CHAPTER 14 - FINANCE

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Chapter 14

Finance

14 FINANCE

I. INTRODUCTION

14.01 The finance, banking and insurance sector entered the Seventh Plan period on a sound footing with adequate capitalization levels and good asset quality. In particular, the continuing efforts of the Government to develop the financial system and implement policies to promote a robust and resilient financial system as well as reduce the potential for financial instability ensured that the financial sector was able to remain sound and intact despite the severe consequences of the recession following the Asian crisis. Consolidation of the domestic financial institutions through recapitalization and mergers was also initiated to develop a core of strong domestic institutions.

14.02 For the Eighth Plan period, a comprehensive, efficient, resilient and competitive domestic financial system will continue to be a vital element in meeting the economic aspirations of the nation. Measures will focus on further strengthening the financial sector to meet the challenges of globalization. In particular, these measures will be undertaken with a view to creating a strong, efficient and competitive banking system that will be able to withstand future shocks, thereby minimizing the adverse implications on macroeconomic stability. The restructuring of the financial institutions through consolidation will facilitate the development of an efficient and competitive banking system to support the growth of the economy. In addition, the financial sector will be made to provide a catalytic role in providing financing options for high-growth activities, particularly in the knowledge- and technology-intensive industries. To complement the measures in the banking sector, efforts will be taken to further develop the capital market as an internationally competitive and highly efficient capital market. Emphasis will also be placed on the introduction of new financial instruments, among others, through the development of the Ringgit bond and derivatives markets to further broaden and deepen the capital market as well as avoid the problem of funding mismatch.

II. PROGRESS, 1996-2000

14.03 During the Seventh Plan period, the finance, banking and insurance sector expanded at an average rate of 7.3 per cent per annum in spite of a contraction in 1998 arising from the Asian financial crisis. In terms of contribution to the Gross Domestic Product (GDP), its share increased from 10.4 per cent in 1995 to 11.6 per cent in 2000, surpassing the agriculture sector. Employment in the sector was 508,700 or 5.5 per cent in 2000.

Banking System

Assets and Deposits

14.04 The total assets of the banking system increased at an average rate of 10 per cent per annum from RM414.4 billion as at the end of 1995 to RM661.1 billion as at the end of 2000, as shown in *Table 14-1*. The increase in assets was mainly due to the strong growth of loans and advances in 1996 and 1997. In terms of total assets and deposits, commercial banks continued to record the largest share at 77.9 per cent and 77.0 per cent, respectively.

Loans

14.05 During the Plan period, the growth of loans underwent three distinct phases, namely, rapid growth in 1996-1997, contraction in 1998-1999 and recovery in 2000. Loan growth was in excess of 20 per cent per annum since 1995, and remained high in 1996 and 1997, expanding by 28.5 per cent and 26.6 per cent, respectively. The rapid increase was underpinned by strong economic activities, which saw a buoyant property and stock market. Apart from the great demand for credit during the period, there were also supply-side factors which resulted in an increased reliance on bank financing. Firstly, while there was significant progress in the equity market, the bond market was relatively underdeveloped. Borrowers could raise only a limited amount of funds through the issuance of private debt securities (PDS). Secondly, the success of privatization meant a bigger role for the private sector and the concomitant increase in the amount of financing required by the private sector. As the capital market was underdeveloped, most of the financing was provided by the banking institutions. The policy of tiering the banking institutions based essentially on their value of capital was also a contributory factor, especially in 1995 and 1996. With increased capital,

TABLE 14-1

TOTAL ASSETS, DEPOSITS AND LOANS OF THE BANKING SYSTEM, 1995 AND 2000

(RM million)

Institution	*Total Assets*					*Total Deposits*					*Total Outstanding Loans*[1]				
	1995	*%*	*2000*	*%*	*Average Annual Growth Rate, 1996-2000 %*	*1995*	*%*	*2000*	*%*	*Average Annual Growth Rate, 1996-2000 %*	*1995*	*%*	*2000*	*%*	*Average Annual Growth Rate, 1996-2000 %*
Commercial[2] Banks	295,460	*71.3*	514,838	*77.9*	*11.7*	196,851	*69.6*	364,353	*77.0*	*13.1*	182,079	*69.8*	345,620	*76.1*	*13.7*
Finance Companies	91,892	*22.2*	109,396	*16.5*	*3.5*	69,963	*24.7*	83,817	*17.7*	*3.7*	64,669	*24.8*	87,947	*19.4*	*6.3*
Merchant Banks	27,062	*6.5*	36,885	*5.6*	*6.4*	16,093	*5.7*	24,764	*5.3*	*9.0*	14,144	*5.4*	20,646	*4.5*	*7.9*
Total	**414,414**	***100.0***	**661,119**	***100.0***	***9.8***	**282,907**	***100.0***	**472,934**	***100.0***	***10.8***	**260,892**	***100.0***	**454,213**	***100.0***	***11.7***

Notes:

[1] Including housing loans sold to *Cagamas Berhad*

[2] Including Islamic Banks

many banking institutions were able to expand their lending activities. In terms of loans by sector, an increasing amount of loans during the period were channelled to the property sector as well as for consumption and the purchase of securities. *Bank Negara Malaysia* (BNM) had instituted pre-emptive remedial policy prescription as early as 1995. Interest rates were gradually raised from 1995, complemented with a tightening on the guidelines on the hire-purchase loans for passenger cars and for the purchase of residential houses, apartments and shophouses. Further measures were introduced in 1997 to contain the amount of credit for the purchase of stocks and shares as well as selective categories of property.

14.06 Despite showing signs of moderation, loans continued to grow at levels considered to be unsustainable and creating imbalances in the financial sector. With the onset of the financial crisis, emphasis was given towards addressing the excessive loan growth problem and the high exposure of banking institutions to the property and stock markets. Specific tightening measures were undertaken, namely, a stricter guideline on loans to selected categories of property and the introduction of a credit plan. The latter was drawn in consultation with the banking institutions and stipulated a clear downward path for loans for successive quarters, beginning from the fourth quarter of 1997 to the fourth quarter of 1998.

14.07 The impact of the financial crisis, however, was much worse than anticipated and affected the balance sheets of the banking institutions. As external demand declined, economic activities contracted leading to cash flow and rising non-performing loan (NPL) problems. Banks began to tighten credit and the annual growth in loans decelerated sharply in 1998 to 1.3 per cent and even contracted by 0.1 per cent in 1999. The tight policy stance was reversed in mid-1998. The Government promptly sought to address the NPL problem by creating *Pengurusan Danaharta Nasional Berhad* (Danaharta), an asset management company and recapitalized the banking institutions through *Danamodal Nasional Berhad* (Danamodal). The banking institutions responded positively to these measures and in line with the recovery of the economy, loans began to increase in February 2000. By the end of 2000, outstanding loans recorded an annual increase of 5.4 per cent.

14.08 During the Seventh Plan period, loans extended by the banking system were directed mainly to the broad property and manufacturing sectors as well as in the form of consumption credit, as shown in *Table 14-2*. Loans to the broad property sector accounted for 35.9 per cent of the total loans mainly due to higher loans extended to the construction and residential property subsectors. Lending to the manufacturing sector was the second largest, accounting for 15.1 per cent, followed by loans for consumption purposes at 13.1 per cent.

TABLE 14-2

LOANS OF THE BANKING SYSTEM BY SECTOR, 1995 AND 2000
(RM million)

Sector	*1995*	*%*	*2000*[1]	*%*	*Average Annual Growth Rate, 1996-2000 %*
Agriculture, Forestry & Fishing	5,255.1	*2.0*	11,967.8	*2.6*	*17.9*
Mining & Quarrying	1,184.3	*0.5*	1,728.4	*0.4*	*7.9*
Manufacturing	48,818.2	*18.7*	68,422.6	*15.1*	*7.0*
Wholesale & Retail Trade, Hotels & Restaurants	21,432.2	*8.2*	38,347.3	*8.4*	*12.3*
Broad Property Sector of which:	73,557.6	*28.2*	163,214.9	*35.9*	*17.3*
Construction	*20,232.9*		*41,109.1*		
Residential Property[2]	*32,752.9*		*74,281.8*		
Transport, Storage & Communications	5,101.3	*2.0*	13,700.5	*3.0*	*21.8*
Finance, Insurance & Business Services	31,874.0	*12.2*	34,454.6	*7.6*	*1.6*
Consumption Credit	29,518.9	*11.3*	59,724.5	*13.1*	*15.1*
Purchase of Securities	21,737.1	*8.3*	33,520.5	*7.4*	*9.0*
Others	22,413.1	*8.6*	29,131.9	*6.4*	*5.4*
Total	**260,891.8**	***100.0***	**454,213.0**	***100.0***	***11.7***

Notes:
[1] Including Islamic Banks.
[2] Including housing loans sold to *Cagamas Berhad*.

Structural Changes in the Banking System

14.09 The broad policy direction continued to be aimed at enhancing the soundness, effectiveness and efficiency of the banking system. This was undertaken through the implementation of both prudential and institutional measures.

14.10 *Prudential Measures.* During the Seventh Plan period, a number of prudential measures were implemented. Firstly, banking institutions were required to have a strong capital base to be effective inter-bank players. In this regard, finance companies were required to increase their minimum shareholders' funds to RM100 million by 1 January 1997, RM350 million by 1 January 1998 and, subsequently, RM600 million by 1 January 1999, to remain as participants in the inter-bank market. This requirement was imposed to ensure finance companies were well-capitalized to manage their risks in inter-bank transactions. However, the increase of capital funds to RM350 million and RM600 million was deferred in view of the crisis. This requirement was subsequently replaced with the new minimum amount of capital funds requirement where each of the domestic banking groups must hold a minimum capital fund of RM2 billion, whereas foreign banks will be required to hold a minimum of RM300 million by the end of 31 December 2001.

14.11 In addition, prudential regulations were also adjusted in line with development trends in the global financial markets. A comprehensive guideline on Minimum Standards on Risk Management Practices for Derivatives was issued in July 1996 to remove the requirement for approval by BNM on an individual product basis. As part of the effort to raise the standard of internal auditing in the financial industry, the Guidelines on Minimum Audit Standards for Internal Auditors of Financial Institutions were issued in February 1997. In view of the increasing involvement of banking institutions in complex trading operations and the potential for rapid change in their risk profile, a risk-based supervisory approach was adopted in 1997. The risk-based approach focused on areas of greatest risks and involved their identification and assessment as well as ensuring of adequacy of controls over those risks.

14.12 Since the onset of the financial crisis in July 1997, existing regulations were tightened to further strengthen the banking system in terms of sound banking practices, stronger prudential regulations and supervision, and greater transparency. The measures were designed to induce banking institutions to maintain a larger amount of reserves to support any further deterioration in loan portfolio. Beginning 1 January 1998, the default period for classifying a loan as non-performing was reduced from six to three months to be consistent with international standards. However, this reclassification together with the high interest rates resulted in the inability of many companies to service their loans, thus causing further pressure on their operations. The minimum level of general provisions was also raised from 1.0 to 1.5 per cent of total loans, net of specific provisions and interest-in-suspense. Given the adverse effect of this reclassification on the lending activities of banking institutions, the classification period was subsequently lengthened to six months in September 1998. Nevertheless, other prudential aspects were retained including the classification of loans as non-performing when the account was overdue for at least 12 months as well as the requirement of the claw back of interest to day one of default. In addition, the classification period was only a minimum requirement and did not preclude any institution to adopt a more stringent classification requirement.

14.13 In order to promote a risk-based supervisory approach, the level of transparency in the annual financial statements of banking institutions was further increased to provide improved information to depositors and investors, enabling them to assess the financial soundness of the banking institutions. The additional disclosure requirements included the directors' report on business strategy and outlook, sectoral concentration of loans, amount of NPLs and changes to specific and general provisions, capital adequacy ratios and bank rating by external agencies.

14.14 Since July 1997, intensive monitoring and assessment of the health of the banking institutions was conducted. Stress tests were carried out on a monthly basis to gauge the sensitivity of a bank's solvency position to a deterioration in its loan portfolio. Banking institutions were required to take corrective actions well before they reached the point where additional capital was required. These actions included the requirement to build up provisions and exercise restraints on dividend payments. Banking institutions were also required to submit plans to raise additional capital within a specified period should there be a risk of the institution not being able to comply with the minimum capital adequacy ratio.

14.15 *Institutional Measures.* To complement the prudential measures, institutional measures were also implemented in order to address the structural weaknesses in the banking system, strengthen the banking institutions and promote greater efficiency and innovation. The strategy of developing a core of strong domestic banking institutions was implemented to ensure that the increasingly complex and sophisticated demands of the growing and changing domestic economy could satisfactorily be met by the domestic banking industry.

14.16 With the advent of the Asian crisis, comprehensive reform and restructuring of the banking sector was also undertaken to address weaknesses in the sector. As a pre-emptive measure to improve the resilience of the finance companies, a merger process was initiated by BNM in 1997. All finance companies were required to merge with the identified anchor companies or absorbed into commercial banks of which they were subsidiaries or form strategic alliances. To ensure the financial position of the acquiring anchor institution was not weakened, the

Government extended a one-year guarantee to the acquiring anchor institution to provide for any further reduction in the value of the acquired assets, to be determined after a due diligence review. In 1999, the number of finance companies were reduced from 39 to 22.

14.17 With the deepening of the economic crisis and further deterioration in asset quality, active assistance was required both to assist corporate borrowers and the banking institutions. A three-pronged strategy was thus initiated with the establishment of Danaharta and Danamodal as well as the setting up of the Corporate Debt Restructuring Committee (CDRC).

14.18 Deterioration in the asset quality of banking institutions adversely affected the efficiency of the intermediary role of the banking institutions. Specifically, the rising NPLs caused banking institutions to be overly cautious in their lending activities, resulting in viable projects being denied financing. If left unchecked, this development would have destabilizing implications on the overall economy. Therefore, to address the issue of rising NPLs and to ensure the continued efficiency and effectiveness of the intermediation process, the Government established the asset management company, Danaharta, in June 1998. Danaharta aimed at purchasing NPLs from financial institutions and manage these NPLs in order to maximize their recovery values.

14.19 As the sale of NPLs to Danaharta was undertaken at fair market value, banking institutions would usually incur losses. Recognizing the constraint in the ability of shareholders of banking institutions to raise capital on their own under the adverse financial environment, the Government set up Danamodal to inject capital into viable but under-capitalized institutions in order to restore the capitalization of these banking institutions to healthy levels. Danamodal coordinated its activities with Danaharta as well as with the banking institutions in strengthening their capital, liquidity and profitability positions. As a pre-requisite to receiving capital injection, banking institutions seeking recapitalization from Danamodal were required to make a firm commitment to sell their NPLs to Danaharta so that their NPL ratios fall below 10 per cent.

14.20 Since the health of the corporate and banking sectors was interlinked, the restructuring of the corporate debts was crucial to preserve the soundness of the banking sector. In this respect, CDRC was set up to complement the role of Danaharta and Danamodal and served as a platform for both the borrowers and creditors to work out feasible debt restructuring schemes without having to resort to legal proceedings. The restructuring of the corporate sector debts would expedite the recovery of the corporate sector and in turn strengthen the health of the banking institutions.

14.21 By the end of December 2000, Danaharta had acquired and managed loans amounting to RM47.0 billion from the financial system. NPLs from the banking system managed by Danaharta amounted to RM37.5 billion or 44 per cent of the total NPLs in the banking system. To finance the acquisition of these loans, Danaharta issued RM11.1 billion in face value of Government-guaranteed loans and paid RM800 million in cash. This amount was lower than the financing requirement of RM15 billion estimated under the National Economic Recovery Plan (NERP). Significant progress was also made by Danaharta in managing and disposing some of the assets acquired from the financial institutions. Up to the end of December 2000, Danaharta had initiated recovery action on 98 per cent of NPLs under its portfolio. Loans and assets amounting to RM35.8 billion were restructured or disposed with an average recovery rate of 66 per cent.

14.22 Since its establishment in August 1998, Danamodal injected RM7.1 billion into 10 banking institutions in the form of Exchangeable Subordinated Capital Loans. With the improvement in the economy, eight banking institutions made repayment amounting to RM3.4 billion. As at the end of December 2000, the outstanding capital injection was RM4.9 billion involving four banking institutions.

14.23 The CDRC also made considerable progress in corporate restructuring. As at the end of December 2000, CDRC received 75 applications with debt totalling RM47.2 billion, of which 42 restructuring schemes involving debts of RM27.3 billion were resolved. In addition, CDRC was also involved in the restructuring of the transportation industry involving RM7.9 billion.

14.24 In line with the need to develop a core of strong and outward-looking domestic banking institutions, a consolidation exercise aimed at reducing the existing number of domestic financial institutions into 10 banking groups was undertaken. To facilitate the merger programme, tax incentives were granted in the form of exemption from stamp duty, real property gains tax as well as tax credit on 50 per cent of the accumulated losses of banking institutions which were acquired. By the end of the Seventh Plan period, 50 of the 54 banking institutions were consolidated into 10 banking groups. Of the remaining four banking institutions, one was given extension for completion of regulatory approval while the other three were allowed to initiate merger negotiations with new partners.

Islamic Banking

14.25 Total assets of the Islamic banking sector grew rapidly by 51.7 per cent per annum from RM6.2 billion in 1995 to RM47.1 billion by the end of 2000. This constituted 6.9 per cent of the total assets in the banking system, signifying that the Islamic banking system had exceeded the 5 per cent target to be achieved by 2000. Deposits mobilized increased significantly from RM4.9 billion to RM35.9 billion over the corresponding period. The increase in deposits was mainly due to the deposits placed by the domestic non-financial private sector, comprising individuals and enterprises. Financing extended by the Islamic banking sector expanded from RM3.5 billion to RM20.9 billion, channeled mainly to the property sector.

14.26 An important milestone in the development of the Islamic banking system in Malaysia was the establishment of the second Islamic bank, *Bank Muamalat Malaysia Berhad* in October 1999, as a result of the merger between *Bank Bumiputra Malaysia Berhad* and Bank of Commerce (M) Berhad. This enhanced further accessibility to Islamic banking with the increase of Islamic banking branches to 131 as well as 2,087 Islamic counters as at the end of 2000. Recognizing the growing importance of Islamic banking and *takaful*, BNM formulated a 10-year master plan for Islamic banking and *takaful*. In line with this development, a dedicated department, the Islamic Banking and *Takaful* Department was established in BNM in October 2000 to oversee the overall implementation of the measures outlined in the master plan.

14.27 To increase the transparency of Islamic banking among banking institutions participating in *Skim Perbankan Islam* (SPI), a new format for financial statements was introduced in October 1996. This format required the SPI banking institutions to disclose the performance of the Islamic banking operations in their financial reports. In tandem with the new requirements, the policy for income recognition for the SPI banking institutions was changed from a cash basis to an accrual basis. The National *Syariah* Advisory Council for Islamic Banking and *Takaful* was established in 1997 as the sole authoritative body to advise BNM and the Islamic banking institutions including *takaful* companies, on issues pertaining to Islamic banking and *takaful* operations.

14.28 To reinforce further the Islamic banking operations of the SPI banks, the Islamic Banking Unit of each individual SPI bank was required to be upgraded into an Islamic Banking Division. The minimum requirement for the Islamic Banking Fund was also increased from RM1 million to RM20 million for the commercial banks, RM10 million for finance companies and RM6 million for merchant banks. As an incentive to the Islamic banking institutions as well as to increase the activity in the Islamic money market, all Islamic banking institutions were allowed to accept funds on Islamic repurchase agreements of less than one month maturity from non-interbank customers beginning 10 November 1998. This was accompanied by the introduction of two Islamic deposit-taking products in December 1998, namely, the Negotiable Islamic Debt Certificate (NIDC) based on *Bai' Bithaman Ajil* and Islamic Negotiable Instruments of Deposits (INID) based on *Al-Mudharabah* to mobilize savings and provide the Islamic money market with marketable and liquid instruments.

Special Funds

14.29 As part of the Government's continuing efforts to make available financial resources at reasonable cost to promote investments in the priority sectors, a number of new funds were established and additional allocations provided to existing funds. The new funds included the Fund for Small and Medium Industries (FSMI), Rehabilitation Fund for Small and Medium Industries, *Tabung Projek Usahawan Bumiputera* (TPUB) and the Special Scheme for Low and Medium Cost Houses (SLMCH). Additional allocations were also provided for the Fund for Food (3F) and New Entrepreneurs Fund (NEF).

14.30 The FSMI was launched in 1998 with an initial allocation of RM1 billion, with the objective to promote new productive capacity and utilize existing capacity in the manufacturing, agro-based industry and services sectors. To further enhance the effectiveness of FSMI and address the problems faced by the small- and medium-scale enterprises (SMEs) affected by the economic slowdown, the Government had since May 1998 relaxed the operational guidelines of FSMI and increased its allocation to RM1.85 billion as a revolving fund. All activities of SMEs in the manufacturing, agro-based industry and services sectors, for the export or domestic markets, were eligible for loans under the scheme. The eligibility criteria of SMEs were also reviewed to include SMEs with shareholders' fund of up to RM10 million. In addition, the maximum loan amount was increased from RM2 million to RM5 million, while the minimum loan amount was reduced from RM250,000 to RM50,000. To improve accessibility, the scheme was extended to all commercial banks, *Bank Islam Malaysia Berhad*, 10 finance companies and four development finance institutions. As at the end of December 2000, the number of loans approved were 5,668 with a total value of RM4.1 billion.

14.31 In view of the full utilization of the amount allocated under the FSMI, the fund was terminated on 3 April 2000. Nevertheless, recognizing the large demands for financing by the SMEs as well as the importance of the SMEs in the economy, the Government launched the Fund for Small and Medium Industries 2 (FSMI 2) with an allocation of RM200 million on 15 April 2000. The objective of the Fund was to provide financing to SMEs in the manufacturing and services sectors to assist them in penetrating the export market or providing linkages to export-oriented companies. As at the end of December 2000, a total of 192 loans valued at RM99.3 million was approved.

14.32 To complement the FSMI, the RM750 million Rehabilitation Fund for Small and Medium Industries (RFSMI) was launched on 23 November 1998. The Fund focused on SMEs that were viable but experienced difficulties in obtaining credit due to existing NPLs. Under this scheme, the SMEs were allowed to utilize 30 per cent of the approved sum to restructure their problematic loans. SMEs with shareholders' fund not exceeding RM10 million were eligible to apply for loans at an interest rate of 5.0 per cent repayable over seven years. The minimum amount of the loan was RM50,000 and the maximum RM5 million. However, the RFSMI was reduced to RM500 million in 1999 due to the slow uptake of loans. At the end of December 2000, the number of loans approved were 272 with a value of RM288 million.

14.33 *Tabung Projek Usahawan Bumiputera* (TPUB) was established with an allocation of RM300 million on 11 February 2000, to assist small- and medium-scale Bumiputera entrepreneurs and wholly-owned Bumiputera companies that had difficulties in obtaining financing to undertake new projects or to continue with existing viable projects in the construction, manufacturing and services sectors. By the end of December 2000, a total of 140 loans amounting to RM66.5 million was approved.

14.34 As part of the efforts to ensure the availability of affordable houses to meet the needs of the low- and medium-income groups, the Government established the SLMCH with an initial allocation of RM2 billion on 1 May 1998. However, due to low utilization rate, the allocation was reduced to RM1 billion in 1999 and, subsequently, terminated effective from 4 August 1999. The revolving credit scheme provided bridging finance facility to developers at a maximum lending rate of 6.5 per cent per annum for a maximum period of three years. Participating financial institutions under the scheme included commercial banks, finance companies, merchant banks and *Bank Islam Malaysia Berhad*. To speed up the approval process, developers were allowed to submit their applications for financing directly to any participating institution, replacing the previous arrangement, whereby endorsement from *Syarikat Perumahan Negara* was required. By the end of December 2000, a total of 106 loans valued at RM793.5 million was approved.

14.35 The 3F scheme, which was established in 1993 with an initial allocation of RM300 million, was increased by RM400 million in 1997 and another RM300 million in 1999. The additional allocation of RM300 million was managed by *Bank Pertanian Malaysia*. This scheme aimed at boosting domestic food production and reducing the food import bill, thereby assisting in controlling inflation. It provided soft loans for investments to increase the production of primary and processed food products as well as improve their distribution. In 1998, the minimum loan under this scheme was reduced from RM50,000 to RM10,000 per borrower while its scope was extended to include other agricultural activities such as commercial cultivation of *padi* and roselle as well as breeding of prawns. The maximum lending rate remained at 4.0 per cent per annum. A total of 2,487 loans was approved under the scheme amounting to RM661.6 million as at the end of December 2000.

14.36 The NEF was increased to RM1.25 billion through an additional allocation of RM500 million in 1998. The aim of the scheme was primarily to stimulate the growth of Bumiputera SMEs in new business ventures. The scheme focused on Bumiputera SMEs with shareholders' fund of not more than RM10 million. A total of RM1.3 billion was approved for 2,876 loans as at the end of December 2000.

Development Finance Institutions (DFIs)

14.37 DFIs continued to complement other major financial institutions in providing financing to priority sectors. They specialized in medium- and long-term capital financing as well as a range of financial services not normally provided by licensed financial institutions. Lending by these institutions increased by an average rate of 21 per cent per annum from RM5.1 billion in 1995 to RM13.2 billion in 2000. As at the end of 2000, loans extended to the manufacturing sector accounted for 25.1 per cent while the transport/storage and construction sectors accounted for 22.3 per cent and 8.5 per cent, respectively.

14.38 As part of the efforts to promote trade, the Export-Import Bank of Malaysia Berhad (EXIM Bank) facilitated the export of goods and services through the provision of export credit, financing of capital investment as well as advisory services. The main focus of EXIM Bank was in the promotion of exports of capital goods and exports to non-traditional markets.

14.39 *Bank Pembangunan Malaysia Berhad* was converted into *Bank Pembangunan dan Infrastruktur Malaysia Berhad* (BPIMB) to facilitate the financing of infrastructure projects which were not implemented due to difficulties in obtaining loans from the banking institutions. This was aimed at reviving the construction sector and other construction-related activities which were adversely affected by the economic slowdown. In addition, the BPIMB loans provided a new way of financing Government projects through the deferred payments system. To strengthen the capital base of BPIMB, its paid-up capital was increased from RM105.5 million to RM1 billion.

14.40 Recognizing the importance of venture capital as a source of financing to encourage the development of high-technology industries, a fund of RM200 million was established to finance high-tech projects. In this regard, *Bank Industri Malaysia Berhad* (BIMB) was restructured to become *Bank Industri dan Teknologi Malaysia Berhad* (BITMB) to manage the new fund. To further enhance the operations of BITMB, its capital base was increased from RM320.5 million to RM670.5 million.

Other Financial Institutions

14.41 Deposits mobilized by *Bank Simpanan Nasional* (BSN) increased from RM5.2 billion in 1995 to RM10.7 billion in 2000, while total resources increased to RM11.4 billion. The bulk of the investments were in Government securities which accounted for 29 per cent of total investments. Lending operations also expanded with total outstanding loans increasing from RM1 billion in 1995 to RM2.2 billion as at the end of 2000. Loans were mainly extended to individuals, accounting for 88 per cent of outstanding loans for purchase of houses and hire-purchase financing.

14.42 Following the financial crisis, BSN undertook measures to rationalize its operations. Under the banking sector merger programme, BSN's associate and subsidiary companies, namely, BSN Commercial Malaysia Berhad, BSN Merchant Bank and BSN Finance were merged with one of the anchor banks. As a result of this review, BSN focused on its core business of retail banking with an emphasis on personal finance, catering for the total financial requirements of individuals and households.

14.43 The *Employees Provident Fund* (EPF) continued to be the largest among the provident and pension funds in the country with resources constituting about

85 per cent of all such funds. Total resources increased from RM98.8 billion held in trust for the benefit of 7.8 million members in 1995 to RM167.1 billion for 9.5 million members by the end of 1999. During the Seventh Plan period, EPF played an active role in the country's development by providing resources for the financial requirements of both the public and private sectors. Total investments of the EPF increased from RM96.6 billion in 1995 to RM181.5 billion in June 2000.

14.44 As part of the strategy to diversify its portfolio of investments, the Employees Provident Fund Act 1991 was amended with effect from 1 November 1996, mainly to allow its members to invest in approved fund management institutions of up to 20 per cent of the amount in excess of RM50,000 in their retirement account. Since the introduction of the Member's Savings Investment Scheme, withdrawals for investments in approved fund management institutions in 2000 amounted to RM1.5 billion, accounting for 14.6 per cent of total withdrawals. To support the EPF's efforts to promote its annuity scheme, the 2000 Budget provided an income tax relief up to RM1,000 on premiums for annuities purchased under the EPF scheme.

Capital Market

Funds Raised and Secondary Market Activity

14.45 Although the banking system remained as the main source of financing in the economy, the share of new financing from the capital market increased in 1998 and 1999 due to the slowdown in the demand for loans and greater caution on the part of the banks in their lending activities. The ratio of net funds raised in the capital market to loans extended by the banking system reached 3.2 in 1998, indicating that new financing from the capital market was three times the amount of new financing from the banking system. The ratio was even higher in 1999 as net funds raised in the capital market amounted to RM17.2 billion while total loans declined by RM200 million.

14.46 Net funds raised by the *public sector* amounted to RM29.7 billion during the Seventh Plan period. A notable development in the domestic bond market was the implementation of the *Khazanah* bond issuance programme to build the benchmark yield curve. The bonds were interest-free and based on the concepts of *murabahah* and *bai' al-dayn*, issued on a quarterly basis and for an amount of not less than RM500 million per issue. The first issue of RM1 billion nominal value and three-year maturity was in September 1997.

14.47 The *private sector* raised a total of RM121 billion net funds from the capital market. In terms of composition, the equity market mobilized a sum of RM48.2 billion or 39.8 per cent of total net funds, while the balance was raised from the PDS market. Raising of funds from the equity market was substantially contained by the regional financial crisis which reflected the heightened risk aversion of investors and the bearish investor confidence that prevailed throughout most of the crisis period. As a result of this, certain new issues were under-subscribed and posted a discount to their offer prices during the height of the crisis. Trading amounted to 58.3 billion units in 1998 compared with 72.8 billion units in 1997, as shown in *Table 14-3*. The value of market turnover fell by 71.8 per cent from RM408.6 billion in 1997 to RM113.7 billion in 1998.

Development of the Capital Market

14.48 The Securities Commission (SC) also introduced several measures as part of the on-going exercise to ensure the growth and orderly development of the capital market. These measures continued to focus on enhancing protection for investors, ensuring systemic stability, promoting innovation and competition as well as providing a fair and orderly environment for the trading of securities. The Securities Industry Act 1983 (SIA) was reviewed and amended in April 1998 to deter market manipulation and insider practices. The provisions on insider trading were amended to broaden its definition and new provisions were included to enable action to be taken against such market manipulation. To further enhance transparency, the amended SIA required chief executive officers or directors of public companies to disclose their interests in any listed corporation and its associates. In addition, the SC strengthened the rules on related-party and interested party transactions to protect investors.

14.49 To further enhance the efficiency of the derivatives market, the Malaysian Derivatives Clearing House was merged with the Malaysian Futures Clearing Corporation in 1997. With the merger, a common clearing house was created to facilitate more effective risk management. The derivatives industry was further consolidated with the merger of the Kuala Lumpur Commodities Exchange and the Malaysian Monetary Exchange in 1998 under the new entity of the Commodity and Monetary Exchange of Malaysia.

14.50 As part of the measures to curb excessive speculation in the stock market, the Kuala Lumpur Stock Exchange (KLSE) suspended regulated short-selling as well as the lending and borrowing of securities in the domestic stock

Table 14-3

**KEY INDICATORS OF
KUALA LUMPUR STOCK EXCHANGE, 1995-2000**

Indicator	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
Price Indices						
Composite	995	1,238	594	586	812	680
Emas	279	348	151	149	206	160
Second Board	299	576	163	158	181	133
Industrial	1,823	2,359	1,108	1,044	1,389	1,217
Finance	7,562	10,285	3,273	3,660	6,447	5,071
Property	2,104	2,539	761	781	1,027	633
Plantation	2,447	2,864	1,837	1,830	1,677	1,362
Mining	386	588	173	246	235	193
Price Earning Ratio	24.5	28.6	10.3	-130.6	-32.4	21.3
Market Capitalization (RM billion)	564.8	806.8	375.8	374.5	552.7	444.4
Number of listed companies	529	621	708	736	757	795
Turnover (cumulative)						
Volume (billion units)	34.0	66.5	72.8	58.3	85.2	75.4
Value (RM billion)	178.9	463.2	408.6	115.2	185.3	244.1

Note: Figures shown are as at the end of the period except for turnover which is cumulative

market. Listed companies were allowed to buy back their shares following an amendment of the Companies Act 1965. Investors were given protection by an increase in the Compensation Fund to RM314.1 million that could be used against claims relating to defaults, fraudulent acts or insolvency of stockbroking companies. In addition, the Securities Clearing Automated Network Services (SCANS) set up a Standby Facility of RM500 million to reduce the possibility of systemic risk in the stock market arising from the failure of any stockbroking company in meeting its trading obligations. The objective of the Standby Facility was to ensure the integral strength of the system, thereby protecting the overall interest of investors.

14.51 In response to the financial crisis and its effects on the domestic capital market, measures were implemented in early September 1998 to strengthen and further enhance transparency in the equities market. Relevant securities laws were reviewed and amended to enhance the enforcement powers of the SC. In addition, measures were taken to eliminate nominee trading and ensure that all trading of Malaysian shares were transacted through the KLSE. The aim was to promote KLSE as the premier market for Malaysian securities and return offshore trading of KLSE-listed Malaysian equities to the local bourse. Subsequently, the Central Limit Order Book International Market (CLOB) stopped trading on equities of Malaysian companies with effect from 15 September 1998. However, measures were taken to facilitate the trading of these shares in the KLSE under a comprehensive solution arrangement agreed by KLSE and Singapore Exchange Limited (SGX). A total of 160,313 investors, representing 93 per cent of CLOB investors, accepted the agreement for staggered release of their shares on the KLSE bourse.

14.52 The SC and KLSE reviewed their rules and regulations as well as strengthened their supervisory and enforcement capabilities to ensure fair and orderly trading. Measures were taken particularly to further strengthen the capacity in monitoring the financial position of brokers. The SC, among others, widened the scope of its investigative capabilities and strengthened its financial reporting surveillance and enforcement functions.

14.53 Measures were also introduced by the SC to reduce the risk exposure of stockbrokers. In December 1998, the SC approved the Capital Adequacy Requirement (CAR) framework that sought to enable both the KLSE and stockbroking companies to identify more clearly the capital available to cover risks of running a securities business from the actual level of risk faced by the business at any given point in time. This framework came into effect in 1999 and was part of the measures being taken to enhance the prudential regulation of the stockbroking industry.

14.54 As part of the efforts to strengthen the domestic capital market, SC announced the policy framework for the consolidation of 62 stockbroking companies (SBCs) into a core of well-capitalized Universal Brokers able to offer a full range of capital market services. This was a follow-up to the earlier initiatives to encourage mergers and SBCs were allowed to find their own merger partners and to determine their own valuation. In addition to tax incentives provided to encourage mergers, Universal Brokers will be allowed to operate an additional branch for every stockbroking licence surrendered, subject to the approval of the SC.

14.55 In the *PDS market*, net funds raised amounted to RM55.9 billion, the bulk of which was raised by the finance, insurance and business services, and manufacturing sectors. The PDS issued was partly attributable to corporate debt restructuring. There was also a demand for PDS by investors as the yields of the bonds were higher than the prevailing interest rates. The funds were raised mainly through bonds with warrants, *Cagamas* bonds as well as Islamic and conventional bonds. To promote greater market efficiency and expedite the approval process of issuance of PDS, the Malaysian Rating Corporation Berhad (MARC) was established as the second rating agency in 1996 to complement the functions of the Rating Agency of Malaysia (RAM).

14.56 As part of the efforts to develop the secondary market for bonds, the Bond Information and Dissemination System (BIDS) was launched in October 1997, with the aim of providing comprehensive market information on domestic debt securities to market participants. The system facilitated the efficient pricing of new issues, improved liquidity and widened the market. In its first phase, BIDS provided information on both primary and secondary market activities, including information on all outstanding PDS, Malaysian Government Securities (MGS), Treasury bills, *Bank Negara* bills and *Cagamas* bonds.

14.57 Recognizing the need to further develop the bond market as a competitive source of financing and reduce the reliance on the banking system, the National Bond Market Committee was established to provide the policy direction and to rationalize the regulatory framework as well as recommend appropriate implementation strategies. Towards this end, three working groups were established, namely, the Legal and Regulatory Reform Committee, the Product and Institutional Development Committee and the Infrastructure and Operations Working Group.

14.58 SC became the single regulatory authority for the supervision and regulation of the corporate bond market with effect from 1 July 2000. SC introduced several new guidelines and regulations to expedite approval and encourage the issuance of PDS. Among others, these guidelines included greater transparency and flexibility on the issuance of PDS as provided under the shelf registration scheme, allowing repo transactions in PDS as well as introducing restrictions on the utilization of PDS proceeds for the development of certain properties.

Unit Trust Funds

14.59 The number of unit trust funds that were launched increased from 67 in 1995 to 127 in 2000, as shown in *Table 14-4*. The net asset value of funds under management by unit trust management companies was RM43.3 billion or 9.7 per cent of KLSE's market capitalization by the end of 2000. The number of investors also increased from 6.8 million to 9.6 million unit holders over the corresponding period. The growth of the unit trust industry was given a boost with the launch of the RM3 billion *Amanah Saham Wawasan 2020*, a unit trust fund open to all Malaysians between the ages of 12 and 29.

14.60 During the Seventh Plan period, efforts were undertaken to provide a regulatory environment that would protect the interests of the investing public and facilitate the rapid and orderly development of the unit trust industry. In this regard, the SC became the central regulatory authority of the unit trust and property trust industries. Its responsibilities included the approval of unit trust schemes, registration of prospectus and trust deeds as well as approval for the appointments of directors, members of the investment committee and chief executive officers of unit trust management companies. In addition, the Guidelines on Unit Trust Funds was revised in 1997, aimed at liberalizing authorized unit trust investments as well as upgrading skills and professionalism. These Guidelines also required the appointment of internal auditors and compliance officers to enhance disclosure and promote self-regulation. The revision removed the size limit of 500 million units and allowed fund managers to invest in financial instruments such as futures contracts for the purpose of hedging and other collective investment schemes. The Guidelines on Marketing and Distribution of Unit Trusts was promulgated to enhance the skills and professionalism of the unit trust agents and sales persons. To promote accountability and responsibility, personnel involved in the marketing and distribution of unit trust products must register with the Federation of Malaysian Unit Trust Managers (FMUTM) and comply with the Code of Ethics and Standards of Professionalism.

14.61 Recognizing the strategic role of the fund management industry in the development of Wilayah Persekutuan Kuala Lumpur as a financial centre, the SC initiated a multi-pronged approach for its development. These measures included the streamlining of its regulatory framework, deregulation of certain restrictions and development of other forms of collective investment schemes. In this regard, the SC issued the Guidelines for the Establishment of Foreign Fund Management Companies to maximize the opportunities brought about by liberalization, increased customer sophistication, growth of institutional funds

TABLE 14-4

SELECTED INDICATORS OF UNIT TRUST FUNDS, 1995-2000

Indicator	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
Units in Circulation (billion)	31.9	39.0	45.3	46.5	52.6	63.8
Number of Management Companies	27	30	31	32	34	34
Number of Approved Funds	67	77	84	95	107	127
Total Approved Fund Size (RM billion)	37.4	47.1	55.7	61.9	74.4	90.4
Number of Unit Holders (million)	6.8	7.9	8.3	8.6	8.9	9.6
Total Net Assets Value (NAV) of Funds (RM billion)	44.1	60.0	33.6	38.7	43.3	43.3
% of NAV to KLSE's Market Capitalization	*7.8*	*7.4*	*8.9*	*10.3*	*7.8*	*9.7*

Source: Securities Commission.

and the presence of foreign fund managers. To further strengthen the fund management industry, the Futures Industry Act 1993 (FIA) was amended to facilitate the participation of fund managers and unit trust management companies in futures trading with the aim of hedging their investment portfolio.

Venture Capital Financing

14.62 The number of venture capital companies (VCCs) increased from 20 in 1995 to 30 in 1999, as recorded in the annual surveys on VCCs conducted by BNM. During the period 1996-1999, the VCCs invested a total of RM726 million of which 70.8 per cent was in the manufacturing sector. In terms of type of investment, RM193.2 million or 26.6 per cent was channelled to acquisition or buy-out financing, RM100.8 million or 13.9 per cent for second stage financing and RM124.2 million or 17.1 per cent for bridging financing. The VCCs remained reluctant to provide seed capital financing due mainly to its risk-adverse attitude towards investments. Similarly, financing for start-ups was substantially reduced from a high level of RM81.1 million in 1997 to RM7.3 million in 1999.

14.63 In view of the need for technology-based companies to seek competitive forms of financing to enhance their operations, the Malaysian Exchange of Securities Dealing and Automated Quotation (MESDAQ) was launched in 1997. MESDAQ provided an avenue for the high-growth and technology companies access to public funds as well as provided venture capitalization with an early exit route. Since commencement of trading in April 1999, three technology-based companies related to pharmaceuticals, information and communications technology (ICT) and multimedia were listed. By the end of 2000, MESDAQ had registered 15 stockbroking companies as members. In an effort to market MESDAQ, various promotional programmes were organized for potential issuers, the investment community, the media and the general public.

14.64 A number of venture capital funds were also established to further enhance the SMEs access to financing. In this regard, the RM120 million MSC Venture One was established in June 1999, to provide venture capital financing to innovative and emerging ICT and multimedia companies at the various stages of start-up, growth and pre-Initial Public Offer (IPO). As part of the strategy to encourage the development of new high-technology industries, three other venture capital funds with a total amount of RM500 million was established. These included the RM200 million fund to finance high-technology projects channelled through *Bank Industri dan Teknologi Malaysia Berhad* and two funds of RM150 million each established at the commercial banks. In addition, to promote the development of the venture capital industry as an alternative source of financing, tax incentives were granted to VCCs in the form of full tax exemption on all sources of income received during the life span of the VCCs or for a period of 10 years, whichever was earlier.

Insurance

14.65 Total assets of the insurance industry increased at an average rate of 14.6 per cent from RM25.5 billion in 1995 to RM50.3 billion in 2000, despite the dampening effects of the 1997 financial crisis. Such assets accounted for 4.0 per cent of the total assets of the financial system. The insurance industry continued to provide an important source of funds for capital development in the country. Investment in corporate debt securities grew at an average rate of 31.2 per cent per annum and accounted for 40.9 per cent of insurance funds as at the end of 2000. On the other hand, investment in Government papers and loans guaranteed by the Government remained unchanged and accounted for 13.7 per cent of the assets of the insurance funds. Cash and deposits grew by 10.3 per cent per annum to RM10.5 billion or 21.2 per cent of total assets in 2000.

14.66 During the period 1996-2000, the combined premium income of the life and general insurance increased at an average rate of 11.5 per cent per annum from RM8 billion in 1995 to RM13.8 billion in 2000. Premium income of the industry as a percentage of nominal Gross National Product (GNP), increased to 4.6 per cent in 2000 compared with 3.7 per cent in 1995. Total benefits and net claims paid out by the industry increased by 19 per cent per annum to RM5.5 billion in 2000, representing 39.9 per cent of premium income.

14.67 Total assets of life insurance funds increased by 108 per cent, or at an average annual rate of 15.8 per cent from RM17.6 billion in 1995 to RM36.6 billion in 2000. Despite a setback due to the economic crisis in 1997, total premium income of the life sector recorded a 95.6 per cent increase to reach RM8.8 billion in 2000, from RM4.5 billion in 1995. Accordingly, the ratio of premium income to nominal GNP increased from 2.1 per cent in 1995 to 2.9 per cent in 2000. During the same period, total sums insured in force increased by 68.3 per cent to RM414.4 billion in 2000 from RM246.2 billion in 1995, recording an average annual growth of 11 per cent. The ratio of sums insured in force to nominal GNP increased to 138.4 per cent in 2000 from 116.1 per cent in 1995.

14.68 Total assets of general insurance funds increased by 73.4 per cent or at an average annual rate of 11.6 per cent from RM7.9 billion in 1995 to RM13.7 billion in 2000. Total premium income of the general insurance industry recorded an average annual growth of 7.4 per cent per annum, increasing from RM3.5 billion to RM5.0 billion in 2000. The ratio of premium income of the general insurance industry to nominal GNP remained unchanged at 1.7 per cent in 2000 compared with 1995.

14.69 A major development in insurance regulation and supervision during the Seventh Plan period was the introduction of the Insurance Act 1996 and its accompanying regulations on 1 January 1997. This Act, which replaced the Insurance Act 1963, serves to promote better accountability on the part of insurers, insurance brokers and adjusters, strengthen their financial standards, ensure that their operations are conducted in a sound manner and accord greater protection to policy owners.

14.70 With the introduction of the Insurance Act 1996, various policies were implemented during the Seventh Plan period, aimed at consolidating the insurance industry, strengthening public confidence in the industry, improving its competitiveness, and enhancing its role in the development of the economy. Towards this end, measures were undertaken to build up the financial strength of insurers through the imposition of higher minimum paid-up capital requirements for insurers. The capital requirements were implemented in phases to reach RM100 million by 30 June 2001. The minimum solvency requirement for insurers was also progressively increased from RM5 million in 1995 to RM50 million on 1 January 2001. Arising from the introduction of the new capital and solvency requirements, the aggregate paid-up capital of Malaysian incorporated insurers increased from RM1.5 billion in 1995 to RM4.2 billion in 2000. The pace of strengthening the financial position of insurers would have been faster had it not been for the economic downturn, which necessitated a temporary relaxtion of the capital and solvency requirements during the years 1998 to 2000.

14.71 Another measure taken to create stronger insurers was by consolidating the insurance industry through mergers and acquisitions (M&As). During the Seventh Plan period, the Government continued to pursue this initiative by various means, including offering a package of incentives to encourage M&As among insurers, such as according flexibility to insurers in the areas of investment and compliance with operating cost control guidelines as well as granting of *takaful* licences and tax incentives. As at the end of December 2000, five M&As involving 10 insurers were completed, with another nine proposals involving 17 insurers at various stages of implementation.

14.72 Efforts were also directed at improving the general conduct of insurance business and strengthening public confidence in the insurance industry through better corporate governance, adoption of best practices, implementation of various guidelines as well as improvement of skills and expertise in underwriting, claims settlement and risk management. On a sectoral basis, steps were taken to improve the competitiveness of life insurers and accelerate their growth. This took the form of new product development in line with the changing needs of the consumers, enhancing technical expertise in product design as well as in the underwriting of life insurance coverage. To enhance the operational efficiency of life insurers and reduce premium costs to policy holders, guidelines to control operating costs of the insurers were implemented. At the same time, qualitative guidelines were introduced specifying the minimum educational, training and productivity levels to improve professionalism in the insurance industry. These measures increased the market penetration rate from 24.1 per cent in 1995 to 30.9 per cent in 2000.

14.73 In the general insurance sector, various initiatives were taken for the improvement of insurance services, particularly in respect of handling of insurance claims as well as in ensuring fair pricing of insurance products. The Government, in cooperation with the insurance industry, also embarked upon the task of identifying and ensuring the availability of insurance coverage and services for the agriculture sector. The positive response of insurers to the Government's call and other measures taken to optimize the retention of premium within the country also resulted in the net retention ratio improving from 74.4 per cent in 1995 to 89.6 per cent in 2000. These measures included increasing the number of professional reinsurers from five in 1995 to 10 in 2000, implementation of the Scheme for Insurance of Large and Specialized Risks, provision of tax incentives on reinsurance ceded to insurers in the Labuan International Offshore Financial Centre (IOFC), and the enhancement of retention through improvements in skills and expertise in underwriting specialized risks. In addition, under the Guidelines on General Reinsurance Arrangements issued in April 2000, reinsurance premiums placed overseas is subject to a maximum limit of not more than 50 per cent of total reinsurance premiums.

14.74 The *takaful* industry, comprising two operators, namely, *Syarikat Takaful Malaysia Berhad* (STMB) and *Takaful Nasional Sdn. Berhad (TNSB)*, recorded significant growth during the Seventh Plan period with the main business indicators recording strong double-digit growth. Total assets of *takaful* funds grew rapidly by 45.6 per cent per annum from RM183.3 million in 1995 to RM1.2 billion as at the end of financial year 2000. Assets of the family *takaful* funds accounted for 75 per cent of the total fund assets, while general *takaful* funds accounted for the balance of 25 per cent. In terms of distribution of *takaful* fund assets, investment accounts with Islamic banks and banking institutions participating in Islamic banking schemes amounted to RM498.2 million and constituted the largest portfolio at 42.6 per cent of total assets in 2000. This was followed by investments in corporate or debt securities and Government investment issues amounting to RM302 million or 25.9 per cent and RM142.3 million or 12.2 per cent, respectively.

14.75 Total contributions from family and general *takaful* business grew significantly from RM83.4 million in 1995 to RM444.7 million in 2000, an increase of 39.8 per cent per annum. Its strong growth was attributed to increasing awareness of the public on the benefits of participating in *takaful* as well as the expansion of the distribution network with the opening of more branch offices and *takaful* desks by *takaful* operators. In addition, *takaful* operators also engaged specialized marketing personnel to promote their family *takaful* products. As at the end of 2000, there was a total of 118 branch offices and *takaful* desks throughout Malaysia.

14.76 To spur the development of the *takaful* industry, BNM formulated a five-year strategic plan for *takaful* business which included strategic initiatives to enhance the regulatory framework and supervision of *takaful* operators. The review of the *Takaful* Act 1985 was initiated in 1999 with the aim of ensuring financial accountability of *takaful* operators and according greater protection to *takaful* participants. In an effort to promote greater disclosure and uniformity in the accounting treatment of *takaful* business, accounting standards and model accounts were being formulated to ensure uniformity, greater disclosure and transparency in financial reporting. On the part of the *takaful* operators, a code of ethics (Code) was implemented as part of the continuous effort to establish a minimum standard of *takaful* practices and promoting healthy business conduct among *takaful* operators. The Code also aimed at enhancing the standard of governance among the *takaful* operators and creating a common platform for them to collaborate and promote *takaful* business in addition to promoting better understanding and cooperation between *takaful* operators and conventional insurers.

14.77 As a step towards developing the *re-takaful* market and facilitating *re-takaful* exchanges among *takaful* operators in the region, the region's first full-fledged *re-takaful* operator, ASEAN Retakaful International (L) Ltd. (ARIL), was established in May 1997 as an offshore *re-takaful* company in the Labuan IOFC. The establishment of ARIL was to create a vehicle for more dynamic *re-takaful* exchanges among *takaful* operators in the region and, at the same time, provide the additional *re-takaful* capacity to further reduce their dependence on conventional reinsurance. In the international arena, Malaysia is a member of the Developing Eight Group (D-8), an arrangement for development cooperation among eight developing countries, namely, Bangladesh, Egypt, Indonesia, Iran, Malaysia, Nigeria, Pakistan and Turkey, where *takaful* was endorsed as a D-8 project to be spearheaded by Malaysia. To this effect, Malaysia was entrusted with the task to educate and market the concept and application of *takaful* among the members of the Organization of Islamic Countries (OIC), and ultimately to assist in the establishment of *takaful* companies worldwide. Following a two-day workshop on *re-takaful* organized by Malaysia, among the resolutions adopted was the transformation of ARIL into a well-capitalized *re-takaful* operator for D-8 member countries which involved the enhancement of ARIL's paid-up capital and the establishment of more *takaful* operators in D-8 member countries to support ARIL's business.

Labuan International Offshore Financial Centre (IOFC)

14.78 During the Seventh Plan period, efforts continued to be undertaken to expand and deepen the activities of offshore banking, insurance, leasing and fund management as well as Islamic financial activities. In addition, life insurers were allowed to sell life insurance policies transacted in foreign currencies to Malaysians of high net worth, while general insurers were allowed to have limited access to the domestic market to underwrite selected Malaysian risks on a direct basis. To encourage Malaysian insurers to cede reinsurance business to insurers in Labuan, the premium on reinsurance was accorded full tax deductibility. In addition, the Labuan Interbank Offer Rate (LABOR) was launched as a benchmark rate to further promote efficiency and the volume of treasury operations in Labuan. Several measures were also implemented to develop a competitive offshore Islamic financial centre. These measures included attracting full-fledged Islamic banks to operate in Labuan and promoting Islamic funds to operate out of Labuan. Management companies with expertise in Islamic financing were allowed to provide advisory services on the development of Islamic financial instruments and products.

14.79 To further promote Labuan IOFC as a centre for Islamic banking and finance, a working group was set up to formulate the framework for developing an International Islamic Financial Market. As part of the framework, a *Syariah* Advisory Council was established as a consultative body for the setting of rules and guidelines necessary for the issuance of financial instruments as well as establishing prudential standards. To ensure that the Council had the credibility and acceptance in the global financial community, the membership comprised international representatives, scholars and practitioners. In November 2000, the first memorandum of understanding between a Malaysian company with a Labuan offshore Islamic bank was signed to issue Islamic global bonds for the market.

14.80 To boost its growth and create more business activities in the Labuan IOFC, measures were taken to provide a conducive legal and administrative environment. The Labuan Offshore Trusts Act 1996 was enacted for the creation and recognition of offshore trusts. The Labuan Offshore Limited Partnership Act 1997 provided for the establishment and regulation of offshore limited partnerships. To facilitate the development of capital market activities in Labuan, the Labuan Offshore Securities Industry Act 1998 provided the legal framework for the regulation of mutual fund activities and establishment of a financial exchange in Labuan. In addition to the new legislation, the Labuan Offshore Financial Services Authority (LOFSA) was established as a one-stop agency to streamline and rationalize the administrative machinery for the supervision of activities and operations of the offshore financial services industry.

14.81 The offshore business activities in Labuan were given a further boost with the launching of the Labuan International Financial Exchange (LFX) in November 2000. The LFX is a web-based financial exchange that provides listing and trading facilities for a wide range of financial and non-financial products such as Islamic financial products, mutual funds, bonds, derivatives and insurance-linked products. In addition, it would also promote other related offshore activities such as custodial, depository, clearing and trustee services.

14.82 During the Plan period, the number of companies incorporated under the Offshore Companies Act 1990 were more than three times that established during its first five years from 1991-1995. In 2000, there was a total of 2,309 offshore companies, as shown in *Table 14-5*.

TABLE 14-5

TYPE OF COMPANIES ESTABLISHED IN LABUAN IOFC AS AT DECEMBER, 2000

Type	*Offshore Companies*	*Foreign Offshore Companies*	*Domestic Companies*	*Total*
Banks	9	49	2	60
Leasing	19	-	-	19
Insurance	23	16	-	39
Insurance-Related	27	2	-	29
Fund Management	7	1	-	8
Trading and Non-Trading	2,086	13	-	2,099
Trust Companies	-	-	20	20
Audit Firms	-	-	20	20
Liquidator Firms	-	-	15	15
Total	**2,171**	**81**	**57**	**2,309**

III. PROSPECTS, 2001-2005

14.83 During the Eighth Plan period, the finance, banking and insurance sector is expected to expand by 8.5 per cent per annum. Emphasis will be focused on the rationalization and strategic positioning of the sector in a rapidly changing financial landscape driven by advances in technology, globalization of financial markets and increasing reliance on knowledge for value creation. Towards this end, the Financial Sector Master Plan together with the Capital Market Master Plan will provide a comprehensive framework for the strategic development of the financial sector over a 10-year period.

14.84 The overall thrust is to create a strong, resilient and competitive financial sector that will provide the catalyst for higher growth in the economy. To instil a greater sense of public responsibility as custodian of public funds as well as to be more prudent in their operations, the financial institutions will need to practise good governance and enhance professional training, particularly in financial management for all levels of personnel. Strategies for the development of the financial sector during the Eighth Plan include:

- *creating a core of strong, well-managed and adequately capitalized banking institutions;*

- *improving the overall efficiency and competitiveness of the banking sector;*

- *developing Islamic financing as an effective avenue for the mobilization and allocation of funds;*

- *strengthening the capital market as well as developing a strong and competitive environment for capital market intermediation services;*

- *accelerating the development of the bond market to reduce the concentration of risks in the banking sector;*

- *encouraging the growth of the local venture capital industry in order to support the development of knowledge-based and high technology industries; and*

- *further strengthening the insurance industry to facilitate more effective and efficient risk transfers as well as to mobilize resources for long-term financing.*

14.85 A dynamic and competitive financial sector will provide not only an important source of resource mobilization but will also facilitate monetary policy to be conducted increasingly through market-based instruments. As monetary policy operates through the financial system, strengthening of the banking institutions and their increased efficiency will enhance the effectiveness of the monetary policy. The further deepening of the capital market will also enable BNM to move towards more open market operations, rather than rely on direct instruments such as the statutory reserve requirement (SRR) in its conduct of monetary policy.

Banking System

14.86 As part of the efforts to establish a core of strong domestic banking institutions, the minimum capital funds will be raised to RM2 billion for domestic banking groups and RM300 million for foreign-owned banking institutions. With the rapid pace of development in the financial markets, it is crucial that banking institutions are strongly capitalized to better withstand challenges from a more competitive and liberalized economic environment. The stronger capital position will enable the banking institutions to meet the increasingly sophisticated needs of customers and financing requirements of knowledge-based and high-technology industries.

14.87 To facilitate the development of a sound and efficient banking system, a review of the regulatory framework will be undertaken. A balanced approach will be adopted taking into account the stage of development of the economy and the banking sector. In this context, there will be more emphasis on market discipline and self-regulation to generate competition amongst the banking institutions. This will be complemented by regular on-site examinations by BNM to ensure that financial institutions continue to operate in a prudent manner. In addition, prudential regulations will be tightened to minimize sources of systemic risks.

14.88 Measures will also be taken to enhance surveillance and examination by the authorities to ensure the safety and soundness of the banking system. In this regard, the early warning system will be improved to provide advance warning on deteriorating financial conditions in individual institutions to enable prudential surveillance to be undertaken to avert bank failure and contain associated systemic risks. As a complement to off-site monitoring, it will prompt an early inspection and enable the authority to prioritize the utilization of their examiners in critical cases.

14.89 Recognizing the need for shared responsibility in maintaining overall banking system stability, a mechanism will be put in place to limit the Government's financial guarantee for deposits. The establishment of a deposit insurance fund to be managed by BNM will protect or guarantee deposits of banks and other savings institutions.

14.90 Efforts will also be taken to facilitate lending to the productive sectors of the economy such as the agriculture food production industry. In this regard, comprehensive databases will be set up at selected focal points to assist banking institutions in loan evaluation. At the same time, the banking institutions will have to upgrade their expertise and skills in loan evalution, particularly of projects in new growth areas.

14.91 On the part of the banking institutions, they will need to strengthen their capabilities and be innovative to meet the challenges and competition arising from globalization and technological advances in the areas of banking services. In this regard, application of technology will be promoted, especially the use of electronic commerce in the financial sector. Banking institutions will also be encouraged to optimize their delivery channels by offering a complete range of products to their customers. A more extensive cross-selling of financial products and services within the financial group will enable institutions to optimize their network capabilities and improve the quality of services offered. In addition, merchant banks will be encouraged to further expand their business scope and enhance investment banking activities in equities and debt securities. This will enhance the effectiveness of the banking sector in providing value-added financial services and intermediation of risks.

14.92 A comprehensive plan for Islamic banking is outlined in the Financial Sector Master Plan. The future emphasis will be on quality rather than quantity, particularly for banking institutions participating in the *Skim Perbankan Islam*. Core players will be groomed while players who fail to deliver positive results will be phased out gradually. New guidelines and targets for Islamic banking will be introduced including the further development of Islamic banking units in existing banking institutions. The Islamic money market will introduce new benchmarks for the Islamic banking players. In addition, manpower development and training will be emphasized to further upgrade knowledge and professionalism in Islamic financing. In this regard, an industry-owned institute will be established to undertake research and training in Islamic banking, *takaful* and Islamic securities. Efforts will also be geared towards the development of Kuala Lumpur and Labuan as centres in promoting Islamic banking and finance activities.

Capital Market

14.93 The SC, in its continuing efforts to develop the capital market, formulated a Capital Market Master Plan to provide a strategic development framework for the capital market to meet the challenges of regional competition and increasing globalization. The overall objective is to create a capital market that is internationally competitive in all core areas as well as to provide a highly efficient conduit for the mobilization and allocation of funds. The capital market is to be supported by a strong and facilitative regulatory framework that will enable it to perform its functions effectively and will provide a high degree of confidence to capital market users.

14.94 In recognizing the need to further broaden and deepen the capital market to ensure that Malaysia remains the preferred fund-raising centre for Malaysian companies, the Capital Market Master Plan outlines a set of initiatives that includes the further development and enhancement of alternative capital raising avenues such as the corporate bond market and venture capital. A key priority for the development of the capital market is to establish a corporate bond market that provides a competitive source of financing across a wide range of tenure, maturity and risk profile. Towards this end, among others, efforts will be directed at facilitating the domestic issuance of corporate bonds by lowering associated costs; ensuring that the bond market microstructure is robust and efficient, and facilitates innovation; and promoting a greater breadth of investment in corporate bonds by investors. Measures will also be taken to ensure greater liquidity in the secondary market. In addition, the overall process of fund-raising will be made more efficient in an effort to lower the overall cost of raising capital within the capital market.

14.95 Efforts will also be taken to develop a more competitive and vibrant investment management industry, as it is central to mobilizing domestic savings more effectively. Emphasis will be focused on ensuring a significant number and diversity of industry players with greater access to a larger pool of funds available for management; developing a large pool of highly skilled professionals to foster greater innovation and competitiveness in the industry; and ensuring a more facilitative regulatory framework. In this regard, there will be further deregulation of the investment management industry to allow for the development of a larger number and diversity of industry players with greater access to funds available for management. The development of a private pension fund industry will also be facilitated, to supplement the national pensions system and provide for greater competition and diversity in the institutional management of private funds and to ensure that the capital market mobilizes and allocates funds effectively.

14.96 To promote a more conducive environment for investors, emphasis will be placed on enhancing and maintaining a strong framework for corporate governance and shareholder value recognition. Efforts will be taken to fully implement recommendations contained in the Finance Committee Report on Corporate Governance. To complement these efforts, measures will be taken to encourage institutional investors to promote corporate governance, improve avenues for minority shareholders to exercise their rights, enhance the awareness and accountability of corporates, and ensure high standards of financial reporting and continuous disclosure of timely, relevant and accurate information.

14.97 Recognizing the importance of developing internationally competitive market institutions that provide value to all its stakeholders, efforts will be taken to restructure Malaysian exchanges to strengthen their efficiency and competitiveness. This will be undertaken through the consolidation of all existing exchanges to create a single market institution that is able to compete in the global marketplace. In addition, the creation of a single Malaysian clearing house and common trading platform as well as an intergrated clearance and settlement system for all exchange-traded products will be undertaken.

14.98 In developing further the capital market, the SC will focus on strengthening the regulatory framework. In this regard, the SC will progressively implement a system of market-based regulation across all segments of the capital market industry whereby, among others, front-line regulation by market intermediaries and self-regulation by industry associations will complement the regulatory role of SC. Within this context, disclosure-based regulation will also be strengthened to enhance transparency through comprehensive and timely disclosure. To ensure the effectiveness of the regulatory framework, the SC will further enhance its capacity in enforcement. In addition, to ensure regulatory parity in the treatment of all participants in the capital market conducting similar activities, efforts will be taken to implement full functional regulation. In this regard, capital market activities will be regulated according to function rather than by institution. Within such a seamless regulatory framework, gaps and overlaps in the regulation of capital market participants undertaking comparable activities will be minimized, thus reducing the scope for regulatory arbitrage.

14.99 Efforts will also focus on facilitating a more competitive environment for domestic intermediation services with the introduction of full-service Universal Brokers to provide integrated financial services. In addition, there will be further deregulation of the market to allow a more comprehensive range of services and products to be offered and a progressive deregulation of fixed fee structures, while other transaction costs will also be reduced. The SC will continue to ensure that the Malaysian intermediary services are anchored on appropriate prudential standards, with high levels of business conduct and professional skills.

14.100 In order to further develop the capital market, efforts will be taken to encourage the growth of Islamic capital markets, in particular, those in Islamic equities, private debt securities and collective investment and fund management activities. The further development of the Islamic capital market in Malaysia will add to the breadth and diversity of the overall capital market as well as provide a significant contribution to the overall growth of the financial services industry. Towards this end, a comprehensive, multi-pronged approach to enhance the competitive position of Malaysia's Islamic capital market is incorporated in the Capital Market Master Plan. Measures identified include the need to facilitate the development of a wide range of innovative and competitive products and services related to the Islamic capital market; creation of a viable market for the effective mobilization of Islamic fund; ensuring that an appropriate and comprehensive accounting, tax and regulatory framework for the Islamic capital market is in place; and enhancing the value recognition of the Malaysian Islamic capital market internationally.

14.101 Greater efforts will be undertaken to nurture a pool of highly skilled human capital and increase investor awareness. In this regard, the Capital Market Master Plan has identified training initiatives aimed at enhancing market skills and providing greater investor education. The SC's investor education programme will be further developed to enable investors to make informed investment decisions and increase investor understanding of their rights and responsibilities.

14.102 In order to develop a diverse group of active institutional investors to stimulate secondary market trading, the Government will encourage the setting up of fixed income bond funds. To further broaden the investor base, a study will be undertaken to restructure the EPF with the objective of transforming it into more efficient, manageable and focused pension funds units. Consideration will also be given to allow corporates to set up superannuation funds to capture employee contributions in excess of the mandatory EPF deductions and extending tax incentives to these retirement funds as a means to diversify the country's long-term savings pool. To increase the availability of high credit quality papers, incentives will be given to encourage the private sector to issue bonds locally.

Venture Capital Financing

14.103 Recognizing the potential of venture capital as a source of funding to nurture and develop the high-growth and technology industries, efforts will be undertaken to promote venture capital financing. Fiscal incentives will be provided to investments in venture capital funds to finance knowledge-based and high-technology industries at start-up, seed capital and first stage financing. To facilitate access to the capital market and improve the exit mechanism for venture capitalists, several listing requirements on MESDAQ for high-growth and technology companies will be liberalized, including reducing the requirement that 70 per cent of the listing proceeds be used in Malaysia. In addition, a credit guarantee scheme will be considered as a support mechanism for the development of the high-technology industries. The aim of the scheme is to mitigate the risks of the financial institutions through the provision of a guarantee on the viability of a particular technology-based project proposal. Steps will also be taken to enhance institutional participation in venture capital funds. In addition, venture capital companies will be given exempt dealer status under the Securities Industry Act 1983, while venture capital trusts will be allowed to invest fully in unquoted companies.

14.104 To accelerate the development of the venture capital industry, a one-stop agency will be established to ensure its orderly expansion. This agency will formulate, coordinate and monitor all policies, strategies and incentives as well as supervise the development of the venture capital industry. In addition, the Government will establish a venture capital fund totalling RM500 million and consideration will be given to outsourcing the management of the fund to the private sector. The Government will take a holistic approach in developing the venture capital industry so that it can effectively contribute towards financing the requirements of a knowledge-based economy. Other initiatives which were outlined in the Financial Sector Master Plan include facilitating the establishment of Islamic venture capital funds, establishment of matching services, establishment of more business angel clubs and networks and establishment of technology appraisal centres in promoted high-technology sectors.

Insurance

14.105 The Financial Sector Master Plan, which will be implemented during the Eighth Plan period, will provide the framework for the development of the insurance industry. The overall objective of the Master Plan is to build an efficient, effective and stable financial sector that supports both the needs of the real economy and the socio-economic objectives of the country. The aim is also to build at the core of this financial system strong domestic insurers able to provide Malaysian consumers with world-class products and services, while meeting international commitments to liberalize the sector in the medium term. This will enable the insurance industry to be financially resilient, innovative, productive and cost efficient as well as able to mobilize long-term savings, adopt international best practices and display high professional ethics and standards.

14.106 The full implementation of the Master Plan will be undertaken in three phases over a 10-year period ending in 2010. Phase I will involve building up the capabilities of domestic insurers by allowing them greater operational and management flexibility to develop and optimize on skills, scale and technology. For this purpose, deregulatory measures will be taken in areas that will encourage innovation in the market, allow insurers access to a broader product range and leverage on distribution channels as well as promote greater competition among domestic insurers. Phase II will focus on strengthening the financial resilience of insurers and enhancing consumer protection which is expected to lead to industry consolidation and the convergence of performance standards in the domestic industry towards best practice and performance benchmarks. This will also serve to establish the foundation necessary to support a greater role for market discipline to complement regulation and supervision of the insurance industry as well as to prepare the industry for the third phase, which will entail progressive liberalization of the insurance sector. Under Phase III, Malaysian consumers will be provided with greater access to world-class products and services, while the insurance industry is expected to be competitive internationally. The pace at which measures under the Master Plan will be implemented will be determined based on periodic reviews carried out to gauge the progress made by domestic insurers.

14.107 Efforts will also be continued to optimize the retention of insurance premiums within the country. In this regard, BNM will monitor closely the reinsurance programmes of individual reinsurers to ensure that they maximize local insurance capacity before reinsuring abroad. The capacity of Malaysian insurers to retain larger risks will be strengthened through the consolidation and increased capitalization of the insurance industry. In addition, the reinsurance underwriting skills and expertise will be further enhanced through technology transfer by the foreign professional reinsurers as well as the experience and knowledge gained from implementing the Scheme for Insurance of Large and Specialized Risks.

Labuan International Offshore Financial Centre (IOFC)

14.108 The IOFC in the future is not only a centre that thrives on the offshore financial services, but also one, which is developed holistically to support the development of the island, and provides an effective complementary role to the domestic financial market. Moving forward, efforts will be focused on implementing the various recommendations of the Financial Sector Master Plan which primarily stresses on a number of key areas such as promoting and diversifying further the financial players and activities in the IOFC, promoting the development of Islamic banking and *re-takaful* business as well as developing and strengthening the capital market, e-commerce and the ancillary activities.

14.109 To further develop the Labuan IOFC and in line with the Financial Sector Master Plan, legislation will be reviewed to facilitate new businesses, and at the same time allow the offshore service providers to maximize their capabilities and expertise to expand their businesses. Continual review and assessment of the tax structure will also be undertaken to ensure Labuan remains competitive and attractive. Benchmarking against the leading IOFCs around the world in various areas of businesses will be established to ensure that the IOFC will always be competitive, especially in terms of pricing and cost of doing business. Towards this ends, the Labuan Tax and Business Advisory Council, a concultative body comprising tax experts, practitioners and regulators will be formed. Similarly, the supervisory practice and legal framework in the IOFC will be continually assessed and upgraded to ensure that they are in line with the international supervisory requirements.

14.110 Another area of growth for Labuan IOFC will be Islamic banking and *takaful*. The development of the International Islamic Financial Market (IIFM), which is spearheaded by LOFSA, is expected to be a key contributor to the expansion of Islamic financing globally. The *Syariah* Advisory Council will provide input for the development of Islamic banking, finance and *takaful* in the IOFC, particularly in defining the standards and rules required in making the market function smoothly. The development of Labuan, will also benefit from the E-commerce Gateway, a portal which will be developed into a full-fledged e-commerce site to facilitate Islamic financial payments, as a marketplace for financial products and backroom operations activities, and submission of statutory documents and statistical information to LOFSA.

IV. ALLOCATION

14.111 The Federal Government development allocation and expenditure for the period 1996-2000 and allocation for the period 2001-2005 are as shown in *Table 14-6*. The development finance institutions (DFIs) will continue to provide funding for projects in priority areas. In this regard, the capital base of the DFIs will be further strengthened through an increase in Government's equity participation amounting to RM1.9 billion. In addition, an allocation of RM566.6 million will be made available for the development of SMEs through the provision of credit and financial services.

TABLE 14-6

DEVELOPMENT ALLOCATION FOR FINANCE, 1996-2005
(RM million)

Programme	*7MP*		*8MP*
	Allocation	*Expenditure*	*Allocation*
Venture Capital	220.0	220.0	778.0
Industrial Promotion	11.5	11.5	10.0
Small & Medium Enterprise Loans	560.0	527.4	566.6
Other Financial Services	100.6	67.0	44.2
Government Equity	4,000.1	4,000.1	1,880.6
Total	**4,892.2**	**4,826.0**	**3,279.4**

V. CONCLUSION

14.112 During the Seventh Plan period, the contribution of the finance, banking and insurance sector was affected by the regional financial and economic turmoil. Consequently, efforts were focused on strengthening and maintaining the financial sector stability as well as restoring investor confidence. For the Eighth Plan period, these efforts will be continued to further strengthen the sector to mobilize and allocate domestic financial resources effectively and efficiently in facilitating the growth of the economy. Emphasis will be focused on developing a core of strong and competitive domestic institutions that will provide a new source of growth for the economy. At the same time, measures will also be taken to further develop alternative modes of financing to complement the traditional financing sources.