhad (SME Bank), Malaysian Industrial Development Finance Berhad, Sabah Development Bank Berhad, Borneo Development Corporation (Sabah) Sendirian Berhad, Borneo Development Corporation (Sarawak) Sendirian Berhad, Credit Guarantee Corporation Malaysia Berhad, Sabah Credit Corporation and Lembaga Tabung Haji. Prior to 1 October 2005, data included Bank Industri & Teknologi Malaysia Berhad and Malaysia Export Credit Insurance Berhad and excluded SME Bank.

[2] Refers to unit trusts run by Amanah Saham Nasional Berhad (ASNB) and Amanah Saham Mara Berhad, cooperative societies, leasing and factoring companies, and housing credit institutions (comprising Cagamas Berhad, Borneo Housing Mortgage Finance Berhad and Malaysia Building Society Berhad).

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Graph 4.1
Assets of the Financial System as at end-2005*p* (% share)

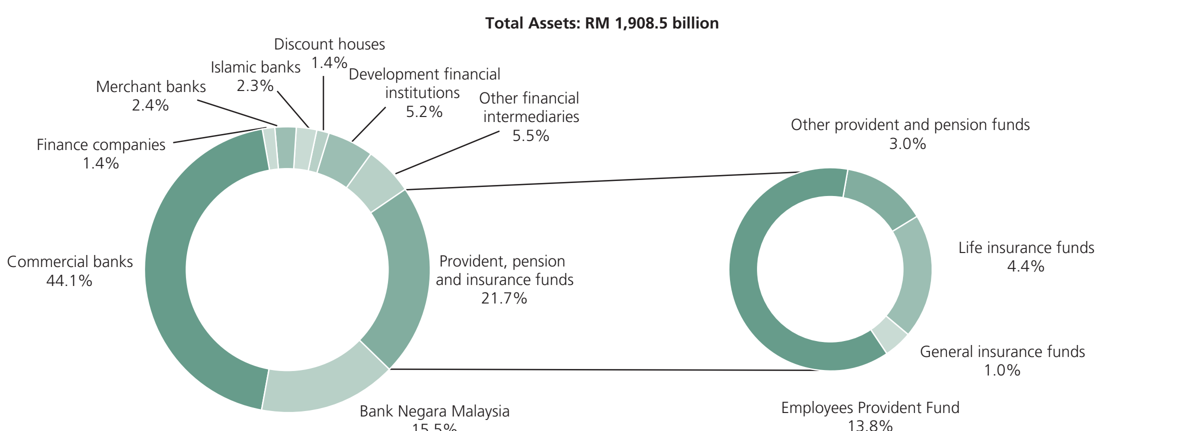

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Table 4.2
Sources and Uses of Funds of the Financial System

	Annual change 2004	Annual change 2005*p*	As at end-2005*p*
	RM billion		
Sources:			
Capital and reserves	18.1	9.3	176.3
Currency	2.9	2.0	34.4
Deposits	126.2	86.6	922.2
Borrowings	3.9	3.7	56.4
Funds from other financial institutions[1]	-15.9	12.5	84.2
Insurance, provident and pension funds	32.3	36.2	374.1
Other liabilities	34.2	-6.7	260.9
Total	**201.8**	**143.6**	**1,908.5**
Uses:			
Currency	-0.5	0.9	6.0
Deposits with other financial institutions	21.6	8.0	256.0
Loans and advances[2]	56.4	66.0	721.7
Securities	23.6	35.0	468.0
Treasury bills	*-3.1*	*1.3*	*1.7*
Commercial bills	*-5.1*	*-1.1*	*7.3*
Malaysian Government (MGS)	*14.3*	*13.7*	*153.2*
Corporate	*17.4*	*19.2*	*290.8*
Private Debt Securities (PDS)	*8.0*	*10.5*	*140.8*
Equities	*9.5*	*8.6*	*150.0*
Foreign	*1.1*	*2.1*	*6.7*
Others	*-1.2*	*-0.1*	*8.4*
Gold and foreign exchange reserves	9.5	8.6	264.4
Other assets	17.1	19.0	192.4

1 Includes statutory reserves of banking institutions.
2 Excludes loans sold to Danaharta.
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the financial system expanded to 2.3% of total financial assets from 1.4% in the previous year. During the course of the year, four additional Islamic banks were established as a result of measures taken to liberalise and accelerate the growth of Islamic banking industry by allowing foreign Islamic banks to operate in Malaysia. Thirdly, as part of the framework for the creation of investment banks, the seven discount houses currently in operation would be rationalised and merged with stockbroking companies and universal brokers to form investment banks. Arising from the rationalisation process, the assets of the discount houses declined by RM5.9 billion to account for a reduced share of 1.4% of total assets of the financial system (2004: 1.8%).

Meanwhile, the expansion in assets of the NBFIs was contributed largely by a higher increase of the provident, pension and insurance funds' assets. Assets of the provident and pension funds (PPFs) increased by 10% during the year and contributed 16.8% of the total assets of the financial system. This growth was attributed to the increase of investments in debt

Graph 4.2
Sources and Uses of Funds of the Financial System as at end-2005p (% share)

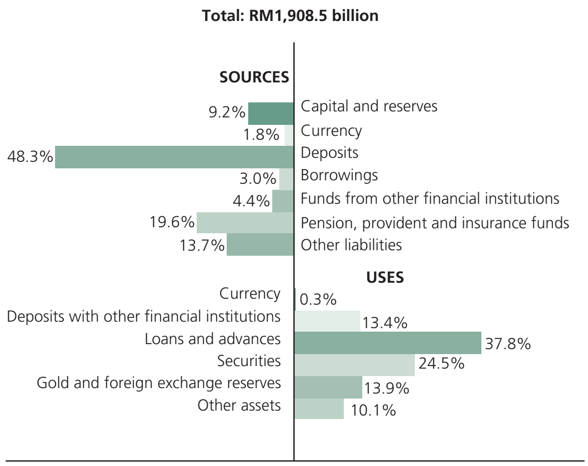

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Table 4.3
Non-Financial Private Sector Deposits[1] with the Financial System[2]

	Annual change 2004	Annual change 2005*p*	As at end-2005*p*
	RM billion		
Deposits[3] with:			
Commercial banks	87.9	64.1	498.0
Finance companies	-35.4	-22.6	6.0
Merchant banks	0.8	1.3	16.0
Islamic banks	2.1	10.8	22.2
Discount houses	1.8	-2.8	9.7
National Savings Bank	1.8	2.2	12.2
Others[4]	5.5	0.7	37.3
Total	**64.6**	**53.6**	**601.5**
Demand deposits	10.3	9.3	97.2
Saving deposits	5.5	2.4	76.5
Fixed deposits	35.3	19.7	362.9
of which:			
Up to 1 year	*34.2*	*19.4*	*334.7*
More than 1 year	*1.1*	*0.3*	*28.2*
NIDs[5]	5.2	10.7	18.6
Repos[6]	8.3	11.5	46.3

1 Refers to deposits placed by business enterprises (excluding NFPEs) and individuals.
2 Excludes provident and pension, insurance and unit trust funds.
3 Refers to demand, savings and fixed deposits, negotiable instruments of deposits and repos.
4 Includes development financial institutions, cooperative societies and housing credit institutions.
5 Refers to negotiable instruments of deposits.
6 Refers to repurchase agreements.
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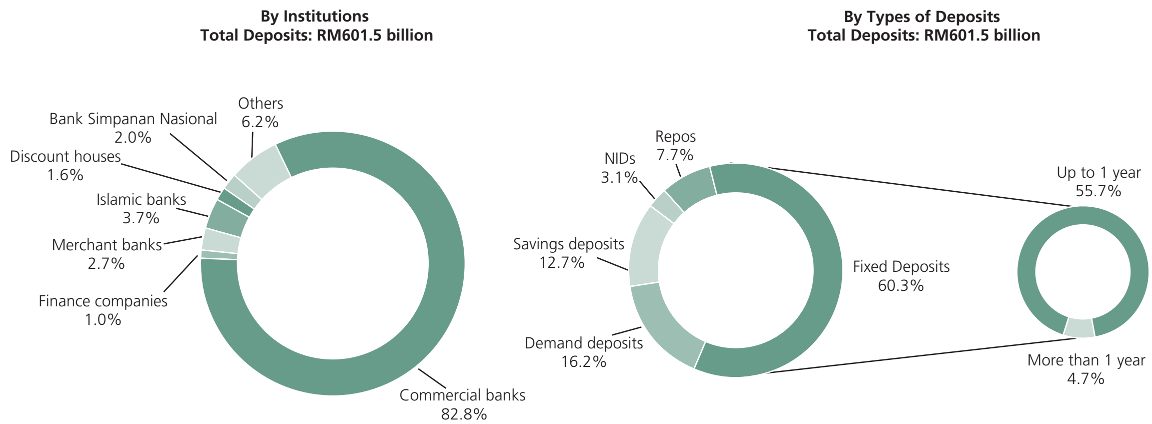
Graph 4.3
Non-Financial Private Sector Deposits with the Financial System as at end-2005*p* (% share)



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securities and equities, as well as from higher lending activity by PPFs in 2005.

Assets of the insurance funds grew at a similar pace, registering 11.6% growth and accounted for 5.4% of the total assets of the financial system as at end-2005. Bulk of the growth in the assets was driven by the life insurance funds (including Takaful family funds) which accounted for 82% of the total insurance funds assets. In terms of growth, the assets of Islamic insurance funds grew at a higher rate of 14.9%, compared to the conventional insurance funds which grew by 11.4%.

The sources of financing for the financial system were contributed mainly by the deposits placed with the financial institutions as well as contributions to the provident, pension and insurance funds. Deposits mobilised by the financial system increased by RM86.6 billion, or 10.4% during the year. The banking institutions remained the largest mobiliser of the deposits, contributing 72.1% of the total increase in deposits during the year and accounted for 77.5% of total outstanding deposits mobilised in the whole financial system.

In terms of deposits by holders, individuals and businesses contributed the bulk of the deposits placed with the banking system and development financial institutions (DFIs). Deposits placed by individuals with the banking system and DFIs increased by 5.4% in 2005 (2004: 9.6%), while deposits placed by businesses grew by 15.3% (2004: 18.8%). In 2005, the growth in deposits was in line with the continued growth in the nation's income as reflected in the strong growth of 11.3% in GNP.

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

	Annual change		As at end-2005*p*
	2004	2005*p*	
	RM billion		
Loans and advances	**55.3**	**70.6**	**683.5**
Agriculture	0.7	0.2	14.2
Mining and quarrying	-0.1	-0.2	0.8
Manufacturing	2.5	-0.4	58.1
Construction and real estate	3.9	4.6	84.4
Purchase of residential properties	19.2	18.5	187.8
Retail, wholesale, restaurants and hotels	3.2	1.6	25.7
Transport, storage and communications	0.0	3.4	18.9
Business services	1.6	1.2	23.3
Electricity, gas and water supply	0.7	-0.4	5.7
Consumption credit	15.0	22.2	133.4
Purchase of shares	-0.4	1.6	20.5
Others	8.9	18.2	111.0
Investments in corporate securities	**15.6**	**21.2**	**289.0**
Total	**71.0**	**91.8**	**972.5**

[1] Excludes credit to non-financial public enterprises.
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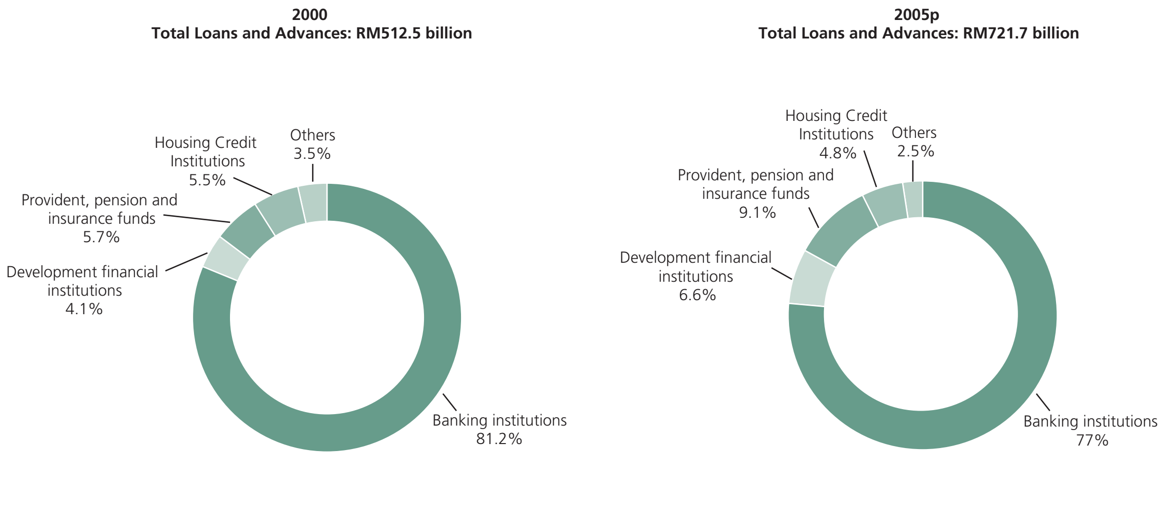
Graph 4.4
Loans and Advances by Institutions (% share)



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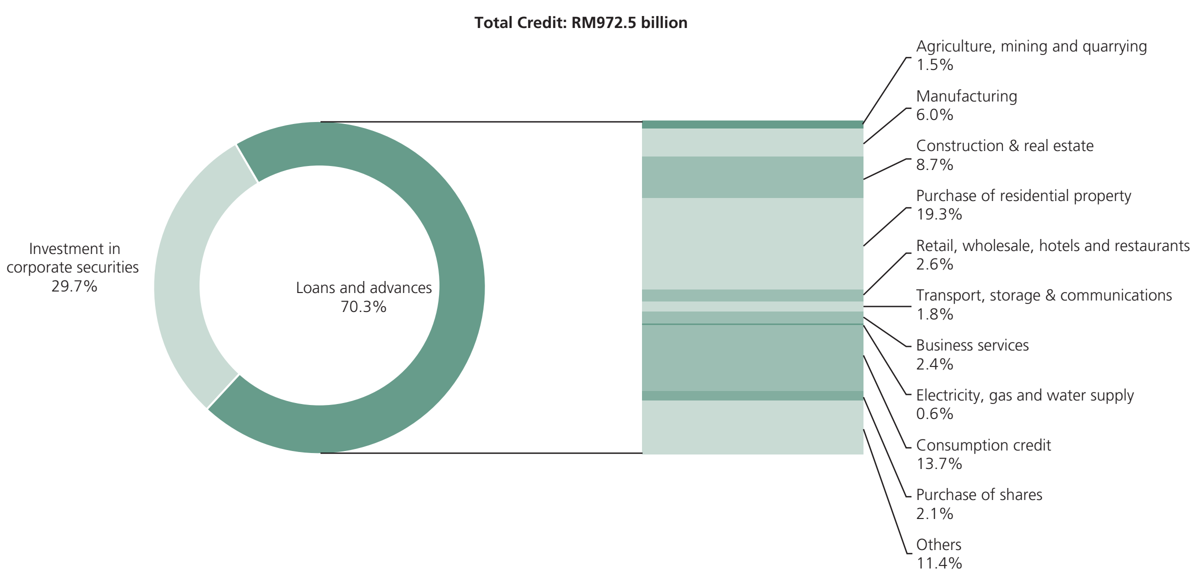
Apart from deposits placed with financial institutions, contributions to the provident, pension and insurance funds remained as the second main source of financing to the financial system, which accounted for 19.6% of the total financing resources. The contributions to the provident and pension funds (PPFs) continued to grow by 10.7% during the year and were largely dominated by contributions to the Employee Provident Fund (91.3% of total contributions to PPFs).

The increase in the total resources of the financial system in 2005 was mainly channeled into loans and advances as well as investment in debt securities and equities.

Graph 4.5
Direction of Credit to the Non-Financial Private Sector as at end-2005*p* (% share)



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Loans and advances extended by the financial system grew by 10.1% during the year and remained the largest type of asset in the financial system (37.8% share of total assets). The banking institutions were the largest provider of the loans and advances with a 77% share, followed by the PPFs and DFIs. The share of loans provided by PPFs and DFIs has expanded since 2000, reflecting the greater role of DFI in financing the economy as well as the diversification of asset allocation of PPFs.

In 2005, the demand for loans and advances were driven mainly by the household sector, particularly for the purchase of residential properties and consumption credit, which together accounted for 57.7% of the increase in total loans and advances during the year. Meanwhile, within the business sector, the loans extended to the small and medium-sized enterprises posted a higher growth of 8.7% in 2005 (2004: 7.7%).

Investment in securities (debt and equities) by the financial system expanded further by 8.1% in 2005 (2004: 5.8%) due mainly to the increase in holdings of securities by PPFs. The PPFs held 50.2% and 47.7% in debt securities and equities investment, respectively. Meanwhile, the holdings of securities by the banking institutions dropped during the year reflecting a shift in portfolio allocation from long-term securities to short-term securities following the anticipation of further interest rate increase in the future.

Progress of Financial Sector Masterplan Implementation

The implementation of the Financial Sector Masterplan (FSMP) is well on track and as at 31 December 2005, i.e. half-way through the 10-year FSMP period, a total of 49 recommendations or more than half of the FSMP recommendations with milestones have been fully implemented. Another 29 recommendations are being implemented on a continuous basis. The list of completed and on-going recommendations is in the Annex.

Throughout the first half of the FSMP period, significant progress was achieved in diversifying the financial structure including further strengthening the position of the domestic financial institutions to operate in a more liberalised environment. Despite a more deregulated and liberalised environment, the domestic banking institutions remained competitive and were able to maintain their market share. As at end-2005, domestic banking institutions maintained 81.7% share of gross loans (end-2004: 81.3%) and 80.5% share of total deposits (end-2004: 80.9%). Profitability levels of domestic banks continued to improve, as exhibited by increases in return on average assets and return on average equity from 1% and 11.5% in 2004 to 1.3% and 15.2% in 2005, respectively. Productivity level also improved further as demonstrated by lower cost to income ratio of 49% in 2005 (2004: 50%). Boosted by stronger profitability level and improving cost to income ratio, the pre-tax profit per RM employee cost of domestic banks also increased from RM1.60 in 2004 to RM1.90 in 2005. Asset quality positions also continued to improve, amidst favourable economic conditions. Net NPL ratio based on the 3-month classification declined by 1.8 percentage points to 6.4% in 2005. Benefiting from the continued capacity building initiatives and efforts taken by domestic banking institutions to further enhance their operational efficiency, several domestic banks have emerged stronger and become performance leaders. These top performers have further narrowed their performance gap as compared with the incumbent foreign banks in all major areas.

Similar to the banking industry, the domestic insurance companies also recorded further performance improvements. Domestic players maintained their dominant position in the general insurance sector with a market share in gross direct premiums of 73.5% in 2005 (2004: 72.6%). Supported by enhanced underwriting capabilities and infrastructure improvements which contributed towards better underwriting results and efficiency gains, the combined return on equity of the larger domestic insurers increased to 29.8% (2004: 20.6%). Significant productivity improvements were also achieved with gross premiums per employee increasing by more than 14% to RM754,301 (2004: RM659,184). In the life sector, the weaker overall growth of life business during the year saw the market share of domestic insurers declining marginally to 34.8% (2004: 35.8%) in 2005. Domestic insurers, nevertheless, maintained their dominant position in the bancassurance market, with a share of 81.9% (2004: 82.4%) of total new premiums generated through banking institutions in 2005. The significant growth of the bancassurance market since 2003 has also seen a number of domestic insurers emerging among the market leaders, with several more positioning themselves to take advantage of the significant growth opportunities to be reaped from their banking alliances.

The Islamic banking industry sustained its expansion in the Malaysian banking system as indicated by the increasing market share of Islamic banking assets to account for 11.3% (2004: 10.5%) of the total assets in the banking system as at end-2005. The market share of deposits and financing also expanded to account for

11.7% (2004: 11.2%) and 12.1% (2004: 11.3%) of the total banking sector deposits and financing respectively.

During the year, various policy initiates were undertaken towards strengthening further the financial system to better support the growing needs of the economy. Measures undertaken in the banking sector, Islamic financial services and the development financial institutions are discussed in detail in chapters *The Banking System, The Islamic Financial System* and *Development Financial Institutions* of the Annual Report 2005. Details on the insurance sector initiatives will be covered in the Insurance Annual Report 2005.

The Malaysian financial landscape will continue to undergo structural changes given the economic transformation and the need for the financial institutions to sustain their competitiveness and resilience. The entrance of new investors and financial players is expected to inject greater dynamism in the financial industry, thus giving more incentives to attain greater performance improvement by domestic financial institutions. The capacity building initiatives will continue to be pursued and intensified during the remaining Phase 2 of the FSMP period to prepare the domestic financial sector for further global integration as we move to the third phase of the FSMP. Gradual liberalisation measures, including the possibility of introducing new foreign competition, will be appropriately sequenced to ensure the achievement of the desired improvement and, new opportunities and benefits to the domestic financial system while preserving overall financial stability.