# The Financial Sector

# The Financial Sector

## SOURCES AND USES OF FUNDS OF THE FINANCIAL SYSTEM

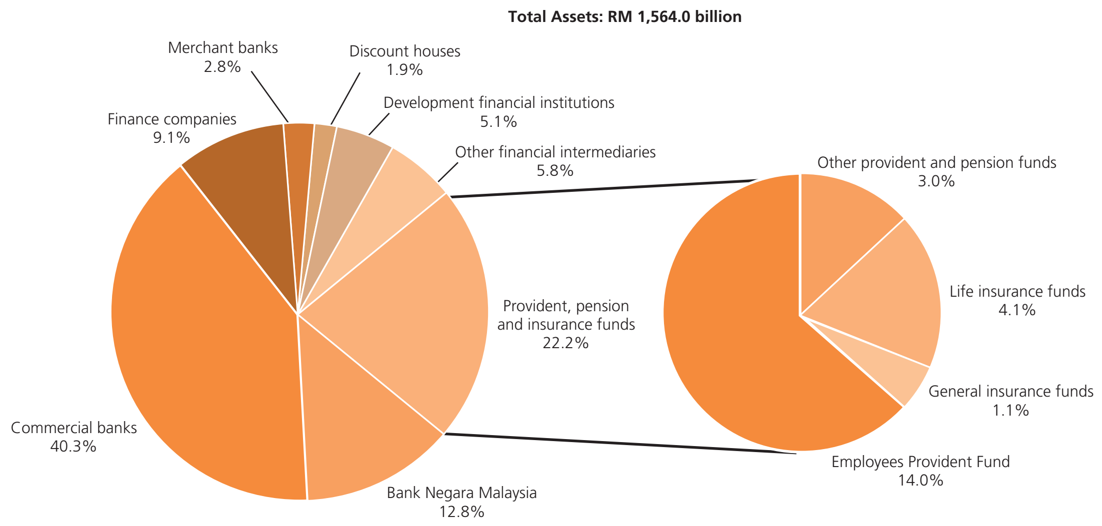
Total assets of the financial system expanded significantly by 12.1% to RM1,564 billion in 2003 in line with the improvement in overall economic performance. As a share of GDP, total assets of the financial system increased to 399% of GDP (2002: 386%).

Assets of both the banking system and the non-bank financial intermediaries (NBFIs) expanded in 2003. Total assets of the banking system increased by 13.2% (2002: 6.8%), while assets of the non-bank financial intermediaries (NBFIs) grew by 8.4% (2002: 8.6%). The bulk of the increase in assets within the banking system was due to the stronger growth in assets of the commercial banks. This reflected mainly the increase in deposits with other financial institutions (19.5%), investment in securities (15%) and loans and advances (7.2%). The growth in assets of the NBFIs was driven principally by an expansion in the assets of the provident, pension and insurance funds (+RM30.5 billion), which accounted for 65.1% of the increase in the total assets of NBFIs.

During the year, the bulk of new resources was contributed by deposits placed with the financial institutions and contributions to the provident, pension and insurance funds. Deposits mobilised by the financial institutions grew at a higher rate of 11.8% in 2003, compared with 6% in 2002. The banking institutions (comprising commercial banks, finance companies, merchant banks and discount houses) continued to be the largest mobiliser of deposits in 2003, accounting for 71.1% of the increase in deposits raised by the financial system in 2003 (2002: 83.5%) and 81.4% of total outstanding deposits of the financial system as at end-2003 (2002: 82.6%). The strong deposit growth was due to improved economic conditions, which resulted in higher disposable income and financial wealth of households and business enterprises.

In terms of holders, deposits were mainly held by the non-financial private sector (comprising individuals and business enterprises), which accounted for 71.2% of the total outstanding deposits as at end-2003 (79.6% as at end-2002). The deposits of this group grew by 16.6% in 2003, with higher deposits by individuals (47.2% of total outstanding deposits). In 2003, deposits of business enterprises also increased significantly by 14.6% (2002: 2.7%), while deposits by individuals grew at 7.7% (2002:6.9%). As in previous years, fixed deposits continued to account for the bulk of the increase in deposits

**Graph 4.1**
**Assets of the Financial System as at end-2003*p* (% share)**




*p* Preliminary

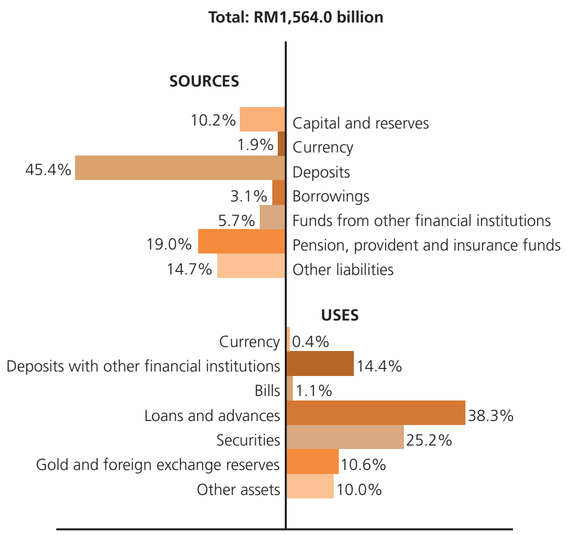
### Table 4.1
### Assets of the Financial System

| | Annual change | | As at end-2003*p* |
|---|---|---|---|
| | 2002 | 2003*p* | |
| | RM billion | | |
| **Banking system** | **58.5** | **122.2** | **1,046.7** |
| Bank Negara Malaysia | 12.5 | 38.6 | 200.8 |
| Commercial banks[1] | 33.2 | 66.7 | 629.6 |
| Finance companies | 8.9 | 11.3 | 142.0 |
| Merchant banks | 0.3 | 2.8 | 44.1 |
| Discount houses | 3.6 | 2.8 | 30.2 |
| **Non-bank financial intermediaries** | **42.6** | **46.8** | **517.3** |
| Provident, pension and insurance funds | 27.0 | 30.5 | 347.7 |
| *Employees Provident Fund* | *15.2* | *18.0* | *220.2* |
| *Other provident & pension funds* | *4.5* | *1.5* | *46.2* |
| *Life insurance funds* | *6.7* | *9.8* | *64.1* |
| *General insurance funds* | *0.6* | *1.2* | *17.2* |
| Development financial institutions[2] | 11.1 | 6.7 | 79.1 |
| Other financial intermediaries[3] | 4.5 | 9.6 | 90.5 |
| **Total** | **101.1** | **169.0** | **1,564.0** |

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

placed by the non-financial private sector, with holders continuing to exhibit preference for deposits with shorter maturities, given the smaller

### Graph 4.2
### Sources and Uses of Funds of the Financial System as at end-2003*p* (% share)




*p* Preliminary

### Table 4.2
### Sources and Uses of Funds of the Financial System

| | Annual change | | As at end-2003*p* |
|---|---|---|---|
| | 2002 | 2003*p* | |
| | RM billion | | |
| **Sources:** | | | |
| Capital and reserves | 12.6 | 24.0 | 158.8 |
| Currency | 1.8 | 2.3 | 29.4 |
| Deposits | 36.3 | 74.8 | 709.4 |
| Borrowings | 9.7 | 3.1 | 48.0 |
| Funds from other financial institutions[1] | 2.3 | 18.0 | 88.9 |
| Insurance and provident funds | 23.0 | 22.7 | 297.1 |
| Other liabilities | 15.5 | 24.1 | 232.4 |
| **Total** | **101.2** | **169.0** | **1,564.0** |
| **Uses:** | | | |
| Currency | 0.3 | -1.1 | 6.3 |
| Deposits with other financial institutions | 13.9 | 36.7 | 224.6 |
| Bills | 2.7 | -2.2 | 16.7 |
| *Treasury* | *1.6* | *-2.1* | *3.5* |
| *Commercial* | *1.1* | *-0.1* | *13.2* |
| Loans and advances[2] | 35.2 | 40.4 | 600.8 |
| Securities | 24.0 | 51.2 | 393.4 |
| *Malaysian Government* | *0.9* | *19.9* | *124.3* |
| *Foreign* | *0.5* | *0.3* | *3.5* |
| *Corporate* | *21.2* | *32.3* | *259.0* |
| *Others* | *1.4* | *-1.3* | *6.6* |
| Gold and foreign exchange reserves | 14.0 | 38.6 | 166.1 |
| Other assets | 11.1 | 5.4 | 156.1 |

1 Includes statutory reserves of banking institutions.
2 Excludes loans sold to Danaharta.
*p* Preliminary

interest differentials between short- and longer-term deposit rates.

Contractual savings with provident and pension funds, as well as contributions to insurance funds, continued to be one of the major sources of funds for the financial system, expanding by 8.3% to account for 19% of the total funds mobilised by the financial system as at end-2003. Meanwhile, capital and reserves of the financial system increased by 17.8% in 2003 (2002: +10.2%), reflecting mainly improved financial performance of the banking institutions.

The increase in the total resources of the financial system in 2003 was invested mainly in loans and advances and securities. Total loans and advances grew by RM40.4 billion or 7.2% in 2003 (2002: RM35.2 billion or 6.7%). This development was due mainly to increased demand from the household sector, as reflected by the higher demand for loans for the purchase of residential property and consumption credit. In addition, financing available to SMEs was also higher during the year, with outstanding loans increasing by

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

| | Annual change | | As at end-2003*p* |
|---|---|---|---|
| | 2002 | 2003*p* | |
| | RM billion | | |
| Deposits[3] with: | | | |
| Commercial banks | 16.1 | 37.3 | 355.2 |
| Finance companies | 3.0 | 0.2 | 64.1 |
| Merchant banks | 0.2 | 2.4 | 13.9 |
| Discount houses | 3.2 | 2.3 | 10.7 |
| Bank Simpanan National | 0.7 | 0.2 | 8.3 |
| Others[4] | 0.1 | 6.6 | 29.9 |
| **Total** | **23.3** | **49.0** | **482.1** |
| Demand deposits | 5.9 | 13.5 | 77.5 |
| Fixed deposits | 9.5 | 17.8 | 300.0 |
| *of which:* | | | |
| *Up to 1 year* | *15.5* | *14.3* | *258.1* |
| *More than 1 year* | *-6.0* | *3.5* | *41.9* |
| Savings deposits | 5.8 | 11.3 | 75.4 |
| NIDs[5] | 0.5 | 0.3 | 2.7 |
| Repos[6] | 1.6 | 6.1 | 26.5 |

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.
*p* Preliminary

10% on annual basis, the highest growth registered since July 2001.

Investment in securities by the financial system continued to expand in 2003, recording a significant increase of 15% in 2003 (2002: 7.5%). The bulk of

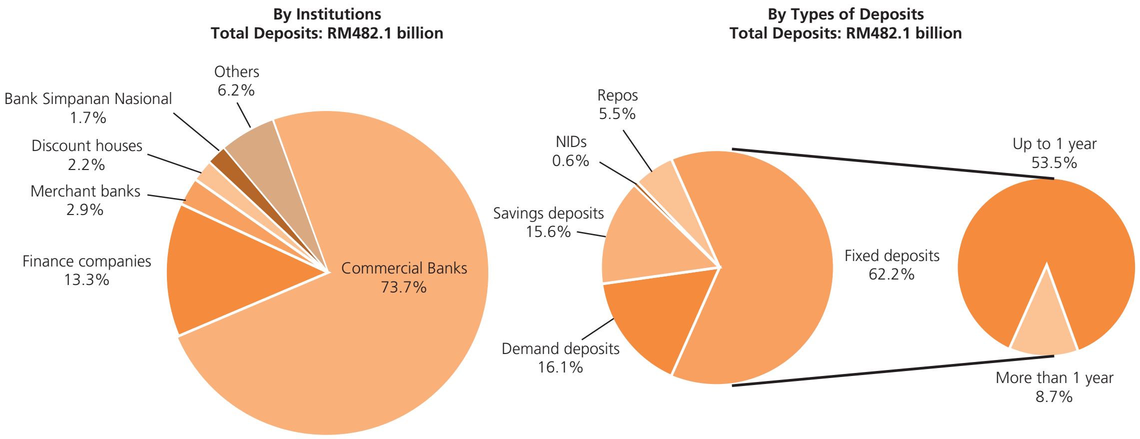
### Table 4.4
### Direction of Credit[1] to the Non-Financial Private Sector

| | Annual change | | As at end-2003*p* |
|---|---|---|---|
| | 2002 | 2003*p* | |
| | RM billion | | |
| **Loans and advances** | **20.8** | **31.2** | **563.1** |
| Agriculture | 0.0 | -0.4 | 13.6 |
| Mining and quarrying | -0.2 | 0.1 | 1.1 |
| Manufacturing | 0.1 | 0.9 | 55.8 |
| Construction and real estate | -1.5 | 4.4 | 80.9 |
| Purchase of residential properties | 17.1 | 16.8 | 147.8 |
| Retail, wholesale, restaurants and hotels | 2.3 | -0.3 | 21.0 |
| Transport, storage and communications | 1.3 | 0.5 | 14.7 |
| Business services | -2.6 | 1.7 | 21.6 |
| Consumption credit | 0.1 | 10.1 | 96.4 |
| Purchase of shares | 0.1 | -1.7 | 19.3 |
| Others | 4.1 | -0.9 | 90.9 |
| **Investments in corporate securities** | **48.1** | **2.1** | **259.0** |
| **Total** | **68.9** | **33.3** | **822.1** |

1 Excludes credit to non-financial public enterprises.
*p* Preliminary

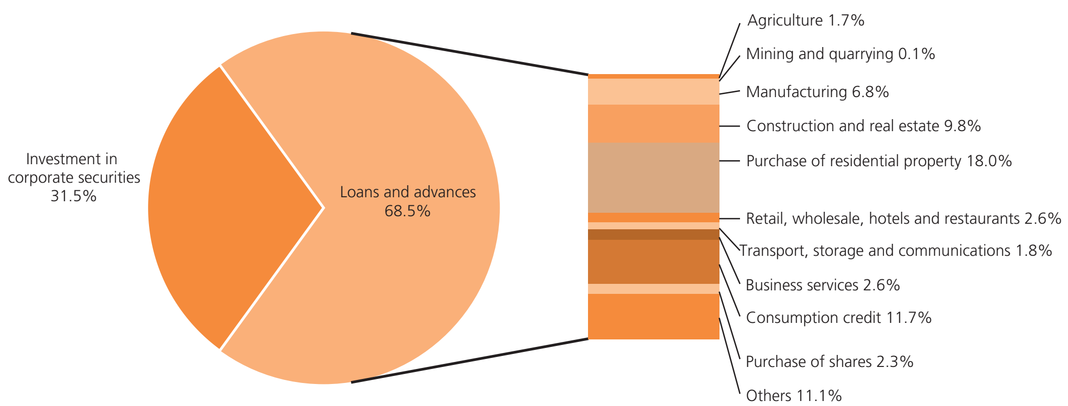
the increase was in equities and reflect improving optimism and opportunity for high returns in the equity market. Provident, pension and insurance funds continued to be the main investors in securities, accounting for 51.4% of the increase in investments in securities. Meanwhile, gross holdings of gold and foreign exchange reserves also recorded a significant rise of RM38.6 billion or 30.3% in 2003 (2002: RM14 billion or 12.3%), on account of larger foreign exchange inflows generated from the large trade surplus, short and long-term capital inflows, and unrealised revaluation gains on reserves.

### Graph 4.3
### Non-Financial Private Sector Deposits with the Financial System as at end-2003*p* (% share)




*p* Preliminary

**Graph 4.4**
**Direction of Credit to the Non-Financial Private Sector as at end-2003*p* (% share)**




*p* Preliminary

## MANAGEMENT OF THE BANKING SYSTEM

The thrust of banking policies in 2003 continued to focus on enhancing the efficiency and competitiveness of the domestic banking institutions while reinforcing the resilience of the banking system to preserve financial stability. Policies implemented over the years to restructure and strengthen the banking system, supported by improved economic performance contributed to the strengthening of the banking system in 2003. The risk weighted capital ratio of the banking system remained above 13% throughout 2003, while non-performing loans were on a declining trend. This had enabled the banking system to effectively support economic activities. New loan approvals and disbursements expanded strongly by 11.2% and 7.2% respectively, while total outstanding loans grew by 4.8% in 2003. Overall, financing provided by the banking system through extension of loans and its holdings of private debt securities expanded at an annual rate of 5.9%.

The completion of financial restructuring and stronger balance sheets have enabled the banking institutions to focus on harnessing their operational efficiency and meeting the needs of their customers. In this regard, the design of banking policies in 2003 was aimed at enhancing the foundations and environment for the banking institutions to efficiently deliver quality products and services, encouraging greater innovation and maintaining financial stability. An important strategy was to ensure that the banking system continued to be a facilitator of growth, particularly in providing financing and other ancillary services to the small and medium enterprises (SMEs).

### Progress of Financial Sector Restructuring

The financial sector restructuring that started during the Asian financial crisis is virtually completed. Following the closure of Corporate Debt Restructuring Committee in August 2002, another important landmark in the financial sector restructuring process in 2003 was the winding-down of the operations of Danamodal Nasional Berhad on 31 December 2003, five years after its establishment in 1998. During its operations, Danamodal injected a total of RM7.6 billion into 10 banking institutions affected by the Asian financial crisis, significantly lower than the initial budget allocation of RM16 billion. Danamodal has recovered RM6.6 billion of the capital investment, while the remaining RM1 billion capital in one institution is expected to be fully divested in 2004. Prior to the winding-down,

The design of banking policies in 2003 was aimed at enhancing the foundations and environment of the banking institutions to efficiently deliver quality products and services, encouraging greater innovation and maintaining financial stability.

**Table 4.5**
**Danaharta: Loan Recovery as at 31 December 2003**

| | Adjusted loan rights acquired[1] (RM billion) | | Expected recovery rate (%) | |
|---|---|---|---|---|
| | Acquired NPLs | Managed NPLs | Acquired NPLs | Managed NPLs |
| Plain loan restructuring | 2.2 | 5.5 | 62 | 87 |
| Settlement | 2.7 | 6.7 | 89 | 78 |
| Schemes of arrangement | 2.9 | 6.9 | 66 | 77 |
| Schemes under Special Administrators | 2.5 | 2.9 | 51 | 35 |
| Foreclosure | 9.9 | 4.5 | 28 | 46 |
| Others | 1.7 | 3.0 | 60 | 53 |
| Legal action | 0.2 | 1.0 | - | - |
| **Total** | **21.9** | **30.5** | **49** | **66** |
| **Overall** | **52.4** | | **58** | |

[1] Comprising total loan rights acquired of RM47.7 billion and accrued interest of RM4.7 billion.
Note: Total may not add-up due to rounding.

Source: Pengurusan Danaharta Nasional Berhad.

Danamodal had redeemed its entire RM11 billion 5-year zero-coupon unsecured redeemable bonds on 21 October 2003. As at end-2003, Danamodal had remaining assets of RM2.2 billion.

The timely establishment of Danamodal ensured the success of the overall resolution of banking sector problems arising from the Asian financial crisis. The funds injected by Danamodal helped to increase the capital of weak but viable banking institutions. With the improved capital position, coupled with operational restructuring, these institutions were able to resume their lending activities. Danamodal's early action and strict adherence to the "first-loss" principle where the existing shareholders absorbed all the losses before the recapitalisation, has kept the total cost of recapitalisation low, at approximately 0.2% of GDP.

Danaharta, which completed acquiring non-performing loans (NPLs) from the financial sector in 2001, has made significant progress in its recovery operations. Of the RM52.4 billion adjusted loan rights acquired in its portfolio, Danaharta expects to recover RM30.6 billion over its lifespan, which translates into an overall expected recovery rate of 58%. As at end-2003, RM22.4 billion or approximately 73% has been collected, of which RM19 billion has been converted into cash, whilst the rest are still in the form of non-cash assets, namely restructured loans, securities and properties. The remaining expected recoveries totalling RM8.2 billion is still pending implementation of the respective recovery strategies. In 2003, Danaharta has cumulatively distributed recoveries amounting to RM13.4 billion in cash and 66,472,441 units of securities to the Government and 36 financial institutions. The distribution to the financial institutions is done in respect of the 80:20 surplus recovery sharing agreement between the financial institutions and Danaharta.

Given the progress of its operations and the commendable recovery rate achieved, Danaharta has paid in full, its RM1.3 billion loans from Khazanah Nasional Berhad and Employees' Provident Fund by June 2003, earlier than scheduled. In addition, Danaharta has also successfully redeemed the first two tranches of zero-coupon bonds with a total face value of RM2.6 billion on 31 December 2003. The remaining 13 tranches, with a total face value of RM8.5 billion, would be maturing in every subsequent quarter up to 31 March 2005. As at end-2003, Danaharta has cash and cash equivalents amounting to RM5.9 billion. With its existing financial position and the remaining assets to be recovered, Danaharta is in the position to redeem its remaining bonds of RM8.5 billion without having to call upon the Government guarantee.

### Thrust of Policy Measures in 2003

The main thrust of policy measures in 2003 was the continuation of efforts to strengthen the capability and capacity of domestic banking institutions. In particular, efforts to enhance the efficiency and competitiveness of domestic banking institutions were further intensified during the year, with particular focus on harnessing human capital in the banking institutions. These initiatives were complemented by measures taken to safeguard financial stability.

Given the importance of financing in ensuring sustainable and balanced economic growth, the thrust of policy in 2003 was also to ensure that all sectors of the economy had adequate and continued access to financing. Towards this end, policies were directed at facilitating access to credit by developing the financial infrastructure to meet the financing needs of various sectors of the economy, particularly the SMEs which are important in generating domestic investment and growth. In addition, a microfinancing programme with an extensive outreach was established during the year for microenterprises.

The growing sophistication of the financial markets and products requires consumers to have greater awareness and understanding of banking products and services, so that they can make well-informed financial decisions. In this regard, the framework for consumer awareness and protection was further strengthened in 2003. The work on this area is aimed at laying the foundation for a more competitive operating environment and where banking consumers will be able to make well-informed decisions and be fully responsible for their decisions.

**Enhancing Domestic Capacity**

In a more competitive environment, domestic banking institutions need to be aware and understand the drivers of performance to meet consumer demands in an effective and efficient manner. More importantly, the banking institutions need to be in a position to provide high quality services at competitive prices to benefit the overall economy. Against these objectives, Bank Negara Malaysia continued to accord priority towards strengthening the capability of domestic banking institutions as well as improving the efficiency of the overall banking system. After three years, the capacity building efforts is showing positive results, with the domestic banking institutions improving not only their financial performance but equally important, their quality of services and product innovativeness as well as increasing usage of technology in delivering products and managing risks.

To gauge the level of service quality of the banking institutions, Bank Negara Malaysia implemented a 4-year programme to assess the requirements, expectations and satisfaction level of consumers on the quality of the products and services provided by banking institutions and insurance companies. As part of the programme, a nationwide survey was conducted in 2003 involving 5,000 banking and insurance customers, comprising individuals, SMEs, large corporations and multinationals. The survey covers various aspects of banking products and services, both conventional and Islamic banking, as well as insurance and takaful products and services. The analysis of the survey result will provide a snapshot of the current level of customers' needs and satisfaction, and highlight the areas for improvement to enhance the level of customer service in the banking and insurance sectors.

The domestic banking groups are also concentrating on maximising the benefits of consolidation, particularly through rationalising and streamlining their internal operations and improving operational efficiency. This had led to the offering of a broader range of financial products and services to meet various customer needs under one roof. Towards this end, an important policy initiative in 2003 was the amendment to the Banking and Financial Institutions Act 1989 to allow the merger of commercial bank and finance company within a domestic banking group into a single legal entity. This single entity will hold two licences, one to carry on banking business and the other to carry on finance company business. This change in the legal framework provides an opportunity for the banking groups to further improve their group structure and rationalise their operations, and thus enhancing their efficiency.

As a service provider, the banking institutions rely significantly on human intellectual capital. At the top level of the management, highly skilled senior managers are vital to drive the strategic direction and position the banking institutions to maximise opportunities presented by the continuously evolving financial landscape. At the same time, staff with appropriate skills at all levels of the institution is necessary to implement the business strategies as well as realise the improvements in business processes and systems. As the business environment and consumer demands are constantly evolving, continuous upgrading of skills of staff is necessary. Recognising this, Bank Negara Malaysia initiated two important measures to provide avenues for continuous learning for the banking institutions to utilise in order to strengthen the competency of their staff. The establishment of the International Centre for Leadership in Finance (ICLIF) was aimed at achieving this objective, to accelerate the development of skilled leaders of financial institutions and corporations. Towards this end, ICLIF is working with renowned international business schools and leading institutions to provide executive management programmes tailored to developing leadership capability and leaders in the financial services sector.

Equally important is the need to provide an avenue for the other levels of staff in the banking institutions to continuously upgrade their skills and expertise in the face of evolving financial market conditions. Increasingly, staff in banking institutions need to possess specialised skills, particularly in the areas of risk management, credit assessment and system development. Towards this end, work has been initiated to reposition the Institut Bank-Bank Malaysia (IBBM) to continuously meet the learning needs of the middle managers, executives and non-executives of banking institutions. In addition,

**The International Centre For Leadership In Finance**

The financial sector has a vital role in promoting growth and economic transformation towards a more diversified economic structure. These aspirations on the financial sector formed the main thrusts of the Financial Sector Masterplan (FSMP), a ten-year plan that was launched in 2001 to develop a more resilient, competitive and dynamic financial sector with best practices that supports and contributes positively to the growth of the economy. In the first phase of the FSMP, efforts are focused on enhancing the capability and capacity of the domestic financial institutions to face the challenges in the changing and more demanding economic and financial environment. This is vital in ensuring that the domestic financial institutions become more innovative, technology-driven and strategically more focused, and able to compete effectively and efficiently, thereby remaining relevant and meeting the changing needs of the economy.

As the financial services sector becomes increasingly more complex and competitive, financial institutions need to make the necessary adjustments to become more productive and innovative in order to meet the greater demands from businesses and individuals and remain competitive. In this respect, the quality of human resource and leadership capability in the financial sector becomes increasingly crucial in defining the success of the institutions. The training needs of middle management and staff of financial institutions are well served by learning institutions such as Institut Bank-Bank Malaysia (IBBM) and Malaysian Insurance Institute (MII). To complement this, there is a critical need for avenues for leaders and senior management of financial institutions to pursue continuous training, particularly in strategic and leadership management, and thereby drive the strategic direction of the institutions and transform the institutions into high-performing organisations. For this, requisite leadership skills for the changed environment require continuous learning. This includes having the ability to create a culture of high performance within the organisation to drive the institution towards excellence and contribute towards the long-term growth of the institution and the financial sector as a whole. The leadership needs to be able to identify and capitalise on new emerging opportunities so that they can adapt rapidly to changes and maximise on the opportunities presented by the changing environment. This was the motivation for developing the infrastructure for high-level training for top management of organisations to create a high quality human resource pool of top management for the financial sector and corporations.

Bank Negara Malaysia established the International Centre for Leadership in Finance (ICLIF) with the objective of providing a focused and coordinated approach towards the development of world class leaders in the financial and business sectors in Malaysia and the region. ICLIF was officially launched on 28 October 2003 and is established as a company limited by guarantee with a trust fund of RM500 million (USD132 million), whereby the income generated from the fund will be utilised to finance the operations of ICLIF. The establishment of ICLIF represents one of Bank Negara Malaysia's contributions in providing an avenue for top management of financial institutions and corporations to seek continuous learning whilst having the opportunity to network, participate in shared learning experiences and able to form strong alumni contacts. In this connection, the mandate for ICLIF is to develop excellence in leaders with regional insights by providing learning opportunities and experience through effective development programmes. ICLIF also strives to serve the needs of the financial institutions in the region and thus, complements efforts in promoting Malaysia as a regional training centre of excellence for the financial services sector.

As ICLIF aims to accelerate the development of intellectual capital and managerial capabilities of senior management of financial institutions and corporations, it adopts a multi-disciplinary approach and offers programmes on strategic management as well as those that are relevant across the whole spectrum of the financial services industry, covering banking, insurance and Islamic financial industry. ICLIF aims to take a proactive approach in identifying the needs of the industry, which then serve as input in designing the programmes. ICLIF's planned programmes are divided into three broad categories:

- Structured executive management programmes, in the areas of strategic management, customer and marketing management, people management, business technology and knowledge management, and risk management;
- Seminars and workshops on topical issues, as well as providing a platform for the top management of financial industry and corporations, regulators and academicians to discuss current economic and financial issues; and
- Specialised programmes in Islamic financial services and other specialist areas.

A distinctive feature of ICLIF is the strategic alliances it has formed with renowned international business schools and learning institutions to provide programmes that are adapted to the regional context and to the needs of the financial industry and corporations. Through these partnerships, ICLIF has entered into arrangements with a number of international business schools to design and deliver structured executive management programmes at ICLIF. The strategic partners provide the resource persons for the programmes while ICLIF provides the necessary infrastructure and facilities. This approach will enable the participants to have access to high quality management programmes at reasonable cost and thereby provide greater opportunities for the leaders from the financial and corporate sectors to benefit from world-class knowledge sharing and networking.

As part of achieving these objectives, ICLIF has developed a unique leadership competency model to analyse and understand competencies that are necessary towards the development of excellent corporate leaders in the regional context. These skills and behaviours will form the foundation in the design and delivery of ICLIF's leadership development learning programmes. One of these programmes is the Global Leadership Development Program (GLDP), which is ICLIF's flagship programme. The GLDP represents ground-breaking design in terms of an executive education programme by drawing faculty from leading learning institutions and consultants, which enables ICLIF to combine the best ideas and thoughts on the various key leadership issues and concerns. These participating institutions and consultants are the Peter F. Drucker Graduate School of Management-Claremont Graduate University, Marshall School of Business-University of Southern California, Stanford Graduate School of Business and Tower Perrins. The GLDP primarily focuses efforts on developing the best leaders across industries by combining an optimal mix of theory and practical application in its leadership development techniques. The programme also provides an opportunity for the participants to strengthen their networking circle and participate in shared learning experiences and discussions with leaders of other organisations. The GLDP will be held twice a year and comprise three parts, with Part 1 and 2 conducted in Malaysia while Part 3 comprises a focused two-week study programme to the United States of America to provide a unique experience for the participants to be exposed to the best learning institutions and corporate organisations in the United States of America. The first GLDP was held from 9 to 13 February 2004 and attended by 20 top management of financial institutions and corporations in Malaysia and from the region.

ICLIF is governed by its own Board of Directors, with the Governor of Bank Negara Malaysia as its Chairman. In addition to the Board of Directors, ICLIF also has an Advisory Council, comprising eminent persons from Malaysia and abroad, to provide strategic direction on training matters and the development of high quality programmes. It evaluates the learning needs of the financial services and corporate sectors in the region in developing programmes that meet the objectives of ICLIF.

The establishment of ICLIF aims to reinforce the notion that investments in human capital, including the pursuit of leadership excellence, is a continuing process in this ever-changing environment. ICLIF will therefore be focused on making positive contributions towards developing excellent leaders and become a regional centre of excellence for leadership training in finance.

IBBM, as a training provider, aims to complement professional institutes, universities and management consultancy firms. Thus, to remain effective as a premier training provider for the financial sector, IBBM is giving priority to two broad areas, namely provision of focused training and accreditation, particularly in the specialised areas, and to act as an effective training adviser to the banking institutions. To achieve this objective, IBBM has developed several broad strategies, which include building a new education and qualification portfolio, improving the institutional structure to support future requirements and building capacity to deliver specialised courses.

Another initiative pursued to strengthen the banking institutions is the setting up of investment banks. Policy proposals have been developed with a view to place the new institutions in a stronger and more competitive position vis-à-vis the regional and global players. At the same time, a prudential regulatory framework is being formulated, taking into consideration existing regulations, the different nature of the new institution and international regulatory frameworks for comparable institutions. This includes the envisaged structure for the investment banks and their permissible activities. Central to this is defining the appropriate capital and liquidity frameworks that seek to converge the manner in which risks are measured under the existing frameworks. The capital and liquidity frameworks are being formulated to best reflect the nature of risks to be undertaken by the new institution in order to give a fair representation of the solvency position and risks undertaken by investment banks.

**Ensuring Continuous Access to Financing**

With policy priority being accorded to generate domestic sources of economic growth, access to financing is critical to promote and sustain both private consumption and investment. As the banking system remains the largest provider of funds in the economy, policy initiatives during the year were directed at ensuring that the lending activities of the banking system were supportive of economic growth as well as facilitating access to financing to all sectors of the economy. Indeed, the increased demand for loans from both the household and businesses, driven by the low interest rate environment and improved economic outlook, was effectively met by the banking institutions.

There has been a marked shift in the lending pattern of the banking institutions to the household sector and small businesses. The share of loans to the household sector has increased from 33.4% at end-1997 to 48.7% at end-2003. This shift in lending pattern has supported the growth in private consumption and has positive spillover effect on the other sectors of the economy. From the financial stability perspective, the shift towards high-volume low-value loans also diversifies the distribution of credit risks within the banking system, minimising the potential occurrence of large losses stemming from the failures of a few large borrowers. At the same time, Bank Negara Malaysia is mindful that a continuous build up in household debts that is not accompanied with an increase in the level of household income could affect the sustainability of the debt servicing capacity of the household sector with destabilising effects on the banking system. Bank Negara Malaysia has in place a surveillance mechanism to monitor the banking system's exposure to the household sector and the debt servicing capacity of the household sector. The exposure to the household sector has thus far remained within prudential levels. With rising income levels, the household sector in Malaysia has continued to accumulate net financial savings, as reflected in higher accumulation of deposits against debt accumulation. In addition, while the level of NPLs for the household sector has increased, the NPL ratio has remained at manageable levels. Equally important is the ability of the banking institutions to manage these risks. Since the crisis, the banking institutions have enhanced their risk management infrastructure and capabilities to better cope with the changing risk profile of their assets. This was further reinforced with the availability of complete positive and negative credit information of all borrowers in the banking system on a real time basis provided by the Central Credit Reference Information System.

In line with the policy priority of strengthening the support to SMEs to promote endogenous sources of growth, particular attention was directed at providing improved access to financing by SMEs.

To promote endogenous sources of growth, attention was directed at providing improved access to financing by SMEs.

Although the Government, through various ministries and agencies, have established various financing schemes, it was evident that the awareness among SMEs of these schemes was low. To address this, Bank Negara Malaysia established the SME Special Unit in May 2003 to assist SMEs to obtain information on the various financing schemes available to them and to provide financial advisory services. In addition, the SME Special Unit also assists in facilitating SMEs in their loan application process. As at end-2003, the Unit has received 1,789 enquiries from SMEs, of which 82% were enquiries on sources of financing, whilst the remainder was related to problems on access to financing and requests for loan restructuring. While the Unit strives to assist viable SMEs, SMEs themselves need to ensure satisfactory financial records are maintained to facilitate the process.

One of the problems faced by SMEs is the existing NPLs, which constrained their ability to obtain new loans despite having on-going and viable businesses. Bank Negara Malaysia has, therefore, established a small debt resolution mechanism in October 2003 to support viable SMEs that are constrained by NPLs by facilitating loan restructuring with their banks. A Small Debt Resolution Committee (SDRC) has been established to undertake independent assessments on the viability of the businesses, and propose the loan restructuring and assess new financing requirements of the affected SMEs. This mechanism is open to SMEs with on-going businesses that have aggregate NPLs of not more than RM3 million. As the debt restructuring may involve new financing, Bank Negara Malaysia has established the Rehabilitation Fund for Small Businesses with an allocation of RM800 million.

As part of the efforts to enhance access to financing, the Fund for Small and Medium Industries 2 (FSMI2) and the New Entrepreneurs Fund 2 (NEF2) were increased further. In 2003, Bank Negara Malaysia provided additional allocations of RM1.35 billion for FSMI2 and RM650 million for NEF2. Consequently, the total allocation of these two Funds increased to RM2 billion and RM1.15 billion respectively. Apart from setting up special funds, Bank Negara Malaysia also required the banking institutions to set their lending targets to SMEs. Where the individual institutions' targets were deemed insufficient, appropriate targets were imposed.

In addition, banking institutions have also undertaken various initiatives to support SMEs in obtaining financing. These initiatives include the establishment of dedicated SME units, provision of financial advisory services and display of client charters. The display of the client charter by all banking institutions enhances the efficiency of loan approval process by disclosing the necessary documentation for submission to the banking institution to support the loan applications, eligibility criteria, definition of project viability, and duration taken by a banking institution to process the loan application. Banking institutions are also required to inform applicants of reasons for their loans being rejected. Bank Negara Malaysia monitors the compliance of the client charter through the on-site inspection process.

The unexpected outbreak of Severe Acute Respiratory Syndrome (SARS) in early 2003 had adversely affected the tourism and other related sectors. Two specific measures were introduced to provide relief to ease the financial burden of affected businesses and their employees. A Special Relief Guarantee Facility of RM1 billion was established in May 2003 to alleviate the cash flow problems faced by businesses directly affected by the SARS outbreak. Under the scheme, affected businesses could obtain working capital loans from banking institutions, up to an aggregate amount of RM2.5 million, at low interest rates. In addition, this was reinforced by the guarantee facility of up to 80% of these loans by the Credit Guarantee Corporation Malaysia Berhad. Banking institutions also provided financial relief to borrowers in the SARS-affected industries by restructuring or rescheduling loans for all types of borrowings and credit facilities. In the case of employees whose remuneration were reduced by their employers, banking institutions extended similar financial relief on the housing loans taken by the employees.

A significant initiative undertaken in 2003 was the strengthening of the existing infrastructure and institutional arrangements to extend the outreach of financial services to microenterprises. In February 2003, Bank Negara Malaysia proposed to leverage on the extensive branch network of Bank Simpanan Nasional and Bank Pertanian Malaysia to provide microfinancing. To equip these development financial institutions with the necessary best practices and skills to provide microfinancing, initiatives were undertaken to develop microfinance products, operating manuals and systems as well as training programmes for loan officers and branch managers. Meanwhile, to promote microcredit, the Government allocated RM1 billion, channelled through Bank Pertanian Malaysia (RM500 million), Bank Simpanan Nasional (RM300 million) and Amanah Ikhtiar Malaysia (RM200 million). Due to the encouraging response from microenterprises, the Government announced in the 2004 Budget an additional allocation of RM1 billion to Bank Pertanian Malaysia and Bank Simpanan Nasional to finance microenterprise activities. Bank Negara Malaysia is also working with the Ministry of Land and Cooperative Development and Department of Cooperative Development to strengthen the cooperative movement as a potential source of financing for microenterprises and low-income groups. Efforts are underway to enhance the infrastructure and regulatory and supervisory frameworks to achieve this objective.

**Promoting Active Consumerism**

A vital aspect in the transition towards greater market orientation is promoting active consumerism. Consumers can be an important force to drive the performance and efficiency of the banking institutions. Towards this, consumers need to be well informed of the different products and services offered, and their rights and responsibilities. There must also be an effective avenue for consumers to seek protection and redress. Efforts during the year continued to focus on increasing consumer awareness and further strengthening the consumer protection infrastructure, including ensuring accessibility to affordable banking services.

for their decisions. However, this does not absolve the banking institutions from their responsibilities to ensure that their products deliver what is promised and that customers will obtain fair value for their money.

The Consumer Education Programme, which has now entered into its second year of implementation, has received encouraging response from the public. As at end-2003, the BankingInfo website has received 6.4 million hits and 1.2 million booklets have been taken up by the public. During the year, another six booklets were published, bringing the total number of consumer booklets published to 18. Two of the new booklets aim to provide information to assist SMEs in preparing loan applications as well as the different types of financing products available. The other new booklets provide information on the role and responsibilities of guarantors, the Credit Guarantee Corporation Malaysia Berhad, house financing-i and charge cards.

Bank Negara Malaysia is also finalising the product transparency and disclosure rules. The objective of such rules is to provide comprehensive, clear and fair information about the risks and liabilities of financial products and services to consumers to facilitate informed decisions. The disclosure standards focuses on four main items deemed most essential for making informed decisions, namely the form and timing of disclosure, items to be disclosed and disclosure requirements in advertisements. To facilitate and reduce the cost of information search by consumers, Bank Negara Malaysia is also developing "Comparative Tables" on the yield and cost of financial products and services offered by the banking institutions. These tables would serve as a one-stop reference centre for information on the costs and features of financial products and services offered. Initially, the focus will be on developing comparative tables on the commonly offered deposit and credit products.

Efforts continued to focus on increasing consumer awareness and strengthening the consumer protection infrastructure, including ensuring accessibility to affordable banking services.

As outlined in the Financial Sector Masterplan, an effective consumer education and protection framework is being developed to set the foundation for an environment where ultimately, banking consumers will need to take greater responsibility for their financial decisions. Once the relevant information and risks have been appropriately disclosed and explained, consumers must be actively involved in comparing, examining and deciding on investments or purchases to be made, and assume responsibility

As consumers become more discerning, competition will drive banking institutions to increasingly offer greater product differentiation and value added services to gain competitive advantage. Banking institutions are increasingly leveraging on advances in technology to introduce and market new products, services as well as new delivery channels. This dynamic environment will see the introduction of an increasingly broader array of financial products and services to consumers. However, as these innovations require substantial investments, costs of the more sophisticated products and services will result in fees and charges. While this development may be inevitable, attention has been given to ensure that the public has access to basic banking services at minimal cost while the more complex and sophisticated products and services reflect their appropriate costs. This is to ensure appropriate pricing of banking services. In achieving this objective, a balance is made between providing an operating environment that promotes innovation while also taking into account consumer interests. Therefore, while Bank Negara Malaysia is committed to a market driven approach to pricing, this will be undertaken under an environment where the interests of consumers are also protected.

In this connection, Bank Negara Malaysia has initiated work on establishing a framework on basic banking services, which aims to ensure that the banking public, especially the low-income group, would have access to affordable basic banking services. Under this framework, all banking institutions would be required to offer a basic bank account that would provide a prescribed minimum level of services and transactions to all Malaysians at minimal cost. The basic banking services framework is being finalised for implementation in 2004.

Attention has also been directed at enhancing dispute resolution mechanisms for consumers to seek redress. Towards this end, Bank Negara Malaysia has finalised the structure and operating framework of the new Financial Mediation Bureau (FMB), which will commence operations in the first half of 2004. This new entity will function as a one-stop centre for the resolution of a broad range of retail consumer issues raised against the financial institutions that are regulated by Bank Negara Malaysia. The enlarged scope of FMB will provide the public with a prompt and more effective resolution mechanism. In addition, regional offices of FMB will be set up to enhance access to its services nationwide. The expanded scope of operations of the new bureau and the increased maximum quantum of claim awards are illustrated in the following table:

| **Elements** | **Banking sector** | **Insurance sector** |
|---|---|---|
| Limit | Losses suffered not exceeding RM100,000 | Claims not exceeding:<br>• RM200,000 (motor and fire insurance);<br>• RM100,000 (others); and<br>• RM5,000 (3rd party property damage) |
| Nature of dispute | All retail banking complaints except those involving policies, credit decisions, quality of service and cases that have been or are referred to court. This would include complaints on the following:<br>• Personal Loans<br>• Housing Loans<br>• Automatic Teller Machine<br>• Credit Card<br>• Hire Purchase<br>• Savings Account<br>• Current Account<br>• Fixed Deposits<br>• Remittances | All disputes between policyholders/ claimants and their own or third party insurers except those involving pricing of insurance product and underwriting issues, fraud cases and cases that have been or are referred to court. |

## Maintaining Financial Stability

The increasingly complex and dynamic financial activities demand continuous enhancements to the regulatory and supervisory frameworks to maintain financial stability. The soundness of the banking system is important to safeguard the interest of depositors and ensure that the banking system is strong and well capitalised to support the growth process through robust lending activities. In this regard, due attention continues to be given to enhance prudential regulations, to ensure that the regulations are relevant in the face of rapid change in the financial markets. At the same time, Bank Negara Malaysia is mindful of the need to ensure that new regulations would not stifle innovation and competition amongst players in the financial market.

To further strengthen the regulatory framework, the Central Bank of Malaysia Act 1958, the Banking and Financial Institutions Act 1989, the Islamic Banking Act 1983 and the Takaful Act 1984 were amended in 2003. A new Payment Systems Act 2003 was also enacted during the year to provide for a comprehensive legal framework to ensure that the payment systems are protected from disruptions that may affect financial stability, and that public confidence in the payment systems and instruments is preserved.

Among the key amendments under the Central Bank of Malaysia (Amendment) Act 2003 are:

- The enhancement of the regulatory and supervisory framework for the over-the-counter Ringgit bond market. This enables Bank Negara Malaysia to carry out its functions in providing infrastructure for the Ringgit bond market, which includes the power to issue regulations necessary for the regulation and operation of the systems for the debt securities market;
- The provision for Bank Negara Malaysia to promote reliable, efficient and smooth operation of national payment systems and payment instruments. This is consequential to the enactment of the Payment Systems Act 2003, which provide the regulatory powers of Bank Negara Malaysia over the designated payment systems and payment instruments; and
- The enhancement of the Shariah Advisory Council of Bank Negara Malaysia *[Please refer to Islamic banking section for details]*.

Corporate governance practices in the banking institutions were also enhanced during the year. Good corporate governance reinforces sound regulation and supervision. In most instances, corporate governance forms the first line of defence against any crisis. For corporate governance to work, good corporate practices need to be instilled and embedded in all aspects of the operations and at all levels within the organisation. Sound corporate governance would lead to greater responsibility and accountability of the board and senior management of the banking institutions. Therefore, the banking institutions need to be headed by an effective board with sufficient skills and a high degree of professionalism. To help achieve this, Bank Negara Malaysia issued in May 2003 the Guidelines on the Establishment of Board Committees, Minimum Qualification and Training Requirement for Directors, and Definition and Responsibilities of Independent Directors. The Guidelines set the requirements on the establishment of three board committees, namely the nominating committee, remuneration committee and risk management committee, and the terms of reference of each of the committee.

The nominating committee is responsible to ensure that only the most competent individuals who can contribute and discharge their responsibilities are appointed to the board and key management position. Among others, the committee is required to provide a formal and transparent procedure for the appointment of directors and chief executive officer, and a mechanism to assess the effectiveness of individual directors, the board, chief executive officer and senior management officers. The remuneration committee oversees the remuneration matters of directors and senior management officers. The committee is responsible for recommending the remuneration framework for directors, chief executive officer and senior management officers. It should ensure that the remuneration framework of the institution is competitive and consistent with the institution's culture, objectives and strategy, and reflects the responsibilities of board members, chief executive officer and senior management officers. The risk management committee is responsible for overseeing senior management's activities in managing credit, liquidity, operational, legal and other risks, and ensuring that the risk management infrastructure and process is in place and functioning.

Given the increased complexity of banking businesses and the heavy responsibilities of the board of directors, directors need to have the necessary qualifications and experience to effectively discharge their duties. In this regard, the Guidelines also focus on the required skills and experience for this purpose. In addition, recognising the critical role of independent directors in spearheading corporate governance and upholding independence of the board, the Guidelines also set out the definition of independent directors, and their expected roles and responsibilities. As their primary responsibility is to protect the interest of minority shareholders and the general public, independent directors are expected to provide effective oversight and ensure a strong independent element on the board. To complement these measures, the Guidelines on the Appointment of External Auditor by banking institutions was issued in August 2003 to mitigate potential conflicts of interest arising from the long-term relationship with an external auditor.

The increasingly complex group structures involving financial conglomerates has called for the development of a comprehensive regulatory and supervisory framework for financial conglomerates. The objective of the framework is to ensure that the financial health of the financial groups can be adequately assessed and monitored by supervisors. Regulation is, therefore, to balance between allowing group synergy and efficiency, and ensuring that the activities of the financial conglomerates do not introduce excessive risks to the financial system. Towards this end, a concept paper on the Consolidated Supervision of Financial Conglomerates was issued in December 2003 with the aim of formalising and strengthening the existing infrastructure and regulatory framework for financial conglomerates. Given the diverse risks associated with the different activities undertaken by the different entities within the financial conglomerates, the proposed framework does not prescribe common prudential requirements for all entities within the financial conglomerate. Instead, the framework emphasises on developing prudential guidelines and principles to ensure that the financial holding companies are financially strong and able to lend support to its subsidiaries.

The framework focuses on five main areas, namely group structures, corporate governance, risk management, intra-group exposures and reporting requirements. On group structures, the framework outlines the main principles that would form the basis for financial groups to determine their optimum group structure, both from a commercial as well as regulatory perspective. While it is recognised that the financial groups would organise their group structures according to their strategies and market niches, sufficient safeguards need to be in place to ensure that the group structure does not pose systemic risk to the banking system. In particular, regulation is required to ensure minimal transmission of financial distress from unregulated entities to the regulated entities within the group, which could destabilise the banking system. In addition, there is a need to ensure that the obligation of the Government in assuring the safety of deposits would not be extended to other non-depository institutions within the group. The framework also establishes basic principles of good corporate governance, which focuses on the processes and structures used to manage the business and affairs of a financial holding company (FHC) and its related entities, placing greater emphasis on the roles and responsibilities of the board of directors and management of the FHC.

As the FHC is expected to provide financial support to all entities within the group, the framework also sets out the capital adequacy requirements for the group. In assessing financial strength of the conglomerate, Bank Negara Malaysia will focus on the capital adequacy of the individual banking institutions on an individual and consolidated basis (if the institution has subsidiaries), as well as on the capital adequacy at the group and holding company level. On risk management, the framework requires the board of the FHC to establish a Group Risk Management Committee to oversee the overall management of the group's risks, review the senior management's control and procedures in managing these risks, as well as ensuring that remedial actions are taken. To ensure that all potential sources of contagion risks, other than cross-selling, are identified and addressed promptly, the framework also requires that written policies on intra-group exposures be incorporated into the risk management at group level. Subsequently, the FHC is required to submit periodic reports to Bank Negara Malaysia to facilitate the continuous assessment of the financial conglomerate.

Bank Negara Malaysia is also reviewing the current Guidelines on the Credit Limit to a Single Customer (GP5) to expand the coverage of exposures to a single customer to include exposures other than credit facilities. This exposure would include amongst others, exposures to holdings of shares and debt securities, and off-balance sheet items. This revision would also entail the streamlining of several existing regulations pertaining to exposures to large customers into a single comprehensive guideline for easy compliance and reference by banking institutions.

As banking institutions make greater use of sophisticated financial instruments, they are increasingly exposed to higher market risk. In this regard, a concept paper on the Incorporation of Market Risk into the Risk Weighted Capital Ratio (RWCR) was issued in mid-2003 to principally assess the impact of incorporating market risk into the RWCR. The study indicated that the RWCR of the banking system would decline marginally by 0.12 percentage points, with all banking institutions maintaining a RWCR of more than 8%. Among the banking institutions, merchant banks exhibited the largest decline in their RWCR primarily due to their principal activities in the capital market. Following a series of discussions with the Market Risk Industry Working Group, the framework was further refined and the second concept paper was issued in January 2004. Among the significant changes made to the framework include the definition of trading and banking books, treatment on holdings of securities resulting from debt/loan restructuring, and valuation of illiquid papers. Banking institutions are required to assess the quantitative impact of the revised framework by February 2004.

The market surveillance also detected incidences of unhealthy trading practices in the domestic bond market. To preserve market integrity, banking institutions were reminded to tighten their risk management practices. The lack of transparency and information gap in the over-the-counter bond market is one of the factors that contributed to the occurrence of irregular trading. To address the information gap and lack of transparency, Bank Negara Malaysia is working with the Securities Commission to enhance the infrastructural development of the bond market. These measures include electronic trading platform to improve price discovery mechanism and the automation and integration of trade-related processes to allow for further improvements in operational efficiency.

On the international front, work on the New Basel Capital Accord or Basel II continued to be the focus of the Bank for International Settlements (BIS). Following the issuance of the second consultative paper in January 2001 and after consultation with the global financial industry, BIS issued the third consultative paper (CP3) in April 2003. Among the main changes in CP3 include a lower risk-weight for residential mortgages, recognition of "past due" loans with significant levels of provisioning, the introduction of an alternative "Standardised" approach for operational risk at supervisory discretion, and fine-tuning some of the elements of the Internal Ratings Based (IRB) approach. Before issuing CP3, the BIS conducted the third quantitative impact study (QIS3) in October 2002 to gauge the impact of Basel II proposals on minimum capital requirements. The results of QIS3, which was released in May 2003, showed marginal increase in credit risk capital requirements relative to the current Accord for banking institutions adopting the "Standardised" approach, while for banking institutions adopting the IRB approaches, substantial reductions in credit risk capital requirements were reported. However, the new operational risk capital requirement more than outweighed the reduction in credit risk capital requirements, resulting in an overall increase in capital for banking institutions adopting the "Standardised" approach. In comparison, the minimum capital requirements of banking institutions intending to adopt the more sophisticated IRB approach were broadly unchanged. The new rules are expected to be finalised by mid-2004.

Bank Negara Malaysia has conducted a preliminary impact study in October 2002 to ascertain the impact of Basel II on the local banking industry using the "Standardised" approach. The results of the impact study indicated that, using the "Standardised" approach, the RWCR of the banking system would decline marginally, but still well above the 8% regulatory requirement. The decline in RWCR was mainly due to the new operational risk capital requirements, which more than offset the increase in the RWCR due to credit risk capital requirements. In addition, the preliminary survey findings indicated that unrated corporate loans and past due loans contributed to the increase in risk-weighted assets.

In tandem with this impact study, a study was also undertaken to determine the readiness of domestic banking institutions to adopt the IRB approach, which requires banks to use internal ratings to calculate the capital adequacy requirements. The main challenge in the adoption of the IRB approach is the availability of clean or usable data, which is required to meet the minimum historical 5-year data requirement. The task of data collection, cleansing and verification is time-consuming. For some banks, the recently concluded merger and consolidation programme and the impending merger between commercial banks and finance companies may further complicate this task as the 5-year historical data could only be developed post-merger to reflect the current risk profile of the institutions. Data storage will become a major factor under Basel II as banking institutions will require data warehouses with sufficient capacity to cater for the data intensive IRB systems. To facilitate implementation, banking institutions will also be required to invest in staff training to gain the technical expertise to assist with Basel II implementation.

In the case of banking institutions that already have internal ratings systems, the challenge is that the systems are relatively new and the results are untested. Some of the banking institutions are also in the process of upgrading their internal rating systems to be two-dimensional, covering the borrower risk as well as the facility risk. Other expected challenges faced by banking institutions include being able to fully utilise the capital relief gained through credit risk mitigation and risk management techniques under Basel II.

To facilitate the implementation of Basel II in Malaysia, a Basel II Task Force would be formed to promote greater consistency and understanding among banking institutions. The task force, comprising Bank Negara Malaysia officials and resource persons from the banking sector will discuss experiences and build on the best practices and approaches to capital regulation.

**Moving Forward**

Significant progress has been achieved in financial sector restructuring and efforts to strengthen the resilience and capability of the banking system. Meanwhile, the Malaysian economy continues to evolve, with new sources of growth emerging. This, combined with changes in the global financial environment will demand greater efficiency, competitiveness and resilience from the domestic banking sector. Hence, moving forward, the strategies aimed at improving the efficiency of the domestic banking sector while preserving financial stability will continue to be pursued. At the same time, given the important role of the banking sector in promoting sustainable and balanced economic growth, due emphasis will continue to be given to ensure that the banking sector remains supportive of meeting the socio-economic agenda of the country.

## SUPERVISORY ACTIVITIES

The supervisory activities throughout the year 2003 were focused on multi-pronged strategies to further promote the stability of the banking system in tandem with the evolving financial industry and increasing complexities of the financial landscape. These activities involved on-site examination, off-site surveillance, market assessment through formal and informal dialogue sessions with industry players, as well as further strengthening the capacity building and assessment methodologies of the supervisors. The on-site examination and off-site surveillance in supervising banking institutions continued to be premised on the risk-based supervisory approach. The overall thrust of this approach is to identify and assess key risks encountered by banking institutions and their capacity to manage these risks. Based on this assessment, a supervisory plan is formulated for each banking group, so that supervisory resources can be optimally allocated in supervising the institutions, with particular focus on areas of high risk.The financial and operating conditions of all entities within a banking group and activities undertaken by these entities are taken into account to ensure that these do not adversely affect the performance of the banking group concerned and pose a systemic threat to the banking system as a whole.

**The supervisory activities in 2003 were focused on multi-pronged strategies to further promote the stability of the banking system.**

In 2003, Bank Negara Malaysia conducted 93 on-site examinations on banking institutions, including the Islamic banks, as well as development financial institutions. These examinations covered head offices, local and overseas branches, bank holding companies and related companies of banking institutions. The supervisory scope has also included the examination of Islamic banking operations and anti-money laundering measures undertaken by banking institutions. In addition to the enhanced supervisory scope, Bank Negara Malaysia has, in recent years, accorded greater supervisory resources in evaluating banking institutions' market and operational risk management practices, besides credit risk.

To complement the on-site examination of banking institutions, on-going monitoring of the financial health of these institutions was conducted through off-site surveillance. Banking institutions were monitored closely through regular reporting and rigorous financial analysis accompanied by periodic stress testing for the early detection of emerging problems. The off-site surveillance function also included the review and approval of the financial accounts of banking institutions to ascertain compliance with accounting standards and Bank Negara Malaysia regulations, with particular emphasis on the adequacy of provisions for impairment of assets, particularly loans and investments. The off-site surveillance function has been intensified, to include credit and fraud surveillance through electronic information database.

The soundness of banking institutions has been evaluated based on the CAMELS rating framework which encompasses the review of a banking institution's capital adequacy, asset quality, management capability, earnings performance, liquidity and sensitivity to market risk. With the inclusion of the "sensitivity to market risk" component to the CAMELS framework in 2003, the Bank has developed a more structured supervisory framework to assess banking institutions' market risk management processes and modeling techniques. During the year, a measurement tool kit for market risk was developed to enable bank supervisors to validate the market risk models used in banking institutions. An essential element of banking supervision included the supervision of banking groups on a consolidated basis. In this regard, the Bank conducted regular examinations of bank holding companies as well as related non-banking entities within the banking groups. These examinations enabled the Bank to identify sources of vulnerability and assess the strength and ability of the holding company in providing financial support to the banking institutions within the group. It also enabled the Bank to evaluate the potential impact that other non-bank entities within the group may have on the banking institutions' solvency.

In engaging the risk-based supervision approach, Bank Negara Malaysia implemented a structured risk assessment framework to evaluate the risk profile of each banking institution and the adequacy of the institution's risk management processes. While banking institutions have mainly focused on implementing credit and market risk management, they have also been moving towards a fully integrated risk management system, which provides the management with a holistic view of risk management so that interactions amongst risks can be identified and managed more effectively. In this regard, banking institutions have also begun developing a more structured process in managing their operational risk. Given that banking institutions are still in different stages of developing their respective integrated risk management framework, the Bank continues its developmental role in monitoring and evaluating the individual banking institution's progress and plans in this area.

In promoting sound corporate governance in banking institutions, bank supervisors conduct assessments of the corporate governance practices of banking institutions to ensure that these practices are indeed instilled and embedded in all aspects of operations and at every level of the institutions. A major part of this assessment is focused on evaluating the effectiveness of the board of directors who are ultimately responsible for the overall management of the banking institutions. The assessment also provides valuable input for the purpose of approving the appointment and reappointment of directors.

In line with the Financial Sector Masterplan, an Enforcement Actions Framework has been developed to provide a comprehensive and incremental approach towards enforcing actions to be taken following supervisory exercise on banking institutions. The first phase of the framework involving the Informal Enforcement Actions Framework (IEAF), has been implemented since September 2002. The IEAF has facilitated Bank Negara Malaysia in taking pre-emptive measures not only on banking institutions but also on related companies of banking institutions to address emerging weaknesses in a timely and effective manner. The Bank is working on the second phase where a Formal Enforcement Actions Framework (FEAF) is being developed as an extension of the existing informal framework. Actions under the formal framework will be taken for institutions with problems or where informal actions have been unsuccessful in achieving the desired outcome. While the legal framework is already in place, the FEAF will refine the mechanism to make the process more transparent. In addition, in enforcing pre-emptive measures on a problem banking institution, the FEAF will incorporate prompt corrective actions, which will be taken once specified thresholds for supervisory intervention are triggered.

Another important supervisory area that has been given greater emphasis since the enactment of the Anti-Money Laundering Act in 2002, was Bank Negara Malaysia's assessment of anti-money laundering measures taken by banking institutions. The framework that has been put in place focuses on five broad functional areas of an institution's operations, namely quality of board and management oversight, comprehensiveness of policies and procedures, effectiveness of internal controls, adequacy and accuracy of the management information system, as well as, quality of the human resource and availability of training.

As part of the Bank's supervisory activities, regular consultative dialogues are held with the board of directors and management of banking institutions, to provide an effective forum for two-way communication on supervisory issues. Through these interactions, the Bank was better positioned to evaluate the institutions' capacity and readiness to meet impending challenges.

The Bank has also long recognised the importance of maintaining the integrity of Information Technology (IT) infrastructure deployed by the banking institutions, which forms the backbone of all banking operations. In order to promote a safe and sound IT environment in banking institutions, to maintain public confidence and minimise service interruptions, supervisory attention is given to the Information System (IS) functions of these institutions through both the on-site examinations and off-site monitoring mechanisms, that ensure the adoption of best IT practices and compliance with regulations. In the year 2003, the Bank had conducted 18 on-site IS examinations on banking institutions including overseas branches and subsidiaries of domestic banking institutions. This is to ensure relevant controls are in place and appropriate systems are deployed in their operations particularly for high risk banking products and services such as Internet Banking, Mobile Banking, Credit Cards and Automated Teller Machine.

In an effort to improve the IS supervisory function and promote supervisory transparency, the Bank has embarked on several strategic measures in line with international standards to improve the quality and effectiveness of its on-site IS examinations. Firstly, a new IS examination methodology has been developed and will be fully implemented for all on-site IS examinations beginning in 2004. The new methodology provides a more balanced appraisal to enhance the quality and standard of IS examinations. It also employs a structured and guided tool for risk assessment and provides a foundation for IT benchmarking. Secondly, an enhanced version of the examination report has been implemented. The Bank is also developing a new guideline that aims to strengthen the level of IT management in banking institutions, which will be enforced in 2004.

In 2003, Bank Negara Malaysia embarked on upgrading its MS ISO 9002:1994 Quality Management System certification for the planning and monitoring of the performance of routine on-site examinations on banking institutions to MS ISO 9001:2000. The scope of registration for the new standard was expanded to include Malaysian banking institutions' branches and subsidiaries, operating outside Malaysia and the incorporation of new quality standards. The new certification reaffirmed Bank Negara Malaysia's commitment to maintain the highest level of professionalism in undertaking its supervision responsibilities. In addition, the Bank is also in the process of obtaining the MS ISO 9001:2000 certification for its on-site IS examinations on domestic banking institutions.

Recognising the increasing challenges of banking supervision, Bank Negara Malaysia is committed to ensure that the knowledge and skills of bank supervisors are continually enhanced to meet the demands of an increasingly sophisticated financial environment. Besides structured training for bank supervisors, bank supervisors are trained in several specialised key areas of banking supervision such as risk modeling and Syariah principles, to keep abreast with market developments; and function as sources of reference and capacity building for the Bank. These measures have further enhanced the capacity of the Bank to perform its supervisory function in a more effective manner as well as provide value-add recommendations to the banking institutions.

With the rapid changes in the financial environment, particularly with the New Basel Capital Accord, the Bank is faced with increasing supervisory challenges. As a pre-requisite for effective supervision, supervisors are provided with continuous training and exposure to keep pace with the developments taking place globally to ensure that Malaysia is at par with international best practices. In meeting the challenges of the New Accord, bank supervisors are being equipped with the necessary knowledge and skills, particularly in effectively evaluating the more sophisticated methodologies to determine capital requirements. These initiatives range from participation in regional and international training programmes, dialogues with other supervisory agencies and international bodies on implementation issues and discussions with the banking industry to facilitate understanding of their level of readiness towards implementing the requirements of the New Accord.

In 2003, the Bank continued to strengthen its working relationship with other domestic and foreign supervisory agencies to facilitate enhanced co-operation and information exchange. This collaboration process has been very valuable to the Bank in facilitating its efforts to undertake effective consolidated supervision of banking institutions. In this context, Bank Negara Malaysia carried out nine examinations of overseas branches and subsidiaries of domestic banks. The assessment of the financial and general conditions of these entities was discussed with the respective host supervisory agencies to identify any common issues of concern and facilitate their resolution. The Bank also jointly conducted two examinations on offshore subsidiaries of domestic banks with the Labuan Offshore Financial Services Authority (LOFSA).

Bank Negara Malaysia is committed in its role in preserving the safety and soundness of the banking system through effective bank supervision. In the Bank's pursuit towards this objective, efforts will continue to be directed at strengthening our supervisory resources and processes. These efforts include a more intensive training in specialized areas of expertise, developing specialists in core banking operations, closer co-operation with other regulatory and supervisory agencies, and international bodies, as well as automation of work processes to achieve greater efficiency.

**Banking Measures Introduced in 2003**

Measures implemented in 2003 were aimed primarily at enhancing the efficiency, competitiveness and soundness of the financial sector. Initiatives were also taken to improve access of businesses, in particular the small and medium enterprises (SMEs), to financing. Institutional arrangements to strengthen consumer protection and to increase the awareness of consumers were also introduced.

**Measures to Enhance Safety and Soundness**

***Guidelines on the Establishment of Board Committees, Minimum Qualifications and Training Requirements for Directors and Definition and Responsibilities of Independent Directors***
The Guidelines were issued in May 2003 as part of Bank Negara Malaysia's continuous efforts to enhance the corporate governance standards among the licensed institutions. The Guidelines outlined the following:

- The requirement on the establishment of board committees comprising nominating committee, remuneration committee and risk management committee, and the terms of reference for each of the committee. The main objectives of the committees are as follows:
  <u>*Nominating Committee*</u>
  To provide formal and transparent procedures for the appointment of directors and chief executive officer and assessment of effectiveness of individual directors and board as a whole and performance of chief executive officer and key senior management officers.
  <u>*Remuneration Committee*</u>
  To provide formal and transparent procedures for developing remuneration policy for directors, chief executive officer and key senior management officers and ensuring that compensation is competitive and consistent with the licensed institution's culture, objectives and strategy.
  <u>*Risk Management Committee*</u>
  To oversee senior management's activities in managing credit, market, liquidity, operational, legal and other risks and to ensure that the risk management process is in place and functioning effectively.

- To ensure that only qualified individuals are appointed to serve on the boards of licensed institutions, the Guidelines set out the minimum qualifications and continuous learning requirements for the directors.

- Recognising the critical role played by independent directors in corporate governance, the Guidelines also set out the definition of independent directors and their expected roles and responsibilities.

***Auditor's Independence and Appointment of External Auditors***
A number of corporate scandals overseas, which involved irregularities in accounting practices, issues on auditors' independence and the role of auditors, have raised the concerns of various regulators

worldwide. In this regard, Bank Negara Malaysia issued Guidelines on the Appointment of External Auditor by licensed institutions which cover:

- The imposition of mandatory rotation of engagement partner after a period of 5 years. The engagement partner relinquishing the assignment would not be allowed to resume the role of audit engagement partner for the licensed institution until after a period of 5 years has lapsed;
- Provision of non-audit services by the same audit firm would require the prior approval of the respective licensed institution's Audit Committee; and
- The approval for the re-appointment of external auditors by Bank Negara Malaysia on an annual basis. There should not be any compromise on auditor's independence in the interim period before the 5 years rotation requirement takes effect.

***Prudential Standards on Asset-Backed Securitisation***

Although significant benefits could be derived from securitisation activities, participation of banking institutions in securitisation activities could potentially increase the overall risk profile of the institutions. In this regard, Bank Negara Malaysia has issued the Prudential Standards on Asset-Backed Securitisation Transactions which outline the general risk management framework as well as specific regulatory treatment relating to asset-backed securitisation transactions undertaken by banking institutions. The Prudential Standards were issued on 10 March 2003.

***Credit Card Guidelines***

The Guidelines were issued in March 2003 to all credit card issuers. The Guidelines were intended to promote active consumerism and consumers' understanding of credit card usage and protecting their interest as card users.

The Guidelines specify the minimum requirements on credit card operations that need to be complied with by all credit card issuers. Among others, the Guidelines set the following:

- Minimum eligibility criteria on credit card application.
- RM250 limit as the cardholders' liability for unauthorised transactions as a consequence of lost and stolen credit cards.
- Barring of credit card usage for unlawful activities.
- The requirement for credit card issuers to undertake prudent credit assessment and verification of credit worthiness of the card applicants using the Central Credit Reference Information System (CCRIS) and other sources of credit information.

***Migration to Chip-based Automated Teller Machine (ATM)***

In an effort to enhance the security of payment cards, banking institutions were required to migrate to chip-based payment card technology. The domestic banking institutions were required to fully upgrade their ATM infrastructure to be fully chip-enabled and convert their customers' ATM card to chip-based by end-September 2003, and the locally incorporated foreign banks, by March 2004.

***Minimum Security Standards for Cheques***

A concept paper on the proposed Guidelines on Minimum Security Standards for Cheques was issued to the banking industry in November 2003. The proposed Guidelines set the minimum standards for security features on cheques, cheque fraud detection facility, security management in cheque printing and consumer advice on best practices.

***Accounting Treatment of Handling Fees for Hire Purchase Loans (HPL)***

To standardise the accounting treatment of handling fees for HPL across the finance company industry, all handling fees for HPL approved and disbursed after 1 January 2004 by finance companies have to be expensed off in the period they are incurred. For HPL approved and disbursed before

1 January 2004 where the amortisation method had been adopted, finance companies were allowed to continue amortising the outstanding handling fees. Accordingly, in the event of prepayment or the HPL turning non-performing, the balance of the unamortised handling fees would be expensed off.

***Recognition of Deferred Tax Assets (DTA) and Treatment of DTA for Risk Weighted Capital Ratio (RWCR) Purposes***

In line with MASB 25 which was issued by the Malaysian Accounting Standards Board (MASB), licensed institutions had to account for all DTA in their financial reports. For RWCR purposes, however, such deferred tax income or expense is excluded from the computation of Tier-1 capital and calculation of risk-weighted assets.

***Concept Paper on Incorporation of Market Risk into the RWCR Framework***

In April 2003, the first concept paper (CP1) on the incorporation of market risk into the RWCR Framework was issued to the industry for comments. CP1 adopted and customised recommendations issued by the Basel Committee on Banking Supervision (BCBS) according to the environment of the local banking industry.

Following a series of discussions with the Market Risk Industry Working Group, the second concept paper (CP2) was issued in January 2004. CP2 incorporated significant changes to CP1, in particular on the following areas:

- Classification of securities in the trading and banking book;
- Holdings of securities resulting from debt/loan restructuring;
- Hedging policy;
- Underwriting positions; and
- Valuation of illiquid papers.

CP2 also aims to gauge the level of readiness for incorporation of the revised market risk framework and assess the quantitative impact of the latest proposal on the financial institutions.

***Concept Paper on Consolidated Supervision of Financial Conglomerates***

In line with Recommendation 3.26 of the Financial Sector Masterplan (FSMP), Bank Negara Malaysia has developed a framework for the Consolidated Supervision of Financial Conglomerates. This is to ensure that the financial health of financial groups may be adequately assessed and monitored by supervisors on a group-wide basis so as to minimise risks emanating from the financial group that could destabilise the financial system.

A concept paper was issued to the banking industry in December 2003. The proposed framework outlines the underlying regulatory principles of consolidated supervision. Specific recommendations were made in five areas, namely group structures, corporate governance, risk management, intra-group exposures, and reporting requirements.

***Implementation of the Anti-Money Laundering Act 2001 (AMLA) Compliance Programme***

To combat money laundering activities, banking institutions were required to put in place a comprehensive compliance programme to comply with AMLA. The compliance programme includes an effective transaction monitoring system that is implemented at all operations of banking institutions including the branches and subsidiaries. There should also be regular on-going employee training and regular independent audit.

**Measures to Enhance Competition and Efficiency of the Banking Industry**

***Guidelines on New Product Approval Requirements***

The Guidelines were issued in March 2003 as part of the measures to promote Bank Negara Malaysia's regulatory philosophy of "what is not prohibited is allowed" as stated in the FSMP. The main essence of the Guidelines is the replacement of the existing product pre-approval requirements with a simple new product notification and approval process that is expected to promote greater incentive for banking institutions to increase their investment in developing more innovative products. The requirements for greater product transparency and consumers to have access to product information are embodied in the Guidelines.

***Investments Linked to Derivatives***

Effective 12 May 2003, banking institutions were allowed to offer additional yield enhancing investment products linked to derivatives, other than investments linked to Ringgit denominated interest rate derivatives. Blanket approval was granted to all banking institutions to offer the following additional investment products linked to derivatives:

- Investment products linked to interest rate, commodity, equity and fixed income derivatives, denominated in both Ringgit and foreign currency; and
- Investment products linked to foreign currency derivatives denominated in foreign currency only.

Nevertheless, banking institutions are required to meet the general conditions when offering investment products linked to derivatives and comply with all exchange control rules. However, investment products linked to credit derivatives would still require specific approval from Bank Negara Malaysia.

***Amendments to the Central Bank of Malaysia Act 1958 (CBA) and Banking and Financial Institutions Act 1989 (BAFIA)***

Both the CBA and BAFIA were amended to incorporate provisions to support the efforts to develop the bond market and to enhance competitiveness and efficiency of the banking industry. The amendments came into force on 1 January 2004 for the CBA and 15 January 2004 for the BAFIA.

The CBA was amended, among others to empower Bank Negara Malaysia to carry out its functions in providing the infrastructure for the Ringgit bond market, including the power to establish and operate systems for the bond market and to make the necessary regulations for the operation of the systems.

The BAFIA was amended to provide for the establishment of a banking and finance company, an entity which will hold two licences, one for banking business and the other for finance company business.

**Measures to Improve Access to Financing**

***Establishment of Bank Negara Malaysia SME Special Unit***

As part of the initiatives to enhance access to financing to SMEs, Bank Negara Malaysia established the SME Special Unit in May 2003 to assist SMEs in the following areas:

- To provide information on the various sources of financing for SMEs;
- To facilitate loan application process for SMEs;
- To deal with problems faced by viable SMEs in accessing financing; and
- To provide advisory services on other SMEs financial requirements.

The role of the SME Special Unit will be expanded to include:

- Coordinating, monitoring and evaluating the financing needs of the SMEs;
- Formulating policies and strategies to enhance access to financing by SMEs;
- Establishing and maintaining database on SME financing;
- Enhancing SMEs awareness on various financing sources; and
- Formulating structured training programmes for SMEs.

***Additional Allocation for Special Funds for SMEs***

As part of efforts to ensure availability of adequate funds at reasonable cost to the SMEs, Bank Negara Malaysia increased the allocation, twice in 2003 for Fund for Small and Medium Industries 2 (FSMI2) and the New Entrepreneurs Fund 2 (NEF2) by RM1,350 million and RM650 million, respectively. Consequently, the total funds available for FSMI2 and NEF2 rose to RM2 billion and RM1.15 billion respectively.

***Small Debt Resolution Mechanism***

To facilitate the restructuring of non-performing loans (NPLs) of SMEs with on-going businesses and to assist in their financing requirements, Bank Negara Malaysia established a Small Debt Resolution Mechanism in November 2003.

Under the mechanism, an 11-member Small Debt Resolution Committee (SDRC) was established to undertake independent assessment on the viability of the businesses, and propose the loan restructuring and financing requirements of the affected businesses. The SME Special Unit at Bank Negara Malaysia serves as the Secretariat to the committee.

This mechanism is open to SMEs with on-going businesses which have aggregate NPLs of not more than RM3 million with the commercial banks, finance companies, Islamic banks, Bank Pembangunan dan Infrastruktur Malaysia Berhad, and Bank Industri & Teknologi Malaysia Berhad.

As the debt restructuring process may involve the provision of new financing to the businesses, Bank Negara Malaysia established the Rehabilitation Fund for Small Businesses with an allocation of RM800 million. In this regard, eligible businesses may obtain new financing up to RM1.5 million at a financing rate of 5% per annum for a maximum of 5 years.

With the introduction of this new mechanism, the existing restructuring and financing mechanisms under Tabung Pemulihan dan Pembangunan Usahawan, and Tabung Pemulihan Industri Kecil dan Sederhana were discontinued.

***Access to Financing by Priority Sectors***

As in previous years, Bank Negara Malaysia continued to place due emphasis on lending by the commercial banks and finance companies to the priority sectors, namely the Bumiputra community, SMEs and purchase of low and medium cost houses. Targets set were based on various factors taking into consideration the capacity of the respective institutions.

***Establishment of a Special Relief Guarantee Facility for Severe Acute Respiratory Syndrome (SARS) Affected Businesses***

As part of the Economic Package announced by the Government in May 2003 to assist businesses affected by the SARS outbreak, Bank Negara Malaysia established the Special Relief Guarantee Facility with an allocation of RM1 billion in the form of guarantee fund provided through the Credit Guarantee Corporation Malaysia Berhad (CGC).

The salient features of the Facility are as follows:

- The Facility is implemented through all commercial banks, Islamic banks, finance companies, Bank Pembangunan dan Infrastruktur Malaysia Berhad and Bank Industri & Teknologi Malaysia Berhad;
- The maximum loan amount allowable under the facility is RM2.5 million for a maximum tenure of 2 years;
- The financing rate is capped at 3.75% p.a for the first year and not more than the 3-month KLIBOR rate plus 1 percentage point for the subsequent year; and
- CGC will guarantee 80% of the loans taken from the implementing institutions.

***Financial Relief Provided by Banking Institutions to Borrowers in SARS-affected Industries***
In response to the SARS outbreak, banking institutions were also requested to formulate appropriate rescheduling or restructuring schemes to reduce the financial burden of borrowers whose businesses and cash-flows were affected by the SARS. The rescheduling/restructuring programme should be implemented on a pre-emptive manner.

To facilitate this measure, the requirement stipulated in the Guidelines on Classification of Non-Performing Loans and Provisions for Sub-Standard, Doubtful and Bad Debts that requires banking institutions to obtain specific approval from Bank Negara Malaysia to reschedule a performing loan account more than once within a 2-year period, was waived.

**Measures Related to Consumerism**

***BankingInfo***
To promote greater financial literacy among the public and enhance public understanding of the roles and functions of the different segments in the financial system, Bank Negara Malaysia launched the Consumer Education Programme (CEP), known as "BankingInfo" in January 2003.

In summary, BankingInfo aims to:

- Disseminate information on features of banking products and services, including the rights and responsibilities of consumers and financial institutions in a clear and simple manner;
- Promote public understanding on the role and functions of the different segments in the financial system;
- Alert consumers on illegal transactions and financial scams;
- Provide information on basic financial management and importance of savings and financial planning; and
- Provide consumers with information on how they can seek redress in the event that they have suffered monetary losses.

To date, 18 booklets have been introduced and are available at all branches of banking institutions. Information on BankingInfo is also available at the Internet website www.bankinginfo.com.my.

***Formation of Financial Mediation Bureau (FMB)***
In line with Recommendation 3.37 of the FSMP, a concept paper on the Formation of the Financial Mediation Bureau (FMB) with the objective of expanding the current role of both the Banking Mediation and Insurance Mediation Bureaus was issued in April 2003.

The members of FMB will comprise:

- Commercial banks, finance companies, merchant banks, and Islamic banks;
- Development financial institutions regulated under the Development Financial Institutions Act 2002;
- Payment systems operators and issuers of designated payment instrument under the Payment Systems Act 2003; and
- Insurance companies, Takaful operators and Malaysian Nasional Reinsurance Berhad.

The formation of the FMB is expected to facilitate the financial institutions in enhancing their customer service level and would cover a broad range of retail consumer complaints against all financial institutions regulated by Bank Negara Malaysia.

## PERFORMANCE OF THE BANKING SYSTEM

### Overview

The financial position of the banking system in 2003 was strong. The key financial indicators of the banking system remained favourable with no signs of vulnerabilities. The level of capitalisation was high, non-performing loans (NPLs) declined whilst profitability improved. Amidst ample liquidity and continued recovery in business and consumer sentiments, the banking institutions registered strong lending activities. The strong performance of the banking system was characterised by:

- High level of capitalisation attributable to higher profit and capital injections;
- Ample liquidity in the financial system throughout the year;
- Strong resumption in lending activities driven primarily by lending to the small and medium enterprises, and household sector;
- Higher profitability due to higher net interest income, lower provisioning and high recoveries;
- Narrowing of interest margins as competition continued to exert downward pressure on lending rates amidst a more stable return on deposits;
- Improvement in NPLs. There was a decline in new NPLs, whilst recoveries and reclassifications to performing accounts remained strong; and
- Exposure to market risks remained within prudential levels.

### Profitability

Against the backdrop of improving economic conditions, gross operating profits of the banking system increased by 7% to RM11.8 billion in 2003, driven primarily by higher net interest income. Commercial banks and finance companies posted growth in gross operating profits of 7.7% and 9.7% respectively, while those of merchant banks declined by 18.5%, mainly due to lower net interest income and income generated from fee-based activities.

Total loan loss provisions of the banking system declined by 4% during the year, attributed mainly to higher recoveries which grew by 10.1% or RM384.8 million. The improved economic conditions and debt restructuring exercises undertaken over the years had strengthened the debt servicing capacity of borrowers, thus contributing to the higher recoveries. The decline in loan loss provisions, coupled with the higher gross operating profits, resulted in the preliminary unaudited pre-tax profits to increase by 10.2% to RM10.3 billion in 2003. Consequently, the return on equity of the banking system increased to 17.1%, whilst the return on assets was 1.4%.

Given the strong competition in the loan market and greater disintermediation from the capital market, interest income from loans and financing declined marginally by 1.1% in 2003. However, this was offset by higher interest income earned from debt securities held and lower interest-in-suspense. By type of institution, the commercial banks and finance companies recorded increases in net interest income of 6.4% and 5.9% respectively in 2003. The net interest income of merchant banks declined by 7.7%, a trend that has been prevalent for a number of years as merchant banks started to shift their business focus from traditional fund-based activities to fee-based activities.

Although fee-based income grew strongly by 9.9%, as a percentage of total assets, it remained stable at 0.5%. Fee-based income from loan and financing activities rose by 11.8%, in tandem with the growth in lending activities. Nevertheless, fee-based income

**Table 4.6**
**Banking System[1]: Income and Expenditure**

| | For the calendar year | | | |
|---|---|---|---|---|
| | 2002 | 2003*p* | Annual change | |
| | RM million | | | % |
| Interest income net of interest-in-suspense | 35,481 | 37,420 | 1,940 | 5.5 |
| *(Interest-in-suspense)* | *5,578* | *4,752* | *-826* | *-14.8* |
| Less: Interest expense | 17,763 | 18,673 | 910 | 5.1 |
| Net interest income | 17,718 | 18,748 | 1,030 | 5.8 |
| Add: Fee-based income | 3,314 | 3,642 | 328 | 9.9 |
| Less: Staff cost | 4,698 | 4,981 | 284 | 6.0 |
| Overheads | 5,315 | 5,614 | 299 | 5.6 |
| Gross operating profit | 11,019 | 11,795 | 776 | 7.0 |
| Less: Loan loss provisions | 5,497 | 5,276 | -220 | -4.0 |
| Gross operating profit after provisions | 5,523 | 6,518 | 996 | 18.0 |
| Add: Other income | 3,805 | 3,759 | -46 | -1.2 |
| Pre-tax profit | 9,328 | 10,278 | 950 | 10.2 |
| Of which: | | | | |
| Commercial banks | 6,357 | 6,908 | 550 | 8.7 |
| Finance companies | 2,379 | 2,678 | 298 | 12.5 |
| Merchant banks | 591 | 692 | 101 | 17.0 |
| Return on assets (%) | 1.3 | 1.4 | | |
| Return on equity (%) | 16.3 | 17.1 | | |
| Cost to income[2] (%) | 47.6 | 47.3 | | |

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

from loans and financing only accounted for 0.2% of total outstanding loans, far lower than the average level recorded by foreign banks of around 0.5%. In the case of merchant banks, their total fee-based income declined marginally by 3.1% to RM327.6 million. This was mainly due to lower income from corporate advisory and underwriting activities, which declined by 12.4% and 9.6% respectively, partly due to lower number of debt restructuring exercises undertaken in 2003.

The rationalisation efforts undertaken consequent to the merger programme to improve operational efficiency have begun to yield positive results, with gross operating profits per employee improving from RM125,500 in 2002 to RM134,800 in 2003. Marketing expenses, however, increased by 7.4% as banking institutions intensified efforts to enhance market share. Staff cost per employee also increased marginally from RM53,500 in 2002 to RM56,900 in 2003 given the better remuneration packages offered by banking institutions to retain and reward their staff.

### Interest Margin

Reflecting the banking system's role as the main provider of funds to the economy, interest income from loans and financing activities constituted 66% of gross operating income of the banking system in 2003 (2002: 69%).

Gross interest margin narrowed further in 2003 as intense competition surrounding the bank lending activities continued to exert downward pressure on lending rates amidst a more stable return on deposits. The gross interest margin, defined as difference between the average lending rate (ALR) banking institutions charged on loans and advances and the rate banking institutions paid on deposits and borrowed funds (average cost of funds or ACF), declined by 21 basis points to 3.69 percentage points for the commercial banks (2002: 3.90 percentage points). Similarly, the gross interest margins for the finance companies narrowed to 5.70 percentage points from 6.08 percentage points at end-2002.

The narrowing of the gross interest margin was due to the larger decline in ALR, offsetting the marginal decline in the ACF. At end-2003, the ALR of the commercial banks stood at 6.11% per annum, whilst that of the finance companies was 9.11% per annum (2002: 6.51% per annum and 9.75% per annum, respectively). The decline in ALR reflected the 50 basis points reduction in the Bank Negara

**Table 4.7**
**Weighted Average Lending Rates for New Loans Approved**

| | Commercial banks | | Finance companies | |
|---|---|---|---|---|
| | Average for the year (% per annum) | | | |
| | 2002 | 2003 | 2002 | 2003 |
| Business loans | 6.16 | 5.97 | 7.46 | 7.30 |
| *of which: SMEs* | *6.55* | *6.40* | *7.40* | *6.99* |
| Household loans[1] | 4.78 | 4.81 | 7.02 | 6.53 |
| *of which:* | | | | |
| *Purchase of residential properties* | *4.42* | *4.46* | *4.49* | *4.00* |
| *Purchase of passenger cars* | *n.a.* | *n.a* | *7.16* | *6.70* |

[1] Excluding credit card loans.
n.a. Not applicable.

Malaysia intervention rate in May 2003 that led to a decline in the base lending rate of 40 basis points. Notwithstanding the 50 basis points reduction in the policy rate, the ACF declined by a lower margin (20 and 26 basis points for commercial banks and finance companies, respectively) as bulk of the commercial banks' and finance companies' funds comprises mainly fixed deposits, the interest rates of which declined only marginally.

The lending rates (excluding credit cards) on new loans approved by the commercial banks averaged 5.59% per annum in 2003. Meanwhile, the average lending rates on new loans approved by the finance companies declined by 44 basis points to an average of 6.64% per annum. During the year, the average lending rates on newly approved business and SME loans by the commercial banks declined to an average of 5.97% per annum and 6.40% per annum, respectively (2002: 6.16% and 6.55% per annum, respectively).

The ALR, however, overstates the interest income earned by the banking institutions as it recognises the accrued but unearned interest on non-performing loans (NPLs) (that is interest-in-suspense or IIS) even though the banking institutions continue to incur costs on funds that are borrowed, mainly deposits, to finance these loans. In addition, the banking institutions also incur administrative costs in managing and monitoring these loans. Net interest margin (gross interest margin after adjusting for IIS and administrative costs) improved marginally for the commercial banks to 1.31 percentage points (2002: 1.25 percentage points) while the net interest margin for the finance companies remained at 3.14 percentage points. The improvement was due to lower IIS and administrative costs. In tandem with declining NPLs, the amount of IIS declined from

1.16% to 0.93% of loans for the commercial banks, and from 1.56% to 1.28% of loans for the finance companies. In addition, both commercial banks and finance companies recorded lower overheads and staff cost of 1.46% of interest-related assets for the commercial banks and 1.28% for the finance companies in 2003 (2002:1.49% and 1.38% of interest-related assets, respectively).

With growing competition in the loan market amongst the banking institutions as well as with the non-traditional players, the challenge is for the banking institutions to further improve operational efficiencies and risk management capabilities. This is important to sustain their revenue performance and hence their returns.

**Lending Activity**

Lending indicators demonstrated increasing trends during the year despite the outbreak of the as well as the uncertainty regarding the structure of excise duty on cars. The issuance of new private debt securities during the year also increased. The diversification in sources of financing, especially for the corporate sector, has resulted in a greater proportion of lending by the banking system being channelled to the retail customers and small and medium enterprises, thus supporting the growth in private consumption and business activity. The pre-emptive actions by the Government contributed to mitigate the effects of SARS on the economy. As consumer and business sentiments recovered, business activities regained growth momentum whilst consumer spending increased, thus stimulating demand for additional financing.

**Table 4.8**
**Banking System[1]: Financing Activities**

| | For the year | | Annual growth (%) |
|---|---|---|---|
| | 2002 | 2003 | |
| | RM billion | | |
| Loan approvals | 136.1 | 151.4 | 11.2 |
| Loan disbursements | 404.3 | 433.6 | 7.2 |
| Loan repayments | 396.1 | 422.8 | 6.8 |
| | As at end | | Annual growth (%) |
| | 2002 | 2003 | |
| | RM billion | | |
| Outstanding loans | 443.0 | 464.2 | 4.8 |
| Total banking system financing[2] | 468.9 | 496.5 | 5.9 |
| Total financing for the economy[3] | 546.1 | 600.2 | 9.7 |

1 Excludes Islamic banks.
2 Outstanding banking system loans plus private debt securities held by the banking system.
3 Outstanding banking system loans plus outstanding private debt securities.

## Strengthened financial position of banking system enabled increased financing for private consumption and business activities.

New loan approvals by the banking system expanded strongly backed by sustained demand. In 2003, the banking system received loan applications totalling RM220 billion. At the close of the year, more than 2.2 million applications amounting to RM151.4 billion were approved by the banking system, 11.2% higher than the amount approved in 2002. Averaging at RM12.6 billion a month, this is the highest monthly average recorded for loan approvals since the Asian financial crisis, exceeding the level recorded in 2002. Loan applications rejected amounted to RM26 billion, or 11.8% of applications received. Loan disbursements expanded during the year at an annual rate of 7.2% to amount to RM433.6 billion. With disbursements surpassing repayments, outstanding loans expanded by 4.8% to RM464.2 billion as at end-2003. The amount of undrawn loans rose by 3.6% to RM134.3 billion.

*Lending to Households*

Outstanding loans for the household sector expanded by 12.5% to RM226.1 billion to account for 48.7% of outstanding loan portfolio of the banking system. As in the previous year, the lending activities were mainly in mortgage financing, purchase of passenger cars and credit card loans. Demand for new financing remained strong, due mainly to the low interest rates, stable employment conditions and competition among car manufacturers. This was further boosted with the various incentives provided by the Government to house purchasers, including tax relief on interest payments for first-time house owners who purchased properties priced between RM100,000 to RM180,000 from developers, a RM600 cash payment to borrowers in the lower income category and the stamp duty exemption on loan documents for purchases of houses costing not more than RM180,000. In meeting the demand, banking institutions offered attractive financial packages and adopted aggressive promotion strategies.

Higher applications were received during the year totalling RM95.8 billion (+19.4%), the bulk of which were applications to finance the purchase of residential properties and passenger vehicles as well as credit card applications. New approvals expanded by 7.4% to amount to RM71.4 billion at interest rates averaging between 4.32% and 5.09% per annum for the commercial banks and between 6.29% and 6.82% per annum for the finance companies. Approvals for hire purchase financing and credit cards recorded strong increases of 15.2% and 14.1%, respectively. Approvals for house purchases, however, rose only by 2.4% to RM29.7 billion, mainly for the high-end properties, which saw a number of new launches during the year. Similar to the increasing trend in approvals, there was higher disbursements to the household sector. Totalling RM113 billion, this was an increase of 8.6% over the amount disbursed in the preceding year. A notable trend was the high utilisation of credit card lines during the year as card-based payments continued to gain greater acceptance by consumers and retailers. Utilisation of credit card lines increased by 19.6% to RM30.4 billion during the year. Despite the high utilisation, outstanding credit card loans remained a small proportion of 2.6% of outstanding loans.

*Lending to Businesses*

Lending to businesses remained encouraging throughout the year, supporting the stronger economic activities. The various forms of relief introduced by the Government to minimise the effects of SARS had contributed favourably towards sustaining demand for financing by the private sector. To complement these measures, the banking institutions stepped in to reschedule/restructure loans amounting to RM2.5 billion as well as extended new facilities for the affected businesses. The establishment of the RM1 billion Special Relief Guarantee Facility in May 2003 also enabled businesses affected by the SARS outbreak to access new financing at concessionary rates. At end-2003, a total of RM40.3 million in working capital lines were extended to 76 borrowers with guarantees totalling RM32.2 million *[Please refer to the Box on Banking Measures Introduced in 2003 for details].*

For the year as a whole, approvals for credit facilities to businesses increased by 13.5% to RM76.5 billion, despite a decline of 5.1% in loan applications. Loan approvals to businesses were broad-based, with approvals to businesses in the manufacturing (20.8%), construction (14.5%), and wholesale and retail (13.3%) sectors accounting for the bulk of the new credit lines. Notably, approvals to the wholesale and retail businesses rose by 28.6% to RM10.2 billion, whilst new facilities granted to hotels and restaurants grew by 83.4% demonstrating the continued support of the banking sector for these businesses amidst the SARS outbreak. Lending rates on new business loans remained favourable averaging between 5.51% and 6.42% per annum for the commercial banks and between 6.94% and 7.64% per annum for the finance companies.

Stronger economic activity led to higher disbursements to businesses. Disbursements to the business sectors of RM296.8 billion (+7.6%) accounted for 68.5% of total loans disbursed by the banking system. Most of the funds were channelled to the manufacturing sector (36.3%), and wholesale and retail trade sectors (22.9%). Disbursements to these sectors rose by 4.9% and 9.2%, respectively. While funds utilised by the construction sector were generally lower during the year, funds utilised by the general and civil engineering contractors expanded by 18.1% to RM9.4 billion. At end-2003, outstanding loans to the business sectors declined slightly by 2.2% on account of loan conversions into debt securities and large repayments (+8.4%). Meanwhile, unutilised business lines declined by 3.6% at end-2003.

*Lending to Small and Medium Enterprises (SMEs)*

The banking system continued to support the SMEs, channelling more funds for their activities as evidenced by the level of new financing extended during the year. This commitment was further reinforced by the availability of dedicated SME units in almost all the commercial banks. For some institutions, the SME unit undertakes activities beyond the provision of financing, to include developmental and support services such as identifying and structuring financial products and services to meet the requirements of the SMEs, conducting training and workshops, and providing other advisory services such as financial and cash management.

Disbursements were also exceptionally strong, constituting 29% (RM86 billion) of total disbursements to the business sectors. This amount represented an increase of 75.5% over the amount disbursed in the preceding year. Meanwhile, outstanding loans to SMEs expanded by 8.8% to RM80.2 billion, to account for 38.4% of outstanding business loans at end-2003. During the year, nearly 75,000 SMEs obtained new credit facilities totalling RM25.5 billion at favourable lending rates which averaged between 5.96% and 6.87% per annum for the commercial banks, and between 6.57% and 7.38% per annum for the finance companies. This accounted for a third of total approvals to the business sectors.

In 2003, the allocations for two special funds were increased twice to meet the increased demand. The allocation for the Fund for Small and Medium Industries 2 expanded by RM1.35 billion to RM2 billion and the New Entrepreneurs Fund 2 by RM0.65 billion to RM1.15 billion. On aggregate, Bank Negara Malaysia has allocated a total of RM5.6 billion for five[1] special funds for the SMEs in the different segments. Of this amount, a total of RM5.2 billion has been approved as at end-2003.

In tandem with efforts to improve the accessibility of SMEs to financing, the SME Special Unit was established in Bank Negara Malaysia in May 2003. The Unit began its operations focusing on disseminating information on the various sources of financing available to SMEs; facilitating loan application process by SMEs; assisting viable SMEs facing difficulties in securing financing; and providing advisory services on their other financial requirements. In addition, the Unit looks into loan related problems and complaints from SMEs. As at end-2003, the Unit has received 1,789 requests for assistance from the SMEs, of which 82% were enquiries on information and sources of financing and on the details relating to the special funds. To coordinate and further develop access to financing by the SME sector, the scope of the Unit will be expanded to be the one-stop centre responsible for all initiatives on SME financing and financial services *[Please refer to the Box on Banking Measures Introduced in 2003 for details on the expanded role of the Unit].*

To resolve the NPLs of SMEs, the Small Debt Resolution Committee (SDRC) was established to facilitate the restructuring of NPLs of SMEs with viable on-going businesses. Similar to the Corporate Debt Restructuring Committee, the SDRC undertakes an independent assessment on loan restructuring requests by SMEs. Complementing the independent assessment by the SDRC was the setting up of the Rehabilitation Fund for Small Businesses with an allocation of RM800 million *[Please refer to the Box on Banking Measures Introduced in 2003 for details].*

*Loan Profile*

The structure of the banking system loan portfolio has undergone significant changes since the Asian crisis, in terms of greater proportion of smaller-sized loans and more diversified customer base as a result of the greater focus on retail and SME sectors. This has improved the risk distribution within the banking system in particular, and the financial sector in general. The proportion of outstanding loans below RM100,000 constituted 30.9% of total outstanding loans as at end-2003. Outstanding loans of between RM100,000 to RM500,000 grew by 14% to account for 24.4% of total loans at end-2003. On aggregate, outstanding loans of below RM1 million now accounted for 60% of total banking system loans, as compared to 48% during the pre-crisis period of 1996.

*Banking Institutions and the Bond Market*

Net proceeds from new PDS issued by corporations rose substantially to RM45.8 billion, compared with RM26.7 billion in the previous year. More than 60% of the new issues took place in the first half of the year as the higher bond yields in the second half of 2003 resulted in many corporations deferring their proposed issuance. At end-2003, outstanding PDS recorded a strong growth of 30.8% to RM136 billion. Of this amount, 23.7% were held by the banking system. On aggregate, outstanding banking system loans and outstanding PDS grew at 9.7% to RM600.2 billion as at end-2003.

**Asset Quality**

NPLs declined further owing to the favourable economic conditions. The year saw a decline in new NPLs, whilst recoveries and reclassifications to performing accounts were strong. The outbreak of the SARS impacted the cash flows of some businesses, particularly those in the tourism-related industries. The prompt actions from the Government and the banking institutions, however, contributed towards averting a protracted negative impact on the domestic economy.

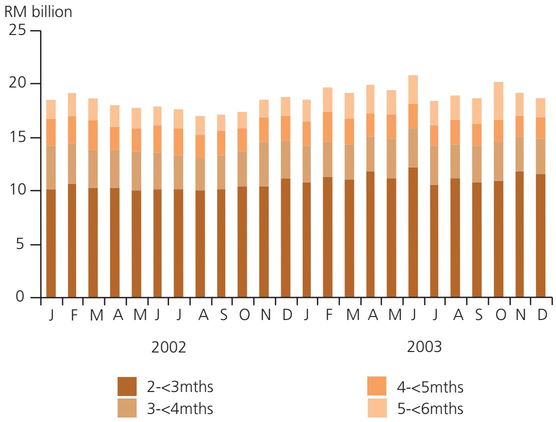
[1] Fund for Small and Medium Industries 2 (RM2 billion), New Entrepreneurs Fund 2 (RM1.15 billion), Fund for Food (RM1.3 billion), Bumiputera Enterprepreneurs Project Fund (RM0.3 billion) and Rehabilitation Fund for Small Businesses (RM0.8 billion)

Net NPLs based on the 3-month classification declined by 8.2% to RM38.3 billion as at end-2003. Consequently, the net NPL ratio improved by 1.4 percentage points to 8.7%. On a 6-month classification, the decline in net NPLs was more gradual at 3.1% to RM29.9 billion to account for 6.8% of total net loans at end-2003, compared with 7.4% as at end-2002. The loan loss coverage ratio also strengthened to 53.9% on the 3-month basis and 59.1% on the 6-month basis. Including the value of collateral, the coverage ratio strengthened further to 157.9% on the 3-month basis and 163.8% on the 6-month basis.

Improvements in the level of NPLs were due to lower incidence of new NPLs, write-offs of bad loans coupled with strong recoveries and reclassifications of NPLs to performing loans. Reflecting the favourable economic conditions, the amount of new NPLs for the year fell by 3.2% to RM24.5 billion. Recoveries and reclassifications remained strong at RM22.6 billion in 2003 despite a slight decrease of 3.5%. This was due to high recoveries and reclassifications of RM23.5 billion recorded in the preceding year. Lower provisioning requirements following the declining NPLs, had enabled banking institutions to write-off RM8 billion of loans in 2003.

During the year, two restructuring schemes under the Corporate Debt Restructuring Committee (CDRC) involving debts totalling RM9.3 billion were implemented. At end-2003, 14 cases with debts totalling RM7.3 billion have yet to be implemented.

**Graph 4.6**
**Banking System[1]: Ageing Profile of Loans in Arrears 2-<6 months**




[1] Excludes Islamic banks

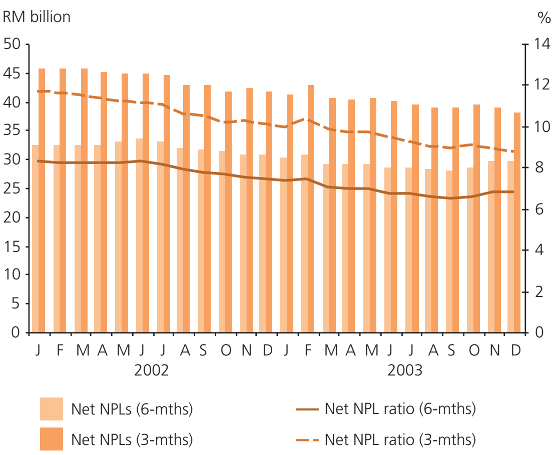
## Enhanced credit assessment infrastructure and practices ensure banking system exposure to households remain within prudential level.

Total loans in arrears excluding NPLs, remained stable throughout the year, except for the temporary increase in June, possibly due to the effects of SARS. As such, loans in arrears remained almost unchanged at RM78.1 billion at end-2003. Of this amount, 23.9% were loans in arrears of between 2 and less than 6 months. During the year, loans in this category recorded a small decline of RM0.1 billion or 0.6% to RM18.7 billion to account for 4% of gross loans at end-2003.

Unlike the banking crisis in the late 1980s where the pace of decline in the NPL ratio was more rapid, recovery in the NPLs since the Asian crisis has been more gradual. This was partly due to the more stringent reclassification rules that were put in place to prohibit evergreening of loans. In addition, growth in the outstanding loans post-Asian crisis has been much slower relative to the periods following the mid-1980s economic recession primarily due to the deepening of the bond market.

NPLs for the business sectors declined substantially to account for 16.2% of total business loans as almost all sectors recorded improvements. Sectors that recorded increase in NPLs include the retail trade, restaurants and hotels (+15.6%), and electricity, gas

**Graph 4.5**
**Banking System[1]: Net Non-performing Loans**




[1] Excludes Islamic banks

**Table 4.9**
**Banking System[1]: Non-performing Loans and Loan Loss Provisions**

| | As at end | | | |
|---|---|---|---|---|
| | 2002 | | 2003 | |
| | Classification | | | |
| | 3-month | 6-month | 3-month | 6-month |
| | RM million | | | |
| **Banking system[1]** | | | | |
| Non-performing loans | 69,760.4 | 57,488.3 | 63,566.7 | 53,428.0 |
| General provisions | 8,520.1 | 7,599.8 | 9,050.7 | 8,000.3 |
| Interest-in-suspense | 9,855.4 | 9,502.9 | 9,226.2 | 8,859.3 |
| Specific provisions | 18,149.0 | 17,150.7 | 16,014.9 | 14,696.9 |
| Net NPL ratio (%)[2] | 10.1 | 7.4 | 8.7 | 6.8 |
| Total provisions/NPL (%) | 52.4 | 59.6 | 53.9 | 59.1 |
| **Commercial banks[1]** | | | | |
| Non-performing loans | 47,957.3 | 40,012.4 | 44,649.2 | 37,669.8 |
| General provisions | 6,423.7 | 5,503.0 | 6,895.7 | 5,844.6 |
| Interest-in-suspense | 6,686.2 | 6,483.0 | 6,237.1 | 6,071.0 |
| Specific provisions | 12,970.8 | 12,392.2 | 11,737.8 | 10,845.2 |
| Net NPL ratio (%)[2] | 9.1 | 6.8 | 8.1 | 6.3 |
| Total provisions/NPL (%) | 54.4 | 60.9 | 55.7 | 60.4 |
| **Finance companies** | | | | |
| Non-performing loans | 17,345.3 | 13,487.0 | 15,713.0 | 12,939.5 |
| General provisions | 1,819.8 | 1,820.4 | 1,909.3 | 1,909.8 |
| Interest-in-suspense | 2,621.8 | 2,485.7 | 2,536.4 | 2,346.0 |
| Specific provisions | 4,209.6 | 3,804.2 | 3,675.4 | 3,264.6 |
| Net NPL ratio (%)[2] | 11.2 | 7.6 | 9.4 | 7.2 |
| Total provisions/NPL (%) | 49.9 | 60.1 | 51.7 | 58.1 |
| **Merchant banks** | | | | |
| Non-performing loans | 4,457.8 | 3,989.0 | 3,204.5 | 2,818.6 |
| General provisions | 276.6 | 276.5 | 245.7 | 245.9 |
| Interest-in-suspense | 547.4 | 534.1 | 452.6 | 442.3 |
| Specific provisions | 968.7 | 954.4 | 601.8 | 587.1 |
| Net NPL ratio (%)[2] | 24.6 | 20.8 | 21.5 | 17.9 |
| Total provisions/NPL (%) | 40.2 | 44.2 | 40.6 | 45.2 |

[1] Excludes Islamic banks.
[2] Net NPL ratio = {(NPL less IIS less SP) / (Gross loans less IIS less SP)} x 100%.
Note: Total may not add-up due to rounding.

and water (+240%). The higher NPLs for these sectors was due to the effects of SARS and delay in the implementation of a borrower's restructuring scheme respectively. These increases did not pose any systemic risks as they accounted for only 5% of banking system NPLs. Gross NPL ratio for both the manufacturing and construction sectors declined significantly to 16.5% and 27.8% respectively following the implementation of the debt restructuring scheme of a conglomerate. Nonetheless, outstanding NPLs remained concentrated in these sectors, constituting 45.5% of total business NPLs.

NPLs of SMEs also declined by RM0.6 billion to RM11.7 billion as at end-2003 to account for 14.6% of total loans to SMEs (Jan 2003: 16.4%). Significant improvement was registered by the construction sector which experienced a substantial decline of 55.2% in NPLs since end-January 2003. About 42.9% of the NPLs of SMEs were loans in the manufacturing and construction sectors.

While household sector NPLs increased by RM0.9 billion, the magnitude remained small. This largely reflected the higher NPLs for mortgage loans (+15.6%) and credit cards (+32.1%). However, the gross NPL ratios for household sector and mortgage loans improved to 7.9% and 8.6% respectively. Meanwhile, the gross NPL ratio for credit cards remained small despite the increase to 4.7%. Higher NPLs for mortgage loans and credit cards were however moderated by lower NPLs for the purchase of transport vehicles which declined by 10.3%. In the current environment, exposure to the household sector still remains within prudential levels. In addition, banking institutions now have real time access to comprehensive credit information of borrowers, including retail borrowers, and therefore the risk of over-indebtedness of the retail customers is mitigated.

With prospect of stronger economic growth in 2004, the declining trend in NPLs is expected to continue. As the growth in outstanding loans is envisaged to

**Table 4.10**
**Banking System[1]: Non-performing Loans by Sector**

| | As at end | | | | |
|---|---|---|---|---|---|
| | NPL by sector | | Change | As percentage of total loans to the sector | |
| | 2002 | 2003 | 2002/2003 | 2002 | 2003 |
| | RM million | | % | | |
| **Business enterprises** | **44,598.0** | **38,806.3** | **-13.0** | **18.4** | **16.2** |
| ***of which SME loans*** | ***n.a.*** | ***11,692.9*** | ***n.a.*** | ***n.a.*** | ***14.6*** |
| **Households** | **16,053.4** | **16,907.3** | **5.3** | **8.4** | **7.9** |
| **Others** | **1,628.6** | **1,181.2** | **-27.5** | **16.8** | **11.1** |
| ***Total*** | ***62,279.9*** | ***56,894.8*** | ***-8.6*** | | |
| Agriculture, hunting, forestry and fishing | 932.9 | 749.3 | -19.7 | 8.2 | 7.3 |
| Mining and quarrying | 158.9 | 143.1 | -9.9 | 16.1 | 13.2 |
| Manufacturing | 12,509.0 | 9,817.4 | -21.5 | 21.0 | 16.5 |
| Electricity, gas and water supply | 422.5 | 1,440.7 | 241.0 | 6.6 | 28.7 |
| Wholesale and retail trade, restaurants and hotels | 4,316.7 | 4,577.6 | 6.0 | 11.8 | 11.8 |
| *Wholesale trade* | *1,851.8* | *1,728.8* | *-6.6* | *9.0* | *8.0* |
| *Retail trade* | *1,202.5* | *1,407.0* | *17.0* | *10.4* | *11.7* |
| *Restaurants and hotels* | *1,262.4* | *1,441.8* | *14.2* | *27.5* | *28.9* |
| Broad property sector | 26,817.5 | 25,802.1 | -3.8 | 15.8 | 14.1 |
| *Construction* | *9,404.6* | *7,831.4* | *-16.7* | *30.5* | *27.8* |
| *Purchase of residential property* | *8,484.1* | *9,808.3* | *15.6* | *8.7* | *8.6* |
| *Purchase of non-residential property* | *4,801.3* | *4,618.0* | *-3.8* | *17.9* | *16.5* |
| *Real estate* | *4,127.6* | *3,544.5* | *-14.1* | *29.9* | *25.7* |
| Transport, storage and communication | 1,406.5 | 1,139.2 | -19.0 | 14.6 | 10.8 |
| Finance, insurance and business services | 3,105.3 | 2,328.1 | -25.0 | 10.5 | 8.0 |
| Consumption credit | 2,359.4 | 2,497.0 | 5.8 | 9.5 | 9.2 |
| *Personal use* | *1,867.6* | *1,879.0* | *0.6* | *13.4* | *12.9* |
| *Credit cards* | *434.2* | *573.8* | *32.1* | *4.1* | *4.7* |
| *Purchase of consumer durable goods* | *57.6* | *44.2* | *-23.2* | *15.9* | *13.3* |
| Purchase of transport vehicles[2] | 3,023.5 | 2,713.3 | -10.3 | 5.2 | 4.2 |
| Purchase of securities | 4,372.8 | 3,777.5 | -13.6 | 20.4 | 19.2 |
| Community, social and personal services | 1,226.3 | 728.3 | -40.6 | 21.6 | 14.8 |

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

remain steady and as bulk of the large problem loans have already been addressed, the magnitude of the decline in NPL ratio will depend on the strategies adopted by banking institutions. This is with respect to the writing-off of legacy NPLs, in particular, where recovery prospects are limited and with respect to the recovery efforts by the special loan rehabilitation units of banking institutions. While risk management practices have improved, the capacity of the banking institutions to effectively manage risks, the changes in the structure of loan portfolio and the nature of risks as a result of greater focus on retail and SME loans, as well as the emergence of new growth areas, would however, necessitate increased resources to monitor the performance of the smaller-sized loan accounts. Thus, a more robust and sound risk management framework would be critical to ensure that the risk management standards are able to effectively manage these risks at all times and under all economic conditions.

### Liquidity Management

Liquidity in the banking system remained ample throughout 2003, mainly due to improved export performance and continued inflow of foreign direct investments. Bank Negara Malaysia conducted liquidity operations to absorb the excess funds through direct borrowings in the interbank market and issuance of Bank Negara papers. Total funds absorbed from the banking system rose

**Graph 4.7**
**Liquidity in the Banking System in 2003**

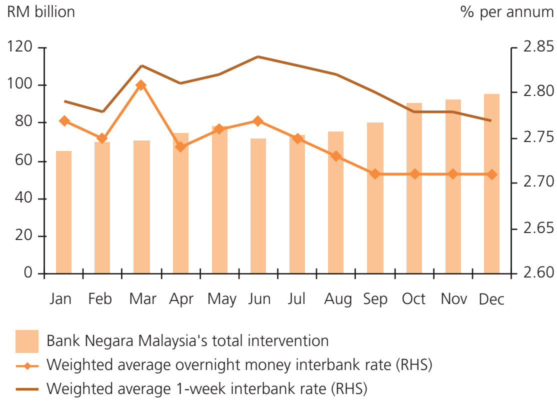


**Table 4.11**
**Banking System[1]: Liquidity Projection as at 31 December 2003**

| | Cumulative liquidity surplus (RM billion) | | Buffer as % of total deposits | |
|---|---|---|---|---|
| | 1 wk. | 1 mth. | 1 wk. | 1 mth. |
| Commercial banks | 44.4 | 77.4 | 12.1 | 21.0 |
| Finance companies | 8.6 | 12.1 | 10.4 | 14.5 |
| Merchant banks | 6.7 | 6.0 | 35.5 | 31.5 |
| **Banking system[1]** | **59.7** | **95.5** | **11.4** | **18.2** |

[1] Excludes Islamic banks.

steadily during the course of the first nine months of 2003, but picked up significantly towards the last quarter of the year. As at end-2003, the total outstanding interbank borrowings by Bank Negara Malaysia and issuance of Bank Negara Bills and Negotiable Notes amounted to RM95.4 billion as compared to RM64.7 billion as at end-2002. As a result of the liquidity operations conducted by Bank Negara Malaysia, interest rates remained stable throughout 2003, with the weighted average overnight interbank rate ranging from 2.71% to 2.81% per annum and weighted average one week interbank rate ranging from 2.77% to 2.84% per annum.

In terms of liquidity management by the banking institutions, the banking system as a whole projected sufficient liquidity to meet any unexpected withdrawals for a period up to one month. As at end-2003, the cumulative liquidity surplus in banking system (excluding the two Islamic banks) was projected at RM59.7 billion to meet demands up to one week and RM95.5 billion for demands up to one month. Commercial banks, finance companies and merchant banks projected large surpluses in the 1-month bucket amounting to 21%, 15% and 32% of their total deposit base respectively.

### Interest Rate Risk

A significant portion of the banking system's assets and liabilities is interest rate sensitive. To assess the banking system's exposure to interest rate risk, the duration-weighted net position (DWP) approach was used to estimate the potential impact on economic value for a 100 basis point shift in interest rates. The DWP approach generates a larger potential loss as it attempts to evaluate on a present value basis all current and future cash flow earnings of banking institutions' on- and off-balance sheet items across each item's entire life. In 2003, the banking system's DWP increased by 9.1% to RM4.6 billion. The increase, however, had minimal impact on the banking system's strong capital position as shown in the table.

For the banking system as a whole, interest rate risk was concentrated in the more than five years to maturity bucket, accounting for more than RM3.1 billion or 68% of total DWP as at end-2003. However, there was a shift in the interest rate risk concentration to the shorter term maturity spectrum in 2003, particularly in the more than one to five years maturity bucket. There was a significant increase of RM13.6 billion or 23% in fixed-rate loans with remaining maturities of one to five years, while fixed-rate loans with remaining maturities of more than five years rose moderately by RM3 billion or 7.2%.

For the commercial banks, the marginal increase of their DWP of 3.6% to RM2.2 billion as at end-2003 resulted from a higher level of fixed-rate loans in the more than three years remaining maturity bucket, which rose by 18.3% in 2003. The higher level of fixed-rate loans extended by the commercial banks comprised primarily Islamic housing loans. Holdings of fixed-rate securities with remaining maturities greater than two years had also increased by 23% to RM28.9 billion as at end-2003. Some of these exposures were offset by increased long-term funding strategies particularly through the issuance of long-term notes and the sale of loan assets to Cagamas.

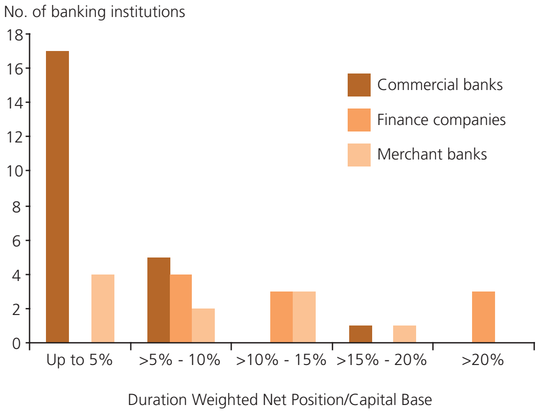
The finance companies' higher DWP of RM200 million in 2003, was mainly attributed to hire purchase loans. These exposures were partially offset by long-term fixed-rate funding sourced primarily from the sale of loan assets to Cagamas. The interest

**Table 4.12**
**Banking System[1]: Impact of 1% Rise in Interest Rate on Capital Strength**

| | Duration-weighted net position | | | | | |
|---|---|---|---|---|---|---|
| | RM million | | As a percentage of Capital base (%) | | Impact on Risk Weighted Capital Ratio (percentage point) | |
| | As at end | | | | | |
| | 2002 | 2003 | 2002 | 2003 | 2002 | 2003 |
| Commercial banks | -2,117 | -2,194 | -4.6 | -4.2 | -0.9 | -0.9 |
| Finance companies | -1,710 | -1,911 | -16.1 | -16.7 | -2.2 | -2.2 |
| Merchant banks | -392 | -499 | -8.9 | -11.1 | -3.2 | -3.7 |
| Banking system[1] | -4,219 | -4,604 | -6.9 | -6.8 | -1.3 | -1.4 |

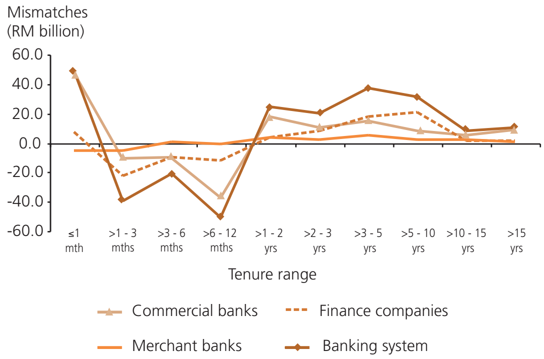
[1] Excludes Islamic banks.
Note: Total may not add-up due to rounding.

**Graph 4.8**
**Banking System[1]: Distribution of Duration-Weighted Net Position as a Percentage of Capital Base as at 31 December 2003**




[1] Excludes Islamic banks

**Graph 4.9**
**Banking System[1]: Net Interest Rate Position Mismatches as at 31 December 2003**




[1] Excludes Islamic banks

rate exposure arising from fixed-rate hire purchase loans of the finance companies can be further mitigated by greater utilisation of Cagamas facilities. Mergers between commercial banks and finance companies would also allow such exposures to be better managed. Simulating the exposures of the commercial banks and finance companies on the basis of their impending rationalisation, the impact on risk-weighted capital ratio (RWCR) was reduced to 1.4 percentage points compared with 2.2 percentage points if the finance companies operated on a stand alone basis.

Within the banking system, the merchant banks registered the highest percentage increase in DWP of 27% in 2003. This was due to the structural transformation of merchant banking business towards investment banking activities from the traditional loan-based institutions. Hence, as the merchant banking industry runs down its loan books, the significant increase in its holding of debt securities with remaining maturities of above one year contributed to the increase in DWP. The merchant banks' holding of the more than one year debt securities rose by 25% or RM2.5 billion to RM12.2 billion as at end-2003. Almost half of the increase was concentrated in the more than five years maturity bucket. Although long-term funding positions to match these exposures remained at RM3.8 billion, the relatively liquid nature of these exposures would allow the merchant banks to adjust the profile of their interest rate exposure accordingly.

In line with the Basel Committee on Banking Supervision (BCBS)'s recommendation, banking institutions will be required to incorporate their market risk into the RWCR framework using the "Standardised" approach, which include interest rate and equity risks for trading book positions, and foreign exchange rate risk for the entire banking institution's position. Based on the impact study of the proposed framework conducted on positions as at end-2003, the potential loss from exposures to

**Table 4.13**
**Banking System[1]: Impact of Market Risk Capital Framework on Capital Strength as at 31 December 2003**

| | RM million | | | | Impact on Risk Weighted Capital Ratio (percentage point) | Total market risk/Capital base (%) |
|---|---|---|---|---|---|---|
| | Total market risk | of which: Interest rate position risk | Equities position risk | Foreign exchange risk | | |
| Commercial banks | 1,434 | 972 | 62 | 377 | -0.3 | 2.8 |
| Finance companies | 71 | 35 | 36 | n.a. | -0.1 | 0.6 |
| Merchant banks | 828 | 644 | 123 | 14 | -2.3 | 18.4 |
| Banking system[1] | 2,333 | 1,644 | 221 | 392 | -0.3 | 3.4 |

[1] Excludes Islamic banks.
n.a. Not applicable.
Note: Total may not add up due to rounding.

market risk amounted to RM2.3 billion or 3.4% of capital base, while the impact on the RWCR of the banking system as a whole was marginal.

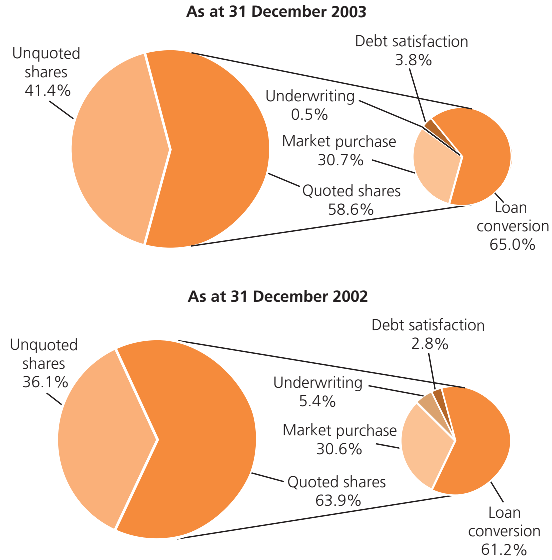
Banking institutions' interest rate risk in their trading books accounted for over 70.8% or RM1.7 billion of total market risk, of which 58.9% and 39% were attributed to the commercial banks' and merchant banks' trading activities respectively. Equities and foreign exchange risks of banking institutions accounted for approximately 26.3% of total market risk.

### Equity Risk

Exposure of the banking system to equity risk remained insignificant, with overall outstanding equity holdings representing only 0.4% of the banking system's total assets as at end-2003. Banking institutions increased their equity investments by 30.6%, to RM3.5 billion as at end-2003 from RM2.6 billion as at end-2002. This was attributed largely to the conversion of loans into equity as a result of debt restructuring activities.

Investments in quoted shares by the banking system increased by 19.7% to RM2 billion from RM1.7 billion during the year while investments in unquoted shares registered a significantly higher increase of 50%. These were reflective of the restructuring activities undertaken by banking institutions in 2003. As at end-2003, holdings of unquoted shares accounted for 41.4% of the total equity investments by the banking system compared to 36.1% as at end-2002. In addition, banking institutions' holdings of quoted shares were purchased directly from the market, which increased by RM105 million or 20.3%. Shares held as a result of underwriting declined by RM80 million or 88.6%, reflecting the better performance of the stock market in 2003.

**Graph 4.10**
**Banking System[1] : Composition of Equity Investments**




[1] Excludes Islamic banks

The finance companies registered the highest increase in the holding of equity investments within the banking system, that is by RM329 million, of which 62.7% were unquoted shares. 94.7% of the increase in the holding of quoted shares by finance companies was as a result of loans-to-equity conversion. The same was true for the commercial banks as a group, where 54.6% of the increase in equity holdings comprised unquoted shares, and the 25.7% increase in holdings of quoted shares was almost entirely due to loan conversion and debt satisfaction.

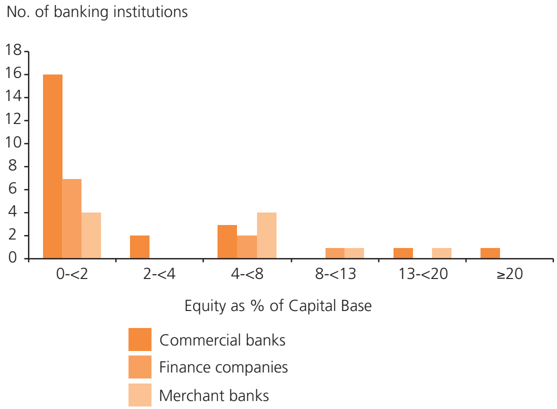
With respect to the merchant banks, the substantial decline in equity holdings resulting from underwriting and loan conversion had offset the significant increase of 96.7% in quoted shares

**Table 4.14**
**Banking System[1]: Equity Exposure**

| | Equity[2] holdings (RM million) | | Equity[2] / Capital base (%) | | Potential equity[2] loss / Capital base (%) | |
|---|---|---|---|---|---|---|
| | As at end | | | | | |
| | 2002 | 2003 | 2002 | 2003 | 2002 | 2003 |
| Commercial banks | 853.8 | 1,073.3 | 1.8 | 2.1 | 0.1 | 0.2 |
| Finance companies | 429.0 | 551.7 | 3.9 | 4.8 | 0.3 | 0.4 |
| Merchant banks | 410.7 | 402.3 | 9.0 | 8.9 | 0.7 | 0.7 |
| Banking system[1] | 1,693.5 | 2,027.3 | 2.7 | 3.0 | 0.2 | 0.2 |

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

**Graph 4.11**
**Banking System[1]: Distribution by Equity as a Percentage of Capital Base as at 31 December 2003**




[1] Excludes Islamic banks

purchased directly from the market during the year. Collectively, the merchant banks' equity holdings were marginally lower in 2003 than in 2002.

Even as the equity holdings of the merchant banks remained unchanged, they continued to record the highest level of equity exposure as their holdings of quoted shares accounted for 8.9% of capital base as against 2.1% for the commercial banks and 4.8% for the finance companies as at end-2003. Individually, most banking institutions had less than 2% of their capital base exposed to equity risk.

As at end-2003, the potential maximum loss for the banking system as a whole was lower at 7.9% compared to 8.2% in 2002. This was in terms of equity value based on a 10-day volatility of the Kuala Lumpur Stock Exchange Composite Index (KLSE CI) in 2003. Based on the estimated potential maximum loss of KLSE CI, therefore, potential loss to the banking system was estimated to remain at 0.2% of capital base despite the increase in the holdings of quoted shares. The potential loss for the commercial banks and finance companies remained insignificant, at 0.2% and 0.4% of their capital base respectively. The potential loss for the merchant banks was maintained at 0.7% of the capital base.

**Table 4.15**
**Banking System[1]: Foreign Currency Exposure**

| | NOP (RM million) | | NOP/Capital base (%) | |
|---|---|---|---|---|
| | As at end | | | |
| | 2002 | 2003 | 2002 | 2003 |
| Commercial banks | 2,786 | 2,574 | 5.8 | 5.0 |
| Merchant banks | 73 | 50 | 1.6 | 1.1 |
| Banking system[1] | 2,859 | 2,624 | 5.5 | 4.7 |

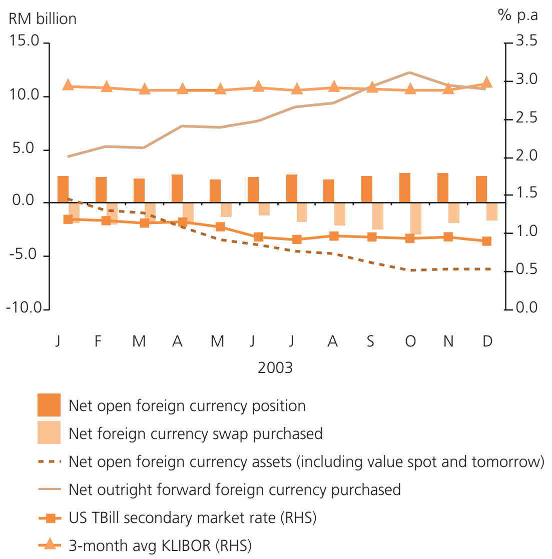
[1] Excludes Islamic banks.

### Foreign Exchange Risk

The exposure of the banking system to foreign exchange risk in 2003 remained within prudential levels. Throughout the year, the net open foreign currency position (NOP) of the banking system moved within a narrow range of RM2.2 billion to RM2.8 billion. As a percentage of the banking system's capital base, the NOP registered a decline from 5.5% as at end-2002 to 4.7% as at end-2003.

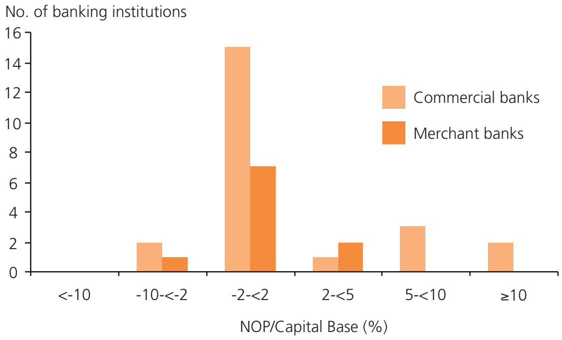
The banking institutions remained net foreign currency forward purchasers in 2003 as exporters capitalised on the forward premiums which ranged between 42 to 52 basis points for the one-month forward rates. However, as the forward premiums stabilised in 2003, the increase in the amount of forward contracts purchased by the banking institutions during the year was sustained at about the same level as in 2002. Forward foreign currency contracts purchased by the banking institutions rose by RM7.2 billion or 53.2% in 2003 compared with an increase of RM6.7 billion or 98.3% in 2002. Demand for forward contracts by exporters remained strong in 2003.

**Graph 4.12**
**Banking System[1]: Components of Foreign Currency Exposure**




[1] Excludes Islamic banks

**Graph 4.13**
**Banking System[1] : Distribution of Net Open Foreign Currency Position as at 31 December 2003**




[1] Excludes Islamic banks

To manage their forward purchases and capitalize on the relatively cheaper USD borrowings, banking institutions increased their foreign currency liabilities by RM4.3 billion or 10.1% to RM46.7 billion as at end-2003. Banking institutions, however, reduced their foreign currency assets by RM3.3 billion to RM40.4 billion as at end-2003 on account of diminishing returns. On a net basis, the banking system had a net foreign currency liability of RM6.3 billion as at end-2003 as against a net foreign currency asset position of RM1.2 billion as at end-2002.

The banking system is expected to maintain a net foreign currency liability position and remain a net forward foreign currency purchaser in an environment in which the interest rate differential between USD and Ringgit is expected to remain positive resulting in continued favourable forward premiums.

### Capital Strength

The banking sector remained resilient and well-capitalised, with RWCR and core capital ratio sustained consistently above 13% and 10% respectively throughout the year. The capital base of the banking system increased by RM4.5 billion, of which audited profits contributed RM1.2 billion, while capital raising exercises by a number of banking institutions contributed another RM3.3 billion. These new capital injections offset the reduction in capital as a result of a merger of two large commercial banks during the first half of 2003. In line with higher financing activities, risk-weighted assets of the banking system grew by RM28.3 billion or 5.9% to RM506.6 billion at end-2003.

In tandem with the higher profits and new issuance of shares, total Tier-1 capital increased by 2.8% or RM1.6 billion, to RM59.3 billion as at end-2003. Nevertheless, a higher increase in the risk-weighted assets caused the core capital ratio to decline marginally to 10.7%. Meanwhile, total Tier-2 capital recorded a stronger growth of 14.4%, following the issuance of subordinated debt by four banking institutions, mainly to strengthen their capital position. Combined with the reduction in investment in subsidiaries as a result of the merger of two large commercial banks, the RWCR of the banking system strengthened further to 13.4% (end-2002: 13.3%).

The RWCR of commercial banks increased to 13.6% due to higher capitalisation and reduction in investment in subsidiaries, while there was a decline in capital base for merchant banks due to a significant increase in the holdings of other banking institutions' shares by one merchant bank. This, combined with an increase in risk-weighted assets of 2.4%, resulted in the RWCR of the merchant

**Table 4.16**
**Banking System[1]: Constituents of Capital**

| | As at end | | Annual change | |
|---|---|---|---|---|
| | 2002 | 2003 | | |
| | RM million | | RM million | (%) |
| Tier-1 capital | 57,662.0 | 59,282.5 | 1,620.5 | 2.8 |
| Tier-2 capital | 16,756.7 | 19,174.4 | 2,417.7 | 14.4 |
| Total capital | 74,418.7 | 78,456.9 | 4,038.2 | 5.4 |
| *Less:* | | | | |
| Investment in subsidiaries and holdings of other banking institutions' capital | 11,016.4 | 10,591.9 | -424.5 | -3.9 |
| Capital base | 63,402.4 | 67,864.9 | 4,462.5 | 7.0 |
| Risk assets: | | | | |
| 0% | 139,125.1 | 170,856.6 | 31,731.5 | 22.8 |
| 10% | 15,544.0 | 16,849.8 | 1,305.8 | 8.4 |
| 20% | 96,968.9 | 119,938.6 | 22,969.7 | 23.7 |
| 50% | 102,628.2 | 117,511.0 | 14,882.9 | 14.5 |
| 100% | 406,009.8 | 422,137.2 | 16,127.4 | 4.0 |
| Total risk-weighted assets | 478,272.1 | 506,565.5 | 28,293.5 | 5.9 |
| Risk-weighted capital ratio (%) | | | | |
| **Banking system[1]** | **13.3** | **13.4** | **0.1** | |
| Commercial banks | 13.2 | 13.6 | 0.4 | |
| Finance companies | 12.0 | 11.3 | -0.7 | |
| Merchant banks | 19.0 | 18.4 | -0.6 | |

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

## FINANCIAL SECTOR MASTERPLAN

The Financial Sector Masterplan (FSMP) which was launched in March 2001 sets out the broad strategies for the development of the financial sector over a ten year period. The end objective is to evolve the financial system into one which is competitive, resilient and dynamic. Efforts that were undertaken during the initial stage of the implementation of the FSMP were predominantly directed towards enhancing the capacity and capability of domestic financial institutions in order to enhance their level of effectiveness and competitiveness, strengthening the regulatory and supervisory framework, promoting a safe and efficient payments system as well as developing the framework on consumer education and protection.

During the first three years of the implementation of the FSMP, a total of 31 out of the 119 recommendations have been fully implemented, with an additional 24 recommendations are being implemented on a continuous basis. Details of the recommendations which have been fully implemented are as listed in the accompanying table.

**Completed Recommendations**

| | |
|---|---|
| | **Banking Sector** |
| R3.4 | Liberalise restrictions on salaries and staff mobility in the banking industry to enable the industry to attract the best talent and reward them accordingly |
| R3.5 | Uplift restriction on employment of expatriates to attract the best international talents to meet the demand for expertise in specific areas of banking |
| R3.6 | Establishment of board committees, namely Nominating, Compensation and Risk Management Committees to further enhance corporate governance standards |
| R3.7 | Allow group rationalisation through cross-selling of products and consolidation of back-office processes as well as facilitate the merger of commercial banks and finance companies to further enhance efficiency and competitiveness |
| R3.12 | Encourage outsourcing of non-core functions to gain greater strategic focus and efficiency |
| R3.14 | Encourage the development of new delivery channels to increase the range of products and services to further enhance competitiveness |
| R3.15.1 and R3.15.2 | Introduction of a simpler product notification process to provide incentive for development of new and innovative products, and outline clear set of guidelines providing criteria for product notification and specific product approval requirements |
| R3.21 | Issuance of examination manuals for implementation of risk-based supervision with supervisory focus on high risk areas and greater attention on weak institutions |
| R3.28 | Allow market forces to shape developments in the payments system to allow greater competition and increase innovation in payments system |
| | **Insurance Sector** |
| R4.1 | Remove restrictions on outsourcing to enable insurers to further develop core competencies and effective business strategies |
| R4.2 | Allow eligible insurers to use the internet as a distribution channel to enhance competitiveness and efficiency of the insurance industry |
| R4.6 | Relax the restrictions on employment of expatriates to accelerate the development of skills and expertise in the industry |
| R4.16 | Increase the statutory minimum paid-up capital of insurers to enhance their financial resilience and to accelerate the consolidation of the industry in order for domestic insurers to capture the size and scale needed to compete effectively in a more deregulated and liberalised market |
| R4.18 | Establish board committees with specific responsibilities and enhance disclosure of compensations to directors and senior management to ensure they act in a manner that will increase shareholder value |

| | |
|---|---|
| R4.19 | Raise the entry requirements for the agency force to ensure the recruitment of more qualified and competent agency force |
| R4.20 | Introduce additional compulsory exams as part of continuing education programmes for agents to upgrade their knowledge and skills |
| R4.21 | Further strengthen performance-based supervision to maintain stability under more deregulated and competitive market conditions |
| R4.26 | Introduce 'best advice' regulations to enhance consumer protection and professionalism in the sale of life insurance products by insurance intermediaries |
| R4.27 | Strengthen regulations on unfair trade practices to ensure sound business practices and fair treatment of consumers |
| R4.29 | Allow financial and non-financial institutions to acquire interests in direct insurers to create business synergies |
| **Islamic Banking and Takaful** | |
| R5.3 | Build strong management through the establishment of board committees, benchmarking and employment of experienced and qualified staff |
| R5.6 | Increase the number of takaful operators to accelerate the expansion of takaful industry |
| **Development Financial Institutions (DFIs)** | |
| R6.4 | Introduce a systematic framework for sourcing funds to ensure the appropriate and adequate funding for the operations of DFIs. |
| R6.7 | Establish a legislative framework to provide for the regulation and supervision of DFIs to ensure that DFIs' policies and objective are consistent with the national policy objectives |
| **Alternative Modes of Financing** | |
| R7.2 | Establish a RM500 million Venture Capital Fund to increase the availability of Venture Capital financing and stimulate new ventures |
| R7.3 | Introduce further tax incentives for the Venture Capital industry to promote the growth of Venture Capital |
| R7.4 | Liberalise the MESDAQ listing requirements to facilitate the exit of Venture Capital companies from their investments |
| **Labuan International Offshore Financial Centre** | |
| R8.3 | Adopt a consultative and market driven approach to create a conducive tax and business environment to enhance the competitiveness and attractiveness of Labuan |
| R8.6 | Strengthen Islamic banking and finance as well as takaful to develop Labuan with a strategic focus on Islamic products and services |
| R8.7 | Enhance Labuan International Financial Exchange (LFX) to be a one stop financial exchange for residents and global companies |

The recommendations implemented and the various initiatives undertaken during the first three years of implementation have contributed towards enhancing capacity and capabilities of domestic financial institutions, as well as providing a robust infrastructure to ensure overall stability of the financial sector.

**BANKING SECTOR**

Initiatives that were undertaken during Phase 1 of the implementation of the FSMP were primarily focused on building the capacity and capabilities of domestic banking institutions to enhance their competitiveness and building the infrastructure within which the banking institutions operate to promote the development of a more robust banking system. Attention was also accorded towards creating the necessary infrastructure for a more market-based consumer protection framework.

One of the key milestones for Phase 1 of the FSMP is to drive performance improvement. The industry-wide benchmarking programme which was initiated in 2002 provided banking institutions with a tool to enable more effective strategic focus and business planning and provided the relative ranking of each institution in all areas of performance. The benchmarking exercise also enabled Bank Negara Malaysia to assess the progress of the industry, particularly the performance improvements recorded by the domestic financial institutions thereby determining the speed of transition and progress.

The domestic banking institutions have steadily recorded improvements over the past three years yielding desirable results. The consolidation programme has resulted in larger and better capitalised domestic banking institutions. The average total assets and shareholders' funds per domestic commercial banks have more than doubled from RM18.1 billion as at end-1999 to RM44.9 billion as at end-2003 and from RM1.4 billion as at end-1999 to RM3.8 billion as at end-2003 respectively. The profitability levels have increased over the past three years. Return on average assets and return on average equity of the domestic banks have increased from 0.7% and 8.4% in 2001 to 1.2% and 13.4% in 2003 respectively. Pre-tax profit per employee had also increased significantly from RM50,196 in 2001 to RM108,728 in 2003. The cost to income ratio also declined from 41.2% in 2001 to 40.1% in 2003. Improved management of the operating costs had stabilised the operating expenses as a percentage of average assets at RM1.42 per every RM100 of assets over the same time period.

The banking institutions in Malaysia operate in an open environment. Both the domestic and foreign controlled banking institutions are governed by the same set of legislations and regulations, with the only remaining restriction on foreign banks being in the area of branching. Foreign controlled banking institutions nevertheless have a strong presence in the market, accounting for 26%, 27% and 25% of the commercial banking assets, loans and deposits markets respectively.

Competition has resulted in the narrowing of gross interest margins of commercial banks from 4.14 percentage points in 2001 to 3.69 percentage points in 2003. In this more competitive environment, the domestic banking institutions have been able to sustain their market share at 80%. The foreign banking institutions have expanded their loan market share mainly in housing loans. The domestic banking institutions continue to be the main provider of financing for businesses, particularly for the small and medium enterprises, where 83% of the loans to this sector were extended by the domestic banking institutions. The domestic commercial banks have also expanded their market share in the credit card business, which was previously the domain of the foreign controlled commercial banks to 47% of the market (2000: 43%).

To enhance the level of operating efficiency and allow greater strategic focus on business operations, banking institutions can now outsource non-core operations to third party service providers. They are also permitted to rationalise common internal operations such as treasury function and human resource management. A number of banking institutions also cross-sell products and services within the same banking group. Strategic alliances between banks and other banking institutions as well as non-banking institutions have also taken place to further enhance competition and innovation. One example is in the area of bancassurance and the sale of unit trusts. In addition, domestic banking institutions have also introduced new services such as wealth management and structured deposit products.

To enhance the delivery of products and services to customers, banking institutions have embraced innovative technology-based delivery channels such as internet and mobile banking. This widens the accessibility of banking services and facilitates seamless connectivity in the delivery of financial products and services to customers through the operation of one-stop financial centres. Efficiency of the banking sector has also improved, with the average time taken by commercial banks to process housing loan applications having declined from 4 days in March 2002 to 3.1 days and from 11 days to 9.5 days for new credit card applications. With greater emphasis on customer relationship, the percentage of customer complaints that are resolved within 14 days have improved from 82.1% in March 2002 to 87.6% in December 2003.

As a result of the significant progress made by the domestic banking institutions, liberalisation of the system has been brought forward in several areas. While the domestic banking institutions were allowed to offer full internet banking services beginning 1 June 2000, the locally-incorporated foreign banks were permitted to offer such services beginning 1 January 2002, earlier than was announced. The requirement for a non-resident controlled company to source at least 50% of its financing requirements from domestic banking institutions was also uplifted with effect from 1 April 2003.

A smooth functioning payments system which is efficient and effective is also important. As the payments technology and the structure of the financial services industry change rapidly, it is necessary to have a payments system which responds to this new environment. To encourage greater innovation and competition, Bank Negara Malaysia has shifted its role from being directly involved in the development process to a more facilitative role, particularly in the retail payments system. Bank Negara Malaysia will however, continue to ensure that minimum security standards are applied when any new systems are introduced. The Payment Systems Act 2003 was enacted to facilitate the development of payments system and to ensure that it is secure and efficient.

An important aspect of stability in the financial system relates to the ability of the system to undergo the transition to deregulation and increasing competition with no disruption in the level or reliability of services to customers. The customers also play an important role to drive performance improvement of the financial institutions. Crucial to this is active consumerism, which can only be attained with the public having the necessary information and understanding of financial products and services. Towards this, a 10-year consumer education programme was launched to disseminate information to consumers including information on consumer rights and responsibilities. In addition, efforts have also been put in place to encourage consumers to pursue formal administrative and legal redress for their grievances. Banking institutions are required to set up dedicated complaint units to manage complaints received from customers.

The banking system remains the largest provider of funds to the private sector, providing support to the various sectors of the economy. In line with the objective to develop a well-diversified financial system with well-functioning, deep and liquid markets, Bank Negara Malaysia continued to take an active role in the development of the bond market to meet the changing needs of the Malaysian economy. As a result, the bond market experienced a rapid growth since the Asian financial crisis. As at end-2003, the size of the bond market was equivalent to 87.6% of GDP, compared with 46.9% in 1996. The private debt securities (PDS) market has emerged as an important source of financing for the private sector since 1998. PDS outstanding represented 34.3% of GDP at end-2003.

To enhance the liquidity in the secondary bond market, the Guidelines on Securities Borrowing and Lending (SBL) Programme under the Real Time Electronic Transfer of Funds and Securities System were issued to support trading strategies for principal dealers and enhance the return on bond portfolio investment for investors. Through SBL, principal dealers (PDs) can now participate as both borrower and lender, which allow PDs to quote two-way prices more effectively and at the same time able to meet commitments of their treasury activities. In addressing the captive bond market issue and to promote the secondary trading, greater investment flexibility was accorded for insurance companies to invest in Malaysian Government Securities and PDS.

To increase the availability of risk management tools for market participants, more players were allowed to undertake repo transactions with the licensed financial institutions. The Prudential Standards on Asset Backed Securities Transactions by Licensed Institutions issued by Bank Negara Malaysia in 2003 helped in creating greater awareness and participation in securitisation transactions. Universal brokers have been allowed to participate in fixed income market and thus engage the services of money-brokers. A broader investor base is an important factor in contributing to liquidity in the secondary market.

Concerted efforts were also made to develop the Islamic financial markets to meet the demands of institutional investors such as the issuance of Islamic based Government investment issues and the development of a risk-free benchmark Islamic yield curve to help in the pricing and trading of Islamic securities. To further develop the Islamic capital market, the Government had provided incentives such as tax exemption for expenses incurred on the issuance of Islamic PDS. As a result of these efforts, the Islamic PDS market has grown significantly. Total outstanding of Islamic PDS stood at RM69.1 billion, or 46% of total PDS outstanding as at end-2003.

Measures that have been put in place over the past three years were implemented to ensure that the banking system will continue to support sustainable economic growth and to prepare the Malaysian banking sector for a more liberalised and global operating environment. The strategy for the banking system on the latter has been one of gradualism. A managed and sequenced deregulation and liberalisation process is adopted to ensure that financial reforms will be effectively implemented without destabilising implications on the system.

**INSURANCE SECTOR**

The recommendations implemented in the first phase of the FSMP are aimed at building the capabilities of domestic insurers to compete more effectively, strengthening the consumer protection framework and raising corporate governance standards to further enhance the protection of policyholders and shareholders value.

The capacity-building initiatives and measures implemented under Phase 1 of the FSMP have brought about positive developments in the industry over the last three years. Significant progress was achieved in the consolidation of the industry, particularly in the more fragmented general insurance sector, following the increase in the minimum paid-up capital requirement for insurers from RM50 million to RM100 million in 2001. A total of 15 mergers and acquisitions involving a total of 28 general insurers (including four composite insurers) have been successfully completed since 1999. As a result, the average capitalisation of general insurers strengthened by 54.4% from RM92.2 million in 2000 to RM142.3 million in 2003, improving the competitive position, and therefore better able to take advantage of the opportunities presented in the more open market environment.

Domestic insurers continued to maintain their dominant position in the general insurance sector, while also achieving productivity and profitability gains. As at end-2003, domestic insurers accounted for 73.3% of gross general insurance premiums, with the top five domestic insurers collectively controlling 31.8% of the total gross premiums in the industry. Employee productivity rose from RM498,857 in 2000 to RM797,923 in 2003. Overall profitability, as measured by gross premiums generated per employee, also improved, with domestic insurers sustaining a higher return on equity over foreign insurers (24.7% as against 20.4% by foreign insurers for the year 2003).

In the life insurance sector, significant attention was directed at developing new growth opportunities to increase the market penetration, and hence economies of scale. In this respect, domestic insurers secured a dominant position in bancassurance business, accounting for 76.6% of the total new insurance premiums generated through banking institutions in 2003. The commitment of domestic insurers to the development of bancassurance was supported by the encouraging sales of non-credit related products. Domestic insurers accounted for more than 80% of total non-credit related bancassurance business in 2003.

As at end-2003, a total of 12 life insurers had been given approval to enter into bancassurance arrangements with banking institutions. Business generated through this alternative distribution channel has quadrapled since 2000 to reach RM1,859 million in 2003. Two domestic insurers have successfully leveraged on the banking distribution network to become market leaders in bancassurance, with a combined market share of 36% of total bancassurance premiums generated in 2003. Bancassurance currently accounts for more than 38% of total new life business premiums in the market and has been a major factor contributing to the higher penetration of life insurance business in Malaysia which increased from 31.5% in 2000 to 36.4% in 2003.

Domestic life insurers succeeded in making further inroads in investment-linked business, which has emerged as a new growth area. The market share of investment-linked business attributed to domestic insurers has increased progressively from 16% in 2001 to 27.9% in 2003, contributing to a higher overall new business growth rate of 31.5% achieved by domestic life insurers in 2003, compared with 19.4% registered by foreign insurers.

The capacity building initiatives under Phase 1 of the FSMP also introduced a more flexible operating regime aimed at enabling domestic insurers to innovate, develop expertise and enhance efficiency levels. In this respect, the transfer of expertise to domestic insurers was facilitated by a more flexible policy on the appointment of expatriates. As at end-2003, a total of 42 expatriates were employed in the insurance industry to provide technical support in the areas of information technology, underwriting, actuarial and agency development. In the more flexible operating environment, an increasing number of insurers also leveraged on effective outsourcing strategies to lower costs while delivering higher service quality to their customers.

As at end-2003, more than 30 insurers were engaged in outsourcing arrangements, primarily in back-end support functions related to management information systems, data processing and customer service support. Consumer access to insurance was also made more convenient with approval given to 18 insurers to provide insurance over the internet, including eight insurers which are now able to offer motor insurance policies on-line through an interactive website. The process improvements enabled by these developments resulted in an overall improvement in the efficiency levels of domestic insurers. Domestic life insurers registered a lower expense rate of 34.2% in 2003 (2000: 36.8%), while the combined management expense ratio of domestic general insures improved to 24% in 2003 (2000: 24.4%).

Notwithstanding the positive developments in the industry, domestic players with significant overall market share have yet to emerge in the life insurance sector. In the transition to the second phase of the FSMP which envisages a level playing field between domestic and foreign players, the focus of policy will continue to be directed at developing domestic insurers, in particular life insurers, to consolidate domestic strengths in the penetration of alternative distribution channels, promote further innovation and facilitate strategic alliances.

The implementation of specific measures under Phase 1 of the FSMP to promote greater market discipline and strengthen corporate governance will support further performance improvements by domestic insurers. Enhanced disclosure requirements and the implementation of a comprehensive consumer education programme will empower consumers to make informed decisions on their choice of financial products and services which in turn, will serve as a strong incentive for improved product and service offerings by insurers. The strengthened corporate governance framework underpinning these initiatives will also serve to ensure that the board of directors posses the appropriate qualifications and experience to enable them to provide effective strategic direction to insurers in the more challenging environment. These measures supplement the changes being made to the regulatory framework and constitute important elements of a comprehensive approach to develop a robust, stable and dynamic insurance sector.

**ISLAMIC BANKING AND TAKAFUL**

The Islamic banking and takaful sector strengthened and expanded significantly during the first phase of the FSMP. The Islamic banking market share increased to account for 9.7% (2000: 6.9%) of total assets, 10.4% (2000: 7.4%) of total deposits and 10.3% (2000: 5.3%) of total financing of the banking system.

The takaful sector also expanded rapidly to constitute 5.7% (2000: 3.9%) of total assets and 6.0% (2000: 3.9%) of total contributions of the insurance industry. Phase 1 also witnessed significant progress being achieved in the development of the financial infrastructure for Islamic banking and takaful to function efficiently and effectively in parallel with conventional banking and insurance.

A significant milestone was achieved in the legal infrastructure development with the assignment of a dedicated High Court in 2003 to adjudicate all Islamic banking and finance cases. This development, reinforced by the formation of the Law Review Committee to undertake a holistic review of the present common law-based legislations will serve to establish an effective legal structure to cater for the unique nature of transactions in Islamic banking and finance. To complement these initiatives, a preliminary review of the Islamic Banking Act 1983 and Takaful Act 1984 was also undertaken.

The Shariah advisory structure was also strengthened with the amendment of the Central Bank of Malaysia Act 1958 which conferred a legal stature to the Shariah Advisory Council at Bank Negara Malaysia as the sole authority to decide on Shariah matters on Islamic banking and finance that fall under the purview of Bank Negara Malaysia. Guidelines will be issued to strengthen the structure of the Shariah Committees at the Islamic banking institutions and takaful operators and to define the composition, roles and responsibilities of these Shariah Committees. With the guidelines in place, the overall effectiveness of Shariah governance framework will be significantly enhanced.

The regulatory framework has been enhanced to address the characteristics of Islamic banking and takaful as well as to strengthen institutional capacity and financial resilience of Islamic banking and takaful players. The introduction of the standard framework for the computation of the rate of return in Islamic banking operations in 2001 provided greater transparency in the derivation of the rate of return to ensure a more equitable distribution of income between the bank and its depositors. The framework enhanced the capability of Islamic banking institutions to manage volatility in the rate of return more effectively and to remain competitive relative to the conventional banking institutions. The issuance of the Guidelines on the Specimen Reports and Financial Statements for Licensed Islamic Banks (GP8-i) in 2003 further increased financial disclosure to promote a more effective role of market discipline.

The capital position and financial resilience of the Islamic banking system strengthened significantly as a result of the regulatory requirement for conventional banking institutions participating in the Islamic Banking Scheme (IBS banks) to observe the minimum risk-weighted capital ratio for their Islamic banking portfolios. The minimum capital requirement of takaful operators would be raised from RM35 million to RM100 million with effect from 31 December 2004 to position takaful operators at par with conventional insurers.

The benchmarking programme for performance measurement has also been put in place to enhance the ability of Islamic banking institutions and takaful operators to assess their relative efficiency and formulate strategies to improve operational efficiency and to be at par with international best practices. In the area of corporate governance, the issuance of guidelines on the establishment of board committees, minimum qualifications and training requirements for directors, as well as the roles and responsibilities of independent directors in 2003 aim to strengthen the management of Islamic banking institutions and takaful operators as shareholders play a more active role in overseeing the effectiveness of the board of directors and management.

The issuance of the Guidelines on the Sell and Buy Back Agreement in 2002 enhanced the capacity of Islamic banking institutions to better meet their liquidity requirements as part of the efforts to develop a deep Islamic financial market structure. The variable rate financing mechanism introduced in 2003 provided a competitive tool for Islamic banking players in pricing product offerings to sustain their competitive position in a dual banking environment and concurrently assist Islamic banking institutions to effectively manage risks in pricing arising from asset and liability mismatches. The detail implementation framework for *mudharabah* (profit-sharing) and *musyarakah* (profit and loss sharing) financing is in the final stage of completion and is expected to further promote greater diversity in the mode of financing as the Islamic banking system advances into Phase 2 of FSMP.

The establishment of the Islamic Banking and Finance Institute Malaysia (IBFIM) in 2002 as an industry-owned training and research institute was another important progress achieved. IBFIM will spearhead the development of a pool of knowledgeable and competent Islamic bankers and takaful operators to meet the requirements of the Islamic financial industry. The organisation of the Islamic Banking and Takaful Week in 2001 and 2003 as well as the launching of the Consumer Education Programme have also played an important role in enhancing the level of public literacy in Islamic banking and takaful. Consumers are now more aware of the characteristics of Islamic banking and takaful, its underlying Shariah principles and concepts as well as the range of products and services offered by Islamic banking institutions and takaful operators.

Progress has also been achieved in the development of the institutional infrastructure. Two additional takaful operators have been licensed. In Islamic banking, a review of the existing "window" institutional structure of the IBS banks is being undertaken to prepare an enabling structure that can assimilate these developments and thus strengthen the prudential regulatory and supervisory regime.

As the progress of development has exceeded initial expectations in Phase 1, Bank Negara Malaysia has brought forward the liberalisation for the Islamic banking sector from Phase 3 to Phase 2, three years earlier than envisaged by the FSMP. The liberalisation of the Islamic banking sector will further hasten the pace of development and strengthen global integration to prepare the enabling environment for Malaysia to evolve as a regional centre for Islamic banking and finance.

**DEVELOPMENT FINANCIAL INSTITUTIONS**

In tandem with the strategic directions outlined in the FSMP, efforts undertaken during Phase 1 of the FSMP were focused on fostering a pool of efficient and effective DFIs to complement banking institutions in providing financing to identified priority and strategic sectors in the economy.

During Phase 1 of FSMP, strategies undertaken were centred mainly on strengthening the regulatory framework and capacity building of the DFIs. These strategies and initiatives include the legal infrastructure and policy development to support an orderly and sound development of effective DFIs.

A comprehensive regulatory and supervisory framework to facilitate the overall policy development of DFIs, especially in strengthening the financial and operational soundness of the DFIs was completed with the enactment of the Development Financial Institutions Act 2002 (the Act) in February 2002. The Act provides comprehensive mechanisms to ensure DFIs perform their mandated socio-economic functions. Following the enactment of the Act, six DFIs were subjected to the regulatory and supervisory framework embedded in the Act.

The major policy framework on building the capacity of DFIs aimed to ensure that as specialised development institutions, the institutions would have an effective role in supporting developmental needs of the nation. The DFIs are required to prepare and submit statement of corporate intent which highlight the planned business activities, implementation strategies and performance target within the mandated roles and Government's development objectives to ensure that DFIs remained focused on their mandated roles.

Prudential measures, namely, the classification of impaired loans and loan loss provisioning requirement have been introduced to ensure that the impaired loans and potential losses are identified and recognised in a timely manner, and loan assets and income are fairly and prudently stated. The maintenance of minimum liquidity has been introduced to enhance the financial soundness of DFIs. The policy on minimum capital requirement has been initiated to ensure DFIs have the financial capacity to sustain their operations. During Phase 1, regular on-site examinations of the six DFIs were conducted to assess the DFIs' performance in meeting the mandated roles.

To further equip DFIs as specialised development institutions, measures were undertaken to enhance their role in providing non-financial services. A joint project with the Japan International Cooperation Agency and selected DFIs was initiated to enhance the provision of advisory services of these DFIs to SMEs. The project will formulate action and implementation plans to enhance the institutional capability, including human resource skills.

To strengthen corporate governance, guidelines were issued to assist the DFIs and their stakeholders in instituting effective governance structure and oversight of Board of Directors. The main areas addressed in the guideline are duties and responsibilities of the board of directors, minimum requirements and rules governing the appointment of directors and chief executive officers as well as the establishment of board committees.

Moving forward, measures implemented will continue to be focussed on providing the enabling environment for the DFIs to operate efficiently and effectively. Strategies in the near term will focus on institutional development of the DFIs in the areas of risk management and the advisory and consultancy capability for other targeted customers, besides the SMEs. At the same time, efforts to promote institutional efficiency of the DFIs through the formulation of performance indicators will also be intensified to strengthen their financial and operational conditions.

**MOVING FORWARD**

The measures that have been implemented thus far were aimed towards providing a strong foundation on which the financial sector will be developed in the future. In addition to the measures that were implemented in the banking, insurance, Islamic banking and takaful, and development financial institutions sectors, significant strides have also been recorded in introducing alternative modes of financing in the domestic financial system. Significant progress has also been made in the development of Labuan as an international offshore financial centre. On the former, the Government has been in the forefront in the development of the venture capital (VC) industry, a key step towards transforming Malaysia into a knowledge-based economy. Initiatives such as the establishment of a one-stop centre for the VC industry, tax incentives and VC fund will continue to spur development in the industry. With the rapid recognition and growing demand for Islamic finance, Labuan has strategically promoted itself as an Islamic financial centre. Supported by the strong onshore Islamic financial sector, Labuan is well positioned to participate in the growing global Islamic financial market.

As we move forward, further efforts in institutional development will be undertaken, in particular, for the domestic financial institutions. This will be accompanied by gradual liberalisation, with the balance being made to ensure that the benefits will be maximised while any destabilising implications minimised. In addition, a more diversified financial services landscape will emerge with the capital market, insurance and venture capital having a significant role in the financial sector.

## The Proposed Deposit Insurance System in Malaysia

In 2003, substantial progress was made towards finalising the features of the proposed deposit insurance system for Malaysia, thus paving the way for its establishment. The improved strength, competitiveness and resilience of the banking system following the comprehensive restructuring and capacity building initiatives support a positive environment for the effective implementation of a deposit insurance system that will contribute to the stability of the financial system.

As an integral component of the financial safety net, the deposit insurance system will further strengthen incentives for financial institutions to adopt sound financial and business practices and enhance public confidence in the financial system by providing explicit protection of deposits. The proposed features underpinning the Malaysian deposit insurance system fully support these objectives.

In developing the design features, Bank Negara Malaysia has considered various models adopted in other countries that operate explicit deposit insurance systems, adapting them as appropriate, in order to achieve a system that will function efficiently, equitably and in a manner that provides the appropriate economic incentives for all participants within the Malaysian context. Key elements of the proposed design features include:-

(a) a **legislated mandate** for the agency responsible for the administration of the deposit insurance system (hereafter referred to as 'Agency'). This will ensure clarity of its role and responsibilities within the financial safety net and provide the basis for the statutory powers to be accorded to the Agency;

> *The proposed mandate for the Agency is to:-*
> *(i) administer the deposit insurance system;*
> *(ii) protect depositors from the loss of their deposits up to the insured limit in the event of a bank failure;*
> *(iii) strengthen incentives for sound risk management in the banking industry; and*
> *(iv) promote or otherwise contribute to the stability of the financial system.*
>
> *Within its proposed mandate, the Agency will have the role, in certain circumstances, to undertake the resolution of banking institutions, as may be required based on the assessment of Bank Negara Malaysia. In this role, the Agency will also be responsible to minimise the costs of bank resolutions to the financial system, taking into account factors affecting financial system stability.*

(b) **compulsory membership for commercial banks** (including subsidiaries of foreign banks operating in Malaysia) and **finance companies** licensed under the Banking and Financial Institutions Act 1989, and **Islamic banks** licensed under the Islamic Banking Act 1983, to accept deposits (hereafter referred to as 'member institutions'). This will avoid risks associated with adverse selection whereby only small and perceived weaker institutions participate in the system. This is important to enhance the viability of the deposit insurance system;

(c) **protection** up to the prescribed limit (for eligible deposits) for **all depositors** of member institutions. Provisions will be made for the Agency to approve additional financial instruments as being eligible for deposit insurance to accommodate new types of deposit products that may be introduced in future. Deposits that are not payable in Malaysia, foreign currency deposits, negotiable instruments of deposit or other bearer deposits, repurchase agreements and money market placements would not be insured;

(d) an **adequate basic level of protection** provided **for every depositor's deposits in *each* member institution.** Depositors with deposits in more than one member institution will be insured separately for their deposits in each institution. Joint and trust deposits will also be separately insured, providing additional coverage within the system for depositors with such accounts. The deposit insurance limit will be set at a level that is sufficient to protect the vast majority of depositors in full. At the same time, the deposit insurance limit will retain sufficient incentives for the larger and institutional depositors to monitor the financial condition of member institutions. This is important to promote sound financial and business practices, thereby further enhancing financial stability;

(e) **equivalent protection for Islamic and conventional deposits** which will be separately insured up to the deposit insurance limit to avoid any competitive distortions between the Islamic and conventional banking systems. In this respect, extensive consultations have been held with the National Shariah Advisory Council on elements of the deposit insurance system relating to Islamic deposits to ensure consistency and compliance with Shariah principles;

(f) **annual premiums** to be paid by member institutions to the deposit insurance fund to be **based on** the institution's total **insured deposits**. The annual premiums will be borne entirely by member institutions and should not result in the imposition of additional service charges, either explicitly or implicitly, on consumers. The deposit insurance fund may be used to reimburse the depositors of a member institution that is unable to meet its obligations to depositors or otherwise provide financial assistance for the resolution of the institution. The annual premiums may be supplemented by additional premiums imposed on member institutions to cover any loss resulting from the implementation of resolution schemes; and

*An Islamic deposit insurance fund, funded by premiums collected on insured Islamic deposits, will be separately maintained to ensure that the coverage accorded to Islamic deposits fully comply with Shariah principles.*

(g) the implementation of a **differential premium system** to determine the premiums payable by each member institution. Consistent with the Agency's mandate to strengthen sound risk management practices among member institutions, financial consequences (through higher premium rates) will be attached to practices of member institutions that increase the risk of loss to the deposit insurance system. In line with the basic structure of proven and tested rating systems employed in other countries, both qualitative and quantitative criteria will be taken into account to determine the premium category in which a member institution is classified.

It is envisaged that the deposit insurance system will be administered by a separate statutory body established under an Act of Parliament to accord greater focus and clarity to the fulfilment of the deposit insurance mandate. The Agency will be supported by an independent board comprising relevant representatives from the public and private sectors. As separate components of the financial safety net, appropriate institutional arrangements will also be put in place to facilitate effective co-operation and co-ordination of actions between Bank Negara Malaysia and the Agency.

Following a consultation process with the banking industry, the deposit insurance system will be implemented subsequent to the passing of legislation in Parliament, and the establishment of the necessary infrastructure.

bank industry to decline to 18.4% (end-2002: 19%). In the case of finance companies, the continued strong demand for hire purchase financing during the year led to a higher growth in risk-weighted assets as compared with the moderate growth in capital base, resulting in the RWCR declining to 11.3% (end-2002: 12%).

The higher expansion in loans contributed to the increase in total risk-weighted assets of the banking system, which grew by 5.9% to RM506.6 billion. The increase was noted across all risk categories, especially at the 0% and 20% category. The increase in the 0% category by 22.8% to RM170.9 billion, was mainly due to Bank Negara Malaysia's liquidity operations. In line with the higher lending for the purchase of residential properties, the assets in the 50% risk-weight category increased by 14.5% to RM117.5 billion. Risk-weighted assets in the 100% risk-weight category grew by 4% or RM16.1 billion, attributable to other loan financing.

Given its strong level of capitalisation, the banking system is well placed to efficiently and effectively support economic activities, which augurs well for the growth of the economy in 2004.

## OTHER FINANCIAL INSTITUTIONS

### Discount Houses

Amidst ample liquidity in the financial system, total resources mobilised by the discount houses increased further during the year by 10.3% or RM2.8 billion (2002: 15% or RM3.6 billion). Deposits (primarily in the form of short-term fixed deposits) continued to be the main source of funds, increasing by 19.3% (2002: 32.1%). With the stronger growth in deposits, discount houses were able to further wind down their interbank borrowings, which declined by 24.7% (2002: -22.5%).

There was a marked shift in the allocation of funds mobilised by the discount houses. A significant decline in holdings of banker's acceptances (BAs), together with lower holdings of MGS and Khazanah bonds, were offset by a large increase in holdings of PDS. PDS investments increased by RM3.2 billion or 27.7% in 2003 (2002: -RM0.9 billion or -0.9%) as discount houses took advantage of the low PDS prices in the second half of the year when market sentiment turned more cautious on bonds. The increase in deposit funds was also placed in the interbank market. Interbank placements rose by

**Table 4.17**
**Discount Houses: Sources and Uses of Funds**

| | Annual change | | As at end-2003 |
|---|---|---|---|
| | 2002 | 2003 | |
| | RM million | | |
| Sources: | | | |
| Approved capital funds | 300 | 153 | 2,443 |
| Deposits | 4,834 | 3,847 | 23,751 |
| Interbank borrowings | -1,370 | -1,169 | 3,559 |
| Others | -185 | -13 | 448 |
| **Total** | **3,578** | **2,818** | **30,201** |
| Uses: | | | |
| Investment in securities: | 2,876 | 809 | 24,055 |
| *Government debt securities* | *112* | *-571* | *1,329* |
| *MGS held* | *-364* | *-262* | *835* |
| *Khazanah bonds* | *-281* | *123* | *497* |
| *BNM bills* | *229* | *16* | *365* |
| *Private debt securities* | *-104* | *3,197* | *14,730* |
| *Bankers acceptances* | *2,754* | *-2,752* | *3,237* |
| *Negotiable instruments of deposit* | *-125* | *752* | *848* |
| *Cagamas debt securities* | *471* | *610* | *2,168* |
| *Others[1]* | *-181* | *-567* | *882* |
| Interbank placements | 1,031 | 1,921 | 5,809 |
| Others | -329 | 87 | 337 |
| | **2001** | **2002** | **2003** |
| Number of discount houses | 7 | 7 | 7 |

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

RM1.9 billion or 49.4%, partly due to the temporary placement of funds in the interbank market at the end of 2003 by a discount house, whose holdings of Danaharta bonds matured at the same time.

Discount houses continued to expand their fee-based activities during the year. The industry arranged, lead-managed and co-managed the issuance of PDS worth RM9.8 billion (2002: RM8 billion), while the total amount underwritten increased to RM2.6 billion (2002: RM1.9 billion) for 31 PDS issues (38 issuances in 2002).

### Provident and Pension Funds

Total resources of the 13 provident and pension funds (PPF) surveyed by Bank Negara Malaysia increased by 7.9% to RM266.4 billion in 2003. Accumulated contributions, which accounted for 90.2% of the total resources of the PPF, grew by 9.2% in 2003 (2002: 8.5%). The increment was due to increases of 16.2% in net contributions and 15.7% in dividends credited to contributors' accounts during the year. The latter was made possible by higher investment income in 2003. The Employees Provident Fund (EPF) remains the largest PPF, accounting for 82.6% of the total resources of the PPF.

The strong increase in net contributions in 2003 was the result of both higher gross contributions and lower withdrawals. Gross contributions increased by 1%, due mainly to the increase of 12.4% in the number of contributors, which more than offset the reduction in the employee contribution rate to EPF to 9% from 11% for a year, effective June 2003. The reduction in the employee contribution rate was one of the measures under the Economic Package announced by the Government in May 2003 to stimulate consumption.

Meanwhile, withdrawals declined by 10.5% during the year due to the significant decline in withdrawals by pensionable employees under the EPF's Pensionable Employees Withdrawal Scheme, which was launched in 2000. The bulk of these withdrawals was made in 2001. Withdrawals for investment and housing purposes, however, increased by 8.7% and 2.1% respectively.

Investment income of the EPF increased by 3.4% to RM11.1 billion in 2003 due mainly to the increase in investment income from fixed income instruments by 3.4%. Investment in fixed income instruments contributed 77.4% of the total investment income of the EPF in 2003. In line with the strong performance of the equity markets, investment income from equities (including income from external equity fund managers) registered the highest increase (17.1%) among all asset classes in 2003.

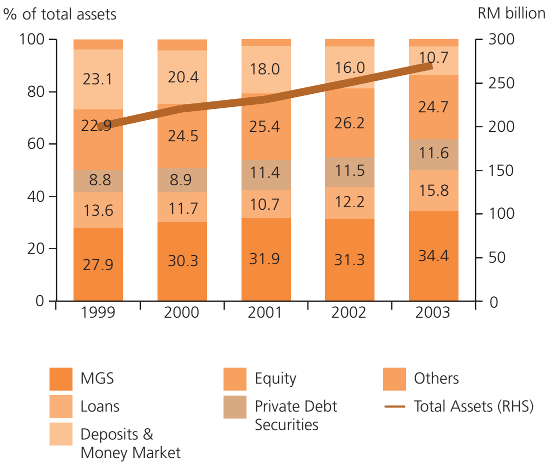
**Table 4.18**
**Provident and Pension Funds: Selected Indicators**

| | 2002 | 2003*p* |
|---|---|---|
| | RM million | |
| **As at end-year** | | |
| Number of contributors ('000) | 18,436 | 20,718 |
| *of which:* | | |
| *EPF* | *10,335* | *10,490* |
| *SOCSO* | *7,912* | *9,997* |
| Accumulated contributions | 220,094 | 240,238 |
| Assets | 246,974 | 266,438 |
| *of which:* | | |
| *Investments in MGS* | *77,387* | *91,589* |
| **During the year** | | |
| Gross contributions | 24,000 | 24,233 |
| Withdrawals | 13,689 | 12,249 |
| Net contributions | 10,311 | 11,984 |
| Dividends credited | 8,117 | 9,393 |
| Investment income | 10,553 | 12,200 |

*p* Preliminary

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

**Graph 4.14**
**Provident and Pension Funds: Major Asset Composition**




Holdings of all asset classes, except deposits and money market instruments, increased in 2003. Given the low interest rate environment, the decline in the holdings of deposits and money market instruments of PPF was part of an investment strategy to shift into assets which offered higher returns. In line with this strategy, the shares of loans and Malaysian Government Securities (MGS) in total assets of the PPF rose in 2003. The increase in the PPFs' holdings of MGS was also due to the higher issuance of MGS in 2003. Investments in equities by PPF increased marginally by 1.6%, while overseas investment increased by 14.5%. The share of overseas investment in total assets of the PPF, however, remained small at 0.3%.

**Venture Capital**

In 2003, the venture capital (VC) industry continued to expand as an alternative source of financing to the economy. As a result of efforts taken by both the Government and the private sector, the VC industry recorded further growth in terms of fund size, number of investee companies, number of venture capital fund management companies (VCFMCs) and venture capital companies/funds (VCCs). Total funds available for VC investment grew by 10.5% to RM2.1 billion. As at end-2003, investee companies that received funding from VC sources, increased to 298 companies, with higher net investment of RM878.7 million.

The Government remained supportive of the development of the VC industry through the provision of financing and incentives, which were

**Table 4.19**
**Key Statistics of Venture Capital Industry**

| | As at end-year | |
|---|---|---|
| | 2002 | 2003 |
| Venture capital funds (RM million) | 1,953.1 | 2,118.1 |
| Net investment[1] (RM million) | 862.6 | 878.7 |
| *Local sources (RM million)* | *n.a.* | *769.0* |
| *Foreign sources (RM million)* | *n.a.* | *109.6* |
| No. of venture capital companies/ funds | 38 | 43 |
| No. of venture capital fund management companies | 29 | 31 |
| No. of investee companies | 183 | 298 |
| | **During the year** | |
| | 2002 | 2003 |
| Gross investment (RM million) | 191.4 | 227.2 |
| *Local sources (RM million)* | *n.a.* | *192.5* |
| *Foreign sources (RM million)* | *n.a.* | *34.8* |
| No. of investee companies | 80 | 115 |

[1] Gross investment less divestment activities.
n.a. Not available.

Source: Securities Commission

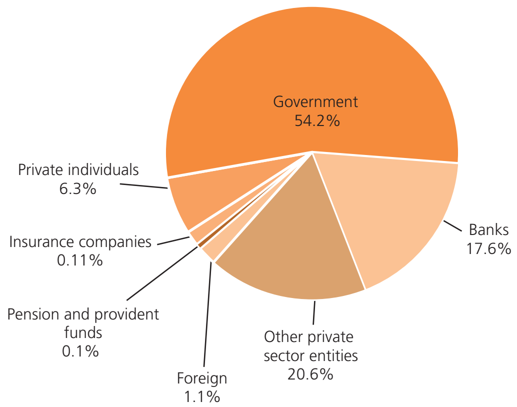
announced in the Economic Package and the 2004 Budget. The Cradle Investment Programme (CIP), a programme initiated under the Economic Package announced in May, was launched with an allocation of RM100 million and was administered by the Malaysia Venture Capital Management Berhad (MAVCAP). The CIP was established in mid-2003 to provide pre-seed funding and entrepreneurial support to generate new ideas and innovations by individuals, research institutes and institutions of higher learning. As at mid-March 2004, a total amount of RM1.2 million had been disbursed to finance 93 ideas and innovations.

MAVCAP continued to offer and subsidise the "Ignite the Technopreneur Fire" series of workshops to interested technopreneurs, which was aimed at addressing issues of entrepreneurship like technology assessment, commercialisation and financing. These workshops helped to address technopreneurs' concerns on management, human resources and operations. Another initiative was the "Three M" (Monday Meeting of the Month) meeting, which was initiated and sponsored by MAVCAP and jointly organised with the Malaysian Venture Capital Association (MVCA). The monthly forums were aimed at providing the opportunity for technopreneurs and financiers to interact and discuss issues of concern. Venture Accelerate 2003 took on a new approach which aimed at accelerating the development of promising entrepreneurs into successful start-ups, via a strong focus on intensive mentoring and skills-building over a 6-month period. The main objective was to produce quality entrepreneurs and, in turn, generate a more vibrant and sustainable entrepreneurial environment in Malaysia. The programme was launched on 17 September 2003 and is expected to end in June 2004.

The Venture Capital Consultative Council (VCCC), which was established in 2002, contributed effectively in developing further the VC industry. By providing a consultative forum for both public and private sectors involved in the VC industry, the VCCC has addressed several areas of concern, which affected the development of the industry. Among others, key areas of improvement attributable to the VCCC were addressing tax incentive-related issues, streamlining data collection, ensuring constant dialogues between the public and private sector involved in the VC industry and initiating educational programmes.

A greater level of private sector involvement was reflected in the increased funding for VC

**Graph 4.15**
**Sources of Venture Capital**
**(% share, as at end-2003)**



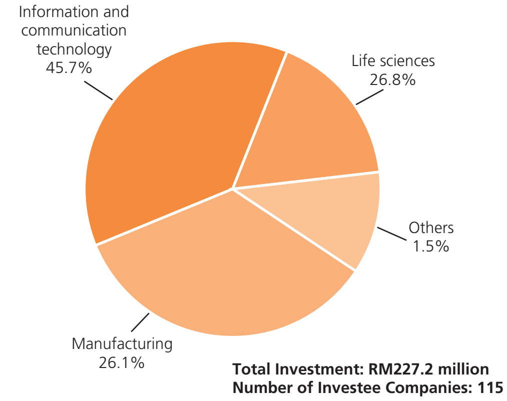

Source: Securities Commission

**Table 4.20**
**Investment by Stages during 2003**

| No. of Investee Companies | 115 | |
|---|---|---|
| Business Stage | RM million | % share |
| Seed capital | 19.9 | 8.7 |
| Start-up capital | 47.9 | 21.1 |
| Early stage | 17.2 | 7.6 |
| Expansion, Growth | 81.4 | 35.8 |
| Bridge, Mezzanine, Pre-IPO | 20.3 | 8.9 |
| Management buy-out | 11.7 | 5.1 |
| Management buy-in | 16.8 | 7.4 |
| Cashing-out (Secondary purchase) | … | … |
| Other types of investment | 12.1 | 5.3 |
| **Total** | **227.2** | **100.0** |

Source: Securities Commission

### Graph 4.16
### Gross Investment in 2003 (% share of total)




Source: Securities Commission

### Table 4.21
### Investment by Sectors

| | As at end-2003 | |
|---|---|---|
| | RM million | % share |
| Manufacturing: | 304.8 | 34.7 |
| *Of which,* | | |
| *Wood and wood products, including furniture* | *39.5* | *4.5* |
| *Transport equipment, automotive components* | *10.3* | *1.2* |
| *Advanced manufacturing: electronics, automation systems, electro-optics, advanced materials* | *65.3* | *7.4* |
| *Fabricated metal products, machinery and equipment* | *19.9* | *2.3* |
| *Electrical and electronic products (manufacture, assemble)* | *19.1* | *2.2* |
| *Others* | *150.7* | *17.2* |
| Information and communication technology | 326.0 | 37.1 |
| Life sciences | 147.3 | 16.8 |
| Electricity, power generation, gas and water | 15.6 | 1.8 |
| Wholesale, retail trade, restaurant and hotels | 5.0 | 0.6 |
| Education | 4.0 | 0.5 |
| Construction | 0.1 | 0.0 |
| Transport, storage and communications | 1.4 | 0.2 |
| Financing, insurance, real estate and business services | 9.8 | 1.1 |
| Others | 64.7 | 7.4 |
| **Total** | **878.7** | **100.0** |

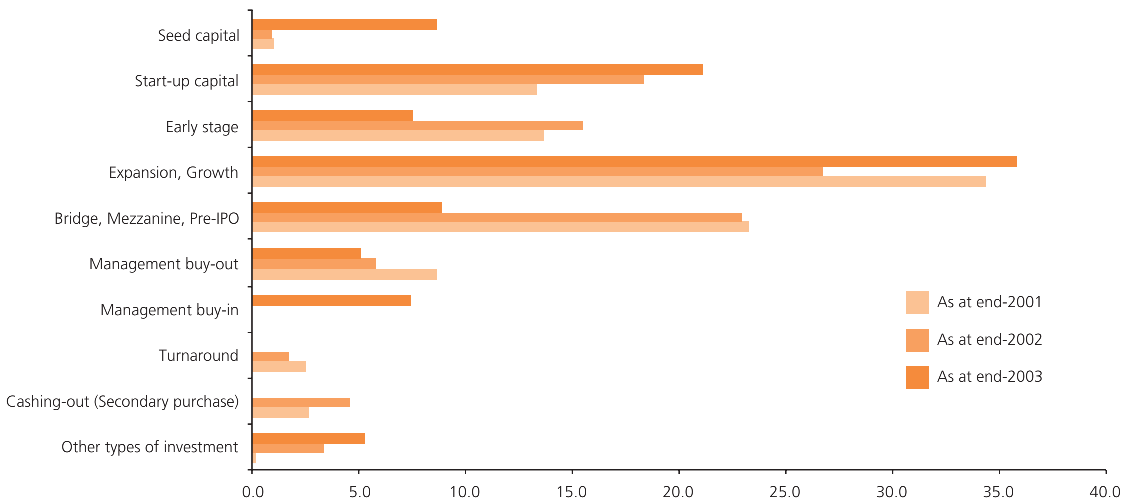
Source: Securities Commission

investments. Contributions from the private sector rose by 18.9% to account for 45.8% of total funds raised during the year (38.5% in 2002). VC funds from foreign sources were small, amounting to RM109.6 million as at end-2003. Almost 75% of VC funds from foreign sources were invested in the ICT and life sciences sectors.

In 2003, private sector initiatives undertaken to promote VC investment were substantial, with the total number of investee companies at the start-up stage remaining high at 21.1% of total VC investments in 2003. While remaining small, the cumulative investment in the seed-capital stage also increased in 2003, reflecting an increase in the risk appetite within the VC industry. At the same time, the Kuala Lumpur Stock Exchange (KLSE) provided an effective exit mechanism for VC investments. This was evident with the higher number of initial public offerings (IPOs) in 2003, by small companies with high-growth potential.

During the year, most of the VC investments were channelled to the new growth sectors of information and communication technology (ICT), life sciences

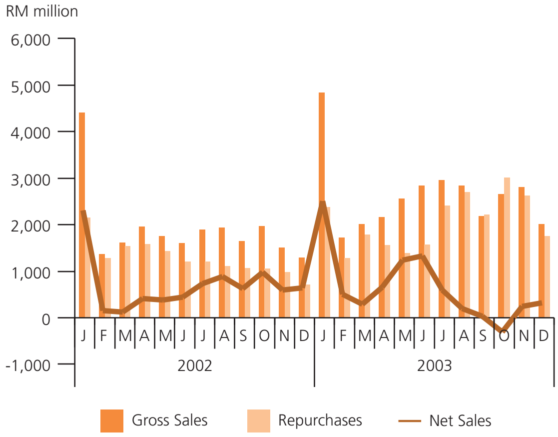
### Graph 4.17
### Outstanding Investment by Stages (% share)




Source: Securities Commission

and advanced manufacturing. In value terms, the software, internet services and e-businesses sub-sector received the highest amount of funding (21.1% of total), followed by medical and biotechnology sub sector (15.5%). As at end-2003, the bulk of total outstanding investments of VCCs (61.3%) were concentrated in the new growth sectors of ICT, life sciences and advanced manufacturing sectors. Investments in other sectors amounted to RM340.1 million, with the manufacturing sector (excluding advanced manufacturing) accounting for 27.3% of total outstanding VC investments. While domestic VC funds were mostly invested in the manufacturing (38.1%), ICT (36.7%) and life-sciences (14.2%), foreign VC investments concentrated on ICT (39.9%) and life-sciences (34.8%) only.

**Graph 4.18**
**Unit Trust Industry - Gross Sales, Repurchases and Net Sales**




### Unit Trust Industry

The unit trust industry continued to expand in 2003, with a larger number of new funds launched and continued increase in the number of units in circulation. In line with the significant improvement in the performance of the KLSE, the net asset value (NAV) of the industry expanded by 30.5% in 2003. As a result of the intensified marketing efforts and the introduction of a greater variety of products by the unit trust management companies to cater to the diverse investor needs and preferences, gross sales of unit trust funds increased by 37.5% in 2003. The gross sales level remained consistently high throughout the year. However, due to high repurchases made during the second half of the year, net sales were slightly lower compared with 2002. This development was the result of portfolio rebalancing exercises by investors in view of the better performance of the equity market in the third quarter. In September and October, net repurchase positions were recorded. Nevertheless, given the continued favourable sentiments and expectations of better performance in equity investments, net sales were recorded in the fourth quarter.

One segment of the unit trust industry that has grown significantly in recent years was the Islamic unit trust. In 2003, 14 new Islamic funds were launched (8 in 2002), bringing the total number of Islamic funds to 50. The NAV for Islamic funds grew substantially by 47.8% in 2003. The share of Islamic funds of total NAV of the unit trust industry rose to 6.7% from 6% in 2002.

In the development of unit trust activities, Bank Negara Malaysia has liberalised regulations pertaining to investment abroad by the unit trust industry,

**Table 4.22**
**Unit Trust Industry (Including Islamic Unit Trust Funds) - Selected Indicators**

| | 2002 | 2003 | 2002 | 2003 |
|---|---|---|---|---|
| | | | Growth (%) | |
| Number of Unit Trust Management Companies | 39 | 36 | 5.4 | -7.7 |
| Number of Unit Trust Funds* | 175 | 217 | 17.4 | 24.0 |
| Number of New Funds Launched | 26 | 42 | | |
| Units in Circulation (billion) | 84.5 | 97.4 | 18.4 | 15.2 |
| Number of Accounts ('000) | 10,175 | 10,221 | 1.9 | 0.5 |
| Net Asset Value (RM billion) | 53.7 | 70.1 | 13.4 | 30.5 |
| Average Monthly Gross Sales (RM billion) | 1.9 | 2.6 | | |
| Average Monthly Repurchases (RM billion) | 1.3 | 2.1 | | |
| Net Sales (RM billion) | 7.6 | 6.9 | | |
| Ratio of NAV to KLSE market capitalisation (%) | 11.1 | 10.9 | | |

* Refers to funds already launched.

Source: Securities Commission.

**Table 4.23**
**Islamic Unit Trusts**

| | 2002 | 2003 | 2002 | 2003 |
|---|---|---|---|---|
| | | | Growth (%) | |
| Number of Unit Trust Management Companies | 27 | 27 | 17.4 | 0.0 |
| Number of Unit Trust Funds* | 36 | 50 | 28.6 | 38.9 |
| Units in Circulation (billion) | 5.8 | 8.6 | 35.1 | 49.1 |
| Number of Accounts | 303,000 | 346,000 | 13.5 | 14.2 |
| Net Asset Value (RM billion) | 3.2 | 4.7 | 32.6 | 47.8 |
| Net Sales (RM million) | 980.4 | 1,169.9 | | |
| Ratio of NAV to KLSE Syariah Index market capitalisation (%) | 1.2 | 1.3 | | |

* Refers to funds already launched.

Source: Securities Commission.

which would accord flexibility for unit trust management companies to diversify their portfolio in order to improve returns to investors. Effective 1 April 2004, unit trust management companies can freely invest in foreign assets up to 10% of NAV per fund for funds subscribed by residents, and up to the full amount of NAV for funds subscribed by non-residents. Unit trust funds of different companies may also be pooled to benefit from economies of scale when investing abroad.

In addition, the Securities Commission also revised the Guidelines on Unit Trust Funds on 1 April 2003. Key improvements introduced included greater flexibility for the issuance of specialised unit trust products, faster assessment of applications for the issuance of unit trust products, faster prospectus registration, streamlining approval process, and enhancing disclosure and reporting requirements.

**FINANCIAL MARKETS**

**Overview**

Increased activities in the money market reflected higher trading in both interbank deposits and money market papers. The volume of transactions in the interbank market increased more significantly with the shift in market preference towards shorter-term money market instruments.

In the Kuala Lumpur interbank foreign exchange market, the average daily volume of transactions increased during the year due to greater trade and investment flows, as well as increased hedging activities to mitigate the impact from greater volatility in international foreign exchange markets. While trading activity continued to be dominated by transactions in the ringgit against the US dollar, the share of euro and Japanese yen transactions against the US dollar increased in line with the higher transactions and hedging needs by market participants to manage the volatility of the G3 currencies.

Trading activities were also higher in the equity, bond and exchange-traded derivatives market. The KLSE Composite Index (KLSE CI) rose by 22.8% while the average daily trading activities rose significantly by 103.3% in terms of volume, and by 58.5% in terms of value. In the bond market, low interest and ample liquidity situation were significant factors that caused increased trading in the private debt securities (PDS) market, particularly in the first half-year.

Higher turnover was also recorded in the derivatives markets with the Crude Palm Oil (CPO) Futures market emerging as the best performer. The stronger performance was due to imbalances in the global vegetable oil market as production of major oilseeds increased only marginally, while demand, particularly from India and People's Republic of China, increased significantly. Active trading of KLIBOR Futures was influenced by expectations on the interest rate outlook. Two new derivatives products, the 3-year and 10-year MGS Futures contracts, were introduced in 2003.

Total funds raised in the capital market in 2003 were significantly higher, with gross proceeds amounting to RM105.1 billion, compared with RM69 billion in 2002. After accounting for redemptions, net funds raised in the capital market were significantly higher, amounting to RM54 billion (2002: RM23 billion). Net funds raised through the PDS market accounted for a majority share of 69.6% (2002: 13.4%). The Federal Government continued to tap the domestic market to finance most of its financing requirements, given the ample liquidity situation. Gross proceeds of RM41.3 billion were raised, mainly through 13 issuances of Government Securities. The private sector raised RM58.7 billion from the PDS and

## Strengthening economic fundamentals and improved prospects for the Malaysian economy led to substantially higher trading activities across all segments of the financial markets.

**Graph 4.19**
**Net Funds Raised in the Capital Market by the Public and the Private Sectors**

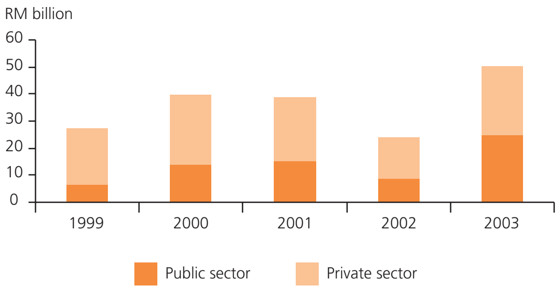


**Table 4.24**
**Funds Raised in the Capital Market**

| | 2002 | 2003*p* |
|---|---|---|
| | RM million | |
| **By Public Sector** | | |
| Government Securities (gross) | 16,266 | 41,262 |
| *Less* Redemptions | 8,900 | 18,600 |
| *Less* Government holdings | 0 | 0 |
| *Equals* Net Federal receipts | 7,366 | 22,662 |
| Khazanah Bonds (net) | 0 | 346 |
| Government Investment Issues (net) | 738 | 1,729 |
| Malaysia Savings Bond (net) | 464 | -9 |
| **Net Funds Raised by Public Sector** | **8,568** | **24,728** |
| **By Private Sector** | | |
| Shares | 13,291 | 7,772 |
| Debt securities | | |
| Issuance (gross) | 36,195 | 50,975 |
| *Less* Redemptions | 34,137 | 33,189 |
| *Equals* Net Issues | 2,058 | 17,786 |
| **Net Funds Raised by Private Sector** | **15,349** | **25,558** |
| **Total Net Funds Raised** | **23,917** | **50,286** |
| Short-term papers and notes (net)[1] | -880 | 3,753 |
| **Total** | **23,037** | **54,039** |

[1] Refers to Commercial Papers, Cagamas Notes and Medium Term Notes.
*p* Preliminary

equity markets (RM49.5 billion in 2002). Companies with strong credit profiles continued to lock-in low financing costs through the issuance of PDS. There was also an increase in issuance of asset-backed bonds as well as convertible bonds, in light of improving interest in the equity market. The equity market remained an important source of financing, especially for small and high-growth potential companies. The number of IPOs offered on the KLSE was 58, the highest since 1998 and RM7.8 billion were raised from these new issues.

The Government remains strongly committed to the further development of a broad and liquid capital market. Several measures and initiatives were taken in 2003 to improve retail investors' participation and protection, enhance market liquidity and efficiency, ease capital-raising exercise and listing policies and strengthen intermediation in the Malaysian capital market. Details are contained in the box "Key Capital Market Measures in 2003".

### Money Market

Increased activities in the money market in 2003 were reflected mainly in higher trading of interbank deposits. Trading of money market papers increased marginally.

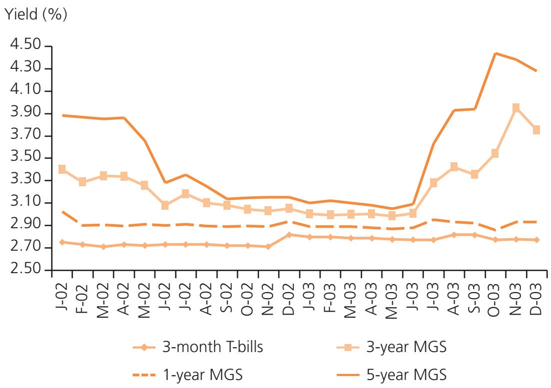
**Table 4.25**
**Money Market[1]**

| | 2002 | | 2003 | |
|---|---|---|---|---|
| | Volume (RM billion) | Annual change (%) | Volume (RM billion) | Annual change (%) |
| **Total money market transactions** | **1465.1** | **-2.4** | **1538.4** | **5.0** |
| **Interbank deposits** | **1011.7** | **-4.1** | **1084.7** | **7.2** |
| **Money market papers** | **453.4** | **1.8** | **453.7** | **0.1** |
| Bankers Acceptances (BAs) | 51.3 | -15.2 | 37.3 | -27.3 |
| Negotiable Instrument of Deposits (NIDs) | 36.7 | 7.0 | 43.1 | 17.4 |
| Malaysian Government Securities (MGS) | 244.1 | 11.0 | 231.4 | -5.2 |
| Khazanah bonds | 15.5 | -13.4 | 18.8 | 21.3 |
| Treasury bills | 8.4 | -37.3 | 9.9 | 17.9 |
| Bank Negara Bills | 54.4 | -1.4 | 71.5 | 31.4 |
| Cagamas bonds | 29.2 | 12.7 | 25.6 | -12.3 |
| Cagamas notes | 13.8 | -25.0 | 16.1 | 16.7 |

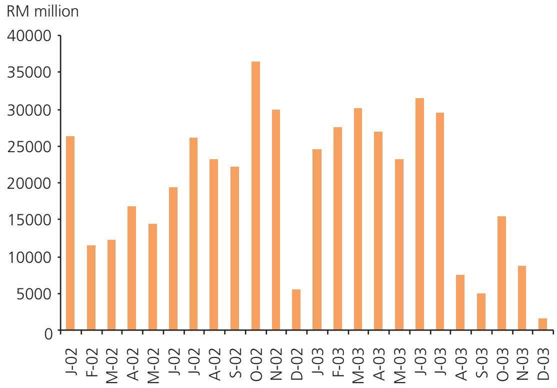
[1] All data are sourced from the Bond Information and Dissemination System, except BAs and NIDs which are sourced from money market brokers.

Activities in the interbank money market in 2003 were marked by two periods of changing market expectations. In the first half, trading in the market was largely influenced by concerns regarding the adverse impact of increased geopolitical uncertainties on economic growth following the war in Iraq. The outbreak of SARS in the region further aggravated this uncertain environment. As a result, most of the market players took a view that the existing accommodative monetary policy stance will remain for an extended period. Against the background of a low inflation, the prevailing uncertainty increased the market's preference for fixed-income instruments, especially in the higher-yielding longer dated papers. From January to July 2003, the average monthly MGS volume traded was higher at RM27.6 billion compared with RM18.1 billion in the same period of 2002. Nevertheless, the overall

**Graph 4.20**
**Yields of Money Market Instruments**



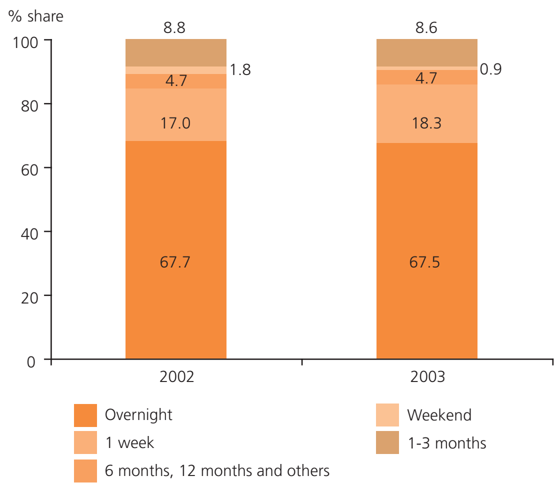
**Graph 4.21**
**Volume of Traded MGS**



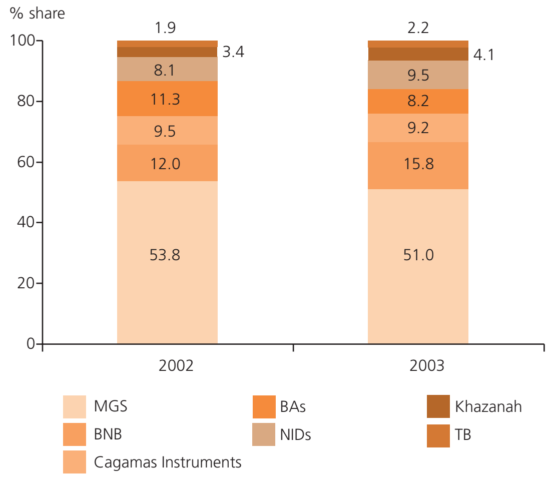

MGS yields remained stable during this period as the greater demand for the longer dated papers, was offset by the steady supply of the MGS to the market. During the first half of the year, net issuance of MGS amounted to RM13.3 billion.

Nevertheless, the uncertain outlook proved to be temporary as business activities picked up steadily in the second half of the year. This prompted market players to factor-in an expectation for an earlier turnaround in the interest rate cycle in the near future. The improving corporate performance amidst strengthening financial position of corporations and the better-than-expected GDP growth in the third quarter, led to a shift in asset allocation towards equity. The rising perception of market risk resulted

**Graph 4.22**
**Share of Total Volume Traded: Interbank Deposits**




**Graph 4.23**
**Share of Total Volume Traded: Money Market Instruments**



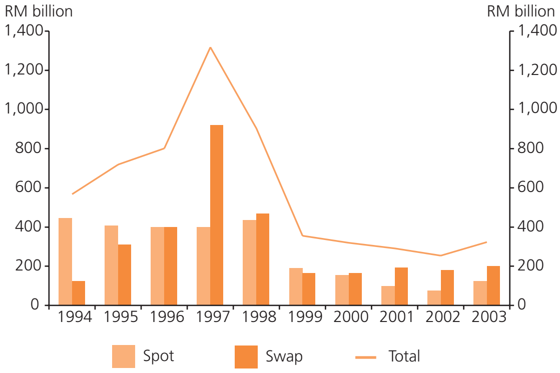

in lower volumes traded in the money market. Trading in MGS was also relatively subdued during the period of August to November. This was caused by concerns over the direction of interest rates following the upward adjustment in policy rates by two central banks (Australia and United Kingdom) and the brighter prospects for the US economy. These factors contributed to the upward shift in the MGS term structure, with the yields on the 3-year and 5-year MGS increasing by 94 and 129 basis points respectively.

The volume of transactions in the interbank deposit market also rose significantly in the second half of 2003. Trading on interbank deposits increased by 21.5% (-3.7% during the same period in 2002) in the second half of 2003 with a shift in the market's preference towards shorter-term money market instruments.

**Foreign Exchange Market**

In the Kuala Lumpur interbank foreign exchange market, the average daily volume of interbank foreign exchange transactions (spot and swap transactions) increased by 27% compared to 2002, arising from higher trade and investment flows. The higher volume of transactions also reflected higher spot and swap trades following increased activity by market participants to manage their exposure due to greater volatility in international foreign exchange markets. Trading activity comprised mainly trade-related transactions, as position-taking activity on the

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




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

ringgit has been contained through the elimination of the offshore ringgit market and through guidelines governing the operating framework of banking institutions.

By composition, 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 81.7% of total transactions in 2003 from 80.8% in 2002. The dominance of US dollar transactions against the ringgit reflects the significance of the US dollar in the Kuala Lumpur foreign exchange market as well as the high usage of US dollars in the settlement of trade, services and capital account transactions. A notable development in 2003 was the significant increase in the share of euro and yen transactions against the US dollar. The share of Euro transactions against the US dollar more than doubled, while the share of yen transactions also increased markedly by 33%. These increases can be attributed largely to the higher transaction and hedging needs of market participants to manage the significant volatility among the G3 currencies during the course of the year.

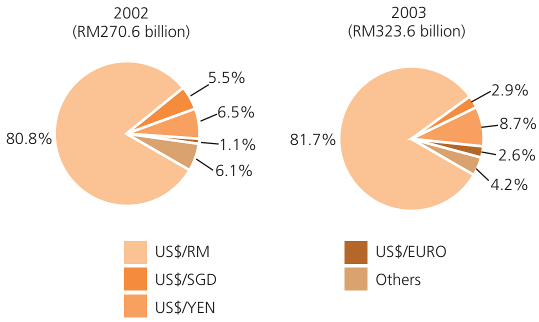
### Equity Market

In 2003, the Kuala Lumpur Stock Exchange Composite Index (KLSE CI) ended the year on a stronger note, following stronger economic growth and improved economic outlook. For the year as a whole, the KLSE CI registered a strong annual growth of 22.8%, while average daily trading activities rose significantly by 103.3% in terms of volume and by 58.5% in value. The higher turnover was supported by both higher retail and institutional participation.

The performance of the KLSE in the first four months was subdued, with sentiments affected by uncertainties on the global economic outlook. Market sentiments turned more positive since May, driven by improved economic outlook, stronger corporate earnings and significant progress achieved in corporate restructuring.

**KLSE CI registered its strongest performance since 1999. Increased domestic participation was evident following the standardisation of board lot sizes to 100 units.**

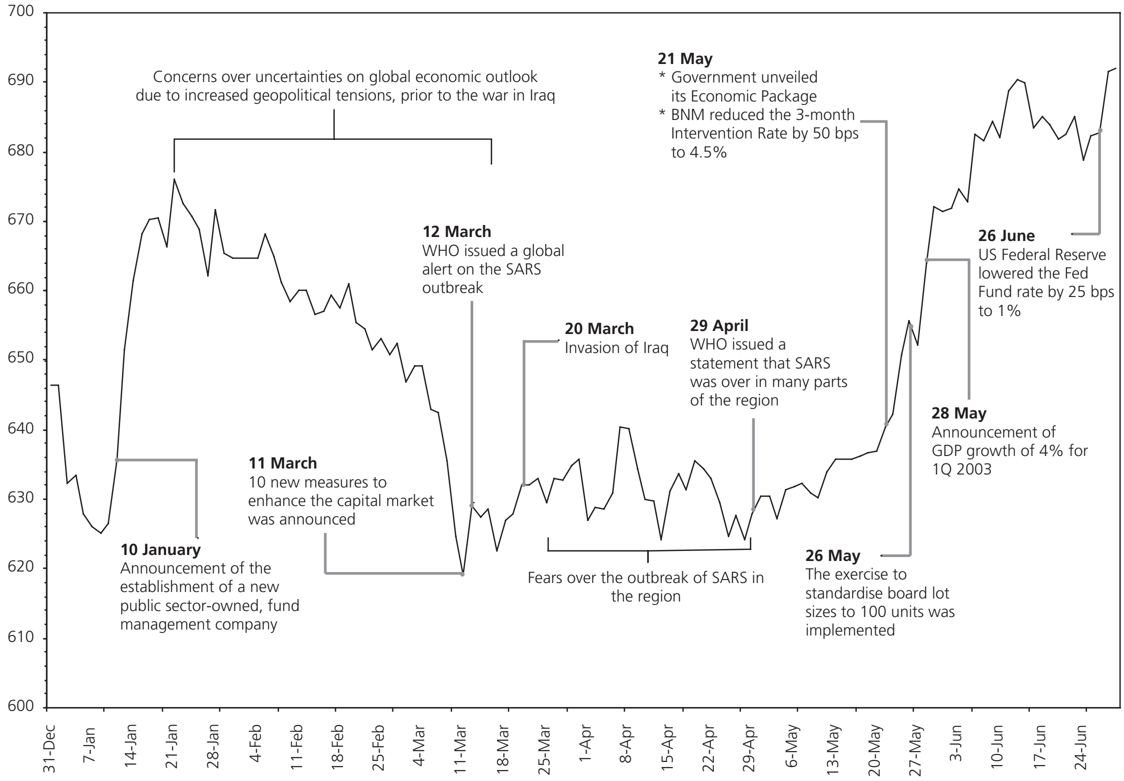
### Graph 4.25
### Transactions in the Kuala Lumpur Foreign Exchange Market by Currency




Policy measures introduced by the Government to promote capital market developments also created a more conducive environment for investors.

The Malaysian Exchange of Securities Dealing & Automated Quotation (MESDAQ) Market Composite Index (MCI) was the best performing index in 2003. The MCI posted a substantial gain of 82.9% (-5.5% as at end-2002). The strong performance of the index and higher trading activities were due to increased new listings of small but high-growth potential companies. The Second Board Index also posted a significant gain of 43.2%, reflecting investors' preference for

**Graph 4.26: Performance of the KLSE Composite Index (31 December 2002 - 30 June 2003)**




**Graph 4.27: Performance of the KLSE Composite Index (1 July - 31 December 2003)**

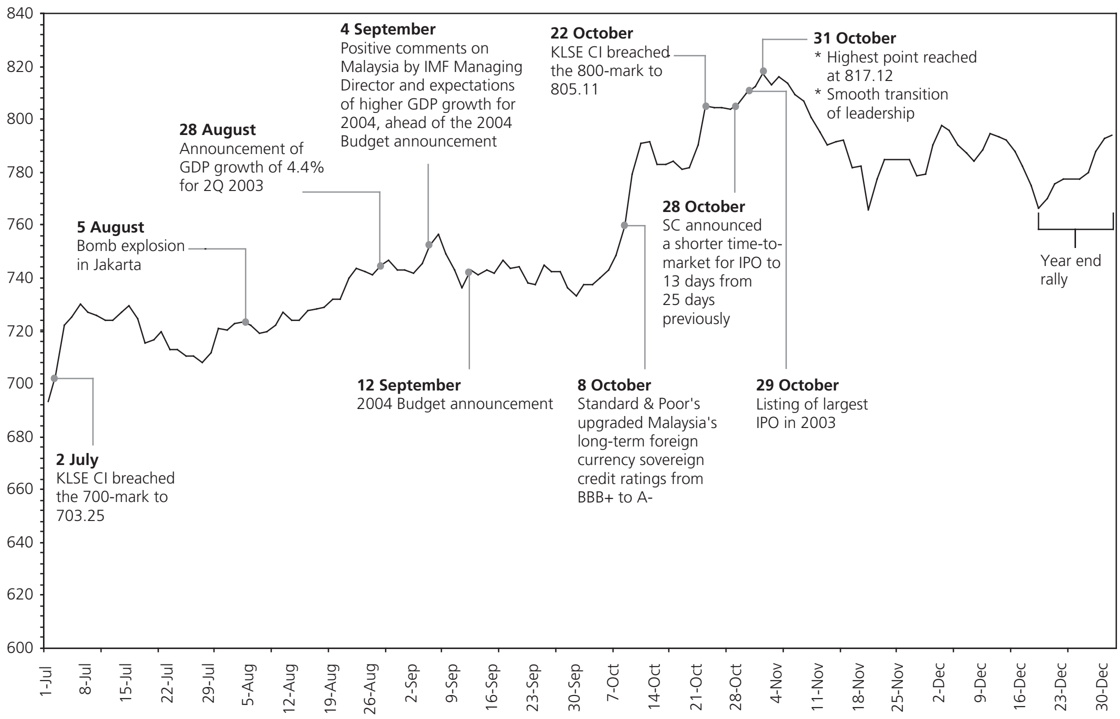


**Table 4.26**
**Kuala Lumpur Stock Exchange: Selected Indicators**

| | 2002 | 2003 |
|---|---|---|
| Price Indices: | | |
| Composite | 646.3 | 793.9 |
| EMAS | 157.3 | 195.6 |
| Second Board | 98.2 | 140.6 |
| MESDAQ | 83.3 | 152.3 |
| Total Turnover: | | |
| Volume (billion units) | 55.6 | 112.2 |
| Value (RM billion) | 117.0 | 183.9 |
| Average Daily Turnover: | | |
| Volume (million units) | 224.3 | 456.0 |
| Value (RM million) | 471.6 | 747.5 |
| Market Capitalisation (RM billion) | 481.6 | 640.5 |
| Market Capitalisation / GDP (%) | 133.5 | 163.4 |
| Total No. of Listed Companies: | 865 | 906 |
| Main Board | 561 | 598 |
| Second Board | 292 | 276 |
| MESDAQ | 12 | 32 |
| Market Liquidity: | | |
| Turnover Value / Average Market Capitalisation (%) | 23.2 | 33.4 |
| Turnover Volume / Number of Listed Securities (%) | 24.3 | 43.4 |
| Market Concentration: | | |
| 10 Most Highly Capitalised Stocks[1] / Market Capitalisation (%) | 34.0 | 31.6 |
| Average Paid-Up Capital of Stockbroking Firms (RM million) | 164.2 | 170.9 |

[1] Based on market transactions only.

Source: Kuala Lumpur Stock Exchange

smaller companies with higher potential for earnings growth. Listed stocks on the Main Board saw more moderate price performances across all sectors.

The strong performance of the equity market was supported by improvements in earnings outlook and sound financial health of corporates. From a sample of 300 listed non-financial corporations (representing almost 75% of total KLSE market capitalisation), cumulative profits for the first three quarters were 54% higher in 2003, compared with the same period in 2002. Annualised return-on-equity for the sample rose to 7.3% in the third quarter of 2003, from 5.4% in the third quarter of 2002. Stronger corporate earnings were observed in most sectors as the impact of the SARS outbreak and geopolitical uncertainties on businesses in the first half of 2003 was only confined to a few tourism-related companies.

Other indicators of corporate health also showed positive developments. Corporate indebtedness remained stable, with aggregate debt-equity ratio

**Table 4.27**
**KLSE: Performance of Sectoral Indices**

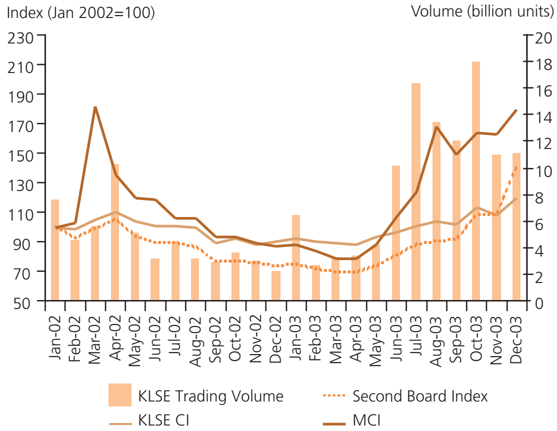
| | 2002 | 2003 |
|---|---|---|
| | Annual change (%) | |
| KLSE Composite Index | -7.1 | 22.8 |
| EMAS | -4.8 | 24.4 |
| Second Board | -26.8 | 43.2 |
| MESDAQ Composite Index | -5.5 | 82.9 |
| Industrial | 0.1 | 31.3 |
| Consumer Products | 0.5 | 28.8 |
| Industrial Products | -2.5 | 23.4 |
| Construction | -14.9 | 24.6 |
| Trading/Services | -6.1 | 18.3 |
| Finance | -4.7 | 33.2 |
| Properties | -9.8 | 38.8 |
| Mining | -5.1 | 74.8 |
| Plantation | 14.7 | 19.3 |
| Syariah | -7.4 | 23.2 |
| Technology | -17.9 | 33.9 |

Source: Kuala Lumpur Stock Exchange

at 0.62 in the third quarter of 2003 (average of 0.61 between the third quarter of 1999 and the third quarter of 2003). The improvements in profitability, together with stable leverage and low interest rates, resulted in stronger debt servicing capacity of the corporate sector. The interest coverage ratio, which measures the number of times a company's earnings before interest and tax exceeds its interest expense, rose to 4.7 times in the third quarter of 2003, its highest level recorded since the third quarter of 1999.

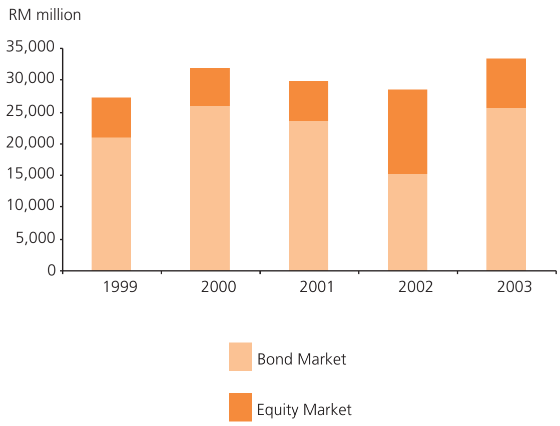
Encouraged by improved market performance and more favourable investor sentiments in 2003, a larger number of smaller firms raised funds in the

**Graph 4.28**
**Kuala Lumpur Stock Exchange Composite Index, Second Board Index, MESDAQ Market Composite Index and KLSE Trading Volume**

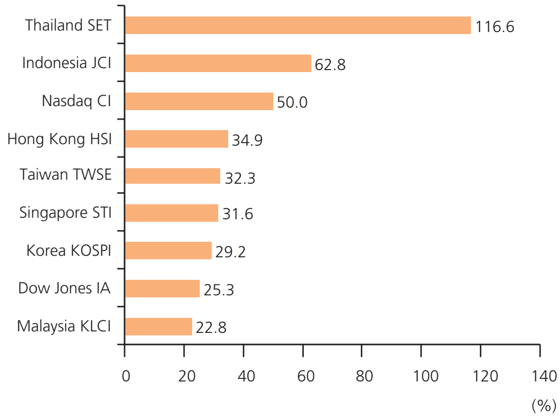



Source: Kuala Lumpur Stock Exchange

**Graph 4.29**
**Funds Raised by the Private Sector in the Capital Market**




**Graph 4.30**
**Performance of Selected Stock Market Indices (% change from end-2002 to end-2003)**




Source: Kuala Lumpur Stock Exchange

equity market. Total funds raised were, however, lower at RM7.8 billion compared with RM13.3 billion in 2002 due to the small size of the initial public offerings (IPOs). The new funds were mainly raised through IPOs (51%) and rights issues (29.4%). A total of 58 new companies was listed, the highest number since 1998. Of this total, 16 companies were listed on the Main Board, 22 on the Second Board and 20 on the MESDAQ Market. Prices of 52 new listings traded at a sizeable premium over the offer prices at the end of the first day of trading, influenced mainly by widespread investor interests and more active retail trading activities. The total number of companies listed on the KLSE was 906 as at end-2003, the second largest number of listed companies on a stock exchange after Hong Kong China in the East Asian region, excluding Japan.

**In 2003, 58 new companies were listed on the KLSE, the highest since 1998. Significantly improved market performance encouraged smaller companies with growth potential to raise funds in the equity market.**

The liberalisation of the listing policy to allow the listing of Malaysian businesses abroad and foreign-based businesses with Malaysian operations resulted in the listing of a large foreign company on the KLSE. The IPO, which raised RM2.03 billion, was the largest in 2003.

Recognising the importance of the capital markets in raising capital to facilitate growth of the Malaysian economy, the Government and relevant authorities introduced new measures to improve retail investors' participation and protection, enhance market liquidity and efficiency, ease the process for capital-raising activities and strengthen intermediation in the Malaysian capital market. Details of these measures are contained in the box "Key Capital Market Measures in 2003".

As part of the demutualisation plan, the KLSE completed on 5 January 2004 its conversion into a public company limited by shares, from a company limited by guarantee. The demutualisation was in line with a recommendation in the Capital Market Masterplan to enhance corporate, organisation and governance structures. While there was no significant diversion of the usual business practice, KLSE's stock exchange businesses were transferred to a wholly-owned subsidiary, Malaysia Securities Exchange Berhad (MSEB). The demutualised KLSE became the exchange's holding company with plans for listing on the exchange.

## Key Capital Market Measures in 2003

Capital market measures introduced in 2003 were aimed at improving retail investors' participation and protection, enhancing market liquidity and efficiency, easing the process for capital-raising and listing, and strengthening intermediation in the Malaysian capital market. The key measures were as follows:

### Enhancing Investor Participation

- Effective 17 March, the cap on **stamp duty for all securities traded on the Kuala Lumpur Stock Exchange (KLSE) was reduced to RM200 per contract** (previously capped at RM1,000 per contract).

- On 26 May, the **exercise to standardise board lot sizes to 100 units** from the previous 1000 units for all securities listed on the KLSE was completed.

### Increasing the Efficiency of the Capital-Raising Process

- In line with the **reduction in the processing time for IPOs** to less than three months from the present six to eight months, the time-to-market period (period beginning from the issue of prospectus to the first day of listing) was also reduced to 13 days (from 25 days previously), effective 1 December 2003.

- Beginning 12 March, all corporate proposals which required **approvals from both the Foreign Investment Committee (FIC) and the Securities Commission (SC) would be processed by the SC only.** In cases where the SC's approval was not required, the approval remained with FIC.

- On 18 November, a set of **guidance notes on share splits** for public listed companies was introduced. Among others, liberalisation included abolishing the requirements for the appointment of a principle adviser to submit proposals and for the approved share split exercise to be implemented within three months.

### Strengthening Investor Protection and Corporate Governance

- On 3 June, the SC issued the "**Guide on Areas of Compliance and Internal Controls for Management Companies and Trustees**" to assist fund management companies and trustees in establishing effective internal controls within their respective organisations. The Guide identified key areas of compliance and internal controls.

### Enhancing Restructuring of Distressed Companies

- On 18 June, the SC issued a set of **criteria for delisted PN4 companies to seek re-listing on the KLSE.** The criteria, among others, allowed delisted PN4 companies to seek re-listing without the requirement for a general public offering, provided that the application was submitted within 12 months from the date of delistment.

- On 19 November, the SC announced **a six-month extension of the deadline for under-capitalised public listed companies to increase their paid-up capital to at least RM60 million for Main Board companies and RM40 million for Second Board companies.** The new deadline is 30 June 2004.

### Liberalisation of KLSE Listing Policies

- Effective 11 March, the **moratorium on the shareholding period for promoters (which includes original owners and stakeholders of the companies) for all new IPOs/ Reverse Takeovers (RTO) was reduced from four years to one year.**

- On 11 March, the SC issued a set of **new guidelines to ease the listing process for large companies.** The new guidelines exempted large companies (with a minimum market capitalisation of RM250 million and after-tax profits of at least RM8 million for the latest financial year) from the three to five profits record requirement.

- On 19 September, the SC announced further liberalisation of the Guidelines on Issues/Offer of Securities to widen the breadth of listings in the Malaysian equity market. The revised listing policy **allowed Malaysian businesses abroad and foreign corporations with Malaysian operations to list on the KLSE.** The companies must also obtain the approval of Bank Negara Malaysia, where applicable, for the use of proceeds from the issue/offering of securities.

- **Amendments to the share buy-back guidelines** were made to allow flexibility for companies to undertake share buy-back activities. With effect from 7 October, a listed company would be allowed to appoint up to two stockbroking companies for the purpose of purchasing its own shares or reselling treasury shares on the exchange.

**Strengthening the Role of Intermediaries**

- Effective 9 June, the SC implemented the **minimum stockbroking commission rates structure.** The minimum commission rates would only apply to retail trades, while the rates applicable to institutional and inter-broker trades would remain fully negotiable. The minimum commission rates announced were as follows:

| Category of trade | Minimum rate per contract |
|---|---|
| Inter-broker and Institutional trades | Fully negotiable |
| Retail trades valued above RM100,000 | 0.30% |
| Retail trades valued up to RM100,000 | 0.60% |
| E-broking transactions | Up to 30% discount |

- On 20 November, the SC refined the **Capital Adequacy Requirement (CAR) framework for stockbroking companies**. The enhancement was aimed at facilitating the re-engineering of business models in the stockbroking industry and would enable stockbroking companies to utilise their capital more efficiently.

- On 10 December, the SC introduced the **Guidelines on the Offering of Structured Products**. The aim was to facilitate universal brokers, merchant banks, commercial banks, including Islamic banks, and performance-guaranteed Special Purpose Vehicles to issue "structured products" to meet the needs of an increasingly sophisticated Malaysian capital market.

**Further Relaxation on the Uses of PDS Proceeds**

- On 1 August, the SC liberalised **rules on use of proceeds from private debt securities (PDS)** to allow such funds to be used to finance the development of hypermarkets. Prior to this, the "construction of hypermarkets" fell under the definition of the "construction of shopping complexes" which was previously not allowed to be funded through PDS proceeds.

**Enhancing Skills and Professionalism**

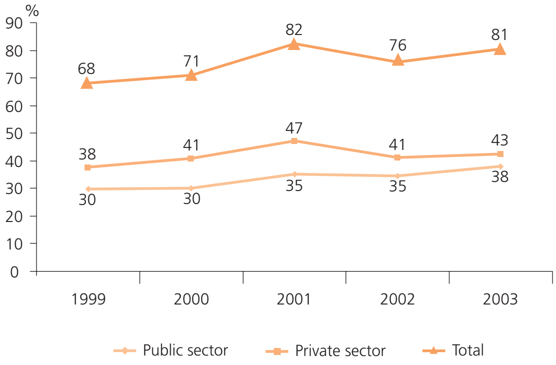
- On 1 April, the SC launched the **Capital Market Graduate Training Scheme** which was aimed at increasing the pool of graduates with skills and knowledge on the capital market.

## Bond Market

Total funds raised in the ringgit bond market were significantly higher in 2003. Gross issuance increased by 74.8% due to higher issuance by both the public and private sectors. After netting off redemptions during the year, total net funds raised in the bond market amounted to RM42.5 billion (RM10.6 billion in 2002). As a result, outstanding ringgit bonds rose by 16.7% to RM319.4 billion, equivalent to 81.5% of GDP. As corporate borrowers stepped up their net issuances during the year, the outstanding Private Debt Securities (PDS) increased by 14.4% to RM170.2 billion or equivalent to 43.4% of GDP, and accounted for 53.3% of total bonds outstanding. The low interest rate environment and ample liquidity situation were significant factors influencing the growth of the PDS market in 2003. Corporations, particularly those with strong credit profiles capitalised on the low interest rates through the issuance of long-term debt securities at competitive costs. The favourable market conditions, particularly in the first half of 2003 also prompted corporations to refinance their existing debt through PDS.

Issuance of Malaysian Government Securities (MGS) was significant as the Government sourced the bulk of its financing requirements from the domestic

**Graph 4.32**
**Ratio of Bonds Outstanding to GDP**




**Total funds raised in the ringgit bond market were significantly higher in 2003. The low interest rate environment and the ample liquidity situation were the main factors influencing the growth of the private debt securities market in 2003.**

**Graph 4.31**
**Bonds Outstanding**

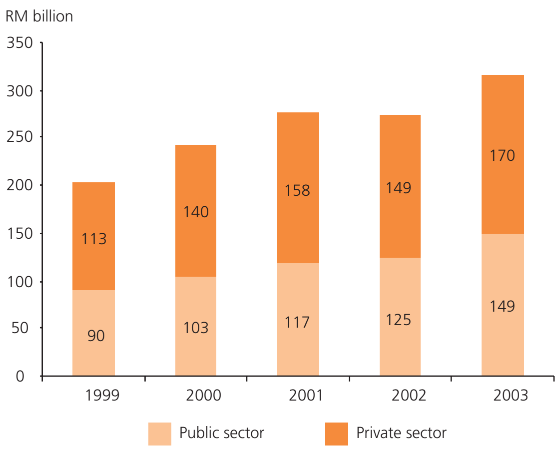



**Table 4.28**
**Funds Raised in the Bond Market**

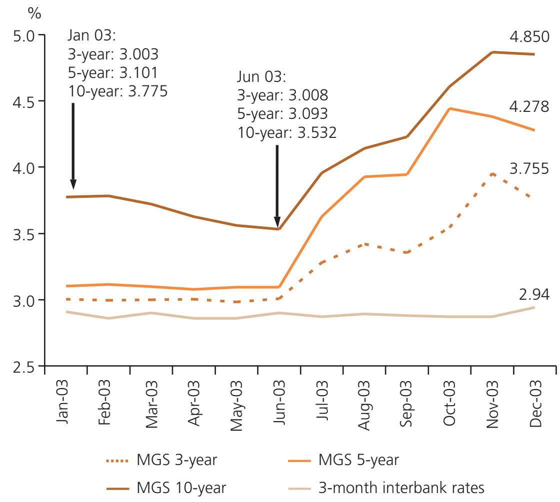
| | 2002 | 2003*p* |
|---|---|---|
| | RM million | |
| **By Public Sector** | | |
| Government Securities (gross) | 16,266 | 41,262 |
| *Less* Redemptions | 8,900 | 18,600 |
| *Equals* Net Federal Receipts | 7,366 | 22,662 |
| Government Investment Issues (net) | 738 | 1,729 |
| Khazanah Bonds (net) | 0 | 346 |
| Malaysia Savings Bond (net) | 464 | -9 |
| **Net Funds Raised** | **8,568** | **24,729** |
| **By Private Sector** | | |
| Private Debt Securities (gross) | 36,195 | 50,975 |
| Straight Bonds | 7,763 | 27,983 |
| Bonds with Warrants | 300 | 0 |
| Convertible Bonds | 2,852 | 3,177 |
| Islamic Bonds | 13,829 | 8,143 |
| Asset Backed Securities | 1,916 | 3,487 |
| Cagamas Bonds | 9,535 | 8,185 |
| *Less* Redemptions | 34,137 | 33,189 |
| Private Debt Securities | 28,770 | 28,037 |
| Cagamas Bonds | 5,367 | 5,152 |
| **Net Funds Raised** | **2,058** | **17,786** |
| **Net Funds Raised in the Bond Market** | **10,626** | **42,515** |
| *Private Debt Securities, excluding Cagamas (gross)* | *26,660* | *42,790* |
| *Net Funds Raised in the Bond Market, excluding Cagamas* | *-2,110* | *14,753* |
| Net Issues Short Term Securities, Commercial Papers / Medium Term Notes[1] | -880 | 3,753 |
| **Total** | **9,746** | **46,268** |

[1] Refers to Cagamas Notes, Commercial Papers, Medium Term Notes.
*p* Preliminary

market. The ample liquidity situation enabled the Federal Government to do so without crowding out the private sector. The Federal Government made twelve Malaysian Government Securities (MGS) issuances, with gross proceeds totalling RM41.3 billion. In addition, the size of the Government Investment Issues (GII) was gradually enlarged to meet the increasing market demand for such Islamic instruments. Including net issuances of Khazanah bonds, the total outstanding public sector bonds rose to RM149.3 billion, or equivalent to 38.1% of GDP.

The bond market in 2003 could be dichotomised into two distinct periods of market developments. Commencing the year on a strong note, the underlying market conditions were favourable to both issuers and investors during the first half-year.

**Graph 4.33**
**Trends in MGS Yields**

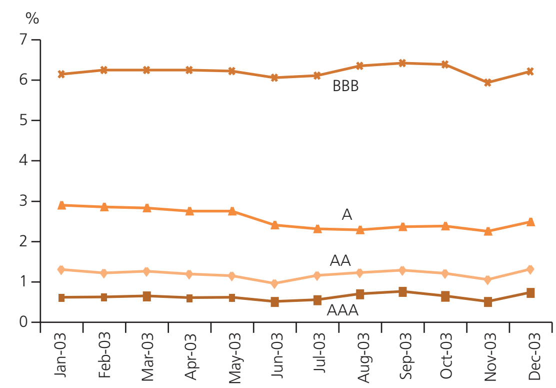



Bond yields trended downwards, influenced largely by concerns regarding the adverse impact of increased geopolitical uncertainties on the global economic outlook. The SARS outbreak further fuelled market expectations that interest rates would remain low for an extended period. Demand for long-dated and higher yielding bonds was high which resulted in a decline of 10-year MGS yields by 53 basis points and in turn caused the narrowing of the PDS credit spreads. With the declining yields and strong demand for debt securities, corporations increased bond issuances during this period. As a result, the bulk of the corporate bonds (65.8%) were issued in the first half-year, with a large portion of the proceeds being utilised for refinancing purposes.

Bond yields, however, reversed direction and trended upwards in the second half-year. Concerns over geopolitical risks and SARS outbreak proved to be short-lived. As signs of strengthening economic growth became evident with market expectations that interest rate might rise, investors reduced bond holdings. The rising yields of the US Treasury securities also influenced the domestic bond yields. Asset allocation shifted to the equity market following improved market sentiments in the equity market. As a result, bond trading activities turned subdued with a 47.2% reduction in the trading volume, compared with the first half of the year. Consequent from the sharp increase in the bond yields, fund-raising activities through the PDS market weakened in the third quarter of 2003, as some impending corporate issues were deferred.

Nevertheless, the weak demand for bonds and the fall in issuance were temporary. Bond yields stabilised

**Graph 4.34**
**Yield Differentials for 3-year PDS vis-a-vis the 3-year MGS**




**Graph 4.35**
**Utilisation of Proceeds**

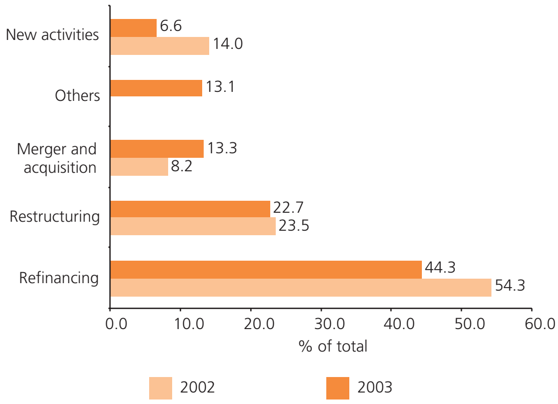


**Table 4.29**
**New Issues of Private Debt Securities by Sector**

| Sector | 2002 | | 2003*p* | |
|---|---|---|---|---|
| | RM million | % share | RM million | % share |
| Agriculture, hunting, forestry and fishing | 971.9 | 3.6 | 993.1 | 2.3 |
| Mining and quarrying | 0.0 | 0.0 | 0.0 | 0.0 |
| Manufacturing | 1,776.8 | 6.7 | 9,072.4 | 21.2 |
| Construction | 2,174.1 | 8.2 | 6,049.7 | 14.1 |
| Electricity, gas and water supply | 1,349.0 | 5.1 | 3,410.5 | 8.0 |
| Transport, storage and communication | 9,099.5 | 34.1 | 8,603.8 | 20.1 |
| Financing, insurance, real estate and business services | 5,513.8 | 20.7 | 8,372.8 | 19.6 |
| Government and others | 4,644.5 | 17.4 | 6,288.1 | 14.7 |
| Wholesale and retail trade, restaurants and hotels | 1,130.8 | 4.2 | 0.0 | 0.0 |
| **Total** | **26,660.3** | **100.0** | **42,790.4** | **100.0** |

*p* Preliminary

in December following portfolio rebalancing activities and strong buying interests of quality papers. The rebound in issuances in December was partly due to the corporate issues which were postponed earlier.

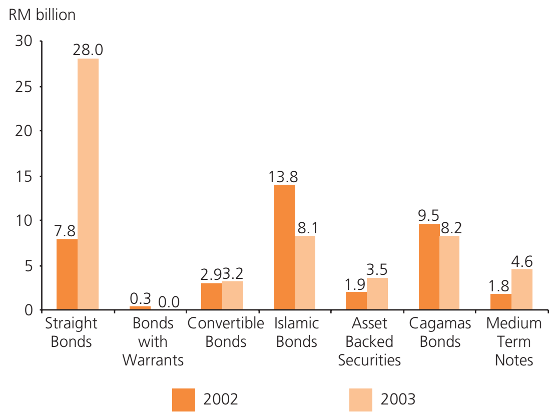
The low interest rate environment was the dominant factor influencing financing decisions of the corporate sector during the year, as reflected in the higher bonds issued for refinancing purposes (44.3% of total bonds issued). The issuers were companies from the transport, infrastructure, utilities and construction sectors. The bulk of funds raised for restructuring purposes was raised by a conglomerate in the manufacturing sector. During the year, total funds raised for merger and acquisition purposes accounted for 13.3% of the total, and were mainly raised by companies in the utilities and telecommunication sectors. Meanwhile, funds raised for new activities were lower and were mainly channelled to utilities-related infrastructure projects, the construction sector and, to a smaller extent, the manufacturing sector. The construction and real-estate property companies utilised the proceeds mainly for land acquisition, refinancing and working capital purposes.

During the year, the bulk of the new issues (52% of total value) were for tenures between five to ten years, in response to investors' preference for short to medium-end PDS. On average, the issue size for PDS increased to RM602.5 million per issuer in 2003 from RM494.7 million per issuer in 2002. Nevertheless, the maturity profile of the domestic market lengthened further, with the longest tenure issued reaching 28 years, compared with 26 years recorded in 2002.

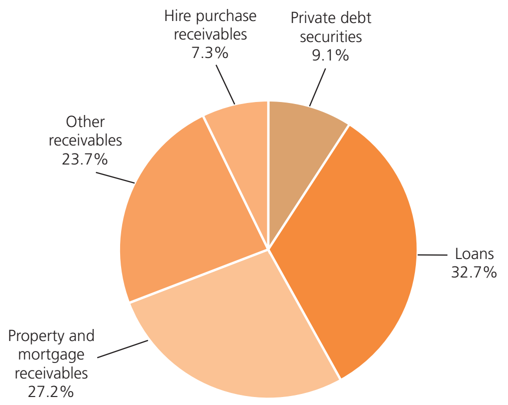
In terms of types of instruments, straight bonds were the most preferred form of debt securities, accounting for 50.4% of total bonds issued. Meanwhile, the improved sentiment in the equity market led to higher issuance of convertible bonds. In recent years, commercial papers/medium-term notes gained more prominence, especially for the purposes of financing working capital requirement.

**Graph 4.36**
**PDS Issues by Tenure**


**Graph 4.37**
**PDS Issues by Type of Instrument**



**Graph 4.38**
**ABS: Types of Underlying Assets (2001-2003)**

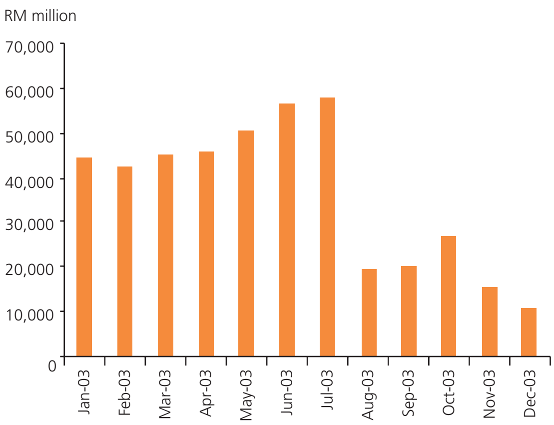



These instruments allowed more flexibility for issuers to take advantage of the low interest rates in the shorter term by issuing commercial papers, while waiting for opportunities to lock-in favourable rates in the medium-term as and when the yields began to trend upwards.

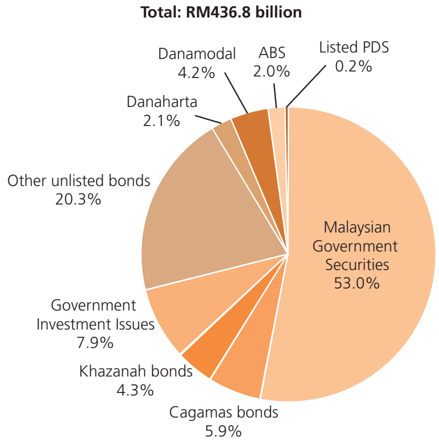
A wide range of Asset Backed Securities (ABS) were issued during the year, which included those backed by hire-purchase receivables, loans and innovative issuance of Islamic principle ABS backed by mortgage assets. In total, there were ten ABS (including one commercial paper ABS) amounting to RM7 billion, since the first issuance of ABS in 2001. The ABS market is expected to develop further, given the tax incentives announced in 2004 Budget.

Despite a challenging operating environment with ample liquidity in the banking system, Cagamas

**Graph 4.39**
**Monthly Trading Volume**



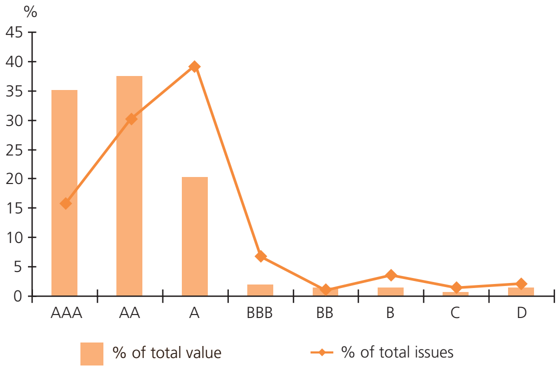

**Graph 4.40**
**Turnover of Selected Debt Securities (Jan-Dec 2003)**




Berhad maintained its position as an active issuer. In 2003, Cagamas issued 33 issues of debt securities at a total value of RM17.9 billion (including 15 short-term Cagamas notes of RM9.7 billion). Most of the Cagamas bond and notes were issued during the second half of 2003, due to the rising bond yields which had prompted the financial institutions to be more active in hedging their portfolios through the sale of loans and debts to Cagamas. Taking into consideration the less favourable market sentiments during the second half-year, Cagamas spaced out the issuances in order to ensure an orderly market performance. Investors' demand for Cagamas bonds throughout the year was firm, as evidenced by the weighted average over-subscription rate of 1.83 times and 2.38 times for Cagamas notes and Cagamas bonds respectively.

Total trading activities in the ringgit bond market increased by 11.6% to RM436.8 billion, with higher activities in the first half of the year. In the second half-year, trading activities were concentrated in shorter-end papers, given the higher risk premium and price volatility of long-dated papers. The most actively traded papers were MGS, accounting for 53% of total trading activities and a liquidity ratio of 1.89 times its outstanding amount. Demand for corporate bonds increased, and accounted for 22.6% of the total trading activities, compared with 14% in the previous year. Nevertheless, the corporate bond market remained less liquid, with a liquidity ratio of only 0.81 times, and trading activities were centred on bonds with high ratings and good credit quality.

**Graph 4.41**
**Rating Distribution of Outstanding PDS**
**(As at end-December 2003)**




Source: RAM and MARC

Rating profiles of long-term debt securities remained healthy. Both the Rating Agency Malaysia (RAM) and the Malaysian Rating Corporation Berhad (MARC) undertook 116 new ratings, with total gross value of RM41.9 billion. In terms of rating profiles, the issues were mainly distributed throughout the AAA, AA and A categories, with the heaviest concentration in the single A category. During the year, RAM and MARC conducted 204 rating reviews on the existing long-term debt securities, of which 161 issues were affirmations/reaffirmations, 10 issues were upgrades and 18 issues were downgrades. The higher number of downgrades were partly due to companies in the tourism-related sector, whose financial positions were adversely affected by the outbreak of SARS.

On the international front, market sentiments for the Malaysia's foreign currency sovereign bonds and corporate bonds remained positive due to expectations of an upgrade in sovereign ratings as economic fundamentals strengthened. Spreads for Malaysian sovereign bonds narrowed significantly during the year. The first Malaysian sovereign Sukuk bond issue which was listed in Luxembourg Stock Exchange and Labuan International Financial Exchange in July 2002 was also listed on the Bahrain Stock Exchange on 24 September 2003. The listing helped to raise the profile of Malaysia to West Asian investors.

**Table 4.30**
**Sovereign Spread Over US Treasury Benchmark**

| | Dec-02 | Mar-03 | Jun-03 | Sep-03 | Dec-03 |
|---|---|---|---|---|---|
| MALAYSIA 09 | 183 | 180 | 123 | 101 | 85 |
| MALAYSIA 11 | 145 | 150 | 83 | 70 | 36 |
| CHINA 11 | 61 | 65 | 29 | 28 | 29 |
| INDONESIA 06 | 348 | 288 | 284 | 173 | 185 |
| KOREA 08 | 110 | 162 | 84 | 69 | 45 |
| PHILIPPINES 10 | 478 | 500 | 382 | 343 | 353 |
| THAILAND 07 | 108 | 90 | 53 | 18 | 5 |
| PETRONAS 06 | 204 | 198 | 145 | 126 | 117 |

Source: Bloomberg

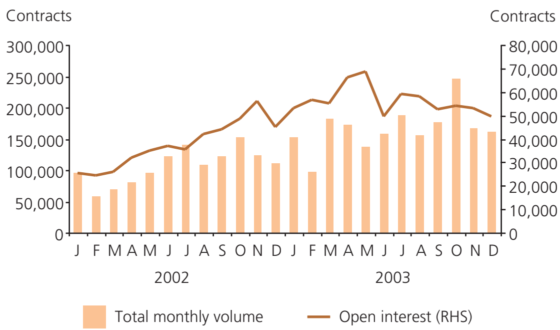
In line with enhancing the development of the bond market, efforts were taken in 2003 to accord greater investment flexibility to insurance companies in investing in debt securities, as well as to provide more risk management products. In November, Bank Negara Malaysia increased the insurers' limits on investment in secured and unsecured credit facilities which includes PDS. In addition, the Malaysian Derivatives Exchange introduced two new products, the 3-year and 10-year MGS futures, which added more hedging instruments in the domestic financial markets.

**Exchange-traded Derivatives Market**

In 2003, higher turnover was recorded for all exchange-traded derivative products on the Malaysian Derivatives Exchange (MDEX), except for trading in the Kuala Lumpur Stock Exchange (KLSE) Options. Total turnover increased significantly by 55.3% to reach more than two million contracts. Following the launch of two new products, the 3-year and 10-year MGS Futures Contracts, which enhanced risk management opportunities for investors, the MDEX now offers seven derivative products.

As in the previous year, the Crude Palm Oil (CPO) Futures market emerged as the best performer on the MDEX in 2003. During the year, the price range for the benchmark 3-month CPO Futures contract widened to RM622 (2002: RM587), with the highest daily traded price at RM1,865 per tonne on 9 December.

**Graph 4.42**
**MDEX: Total Monthly Volume and Month-end Open Interest**




Source: Malaysian Derivatives Exchange

**Table 4.31**
**Performance of MDEX Products**

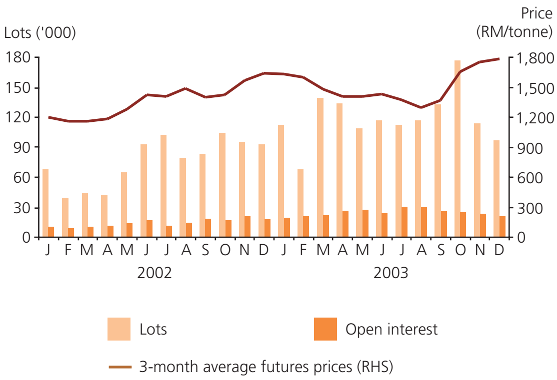
| Products | Turnover | | | | | | Share of total MDEX volume (%) | | Factors affecting performances |
|---|---|---|---|---|---|---|---|---|---|
| | 2002 | | | 2003 | | | | | |
| | Number of lots | Annual change (%) | Average daily volume | Number of lots | Annual change (%) | Average daily volume | 2002 | 2003 | |
| CPO Futures | 909,073 | 89.5 | 3,666 | 1,429,959 | 57.3 | 5,813 | 70.6 | 71.5 | • Strong CPO Futures prices.<br>• Better trading platform with switch to electronic-based system in 2002. |
| KLSE CI Futures | 233,863 | -18.7 | 943 | 331,218 | 41.6 | 1,346 | 18.2 | 16.6 | • Higher trading with implementation of cost-cutting measures. |
| *Open interest position (as at end-year)* | *1,346* | | | *8,993* | | | | | |
| KLSE CI Options | 1 | -99.8 | … | 0 | … | 0 | … | … | • Lack of liquidity and knowledge by participants. |
| 3-month KLIBOR Futures | 64,307 | 17.1 | 259 | 119,659 | 86.1 | 486 | 5.0 | 6.0 | • Higher turnover mainly in the second half of 2003, reflected the shift in market preference from bond market to short-term money and interbank markets instruments. |
| *Open interest position (as at end-year)* | *21,114* | | | *18,977* | | | | | |
| 3-year MGS Futures | n.a | n.a | n.a | 781 | - | 3 | n.a | … | • Introduced in September 2003. |
| 5-year MGS Futures | 80,419 | n.a | 324 | 118,635 | 32.2 | 482 | 6.2 | 5.9 | • Physical bond and bond futures markets experienced a correction in July 2003 following expectations over the direction of global interest rates. |
| *Open interest position (as at end-year)* | *4,860* | | | *127* | | | | | |
| 10-year MGS Futures | n.a | n.a | n.a | 11 | - | … | n.a | … | • Introduced in September 2003. |

n.a. Not available.

Source: Malaysian Derivatives Exchange

CPO futures prices began the year on a strong note, with the monthly prices averaging around RM1,600 – RM1,635 per tonne before consolidating in the following months to average around RM1,300 - RM1,480 per tonne. In the final quarter of the year, CPO prices regained its strength to record the highest level in four years, to average around RM1,660 - RM1,790 per tonne. The strong price performance in 2003 was a reflection of the imbalances in the global vegetable oils and fats markets, as the production of major oilseeds, especially soybean, rapeseed and sunflower increased marginally, whilst demand from the major consumers of edible oils had increased substantially during the year.

**Graph 4.43**
**Crude Palm Oil Futures**




Trading activities in the KLSE Composite Index (KLSE CI) Futures rose significantly in 2003. The Derivatives Liquidity Ratio (DLR), which represents the ratio between the turnover value of futures against the turnover value of underlying KLSE CI component stocks, increased significantly by 40.3% in 2003. The modification of the contract size from RM100 to RM50 and the increase in the tick sizes for the prices of the products effectively reduced the margin requirements and the cost of trade and thus encouraged more participation in the market. Trading activities by both domestic and foreign institutional players accounted for 76% of total trades.

Total volume of the 3-month KLIBOR Futures improved significantly following the sharp fall in bond prices and expectations that interest rates may increase. The higher turnover, mainly in the second half-year, reflected the shift in market preference from the bond market to short-term money market and the interbank market instruments. Meanwhile, the total turnover of 5-year MGS Futures registered an increase of 32.2% amidst expectations on the direction of global interest rates. Market sentiment turned cautious in the second half of 2003. Domestic institutions continued to be the major players in the MGS and 3-month KLIBOR futures markets.

## DEVELOPMENTS IN PAYMENT AND SETTLEMENT SYSTEMS

### Developments in 2003

In November 2003, the Payment Systems Act was enacted by Parliament and is a landmark achievement for the Bank as it sets out a comprehensive regulatory oversight framework, which is essential in governing the changing payment landscape. The primary objective of the Bank is to ensure the security, safety and efficiency of the important payment systems in the country, and that there is continued public confidence in the use of payment instruments. Of significance also is the migration towards the use of advanced technology such as chip cards to provide safer payment modes.

During the year, domestic banking institutions had replaced their magnetic stripe ATM cards with the chip based Bankcard, and with effect from 1 October 2003, all ATM transactions are carried out using the Bankcard. The Bankcard has three standard applications, that is, an ATM function, an e-debit function and the MEPS Cash e-purse. The locally incorporated foreign banks are expected to replace their ATM cards with chip based cards by March 2004. Presently, there has been no report of any ATM fraud through the use of cloned chip ATM cards.

In implementing a long-term measure to prevent the fraudulent skimming of credit cards, the banking industry is currently conducting an industry wide Europay-Mastercard-Visa (EMV) chip migration of their magnetic stripe credit cards. The magnetic stripe cards are going to be replaced by end-2004, and upgraded card acceptance devices will be deployed to accept EMV chip cards by end-2005. As at end-2003, there were about 243,000 EMV chip credit cards issued and about 18,000 card acceptance devices have been deployed to accept these EMV cards.

In addition to the enhancement of security features in the payment systems and instruments, technology also facilitates the development of more efficient payment modes, compared to paper-based payment instruments such as cheques. Electronic funds transfer systems (EFT) are more efficient and faster than cheque processing systems, as well as, being more secure and capable of effecting finality of payment with greater certainty. The Malaysian Electronic Payment System (1997) Sdn Bhd, has developed several electronic payment systems, one of which is the Financial Process Exchange (FPX) which is targeted to be completed in early 2004. The FPX will enable users to make online payments to facilitate electronic commerce transactions using a multi-bank payment platform.

The primary objective of the Bank is to ensure the security, safety and efficiency of the payment systems in the country, and that there is continued public confidence in the use of payment instruments.

Due to its many benefits, the promotion of the migration from paper-based payment instruments to electronic payments is being accelerated. In December 2003, this was discussed at the National Payment Advisory Council, followed by a consultation exercise with financial institutions. Three broad areas were proposed for the industry to consider on the measures that would promote the migration to electronic payments.

(i) Financial institutions should offer efficient and cost effective electronic payments that are accessible and convenient for their customers to use.

(ii) Strategic incentives including pricing should be in place to facilitate the investment and development of the e-payment infrastructure, and make e-payments widely acceptable.

## Payment Systems Act 2003

### Introduction

The Payment Systems Act 2003 (the Act) was gazetted on 7 August 2003 and came into effect on 1 November 2003. The introduction of the Act is in line with the recommendation in the Financial Sector Masterplan for the adoption of a flexible, proactive and effective regulatory framework for the oversight of payments system and to increase efficiency in the payment system. The introduction of the Act reflects the significance of payments system to the country's economic activities and recognizes Bank Negara Malaysia as the sole authority responsible for its oversight. An efficient and well functioning payments system would support the creation of social and economic efficiency and is crucial for the smooth functioning of the financial markets and in maintaining financial stability. In addition, the smooth operation of the payments system is also essential for Bank Negara Malaysia to effectively conduct monetary policy.

The objective of the Act is to ensure the safety and efficiency of the payment related infrastructure, and to safeguard public interest. The Act provides the legal framework to ensure that the financial system, and the public's confidence in the payment systems is well protected. The Act provides the specific legislative authority for a more comprehensive and effective oversight of the payment system. Banking institutions as well as non-bank players offering payment systems and instruments would be governed by the Act.

### New oversight framework on payment system

The Act was drafted to provide a balanced regulatory framework for the oversight of the payment system in line with Bank Negara Malaysia's objective and to promote market innovation. The Act outlines two different oversight regimes for two types of players namely, the operator of payment systems and the issuer of designated payment instruments.

### Oversight on the operator of payment systems

The Act defines a payment system as "any system or arrangement for the transfer, clearing or settlement of funds or securities". Several arrangements including the clearing house recognised under the Securities Industry Act 1983 or clearing house licensed under the Futures Industry Act 1993 are excluded from the definition of payment system. An operator of the payments system is required to submit documents and obtain notification from Bank Negara Malaysia. These documents and information are important for the establishment of a surveillance mechanism that is capable of monitoring developments in the payment system for the formulation of appropriate policies as and when required. Bank Negara Malaysia is also empowered to prohibit the operation of any payment system in the event that it is necessary in the interest of the public, or the operation of such system is detrimental to the reliable, safe, efficient and smooth operation of the country's payment systems.

The Act empowers Bank Negara Malaysia to designate a payment system as a designated payment system (DPS) if such a system poses systemic risks, or if the designation is necessary to protect the interest of the public. Only fit and proper persons can accept appointment as a director or chief executive officer of an operator of a DPS. The operation of a DPS would be subjected to closer oversight by Bank Negara Malaysia, including the requirement to establish good corporate governance. In addition, an operator of a DPS is required to ensure that adequate operational arrangements are in place to ensure the smooth functioning of these payment systems. This includes the establishment of rules and procedures setting out the rights and liabilities of the relevant parties including the financial risks that the parties might incur, as well as procedures for the management of credit risk and liquidity risk and measures to ensure the safety, security and operational reliability of the DPS.

To ensure that a DPS can work effectively, it is necessary for all payment and settlement instructions that are sent through the DPS be considered as final and irrevocable. The Act, therefore, provides that a payment or settlement instruction sent through a DPS shall be final and shall not be revoked or reversed from the time such an instruction is entered into the DPS. The operator of a DPS is required to establish rules that determine the point of time that a payment or settlement instructions is deemed as final.

In acknowledging that a DPS may also adopt netting arrangements in order to reduce settlement risks, the Act gives legislative recognition to any netting arrangements that are entered into, in relation to the DPS, to avoid any uncertainty with regards to such netting arrangements. The Act provides that netting arrangements adopted by participants of a DPS as well as finality of payment and settlement instructions in a DPS prevail over insolvency laws.

**Oversight on the issuance of designated payment instruments**

The Act empowers Bank Negara Malaysia to designate a payment instrument as a designated payment instrument (DPI). These are instruments that are widely used or that should be regulated by Bank Negara Malaysia in the interest of the public. Issuance of a DPI requires the prior approval of Bank Negara Malaysia. Three payment instruments have been designated as a designated payment instrument, namely, electronic money, credit and charge instruments.

Similar to DPS, issuers of DPIs are required to implement adequate corporate governance and operational arrangements to ensure the safety and reliability of these payment instruments. This includes the requirement to establish measures to ensure prudent management of funds collected from the users of the designated payment instruments and to ensure that such funds are available for repayment to the users.

**Powers of Bank Negara Malaysia under the Act**

Bank Negara Malaysia is empowered under the Act to require an operator of a payment system or issuer of a payment instrument to be an incorporated company. This requirement may be imposed where the corporate structure is necessary to provide more permanence, credibility and stature to the entity that will be required to comply with the Companies Act 1965 as well. To ensure effective supervision and monitoring of the payment systems in the country, Bank Negara Malaysia may require the operator of a payment system or the issuer of a payment instrument to submit information on the payment system operated or the payment instrument issued by them. Other powers conferred by the Act to Bank Negara Malaysia include: -

i. *Powers of examination*

   The Act empowers an examiner authorised by Bank Negara Malaysia to examine the premises and offices, apparatus or documents, of an operator of a payment system or an issuer of a payment instrument or any other person falling within the purview of the Act.

ii. *Control over DPS*

   The Act imposes a duty on an operator of a DPS who is insolvent to immediately inform Bank Negara Malaysia. Bank Negara Malaysia, by order published in the Gazette, may assume control of, or to carry on, the whole or part of a DPS's property, business and affairs, as the case may be. Bank Negara Malaysia may appoint a person to carry out such powers on its behalf by making an application to the High Court to appoint a receiver or a manager to manage the company.

iii. *Investigation, search and seizure*

   The Act empowers Bank Negara Malaysia to appoint its employee or any person as its investigating officer for offences under the Act. The investigation officer has the powers of entry into any premise, search and seize property, apparatus, or documents and search of persons. The Act also empowers Bank Negara Malaysia to investigate, with the concurrence of the Securities Commission, clearing houses recognised under the Securities Industry Act 1983 or those licensed under the Futures Industry Act 1993.

*iv. Offences and enforcement*

In order to ensure an effective regulatory regime, the Act includes a schedule of offences that provides for penalties in the event that identified provisions of the Act are contravened. Offences under the Act are assigned penalties in accordance with the severity of their potential effects, including systemic and other risks.

**Conclusion**

The enactment of the Act serves to strengthen Bank Negara Malaysia's oversight over payment systems and instruments. The Act enables Bank Negara Malaysia to identify and monitor systemically important payment systems and important payment instruments, which will be closely regulated under the Act, while giving regulatory flexibility to operators of payment systems and issuers of payment instruments to encourage innovation.

(iii) The financial industry should promote awareness of the electronic payment options and encourage consumers to use electronic payments and instruments by enhancing their confidence in using these means of payments.

### General Payment Profile in Malaysia

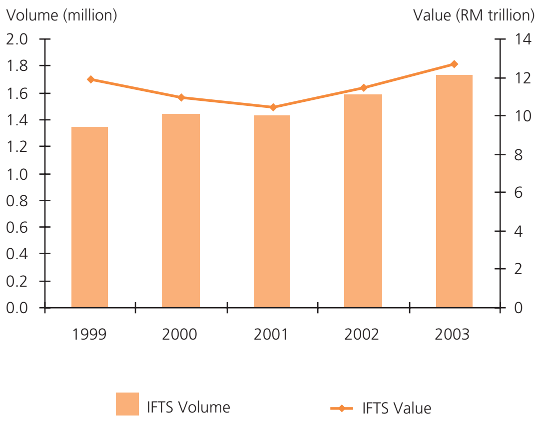
In the financial system, Malaysian consumers are notably heavy users of cheques compared to other payment instruments. The breakdown by percentage for the value and volume of non-cash payment transactions in 2003 is as shown in Table 4.32.

Whilst the banking industry continues to invest significantly in e-payment infrastructures, cheques remained a significant payment instrument. In 2003, cheques accounted for 96.7% of the total non-cash payment value. Although the value of e-purse transactions is negligible in terms of total non-cash payments, its volume accounted for 36.4% of total non-cash payments in 2003. E-purse transactions in Malaysia constituted mainly toll payments, where the Touch 'n Go contactless card was used. Settlement of retail related payments were made through the financial institutions, whereby interbank fund transfers are mainly undertaken through the real-time gross settlement system (RENTAS).

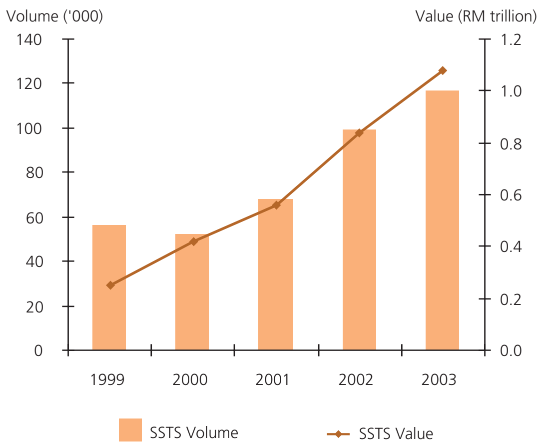
**Table 4.32**
**Non-Cash Payments in Malaysia**

| | Value (%) | Volume (%) |
|---|---|---|
| Cheques | 96.67 | 34.04 |
| Credit cards | 2.48 | 27.68 |
| Credit transfers (Giro) | 0.63 | 0.24 |
| Charge cards | 0.16 | 1.42 |
| E-purse - Toll payments | 0.05 | 36.40 |
| - Retail | 0.00 | 0.00 |
| Debit cards | 0.01 | 0.22 |

**Graph 4.44**
**RENTAS – IFTS Turnover**




**Graph 4.45**
**RENTAS – SSTS Turnover**



In 2003, in terms of value and volume, Interbank Funds Transfer System (IFTS) saw an increase of 10.9% and 9.1% respectively, while Scripless Securities Trading System (SSTS) transactions saw a significant increase of 28.6% and 18.3% respectively, when compared with 2002.

**Efficiency Improvements**

Bank Negara Malaysia had introduced several enhancements to improve RENTAS in 2003. These include the following:

**(i) RENTAS-STP**

The 'Straight Through Processing' (STP) module which is linked to the RENTAS system was introduced to enable all processes in a payment cycle beginning from payment initiation by customers to interbank settlement is integrated electronically. Members are advised to implement RENTAS-STP to improve the efficiency of their banking operations. The RENTAS-STP will reduce human intervention, enabling operational cost savings and resulting in improved customer service. Presently, four members have implemented RENTAS-STP.

**(ii) Intra-day credit enhancement**

In August 2003, the RENTAS system was enhanced to allow intra-day collateral securities to be valued on the net price basis after taking into account market price movements, credit rating changes and margin requirement. This method replaced the earlier method of calculating the 'haircut' which was based on the nominal value and did not reflect the fair value of the security. The intra-day credit enhancement has improved risk management, as the collaterals are now valued based on its fair value derived from the current market prices.

**(iii) Enhancement of RENTAS i-LINK**

In September 2003, Bank Negara Malaysia completed Phase 2 of the RENTAS i-LINK implementation. This system provides a timely and accurate real-time settlement information, allows monitoring, enquiring and analysing information pertaining to management of liquidity, cash and security positions. With the implementation of these modules, the RENTAS members are better able to monitor incoming and outgoing cash/securities flows, to extend vital RENTAS data to the front office for value-added analysis and to prepare management reports and updating the RENTAS members' directory online. This has allowed active management of information by members.

**(iv) Universal Brokers (UBs) membership**

As a measure to support the development of the capital market, the UBs were allowed access to the SSTS modules of the RENTAS system, which enables them to deal directly in the unlisted debt securities together with the other members of the RENTAS system. Since October 2003, two UBs have been admitted as members.

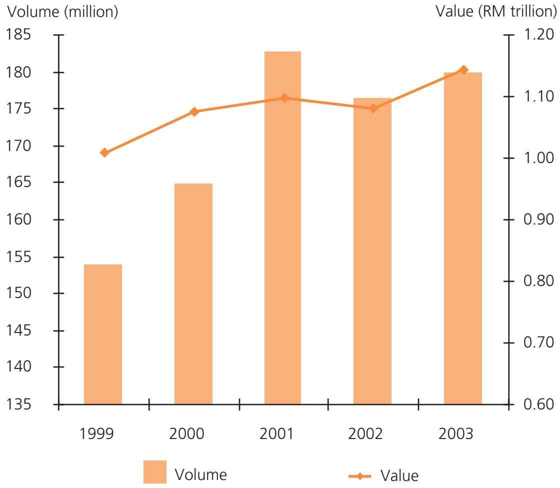
**Payment Instruments and Channels**

**Cheques**

The volume of cheques processed through the three Sistem Penjelasan Imej Cek Kebangsaan (SPICK) cheque clearing centres operated by Bank Negara Malaysia increased marginally by 2.0% from 176.4 million cheques in 2002 to 179.9 million cheques in 2003. The value of cheques cleared, however, remained at about RM1.1 trillion in both years.

In May 2003, the SPICK-KL (the largest of the SPICK centres, the others being in Pulau Pinang and Johor Bahru) was awarded the ISO 9001:2000 certification for another three years, reflecting the commitment of the Bank towards providing quality service. During the year, efforts were continued to further improve the efficiency of SPICK operations, such as the replacement of the Compact Disc Production subsystem and upgrading the operating system to Windows 2000. After the enhancements, the overall SPICK operation for the

**Graph 4.46**
**Volume and Value of Cheques Cleared by SPICK Centres**



three centres showed an improvement in performance with the reduction of clearing time by an average of 1.5 to 2 hours.

As part of the Bank's on-going effort to curb cheque fraud, the Bank had in October 2003 issued a consultative paper on "Guideline on Minimum Security Standards for Cheques" to the banking institutions with the objective of enhancing the security features on cheques, cheque fraud detection facilities, security management in cheque printing and the necessary advise to consumers on best practices. The Guideline also covers the related governance processes. Banking institutions will be required to make the necessary changes to their work processes and upgrade their systems. The Guideline will be enforced later in 2004.

In 2003, the number of blacklisted offenders in Biro Maklumat Cek (BMC) remained constant. As at end-2003, the number of offenders stood at 49,389, including 32,408 individuals compared with 48,814 offenders including 32,351 individuals at end-2002. Account holders, therefore, need to monitor their account balances carefully and ensure that sufficient funds are available before issuing cheques, as the consequences of being blacklisted in the BMC can be damaging.

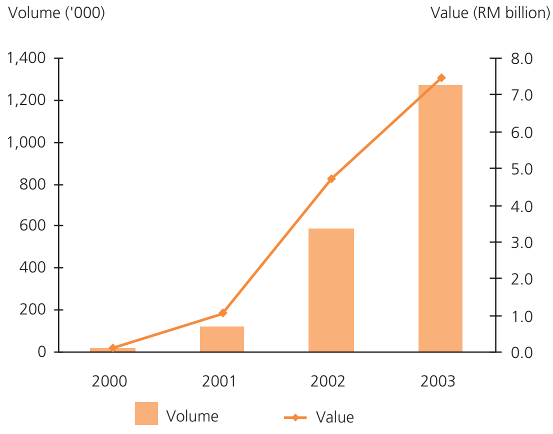
**Giro**

Besides cheques, consumers can also use the Giro credit transfer to make payments. Giro transactions in 2003 are less significant compared to the cheque volume and value. Nevertheless, the volume and value of Giro transactions as at end-2003 had increased markedly by 114.8% and 57.8% when compared to end-2002. Details on the credit transfer transactions via the Giro system are shown in Graph 4.47.

**Credit, Charge and Debit cards**

The number of credit cards issued by the financial institutions had increased in the recent three years, from 2.8 million cards at end-2000 to 5.1 million cards at end-2003. From 2002 to 2003, the total

**Graph 4.47**
**Interbank Giro Transactions**




value of credit card transactions rose by 16% and credit card remains as a preferred payment card. The usage of charge and debit cards was insignificant compared to credit cards as shown in Table 4.33.

As part of the Bank's effort to ensure an adequate level of prudential measure, consumer protection and consumer education, the Bank had issued a "Credit Card Guideline" in March 2003. The requirements in the Guideline among others, stipulates a RM250 limit for consumers' liability for unauthorised transactions, bars credit card usage for unlawful activities such as illegal online betting, requires banks to provide an advisory to their cardholders on the consequences of paying only the minimum repayment amount and requires the banking institutions to utilise the Central Credit Reference Information System (CCRIS) in their credit evaluation for processing applications.

**Electronic Purse - MEPS Cash**

Marketing programmes and awareness campaigns have been undertaken during the year to promote the use of electronic purse and electronic payment channels in the country. During 2003, the banking institutions progressively upgraded their existing card

**Table 4.33**
**Payment Cards**

| | 2002 | | | 2003 | | |
|---|---|---|---|---|---|---|
| | No. of cards (million) | Volume (million) | Value (RM million) | No. of cards (million) | Volume (million) | Value (RM million) |
| Credit cards | 4.4 | 126.9 | 25,304.7 | 5.1 | 146.3 | 29,359.9 |
| Charge cards | 0.3 | 7.8 | 1,860.6 | 0.3 | 7.5 | 1,895.7 |
| Debit cards | n.a. | 1.0 | 74.2 | 2.8 | 1.2 | 87.4 |

n.a. Not available.

acceptance devices on a nationwide basis for merchants to accept MEPS Cash electronic purse. More than 12,000 terminals have been deployed at various merchants by the financial institutions and third party acquirers. As the MEPS Cash scheme has only recently been deployed on a widespread basis, the volume of transactions has yet to reach a significant level.

**Internet Banking**

The Internet is becoming an increasingly important channel for banks to provide banking services to both individual consumers and businesses. During the year, an Islamic bank and a locally incorporated foreign bank began offering Internet banking services, making the number of banks offering transactional Internet banking services to 13 as at end-2003. Consumers and businesses continued to show a growing interest in using the Internet as a bill payment medium and for conducting interbank fund transfers.

Accordingly, in their efforts to increase the adoption of this self-direct channel, the banks have increased the range of services offered via Internet banking including free online bill payment services and the ability to transfer funds to accounts in other banks. With more households and businesses realising the convenience of Internet banking, the number of Internet banking subscribers grew from 1 million as at end-2002 to 1.7 million as at end-2003. The total value of transactions conducted through Internet banking by individual consumers had increased significantly from RM0.9 billion for the quarter ended 31 December 2002 to RM3.5 billion for the quarter ended 31 December 2003.

**Business Continuity Management**

Business Continuity Management is the act of anticipating incidents that will affect critical functions and processes in the organisation and ensuring that it is able to respond to any incident in a planned and prepared manner. The Business Continuity Plan is the processes and procedures an organisation put in place to ensure that essential functions can continue after and during a crisis. As part of the Business Continuity Plan, the RENTAS, SPICK-KL and SWIFT operations has a prescribed plan to ensure that these services, if disrupted, can be re-established swiftly and smoothly.

In 2003, monthly testing and several extended live runs have been carried out to ensure that all operation staff is familiar with the procedures at the alternate site. During the testing periods, the Bank worked closely with member banking institutions to ensure that operations run smoothly, despite a change in location. This encourages close co-operation among the members to ensure that these systems operated by Bank Negara Malaysia are well supported.

## MALAYSIA'S ANTI-MONEY LAUNDERING AND COUNTER FINANCING OF TERRORISM (AML/CFT) PROGRAMME

**Overview**

The global community continues to intensify efforts to enhance measures to detect and deter money laundering and terrorism financing. There has been greater co-operation among national agencies to put in place the appropriate statutes and continue to build capacity of personnel involved in implementing the AML/CFT initiatives.

In Malaysia, Bank Negara Malaysia (the Bank) leads various law enforcement agencies in combating money laundering and terrorism financing. The Bank is the secretariat to the National Co-ordination Committee to Counter Money Laundering (NCC), which was established in 2000 to formulate AML/CFT measures, co-ordinate the implementation of these measures and to ensure that the national efforts are aligned with regional and international initiatives. Representatives of member agencies in the NCC meet several times a year to co-ordinate their concerted efforts in fighting money laundering and in countering terrorism financing. Each NCC member is responsible to study and report on pertinent AML/CFT issues to the NCC as well as implement, and report on the development of, any NCC decision.

**UN International Convention for the Suppression of the Financing of Terrorism**

Malaysia is committed to criminalise the financing of terrorism as called for under the UN International Convention for the Suppression of the Financing of Terrorism. Malaysia proposes to accede to the UN Convention by making appropriate amendments to, and provide new legislative provisions in, five pieces of legislation, namely the Penal Code, Criminal Procedure Code, Subordinate Courts Act 1948, Courts of Judicature Act 1964 and the Anti-Money Laundering Act 2001 (AMLA).

**Anti-Money Laundering (Amendment) Act 2003**

In November 2003, the Parliament passed the Anti-Money Laundering (Amendment) Act 2003, which was gazetted as law on 25 December 2003. When this legislation is brought into force by a Ministerial order, the short title of the AMLA would be changed to "Anti-Money Laundering and Anti-Terrorism Financing Act 2001". The amending legislation extends the Bank's money laundering reporting mechanism to include the reporting of suspected terrorism financing, provides for measures to be taken for the detection and prevention of terrorism financing as well as provides for the freeze, seizure and forfeiture of terrorist property.

**Implementation of the Anti-Money Laundering Act 2001**

The money laundering reporting mechanism under the AMLA covers financial institutions and certain categories of non-financial institutions, which are considered to be of higher risk to money laundering or terrorist financing activities. Our implementation approach of extending the reach of the law incrementally ensures that the reporting institutions are well prepared and able to effectively comply with their obligations under the AMLA.

**Recent AML/CFT Measures under the AMLA**

*Extending the List of Reporting Institutions*

Since the AMLA came into force on 15 January 2002, the requirement to report suspicious transactions was invoked on banking and Islamic banking institutions, insurance companies and takaful operators, money changers and offshore entities. In 2003, several other categories of businesses have been included as reporting institutions. To date, the reporting institutions under the AMLA are as follows.

**Table 4.34**
**Reporting Institutions under the AMLA**

| Invocation date | Type of Reporting Institution | Number of Institutions (as at 31 December 2003) |
|---|---|---|
| 15-Jan-02 | Commercial banks<br>Finance companies<br>Merchant banks<br>Islamic banks | 23<br>11<br>10<br>2 |
| 15-Apr-02 | Discount houses<br>Offshore banks<br>Offshore insurance companies<br>Offshore trust companies<br>Insurance companies<br>Reinsurance companies<br>Insurance brokers<br>Takaful operators | 7<br>54<br>101<br>18<br>44<br>10<br>35<br>4 |
| 1-Jun-02 | Money-changers | 649 |
| 15-Jan-03 | Bank Kerjasama Rakyat Malaysia<br>Bank Simpanan Nasional<br>Lembaga Tabung Haji<br>Pos Malaysia Berhad<br>Genting Casino | 1<br>1<br>1<br>1<br>1 |
| **Total reporting institutions** | | **973** |

Other non-financial institutions that are vulnerable to money laundering and terrorism financing will be brought under the AMLA in stages.

*Increase Reporting Obligations*

The full-fledge reporting obligations under the AMLA, such as record-keeping, retention of record, compliance programme and customer identification requirements have been invoked on the following institutions:

- Commercial banks, finance companies, merchant banks and Islamic banks with effect from 15 January 2003;
- Discount houses, offshore banks, offshore trust companies, offshore insurers, reinsurers, insurers, insurance brokers and takaful operators with effect from 15 April 2003; and
- Money changers with effect from 1 October 2003.

The Bank continues to work in collaboration with these reporting institutions through regular dialogue sessions to ensure effective implementation of the AMLA compliance programme. The banking industry has set up a Compliance Officers Networking Group (CONG), which meets regularly to discuss AML/CFT compliance issues at the premises of the Institute of Bankers Malaysia. Officers of the Financial Intelligence Unit (FIU) in the Bank attend CONG meetings by invitation only.

*Increase Predicate Offences*

In 2003, the number of money laundering predicate offences has increased from 122 to 150 serious crimes from 23 pieces of legislation.

**Suspicious Transaction Reports (STRs)**

As the competent authority mandated by the Minister of Finance, the Bank receives STRs pursuant to section 14(b) of the AMLA. Section 14(b) requires the reporting of suspicious transactions to the FIU in the Bank. The STRs are analysed and, where applicable, shared with the relevant enforcement agencies, which conduct their own surveillance and investigations into these cases based on the Bank's financial intelligence.

**Capacity Building**

*Awareness Programme*

The Bank continues to promote awareness among relevant stakeholders to ensure effective implementation of the AML/CFT measures. A nationwide awareness programme for the banks, including Bank Kerjasama Rakyat Malaysia Berhad, Bank Simpanan Nasional and Lembaga Tabung Haji were conducted in August-October 2003. Dialogue sessions with reporting institutions were also conducted regularly to update and clarify any issues relating to the development of the AML/CFT measures.

*Training Initiatives*

The Bank hosted several workshops to enhance the knowledge and skills of both domestic and regional stakeholders in the AML/CFT initiatives. Financial sector experts from the United States, Australia, the United Kingdom and international and regional bodies such as the IMF, the World Bank and the Asia/Pacific Group on Money Laundering (APG) were invited to share their experiences and expertise at these workshops. The international training programmes organised and hosted by the Bank were:

(i) The ASEAN Anti-Money Laundering Workshop 2003, held from 28–30 July 2003. The workshop formulated strategies for the creation of a comprehensive anti-money laundering regime in each ASEAN country, which included defining the core functions of a financial intelligence unit, identification of the agencies and the role of enforcement agencies in the AML/CFT framework.
(ii) The Basic Analysis and Suspicious Transaction Reporting Workshop 2003, held on 25-29 August 2003. The workshop was co-hosted by the South East Asia Regional Centre to Counter-Terrorism and the Bank. It focused on techniques in basic analytical skills on collection, analysis and sharing of information on suspected money laundering and terrorism financing submitted by reporting institutions.
(iii) The APG Typologies Workshop, held from 8–9 December 2003. The workshop was attended by participants from 34 member and observer jurisdictions of the APG. The workshop focussed on the sharing of trends and cases relating to money laundering and terrorist financing. In addition, various working groups to conduct in-depth study on cash couriers, terrorism financing and corruption related issues were established.
(iv) The APG AML/CFT Assessment Training Workshop, held on 10–12 December 2003. This workshop trained the financial sector experts from the APG member jurisdictions to conduct assessment based on the IMF/ World Bank Methodology for Assessing Compliance with AML/CFT Standards.

**Challenges Ahead**

The Financial Action Task Force reviewed its 40 Recommendations in June 2003. The revision extended the reporting entities to designated non-financial business and professions (DNFBP). The DNFBP includes real estate agents, dealers in precious metals, dealers in precious stones, lawyers, notaries, other independent legal professionals, accountants and trust and company service providers. The Bank will invoke the AMLA reporting obligations on DNFBP in stages taking into consideration the readiness of these entities. The Bank recognises that the consultative process with the DNFBP and the relevant regulatory and supervisory authorities of the DNFBP as significant to the successful implementation of the AMLA reporting obligations.

The amendments to the Penal Code to criminalise terrorism financing and the amendments to the AMLA require the development of appropriate counter-financing of terrorism mechanisms and procedures to ensure effective implementation of the UN International Convention for the Suppression of the Financing of Terrorism. The Bank will work in collaboration with the NCC members to effectively implement the new legislative provisions.

Money laundering trends constantly evolve and hence, necessitate continuous training of law enforcement personnel to upgrade their knowledge and skills. The Bank will continue its leadership role in the fight against money laundering activities.