Development of the Financial Sector

Development of the Financial Sector

The globalisation of financial markets, the changing economic landscape, further technological advancements and greater customer expectations continued to drive developments in the Malaysian financial sector. With the increasing integration and complexity of the global financial system, the challenge for the Malaysian financial system is to adapt to the changing market realities and at the same time to support domestic economic development. The Malaysian financial industry itself has also emerged as an important source of economic growth, accounting for 10.7% of gross domestic product (GDP) in 2007. Given the increasing economic significance of the financial sector, Bank Negara Malaysia continued to accord attention to capacity building measures to further enhance the competitiveness and resilience of the financial system to support domestic-led growth. Efforts were in particular, directed towards developing and further strengthening the financial infrastructure and the financial markets. To position Malaysia as an international Islamic financial centre, a number of strategic initiatives were also implemented during the year. These contributed towards reinforcing a financial system that is comprehensive, diverse, robust and ready to compete in a more liberalised and globalised environment.

INSTITUTIONAL DEVELOPMENT

Continued enhancements were made by financial institutions to strengthen their financial and market positions, thus enhancing their prospects for long-term growth and stability. Within the banking sector, the top five banking groups by asset size have increased their market share of total outstanding loans to 61.1% in 2007 from 52.5% in 2001. These banking groups also recorded increasing profitability with return on equity up from 14.4% in 2001 to 19.4% in 2007 as a result of efforts to improve cost efficiencies and generate higher revenue streams, in response to competitive pressures and demands for improved shareholder value.

Capitalising on the healthy performance over several years, Malaysian financial institutions have taken the opportunity to strengthen and further consolidate their financial position in 2007. Notably, several domestic banking groups invested significant resources in strengthening risk management capabilities and enhancing business operating models. Capital injections received by some institutions from existing and new shareholders provided added financial flexibility to support further business expansions, investments in technology, capacity building initiatives and talent development. More efficient management of capital was also achieved through capital restructuring exercises which saw further issuances of subordinated bonds by several financial institutions. The governance of the financial group structures was also strengthened, while investment banks made significant progress towards completing the amalgamation of the people, systems and processes that were previously operating in separate banking and stockbroking entities.

Domestic banking groups have emerged stronger with strengthened financial positions and sustained market shares despite a more competitive operating environment.

As a result of these developments, domestic banking groups have emerged stronger with strengthened financial positions and sustained market shares despite a more competitive operating environment. These improvements were recorded across the board, including by institutions that had earlier received capital injections from Danamodal Nasional Berhad (Danamodal) during the Asian financial crisis. In line with its mandate to promote the long-term stability of the financial system, Danamodal had injected a total of RM7.49 billion into viable banking institutions based on commercial terms and market principles. As a strategic shareholder, Danamodal also infused best management practices and competencies into these institutions which resulted in enhanced risk management and operating efficiencies. Having emerged on a stronger footing, all of the recapitalised institutions have paid in full the capital injected by Danamodal. The successful turnaround, strengthened financial conditions and positive future outlook of the banking institutions have also attracted strong interest by several foreign financial institutions to establish strategic partnerships. The successful transformation of these recapitalised institutions contributed to positive net results of Danamodal, which recorded pre-tax profits of RM200 million.

The conversion of all Islamic banking windows of the domestic banking groups into Islamic subsidiaries in 2007 has increased the focus on Islamic banking business, supported by clearer accountabilities achieved under separate Board and management structures. This brings the total number of licensed Islamic banks in Malaysia to 16, including four new Islamic subsidiaries that are expected to commence operations in 2008. To tap the strong growth potential in Islamic finance, two locally-incorporated foreign banks (LIFBs) established Islamic banking window operations in 2007. In addition to the above, seven investment banks also offer Islamic banking services through the window structure.

All Islamic banking windows of the domestic banking groups have converted into Islamic subsidiaries.

POSITIONING MALAYSIA AS AN INTERNATIONAL ISLAMIC FINANCIAL CENTRE

Malaysia is at the frontier in the global developments in Islamic banking and finance. The Islamic banking system has emerged as a vibrant alternative financial system in Malaysia, with Islamic banking assets (including Islamic assets held by development financial institutions, DFIs) currently accounting for 15.4% (11.5% in 2003) of the total banking assets (including assets held by DFIs) of the Malaysian financial system.

Capitalising on the ready infrastructure and comprehensive Islamic financial system in Malaysia, the strategic development of Malaysia as an international Islamic financial centre was taken to a new level with the launch of the Malaysia International Islamic Financial Centre (MIFC) initiative in 2006. To accelerate the development of Islamic finance, new banking and takaful licences were offered to attract leading global players to establish operations in Malaysia. During the year, 16 approvals were granted to conduct international currency business operations. These include an international Islamic banking license to an investor from Bahrain, as well as approvals for other domestic financial institutions to establish dedicated international currency business units. Two additional retakaful licences were also granted in 2007 to qualified local and foreign players, further consolidating Malaysia’s position as an international retakaful hub, while contributing to the development of enhanced underwriting and claims practices, and product innovations in the takaful industry. To further facilitate the conduct of takaful business, a tax treatment that recognises the unique characteristics of takaful operators has been introduced. The tax treatment provides for the appropriate recognition of income and expenses arising from takaful business, having regard to the distinct role of takaful operators as risk managers in contrast to conventional insurers which are risk underwriters. Other current initiatives include the review of the tax treatment for the business of leasing which aims to address taxation issues that currently impede the development and growth of leasing and *ijarah* business.

The Malaysian Government continues to provide strong support for the MIFC vision by granting flexibilities to improve business efficiencies and to attract the best talent to Malaysia. In 2007, the Government introduced an "executive green lane" for immigration procedures for foreign experts in Islamic finance, and has made available long-term employment passes with multiple entry visas and professional visit passes. In addition, the Government has also relaxed several Foreign Investment Committee rules for MIFC players, which include allowing 100% foreign equity ownership in Islamic financial institutions established under the MIFC and granting flexibilities in the acquisition of properties and land, both for own use and commercial purposes. In addition, further tax incentives were also granted to promote Malaysia as a centre for origination, distribution, and trading of sukuk (details on the tax incentives are provided in the box article "Sukuk: Efficient Diversification Mechanism and New Asset Class").

Sukuk: Efficient Diversification Mechanism and New Asset Class

Rapid Growth of the Global Sukuk Market

The global sukuk industry experienced enormous growth over this recent five years and is now at the centre of the rapid development of the Islamic financial system. The size of the global sukuk market, including sukuk denominated in domestic currencies, has grown from only USD336 million (or RM1.3 billion) in 2000 to an estimated USD82 billion (or RM281 billion) as at end-2007, representing an average annual growth of 40%. Total issuances in 2007 are valued at USD47 billion (or RM161 billion), an increase of 73% over the total value issued in 2006[1].

Sukuk Salient Features

- Sukuk is certification or trust of ownership for an asset or usufruct.
- It is an asset-based instrument structured in compliance with the precepts of Shariah.
- Returns on sukuk are tied to the underlying asset. Therefore, sukuk needs to be backed by a specific asset or usufruct throughout its entire tenure.

Initially regarded as a niche capital market instrument catering to corporate issuers, governments, state-owned enterprises and financial institutions in Islamic economies for capital-raising exercises, the appeal of sukuk has since extended to large international banks and corporate issuers. Established international financial centres have also taken a more active role in developing the market for this asset class, including enacting enabling legislative provisions which have contributed towards accelerating the development of the global sukuk market.

Record Growth of Malaysian Sukuk Industry

Malaysia continues to be at the forefront of the development of Islamic finance. Malaysia is the world's largest sukuk market with 68.9% or USD62 billion (RM213 billion) of the global outstanding sukuk as at end-2007 having been originated in Malaysia. Total issuances of corporate sukuk in Malaysia amounted to more than RM30 billion in 2007. Malaysia's lead in the development of the sukuk market extends beyond just volume, including as well the introduction of innovative and competitive sukuk structures that appeal to a wider investor base.

Chart 1
Malaysia: Outstanding Sukuk vs. Bonds

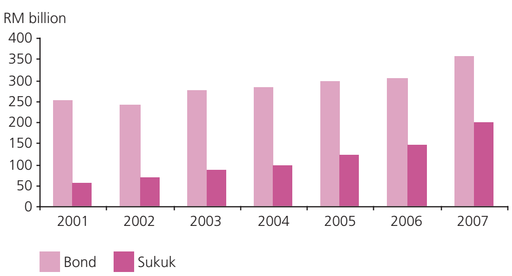
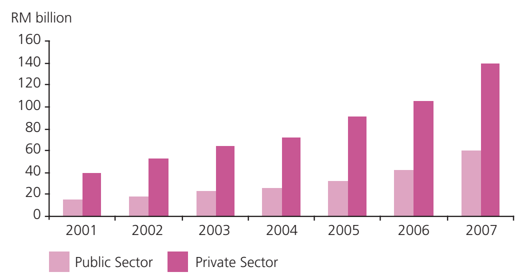


Chart 2
Malaysia: Total Outstanding Sukuk



Beginning with a modest issue size of RM125 million by Shell MDS Sdn. Bhd. in 1990, the Malaysian sukuk market has grown in size and sophistication. The depth of the sukuk market was clearly demonstrated by the recent issuance of the largest sukuk to date, valued at RM15.4 billion (USD4.7 billion), by Binariang GSM Sdn. Bhd., an investment-holding company that facilitated the privatisation of a cellular phone operator. Despite its significant size, the Binariang sukuk was twice oversubscribed.

[1] Source: Islamic Finance Information Service

The primary sukuk market in Malaysia is now one of the world's fastest growing, with an average annual growth in issuances of 22% recorded for the period 2001-2007. Having introduced the world's first global sovereign sukuk in 2002, Malaysia has continued its pioneering efforts in facilitating innovative structures such as the exchangeable *sukuk musharakah* by Khazanah Nasional Berhad, the investment-holding arm of the Malaysian Government. This landmark issuance is the world's first sukuk that incorporates full convertibility features that were previously common only to conventional equity-linked transactions.

Secondary trading in the Malaysian sukuk market has increased in depth and liquidity, with more corporations, including foreign-owned corporations, continuously tapping the market for funding. A significant number of corporate issues have been undertaken to finance long-term funding needs. The wide array and increasing size of sukuk transactions also offer attractive value proposition for investors seeking to diversify their asset portfolios, thus creating a vibrant secondary market.

Key Growth Factors Underpinning Strong Sukuk Development

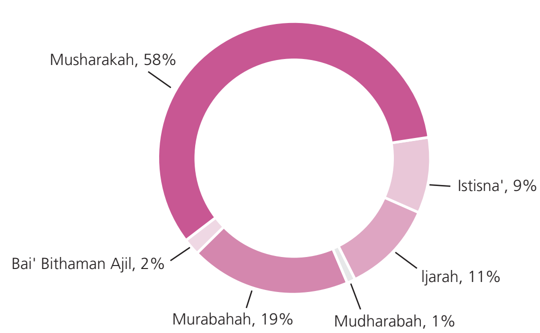
The strength of sukuk lies in its distinct structure. Sukuk is an asset-based instrument, bringing unique value proposition to both investors and issuers. For investors, sukuk offers added portfolio diversification benefits and investment opportunities in the form of new asset classes, while issuers can benefit from increased liquidity by tapping into the growing demand among an increasing number of high net-worth individuals and institutional investors for Shariah-compliant investment products.

The strong growth of sukuk, particularly in the recent five years has been supported by the following key factors:

I. Growing Sophistication of Structures

The flexibility of sukuk structures is a key factor that has led to its growing acceptance. Sukuk are tailored to meet the requirements and preferences of specific target markets. Over the years, sukuk structures have evolved from debt-based structures which are premised on cost-plus sale agreements *(murabahah)*, to lease-based *(ijarah)*, profit-sharing *(musharakah)* and manufacturing contracts-based *(istisna')* sukuk, as well as hybrid structures based on combinations of Shariah contracts that appeal to a wider range of investors.

Chart 3
Sukuk Approved in 2007 Based on Various Shariah Principles



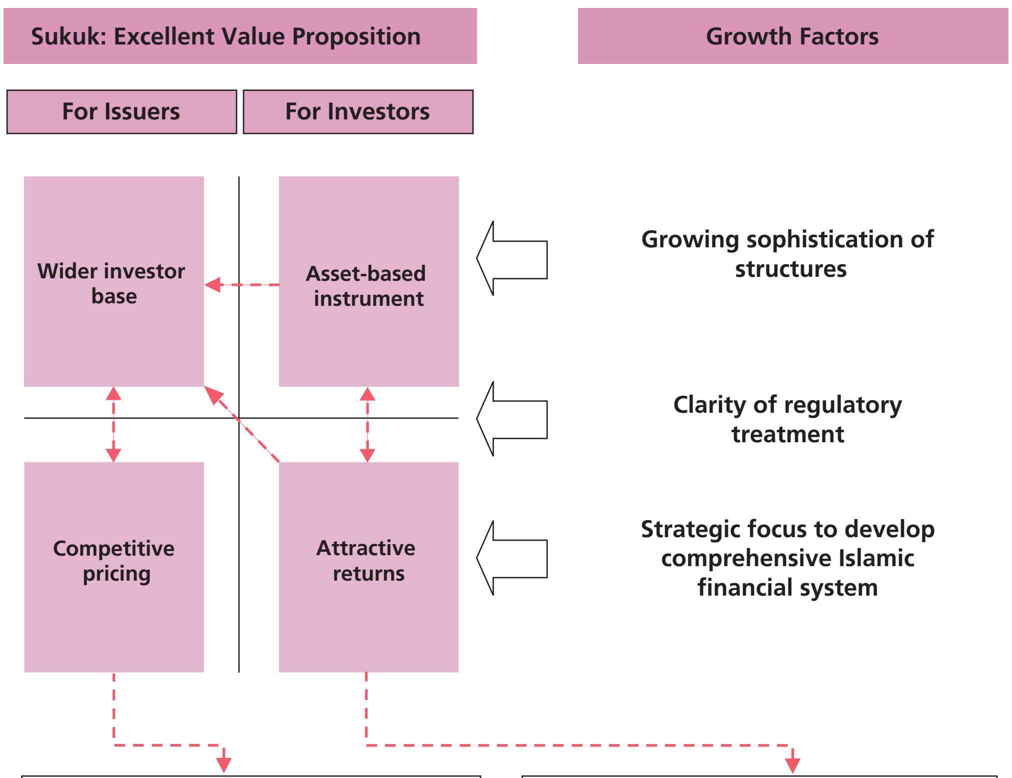
Source: Malaysian ICM Quarterly Bulletin (January 2008), Securities Commission Malaysia

II. Clarity of Regulatory Treatment

Greater clarity on the regulatory treatment of sukuk has provided regulatory certainty to Islamic financial institutions with regard to their investments in these instruments. This has been achieved through the adoption of the Capital Adequacy Standard issued by the Islamic Financial Services Board (IFSB), which specifies the prudential treatment of sukuk investments for regulatory capital purposes. Further work has also been undertaken by the IFSB to develop prudential standards for sukuk securitisation.

III. Strategic Focus to Develop Comprehensive Islamic Financial System

The broader range of instruments as well as structured products offered by the Islamic financial market in response to customer demands has also led to greater demand for sukuk. Sukuk has now become important in supporting the growing number of structured products offered by Islamic banks, takaful operators as well as fund management companies. For example, investments by takaful operators in sukuk have provided a good match for the medium- and long-term liabilities of takaful funds.



- Attracts both general bond investors and investors who invest in Shariah compliant funds.
- Opens up access to a new source of funds.
- Provides additional risk management options (for example in the case of *sukuk musharakah*, where the issuer shares the business risk with investors) and new mechanisms for price discovery.
- In the case of Malaysia, the high demand, as evidenced by issuances being over subscribed by two to thirteen times, has lowered the cost of issuance by at least 10 to 20 basis points.

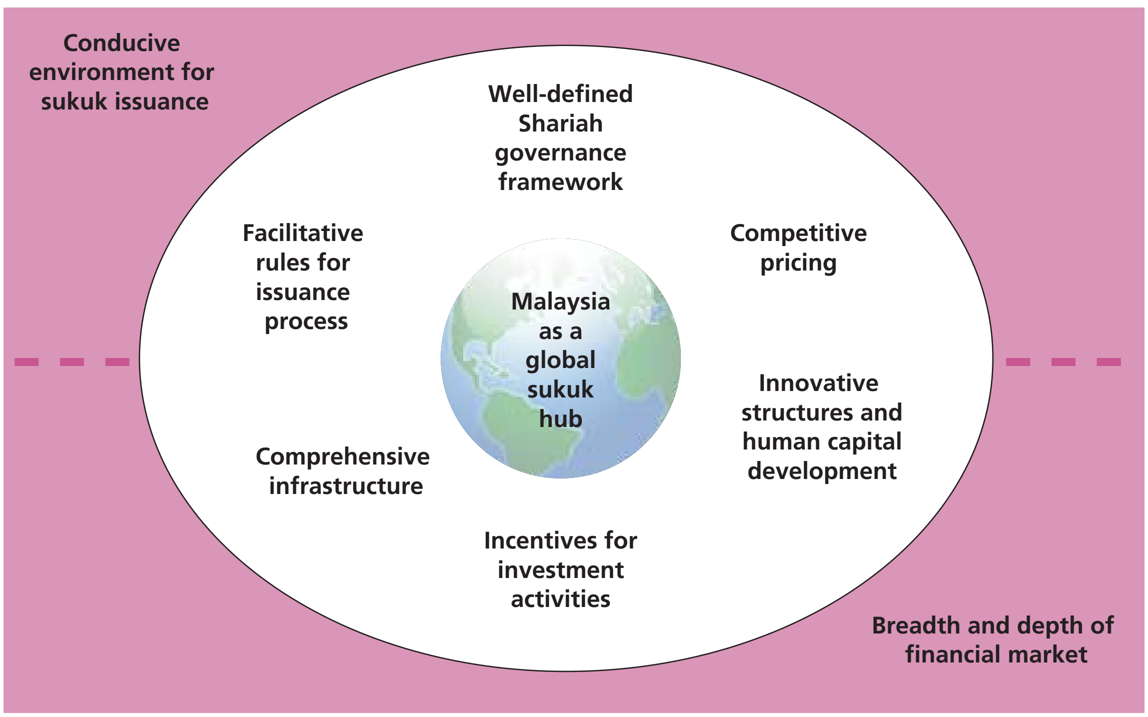
- Allows a share in an asset along with the cashflows, with risk commensurate with such ownership. This limits exposure to the value of the underlying asset, as the issuer cannot leverage in excess of the asset value.
- Scarcity of sukuk has contributed to higher pricing in the sukuk secondary market, thereby generating good investment returns for investors.
- A new asset class for portfolio diversification.

Malaysia's Leading Edge as a Global Sukuk Hub

Malaysia has emerged as a vibrant sukuk hub, offering a total solution for sukuk activities through its conducive issuance environment, facilitative policies for investment activities and comprehensive Islamic financial infrastructure. This has attracted global investors and issuers to Malaysia as a preferred sukuk issuance and investment destination. Global issuers have included international financial institutions such as the International Finance Corporation and the International Bank for Reconstruction and Development.

To further strengthen Malaysia's international position, the Malaysia International Islamic Financial Centre (MIFC) initiative was launched in 2006. MIFC serves to promote Malaysia as a centre for the offering of Islamic financial products and services in the global marketplace by facilitating the growth of investments in Islamic financial markets and by connecting international Islamic financial centres. The promotion of domestic and foreign currency sukuk origination, distribution and trading is one of the MIFC's key focus areas.

Total Solution Approach



Facilitative Rules for Issuance Process

The MIFC Secretariat and Promotion Unit, located in Bank Negara Malaysia, undertakes the coordination and promotion of MIFC's strategic initiatives, including in the area of the sukuk market. Formalised arrangements between the regulatory agencies in Malaysia through MIFC ensures a coordinated approach in continuously improving the delivery channel and efficiency in raising sukuk denominated in any currency in Malaysia. In 2007, flexibility under the foreign exchange administration rules was accorded to multilateral development banks, multilateral financial institutions, sovereigns, quasi-sovereigns and local or foreign multinational corporations to issue foreign currency-denominated sukuk in Malaysia.

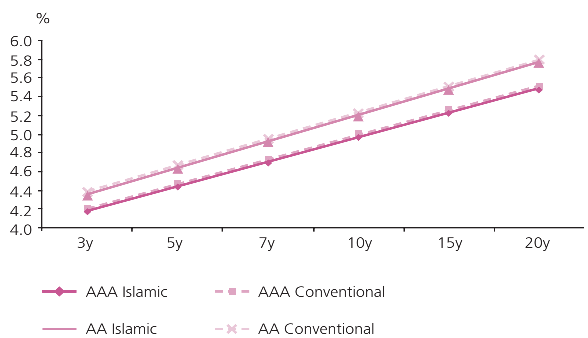
Simplified issuance procedures are adopted for international issuers with good credit ratings. Applications by issuers with a credit rating of at least 'A-' are deemed approved upon proper filing of requisite documents with the Securities Commission at least two working days prior to the issuance of foreign currency sukuk. Applications are also deemed approved upon receipt by the Securities Commission for issuance of ringgit sukuk by AAA-rated foreign sovereign or quasi-sovereign agencies.

To further facilitate the issuance process, no restrictions are placed on the ability to use international rating services, hedge positions and swap issuance proceeds into foreign currency.

Well-defined Shariah Governance Framework
Malaysia's well-defined Shariah governance framework has been instrumental in promoting the development of Islamic finance in general, including sukuk. Sukuk issuances must be approved by Shariah advisors at the respective originating financial institutions. For issuances involving new concepts or structures, further endorsement by the Shariah Advisory Council of the Securities Commission, which advises the Commission on matters pertaining to Islamic capital markets, is required. Together with the Shariah Advisory Council of Bank Negara Malaysia (which is the authoritative body on Shariah matters for financial institutions regulated by the Bank), the Councils serve to ensure compliance with Shariah principles which form the tenets of Islamic finance, while supporting innovation through their pronouncements on the Shariah-compatibility of innovative structures.

Competitive Pricing
One of the hallmarks of an efficient international financial centre is a conducive environment for cost efficient fund-raising platforms. In this regard, the high demand for sukuk, as evidenced by the over subscription of sukuk issuances, has kept the cost of issuance below that of similar rated conventional bonds.

Chart 4
Yield Curve for Corporate Bonds and Sukuk



Source: Bondweb Malaysia (as at 31 December 2007)

Various tax and regulatory incentives have further reduced the cost of issuance and time-to-market for sukuk issuances. These include the following:

- Special Purpose Vehicles (SPVs) used for the issuance of sukuk are not subject to the administrative tax procedures under the Income Tax Act 1967;
- Companies that establish SPVs are given tax deductions on the cost incurred by the SPV for the issuance of sukuk;

- The issuance cost for all Islamic securities approved by the Securities Commission are also eligible for tax deduction; and
- Stamp duty exemption is given on instruments relating to Islamic securities issued under the MIFC until 31 December 2016.

These measures and incentives are expected to further stimulate international currency sukuk issuances, thus expanding the diversity of the sukuk base in Malaysia.

Innovative Structures and Human Capital Development
Apart from the more common Shariah structures based on *musharakah, mudharabah, istisna'* and *ijarah*, Malaysia has pioneered many of the world's innovative sukuk structures. Among the various sukuk structures that were originated in Malaysia are:

1990 – First *bai' bithaman ajil* Islamic debt securities by Shell MDS Sdn. Bhd. (RM125 million)
1994 – First *sukuk mudharabah* by Cagamas Berhad (RM30 million)
2001 – First corporate *sukuk ijarah* by Kumpulan Guthrie Berhad (USD150 million)
2002 – First sovereign *sukuk ijarah* by the Government of Malaysia (USD600 million)
2003 – First tradable *sukuk istisna'* by SKS Power Sdn. Bhd. (RM5.6 billion)
2005 – First *sukuk musharakah* by Musharakah One Capital Berhad (RM2.5 billion)
2006 – First exchangeable sukuk by Khazanah Nasional Berhad (USD750 million)

This would not have been possible without the pool of requisite human capital available in the Malaysian Islamic finance industry. Skills and expertise in this area of finance is in high demand globally, resulting in the need to deepen the talent pool further to sustain current and future needs. In this context, strategic initiatives under the MIFC also include developing Malaysia into an international centre for Islamic finance education. The establishment of the International Centre for Education in Islamic Finance (INCEIF) in 2006 is aimed at supporting the dynamic and evolving global Islamic finance industry through the development of high calibre Islamic financial professionals. To achieve this, INCEIF offers the Chartered Islamic Finance Professional (CIFP) qualification programme, which is its flagship programme, as well as postgraduate Masters and PhD programmes.

Given the parallel financial system in Malaysia featuring both conventional and Islamic finance, the human capital requirements for the country's sukuk and Islamic financial activities are not only met by the pool of Islamic financial professionals, but are also supported by the workforce in conventional financial institutions. This ability to leverage on cross-sectoral expertise has been important in driving product innovation with sound structures and risk management foundations, while complying with Shariah requirements.

Incentives for Investment Activities
To further stimulate and attract investments in sukuk by global investors, several incentives and measures have been announced. These include the following:

- No withholding taxes are imposed on non-resident investors for the profit or income received on foreign currency sukuk originated in Malaysia and approved by the Securities Commission;
- Foreign investors in Malaysia are allowed to hedge their positions with onshore banks with respect to committed flows of funds, such as the repatriation of investment proceeds, dividends and profits from Malaysia as well as the purchase of ringgit assets in Malaysia; and
- Free inward and outward movement of funds relating to both foreign direct investments and portfolio capital investments.

Comprehensive Infrastructure
Malaysia's Islamic capital market continues to register strong growth as seen from the increasing year-on-year growth in assets and diversity of products offered. This can be attributed to the existence of a complete and well-established Islamic financial system with considerable depth and

breadth in the capital market, a responsive and facilitative regulatory environment, as well as an increasing number and sophistication of intermediaries which continue to push the frontiers of product innovation.

A carefully planned and strategic approach which has been adopted in Malaysia to develop a comprehensive Islamic financial system that co-exists with the conventional system within the broader financial system has produced positive results. Malaysia has increased its appeal as an investment destination, offering a wide range of investment opportunities with considerable market depth and breadth. Of importance, the building blocks necessary for an efficient and well-functioning market, are now well entrenched.

A facilitative platform for sukuk issuance and trading activities has also supported more efficient issuances and enhanced the price discovery process. Malaysia's payment and settlement systems, including the Real-time Electronic Transfer of Funds and Securities (RENTAS) system, provide an efficient platform for the trading of bonds, with a high level of post-trade transparency and market liquidity. For global investments, flexibility is also accorded for foreign investors to leverage on international clearing and settlement systems.

Malaysia has continuously strengthened the legal, regulatory and Shariah framework underpinning the Islamic financial system. Its securities laws are formulated to incorporate best practices, and are comparable to those of developed markets, with regularly refinements made to ensure their continued efficiency and relevance. This is necessary to take into account the rapid pace of financial innovation and evolving practices of financial institutions. Malaysia's securities laws were recently updated with the passage of the Capital Markets and Services Act 2007 that came into effect in September 2007. The new Act reinforces a sound investor protection framework and orderly market development, while promoting international best practices in the capital market and among its participants. The Act also clarifies the legislative framework applicable to Islamic securities and provides for the universal nature of the Islamic banking licence accorded under the Islamic Banking Act 1983. With the coming into force of this new legislation, Islamic banks are positioned to take on a more pivotal role in the development of the Islamic capital markets.

The MIFC portal (www.mifc.com) was launched in 2007 as the primary public source of information on the latest MIFC initiatives and developments. Closer linkages are also being fostered with other Islamic financial centres to promote international economic and financial cooperation in the field of Islamic finance. Memoranda of Understanding (MoUs) were signed between Bank Negara Malaysia and two Islamic financial services authorities, namely, the Dubai Financial Services Authority and the Qatar Financial Centre Regulatory Authority. The MoUs signify the authorities' joint commitments to promote the development of the global Islamic financial services industry and pave the way for better cooperation between Islamic financial centres operating in different time zones. Areas covered under the MoUs include capacity building, human capital development and initiatives to enhance the breadth and depth of financial markets as well as promote Shariah harmonisation.

ENHANCING OPERATIONAL EFFICIENCY AND EFFECTIVENESS

With increasing competition in the financial sector placing continued pressure on profit margins, measures to enhance operational efficiencies have become more critical to financial institutions' long-term viability. In the banking sector, gross interest margins continued to decline from 3.2% in 2001 to 2.7% in 2007. This has increased the need for more strategic management of cost structures, product risks, and group synergies. To support the ability of financial institutions to respond quickly to changing market conditions, several regulatory guidelines and processes have been reviewed to accord financial institutions greater operational flexibilities. These included:

- Flexibility allowed for insurance companies to outsource fund management activities to related entities within their respective financial groups, in order to leverage on group expertise and resources;

- Introduction of a "launch-and-file" system which removed the regulatory notification and approval requirements prior to the introduction of new products by banking institutions and DFIs, thus improving the time-to-market. The new "launch-and-file" system is applicable to all conventional banking products with the exception only of investment products that expose consumers to losses exceeding the principal sum invested and designated payment instruments which must be approved pursuant to provisions under the Payment Systems Act 2003; and
- Simplified regulatory procedures for applications to appoint and reappoint directors, senior management and expatriates of financial institutions. This has reduced the time taken for processing the applications.

Increasing customer sophistication and the more complex operating environment demands new and innovative products to cater to the evolving needs of the public and to support economic transformation. In this regard, further flexibilities were accorded to financial institutions, including:

- Flexibility for insurance companies to offer universal life and retirement financing products, which can be customised and have more features to meet the different needs of policyholders. For instance, the new universal life products allow policyholders to pay flexible or fixed premiums, while offering guarantees. Meanwhile, retirement products allow policyholders to choose from various combinations of accumulation and payout periods that are most suited to their requirements; and
- Liberalisation of the Guidelines on Negotiable Instruments of Deposits (NIDs) to allow floating rate NIDs to be priced against any indices other than the Kuala Lumpur Interbank Offered Rate (KLIBOR), and the issuance of NIDs in foreign currencies, thus broadening the product range to meet customers' differing risk appetites.

The Bank also introduced several new money market instruments for liquidity management and investment purposes, which in turn has broadened the range of money market instruments, including:

- The Commodity Murabahah Programme (CMP) which is a cash deposit product auctioned in the Islamic Interbank Money Market via the Fully Automated System for Issuing/Tendering (FAST) and is the first commodity-based transaction that uses crude palm oil as the underlying asset, thus contributing further towards deepening the Islamic money market; and
- Introduction of floating rate Bank Negara Monetary Notes, which are offered through competitive Dutch auctions (uniform price) via the principal dealer network.

To further support sustainable growth in financing, a joint venture was formed between Cagamas Berhad and the Hong Kong Mortgage Corporation to develop mortgage guarantee business in Malaysia and around the region. For financial institutions, the mortgage guarantee cover will provide an alternative tool to hedge credit risk exposures, while allowing institutions to tap into a wider market base and avail of greater growth opportunities, particularly in the Islamic housing finance markets. This development reflects the increasing role of the capital market in complementing the role of traditional financial institutions as a source of financing and in expanding avenues for better risk management. Over the medium term, affordable consumer access to home ownership financing will also be enhanced.

The Bank continued further liberalisation of the foreign exchange administration rules to facilitate business activities and create a conducive environment for economic growth. In 2007, the Bank announced a series of liberalisation measures, which included allowing residents and non-residents to raise foreign currency-denominated bonds and sukuk in Malaysia, abolishing the net open position limit imposed on licensed onshore banks and increasing the limit on foreign currency borrowing that can be obtained by resident corporations from RM50 million to RM100 million equivalent in aggregate. The foreign exchange administration operational procedures were also simplified with the abolition of registration requirements for certain transactions including forward foreign exchange contracts by residents, foreign currency borrowing by residents and prepayment and repayment of foreign currency borrowing by residents. The Monthly Report on Balances of Foreign Currency

Accounts of Residents was also abolished, while the individual reporting threshold for transactions between residents and non-residents was increased from RM50,001 to RM200,001 per transaction (or its equivalent in foreign currency). Details of the liberalised foreign exchange administration rules can be accessed at www.bnm.gov.my/fxadmin.

These and other measures introduced by the Bank to provide greater flexibilities and improve business efficiency have contributed towards the further development of the foreign exchange and bond markets. In 2007, the turnover of foreign exchange transactions by non-residents more than doubled over the previous year. In addition, efforts to position Malaysia as a centre of origination and trading of debt securities, including sukuk, has resulted in a growing interest by foreign corporations to issue debt securities in Malaysia. In 2007, approvals for the issuance of foreign currency-denominated debt securities by foreign corporations totalled USD12.3 billion (of which 68% was foreign currency-denominated sukuk), an increase of 58% from 2006. The more developed debt securities market and the conducive market environment have also encouraged a proliferation of structured products being offered. Structured products approved for issuance quadrupled in value from RM22 billion in 2006 to RM94.2 billion in 2007. Other forms of capital market innovations included asset-backed securities (ABS) and collateralised loan obligations. One such instrument is the issuance of pass-through ABS by financial institutions. The financial market also saw the issuance of more longer dated private debt securities (PDS), with an increase in the issuance of PDS with maturities of 10 years or more as a percentage of total PDS issuances from 8.4% in 2006 to 16.4% in 2007.

ENHANCING FINANCIAL MARKET INFRASTRUCTURE

Significant efforts have been undertaken to support the development of a more diversified and stable financial system. The Asian financial crisis had highlighted the risks associated with over-reliance on the banking sector and the importance of diversifying the country's sources of financing to the capital market. As at end-2007, total outstanding debt securities was RM557 billion compared to RM225 billion as at end-1999. Issuances of debt securities have also been on an increasing trend, with issuances totaling RM302 billion in 2007, an increase of about 65.3% from 2006. Public debt securities accounted for 59% of total issuances. The reduced reliance on the banking sector for financing by corporates is also evident from the increased size of private debt securities as a percentage of total bank loans and financing to corporates, from 36% in 1999 to 56.2% as at end-December 2007.

Issuances of debt securities have also been on an increasing trend, with issuances totalling RM302 billion in 2007.

Bank Negara Malaysia, Bursa Malaysia and the Securities Commission also collaborated to develop an electronic trading platform (ETP) for unlisted bonds. The ETP will assume the function of the Bond Information Dissemination System, currently maintained and managed by the Bank, as the central database on bond trading information. The ETP is expected to further enhance the price discovery mechanism that will facilitate real-time decision making by market participants. This, in turn, will enhance bond trading activities, leading to a more dynamic and vibrant capital market.

To support the Bank's policy making and surveillance functions, the Information and Surveillance System for Debt Securities (INSIDES) is being developed to pull together data and information relating to the debt securities market into one central database to provide a comprehensive view of the market. Once operationalised, the INSIDES system will facilitate a more efficient analysis of trends and impact assessments, while providing useful inputs for the formulation of policies by the Bank. FAST is also being upgraded to cater for new instruments and products in the financial market.

In line with efforts to enhance regulatory transparency, the Bank launched the Regulatory Handbook in June 2007 to enable more timely and efficient dissemination of regulatory guidelines to financial institutions under its purview. The Regulatory Handbook is made available through the Bank's enterprise portal, FI@KijangNet, with functionalities that allow for speedier interactions between the Bank and financial institutions as well as greater accessibility to the regulatory framework for all relevant officers within the institutions.

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STRENGTHENING INTER-AGENCY COOPERATION

As the financial system becomes increasingly integrated, there is a greater need for a more holistic and comprehensive approach to the regulation and supervision of licensed financial intermediaries. Enhanced collaboration and coordination between the regulatory agencies in maintaining financial system stability has become more important as more players engage in activities that extend beyond their traditional roles with greater resulting overlaps in the scope of business. At the same time, increasing linkages between players and markets, both domestically and internationally, have posed challenges in detecting the sources of potential vulnerabilities.

As part of efforts to put in place an efficient and effective collaborative framework, Bank Negara Malaysia and the Securities Commission signed three MoUs relating to investment banks, payment and settlement systems as well as financial advisers and financial planners. The agreements provide for both agencies to enhance cooperation in areas relating to the joint surveillance of the capital market, strengthening the corporate governance framework for public listed companies and public interest entities, and developing Malaysia as an international Islamic financial centre. Similarly, a strategic alliance agreement between Bank Negara Malaysia and the Malaysia Deposit Insurance Corporation has been put in place to outline the accountabilities and responsibilities of both agencies in promoting sound risk management practices in the banking industry and in ensuring financial stability.

Broader collaboration and cooperation was also achieved at the national level to address specific issues impacting the operation and financial viability of licensed institutions. In particular, to address the escalating incidences of vehicle theft at the national level, the Vehicle Theft Reduction Council of Malaysia Berhad was established in 2007. The Council comprises representatives from the Royal Malaysia Police, Bank Negara Malaysia, Royal Malaysian Customs, Ministry of Transport, Road Transport Department, General Insurance Association of Malaysia, Malaysian Takaful Association, Malaysian Automotive Association and Association of Malaysian Loss Adjusters. An immediate priority of the Council will be to coordinate the formation of a National Vehicle Theft Information Exchange. This exchange will provide the platform for all relevant parties to share up-to-date information on stolen vehicles for theft detection, deterrence and also to prevent the sale of stolen vehicles.

HUMAN CAPITAL DEVELOPMENT

Recognising the paramount importance of having in place a sufficient pool of skilled talent to drive and support the long-term growth and development strategies of financial institutions, significant attention has been directed at achieving a more structured and well coordinated effort in human capital development to meet the industry's requirements. Similar to other fast growing emerging markets, the demand and competition for highly-skilled financial professionals has become more acute. Based on a survey conducted by the Bank in July 2007, the banking and insurance industries reported approximately 2,300 vacancies at the entry-level and approximately 1,700 vacancies at the mid-management level. To meet this demand, a holistic approach to talent development has been taken, encompassing initiatives that are tailored to the different levels of personnel in the financial services industry. The human capital development initiatives have also considered the specific requirements of financial services professionals as they progress through the different stages in their career development, from the pre-employment stage through to leadership positions.

At the entry-level, institutions of higher learning are the primary source of new talent for the financial industry. To ensure that graduates are well-equipped for the challenges of the more demanding financial services industry, collaborative efforts between the financial services industry and institutions of higher learning were enhanced. During the year, Bank Negara Malaysia, in collaboration with the Ministry of Higher Education, organised a well-received dialogue between the financial services industry and the institutions of higher learning to address critical competency gaps among new graduates trained in financial disciplines. The dialogue paved the way for the following collaborative initiatives between the financial services industry and institutions of higher learning aimed at closing the gaps identified:

- Involvement of industry practitioners in the development of higher learning curriculum, identification of research areas, design of case studies, and as teaching resources; and
- Implementation of a lecturers internship and research programme under which lecturers from institutions of higher learning will be provided with opportunities to pursue working attachments with financial institutions to obtain practical exposure, or to undertake applied research work in areas relevant and current to the financial services industry. The programme will enable participating financial institutions, lecturers and researchers to combine their respective specialisations, refine existing skills and knowledge, and develop new approaches, models and tools to better understand and deal with new challenges and business opportunities.

A holistic approach to talent development has been taken to meet the specific needs of financial services professionals at different levels and as they progress through different stages in their career development.

Partnerships and strategic alliances were also established between corporate learning centres, industry-based learning organisations and universities to strengthen efforts in research and development, training, and to promote the exchange of ideas and information on issues relating to human capital development. One such partnership was the participation of the Institute of Bankers Malaysia (IBBM) in the University of Nottingham Financial Services Research Forum.

To meet immediate demands for resources at the entry-level, the Financial Sector Talent Enrichment Programme (FSTEP) was developed to equip fresh graduates with the essential technical knowledge and skills needed to assume professional roles in the financial services industry. FSTEP, an industry-led initiative supported by the Bank, is a 12-month programme which integrates classroom training and practical internships with financial institutions. Participants will gain exposure through the programme to the business of commercial banking, investment banking, Islamic banking, insurance and takaful, thus providing them with a comprehensive overview of the financial services industry. In addition, participants will also receive training on key behavioural competencies required to perform effectively in the financial services industry. The first batch of participants commenced training on 10 December 2007.

To ensure that the Malaysian financial industry workforce is at par with their international counterparts while providing a more systematic and structured approach to support the development of capable knowledge workers in the industry, the Banking and Finance Industry Competency Framework was developed by IBBM. These competencies, which are benchmarked against international best practices, highlight the essential traits and skills that employees in the banking and finance industry would require. More importantly, the framework will assist training providers and financial institutions in developing training and assessment programmes and in managing staff development in a more effective manner. The Banking and Finance Industry Competency Framework was launched in November 2007.

In September 2007, Bank Negara Malaysia and the Securities Commission jointly issued proposals to enhance existing institutional arrangements for the professional training and development of financial industry personnel. Broadly, the proposals aim to strategically position the industry training institutes, namely the IBBM, Malaysian Insurance Institute, Islamic Banking and Finance Institute Malaysia and

Securities Industry Development Centre, to meet present and future demands for talent in a more efficient and effective manner, having regard to the increasingly integrated provision of financial services. This strategic initiative is expected to further enhance the quality of training provided, reduce duplication, address gaps in existing programmes and qualifications, and evolve more comprehensive training solutions for the industry.

The International Centre for Leadership in Finance (ICLIF) and the International Centre for Education in Islamic Finance (INCEIF) which were established by the Bank in 2003 and 2006 respectively have continued to play an instrumental role in meeting the human capital development needs of the industry, both in Malaysia and across the region. The mandates and achievements of INCEIF and ICLIF to date are detailed in the box below.

International Centre for Education in Islamic Finance (INCEIF)

Mission

As an Islamic financial education centre, INCEIF aims to elevate and advance Islamic financial knowledge globally by developing high-calibre practitioners, professionals and researchers who are well-versed in modern finance and Shariah principles, thereby contributing to the supply of talent and expertise in the Islamic financial services industry.

Programmes

- More than 1,300 students from 53 countries around the world including from Japan, Saudi Arabia and the United States of America have enrolled in INCEIF's flagship Chartered Islamic Finance Professional (CIFP) programme to date. The CIFP's holistic and comprehensive syllabus is specifically tailored to combine both practical and theoretical aspects of Islamic finance.
- Introduced the PhD by Coursework and Dissertation and PhD by Research programmes which aim to spur advances in theoretical and applied practice of Islamic finance, based on doctoral research conducted in specific areas of Islamic finance. 29 candidates have enrolled in the programme's first cohort.
- A Masters programme is currently being developed and is expected to commence in 2008.

Strategic Partnerships

- Established 11 strategic partnerships to date with various Islamic financial institutions, central banks, institutions of higher learning and training institutes, reflecting the global relevance of INCEIF's programmes and its growing international recognition. The strategic partnerships are with:
  i. Indonesian Banking Development Institute (Lembaga Pengembangan Perbankan Indonesia)
  ii. National Institute of Banking, State Bank of Pakistan
  iii. Meezan Bank Pte. Ltd., Pakistan
  iv. Ceylinco Sussex Business School, Sri Lanka
  v. Emirates Institute of Banking and Financial Studies, United Arab Emirates
  vi. Sudan Academy of Banking Financial Studies
  vii. Central Bank of Syria
  viii. Al-Ghurair University, United Arab Emirates
  ix. University of Science and Technology, Yemen
  x. La Trobe University, Australia
  xi. Universiti Malaysia Terengganu
- Other collaborations included a five-day Continuing Professional Development Programme workshop organised with the University of Reading, United Kingdom and the National Association of Securities Dealers of New York which further contributed towards promoting dialogue and the transfer of skills and expertise in Islamic banking and finance at the international level.

Promoting Talent Development and Research in Islamic Finance

- Provided training opportunities to deserving candidates:
  - i. 38 students from Malaysia, Algeria, Thailand, Pakistan, Uzbekistan and Indonesia were sponsored under the Bright Scholars scholarship programme to participate in the CIFP;
  - ii. Established the INCEIF Fisabilillah Fund (RM400,000) to support the development of a pool of skilled scholars;
  - iii. Established the International Shariah Research Academy for Islamic Finance (ISRA) as a dedicated and specialised Shariah research centre within INCEIF to conduct applied Shariah research in various areas of Islamic finance. ISRA will:
    - a. spearhead research into current Shariah issues in Islamic finance, including in the areas of risk mitigation techniques and tools, product innovations, liquidity management and hedging;
    - b. strengthen human capital development in Shariah and Islamic finance; and
    - c. provide a platform for dialogue and knowledge sharing among practitioners, scholars, regulators and academicians, thereby promoting Shariah convergence and mutual respect.
- In addition, Bank Negara Malaysia has awarded 14 Shariah scholarships and two Shariah research grants under the Fund for Shariah Scholars in Islamic Finance which was established in part to contribute towards the development of Shariah experts in *fiqh muamalat*.

International Centre for Leadership in Finance (ICLIF)

Mission

To provide a focused and coordinated approach to the development of a generation of world class leaders for all sectors and corporations, but with special focus on the financial services sector so as to cater for the needs of the rapidly transforming Asian region by providing learning opportunities and experience through effective leadership development programmes.

Programmes

- Developed the ICLIF Leadership Competency Model which outlines the essential competencies for leadership and supports all developmental aspects of leadership.
- Conducted seven Global Leadership Development Programmes to foster the development of leadership skills and strategic management capabilities required to achieve and maintain high-performing organisations in a rapidly changing environment. The programme is designed and delivered by ICLIF in collaboration with several world-renowned learning institutions and leading consultants.
- Designed and delivered other cutting edge programmes on Leading Change, Leading Innovation, Scenario Thinking and Planning, and Talent Management.
- Entered into a five-year contract with the Indian Railways to conduct six Scenario Thinking and Innovation Workshops for more than 1,000 of its employees.

Strategic Partnerships

- Established strategic partnerships with international organisations to:
  - i. develop and deliver comprehensive and high quality courses in leadership development in banking and finance;
  - ii. facilitate the exchange of data, intelligence, education material, resource persons and experts; and
  - iii. facilitate reciprocal study visits by alumni and groups of banking executives.
- To date, strategic partnerships have been established with:
  - i. the South East Asia Central Banks (SEACEN) Research and Training Centre for its Advanced and Intermediate Leadership Courses on Central Bank Management and Policy Programmes;

ii. the Indonesian Banking Development Institute (Lembaga Pengembangan Perbankan Indonesia); and
iii. the Indian Institute of Banking and Finance.

BROADENING ACCESS TO FINANCIAL SERVICES

Promoting broad-based and balanced economic growth remained an important agenda of the Bank to elevate the standards of living of all segments of the population, thereby contributing to social and political stability. Thus, broad access to financial services which enables the pursuit of economic activities by all levels of society, has been a key policy focus of the Bank. Building on the positive results of previous initiatives, measures continued to be undertaken in 2007 to further promote the potential of small and medium enterprises (SMEs) and micro enterprises. Financing to SMEs by banking institutions registered strong growth, with loans approved increasing by 37.1% to RM55.1 billion during the year. During the same period, loans approved by the six DFIs under the purview of Bank Negara Malaysia[1] increased by 17.9% to RM8.1 billion.

Measures continued to be undertaken in 2007 to further promote the potential of small and medium enterprises and micro enterprises.

With SMEs constituting more than 99% of total business establishments and providing employment to more than 5.6 million people in Malaysia, the development of the SME sector is essential to promote domestic-led growth and to strengthen the resilience of the economy. Based on the Census on Establishment and Enterprise conducted in 2005, the Malaysian SMEs' contribution to GDP was 32% as compared to other countries such as Japan (55.3%) and Germany (57%), indicating the immense potential for a higher contribution of the SME sector to economic growth. To complement improvements made to the existing institutional infrastructure for SMEs, initiatives have been put in place to ensure the effective channeling of funds to SMEs, provide financial advisory support and promote greater awareness on financial products and programmes available for SMEs.

The Credit Guarantee Corporation Malaysia Berhad (CGC) embarked on a transformation exercise in 2005 to further enhance its role in supporting the growth and development of competitive SMEs. As the main provider of guarantee services to SMEs, the transformation aims to position CGC as a more responsive and financially sustainable institution that can better serve the current and evolving needs of the SMEs. Since the transformation, CGC has introduced a wider range of credit enhancement products and advisory services on financial and business development. These include the launch of the Credit Enhancer Islamic Scheme (Enhancer-i) and Direct Access Guarantee Scheme Start Up (DAGS Start-Up) in 2007. Enhancer-i provides access to financing of up to RM10 million and guarantee coverage of up to 90%, while DAGS Start-Up is targeted at new SMEs and provides guarantees for financing of up to RM2 million and coverage of up to 100%.

Access to funding by SMEs was also enhanced with the creation of the RM1 billion Overseas Project Fund established by the Bank in December 2006. The Fund, placed with Export-Import Bank of Malaysia Berhad (EXIM Bank), guarantees and provides co-financing facilities for Malaysian companies to fund their overseas projects. The participating financial institutions will provide financing up to 90% of the contract value in major currencies. As at end-December 2007, a total of RM190.9 million in loans were approved with guarantee coverage of RM143 million. In addition, Cagamas Berhad launched its first securitisation programme for SME loans valued at RM600 million. The securitisation provides banking institutions with greater flexibility in managing their SME loan portfolios, thereby further enhancing their capacity to lend to SMEs.

[1] Bank Pembangunan Malaysia Berhad, Bank Perusahaan Kecil & Sederhana Malaysia Berhad, Export-Import Bank of Malaysia Berhad, Bank Pertanian Malaysia, Bank Kerjasama Rakyat Malaysia Berhad and Bank Simpanan Nasional.

The lack of organised financial records, and perceived higher financial risk associated with SMEs have made complete credit risk assessments of SMEs by financial institutions more challenging. To address these constraints, CGC has entered into a strategic alliance on 3 July 2007 with a provider of credit information services, to set up the SME Credit Bureau. The SME Credit Bureau is a credit databank of SMEs which sources and pools data from various sources, including the Companies Commission of Malaysia, financial institutions and businesses' trade credit data. Information on individual SMEs and their credit ratings would be made available to financial institutions and businesses to facilitate underwriting decisions for loans and trade credit respectively. Further support to SMEs is provided through the establishment of the SME Business Advisers Network, a one-stop web-based directory in the SMEInfo Portal (www.smeinfo.com.my) that serves as a platform for SME business advisers to share expertise, thus facilitating the provision of comprehensive advisory services to SMEs. To further enhance access to commonly used banking services at minimal costs, the "Basic Banking Services Framework" was also extended to SMEs in 2007.

Moving forward, the Small and Medium Industry Development Corporation (SMIDEC) will be transformed into a SME Central Coordinating Agency, a single Government agency dedicated to spearhead the development of SMEs across all sectors of the economy. This initiative is aimed at accelerating the development of the SME sector by focusing on coordinating SME policies and Government programmes across all sectors, and providing one-stop information and advisory services to SMEs. The SME Central Coordinating Agency will report directly to the National SME Development Council and will be placed under the Ministry of International Trade and Industry.

To assist financially distressed SMEs, the financial institutions participating in the Small Debt Resolution Scheme (SDRS) that was established by the Bank in 2003 to facilitate viable on-going SME businesses to restructure their non-performing loans (NPLs) was extended to include Bank Kerjasama Rakyat Malaysia Berhad, Bank Pertanian Malaysia and EXIM Bank, in addition to the commercial banks, Islamic banks and the SME Bank that are already participating in the scheme. As at end-2007, out of 726 applications received, 565 applications involving NPLs of RM324 million had been approved for restructuring under the SDRS.

Small businesses also received special financial support during the widespread flooding throughout the country during the year. In January 2007, a Special Relief Guarantee Facility, with the participation of CGC and financial institutions, was established to alleviate the financial difficulties faced by small businesses that were affected by the floods. The facility provides a guarantee of 80% on new loans taken by the affected businesses for the purpose of resuming their business operations. A total of 4,640 loans valued at RM472 million were approved under the facility.

To further enhance access to financial services for the agriculture sector which is primed to be one of the key economic growth drivers for the country under the Ninth Malaysia Plan, new approaches and business models are required to deliver financial services in the most effective manner. An important step in this direction was taken with the initiative to restructure and strengthen Bank Pertanian Malaysia resulting in its corporatisation in December 2007. With the corporatisation, the paid-up capital of Bank Pertanian Malaysia was increased from RM42.5 million to RM1 billion, thereby expanding the financial resources needed for it to play a more significant role as an enabler of growth in the agricultural sector. Bank Pertanian Malaysia's corporatisation will complement the two agriculture venture capital funds totalling RM300 million established in September 2006 by Bank Negara Malaysia together with two banking groups. The funds are aimed at modernising and evolving a more integrated approach to agriculture business in Malaysia, particularly in farming, fisheries and livestock, as well as to finance new technology-intensive agriculture projects, including biotechnology. As at end-December 2007, total investments from these funds of RM72.9 million had been approved in seven companies.

The microfinance initiative which was introduced in 2006 has gained significant momentum. At present, nine financial institutions (six banking institutions and three DFIs) offer microfinance products. As at end-2007, total financing outstanding amounting to RM224.7 million had been provided to 22,788 microfinance customer accounts, with an average financing size of RM9,800. To create greater public awareness on the availability and benefits of microfinance, a national microfinance logo was launched in September 2007. Since the launch of the logo, financial institutions that offer microfinance have displayed the logo and their microfinance client charters to signify their participation and commitment towards the provision of microfinance services. Microfinance customers who have obtained such financing may also display the logo at their business premises.

The microfinance initiative gained significant momentum in 2007.

Measures to expand the outreach of financial services to the non-urban areas were also pursued. As Malaysia strives to be an industrialised nation, financial inclusion will remain a priority on the Bank's agenda in the years to come. The vision is for the public to have easy and convenient access to banking, insurance and other financial services. Financial institutions also stand to benefit from the vast opportunities to be tapped from those segments of the population which are currently underserved. A number of banking institutions have formed strategic alliances with a variety of service providers to provide selected banking and remittance services to customers in the non-urban areas. Efforts to further expand these services as well as similar initiatives by other financial institutions are currently being pursued.

Advancements in information and communications technology have also enhanced the delivery of financial services. Recent advancements in banking services include cross-border transfers of money via mobile phones and mobile banking services via short messaging services for account enquiries, bill payment and funds transfers. Through the adoption of the latest technology, products and services can be delivered at lower cost with a wider reach to areas which otherwise may not have had access to financial services.

Developmental initiatives and trends relating to SMEs and microfinance are discussed in further detail in the box articles "Development of Small and Medium Enterprises" and "Development of a Vibrant and Sustainable Microfinance Industry" in the Bank's Annual Report 2007, jointly published with this Report.

CHALLENGES AND OUTLOOK

The development focus in 2008 will be directed at further enhancing domestic capacity, developing the financial infrastructure, minimising structural weaknesses as well as strengthening capital market fundamentals. Further, given the uncertainties of the external financial environment and increasing inter-linkages resulting from financial globalisation, efforts will also be geared towards strengthening regional and global cooperation and enhancing the timely exchange of information as part of the continuing efforts to promote financial stability.

The approach to financial sector liberalisation will be driven by the objectives of promoting a more efficient and competitive financial system, while ensuring balanced growth and financial stability.

Greater convergence and the blurring of lines between the banking, insurance and securities industries will continue to define the changing financial landscape. Bank Negara Malaysia will continue to facilitate ongoing consolidation exercises by creating the appropriate operating environment. In addition, the approach to financial sector liberalisation will be driven by the objectives of promoting a more efficient and competitive financial system, while ensuring balanced growth and financial stability.

In the area of Islamic finance, the Bank will continue to strengthen the legal and Shariah infrastructure to reinforce sound financial practices in this sector, while encouraging further innovation in products and services to support specialised Islamic fund and wealth management services. The development of the sukuk market will be accelerated as an important conduit to mobilise longer-term funds to match funding needs and facilitate effective risk transfers. Infrastructure development to facilitate an increase in the supply of suitable Islamic financial instruments to address funding mismatches and promote sound asset-liability management practices will continue to be enhanced. Efforts will also be intensified to achieve greater alignment and harmonisation of business models, processes and principles for the orderly development of the industry.

With continued prospects for increased convergence in products and delivery systems, bancassurance and bancatakaful will be encouraged to enhance the distribution capacity and increase insurance penetration. Work is also ongoing to promote the provision of affordable health-related insurance products and private pension products in view of the changing demographic structure of the population. To support balanced economic development, initiatives will continue to be undertaken to provide the segment of the population that is currently underserved with greater access to affordable financial products and services. Efforts will also continue to be put in place to support the growing SME and microfinance sectors that will become more significant in the economy.

The Landscape of the Malaysian Financial System Today

Introduction

The financial system has undergone significant transformation since the 1990s to meet the needs of an expanding economy and changing market demands. Today, the financial system has evolved to become more diversified, efficient and resilient, thus enabling it to effectively perform the intermediation function and reinforcing its role as a key contributor to economic growth. With an average annual growth rate of 7.4% since 2001, the financial sector now contributes 10.7% to real gross domestic product (GDP). This has been accompanied by enhanced access to a wider array of financial products, services and delivery channels, improved quality of customer service and greater technological innovations.

Diversified Institutional Players and Vibrant Financial Markets Supporting the Needs of the Economy

Structural reforms after the Asian financial crisis, prompted by business considerations and regulatory initiatives, have reshaped the financial landscape and enhanced the competitive capabilities of institutional players. While the commercial banking, investment banking and Islamic banking institutions form the nucleus of the financial system, the financial system has become more diversified. Today, the banking system constitutes about 50% of the financial system's assets. The consolidation and rationalisation of the domestic banking industry and the introduction of the investment banking framework have strengthened the performance of domestic banking institutions and enhanced their role in the economy. Assets of the banking system grew at an average annual rate of 8.2% since 2000, driven mainly by strong growth in loans and holdings of private debt securities (PDS), while total deposits increased by an average annual rate of 8.5% over the same period.

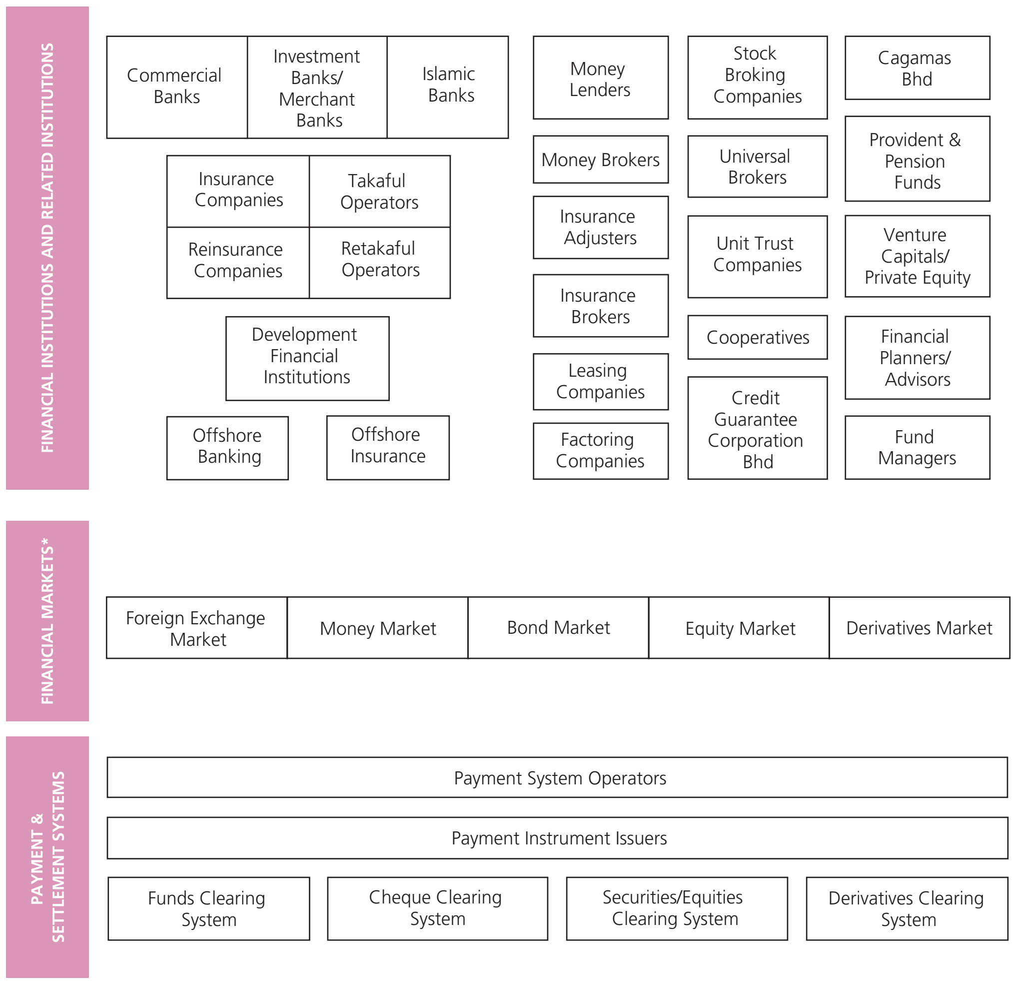
The blurring of the traditional boundaries between the different types of financial activities and the increasing demand for financial services that are offered under one roof have brought about the formation of financial conglomerates. Today, all domestic banking groups undertake the full range of commercial banking (including retail financial services), investment banking and Islamic banking activities. Many of the conglomerates also have insurance companies, fund management and unit trust companies within their groups. This has contributed towards the realisation of the benefits derived from greater economies of scale, as well as the diversification of risks and sources of revenue.

Table 1
Financial Sector: Number of Players

Financial Institutions	1999	2007
Commercial Banks	34	22
Finance Companies	32	0[1]
Investment Banks/Merchant Banks	12	14
Universal Brokers	5	1
Discount Houses	7	0
Islamic Banks	2	11
Insurance Companies	56	41
Life	*7*	*8*
General	*38*	*25*
Composite	*11*	*8*
Reinsurance Companies	11	7
Takaful Operators	2	8
Retakaful Operators	0	2
Development Financial Institutions	14	13[2]

[1] Rationalisation of finance companies and commercial banks within a banking group.
[2] Of which six development financial institutions are regulated under the Development Financial Institutions Act 2002 (DFIA).

The Malaysian Financial Landscape Today



* Includes Islamic Financial Markets

Operating in parallel with conventional finance, Islamic finance has experienced rapid growth over the more recent period, enhancing its significance in the Malaysian financial system. The establishment of dedicated subsidiaries by banking groups to offer Islamic banking products and the entry of new foreign players in the Islamic banking, takaful and retakaful sectors has spurred the growth of Islamic banking assets, which expanded at an average annual rate of 19.3% since 2003 to constitute 15.4% of assets of the total banking system in 2007. Total assets of the takaful sector grew by 18.9% on average annually since 2003 to account for 6.9% of total assets of the insurance and takaful industry. The diversity of players has added a new dimension to financial services, not only in the delivery of financial products but also in the introduction of innovative financing structures such as *mudharabah* and *musharakah* to meet the varying needs of the economy.

Table 2
Assets of the Financial System

	1999	2007*p*
	RM billion	
Banking system	**803.4**	**1,651.8**
Bank Negara Malaysia	147.0	424.9
Commercial banks	471.0	1,050.2
Islamic banks	11.7	81.8
Investment banks	n.a.	94.9
Finance companies	115.9	n.a.
Merchant banks[1]	39.2	n.a.
Discount houses[1]	18.6	n.a.
Non-bank financial intermediaries	**367.2**	**824.1**
Provident, pension and insurance funds	243.6	526.1
Employees Provident Fund	*168.6*	*318.3*
Other provident and pension funds	*28.5*	*76.4*
Life insurance funds	*32.3*	*110.0*[2]
General insurance funds	*14.2*	*21.3*[2]
Development financial institutions[3]	22.4	128.3
Other financial intermediaries	101.2[4]	169.7[5]
Total	**1,170.6**	**2,475.9**

[1] These institutions have been rationalised to become investment banks.
[2] Includes assets of takaful funds.
[3] Includes DFIs not directly regulated by Bank Negara Malaysia.
[4] Includes unit trusts (ASN, ASB, ASW 2020 and ASM Mara), building societies, savings institutions, Pilgrims Fund Board, Credit Guarantee Corporation, Cagamas Berhad, leasing companies, factoring companies and venture capital companies.
[5] Includes unit trusts (ASN and ASN Mara), cooperative societies, leasing and factoring companies and housing credit institutions (comprising Cagamas Berhad, Borneo Housing Mortgage Finance Berhad and Malaysia Building Society Berhad).

p Preliminary
n.a. Not available
Note: Numbers may not necessarily add up due to rounding

The development financial institutions (DFIs) in the Malaysian financial system have also undergone a significant transformation in the recent few years. Six out of the 13 DFIs in the country are placed under the Bank's supervisory oversight since 2002. The policy focus to strengthen the DFIs through rationalisation and greater realignment of their roles and functions, has enabled them to better serve the economy and complement banking institutions in the mobilisation and allocation of funds to key growth areas in the economy, such as agriculture, international trade and, most notably, small and medium enterprises (SMEs). SME loans granted by the six DFIs regulated by the Bank now account for 12.1% (RM13.8 billion) of total outstanding loans channelled to the SME industry, while total outstanding loans by the six DFIs to the agriculture sector accounted for 12.9% (RM3.9 billion) of total loans granted to this sector as at end-2007.

More recently, the Malaysian Cooperatives Commission, proposed by Bank Negara Malaysia, was set up in January 2008 as a central body to spearhead the development of cooperatives in a holistic manner, focusing in particular on the stability and soundness of the cooperative sector. Cooperatives, given their wide distribution network across the nation, provide an additional avenue for micro enterprises to have access to financing, thus complementing the role of the banking institutions and DFIs. The Commission, which regulates more than 4,000 cooperatives nationwide, is expected to enhance the support to the cooperative sector, thereby enabling it to contribute to the socio-economic development of the nation.

With the evolution of a more diversified financial system, the capital market has assumed an increasingly significant role in mobilising and allocating resources to finance capital expenditures for both the public and private sectors. In the debt securities market, total outstanding debt securities increased from RM225 billion as at end-1999 to RM557 billion as at end-2007. Of significance is the rapid growth in the issuance of sukuk, which accounted for 40.7% of total debt security issuances in 2007 (RM122.9 billion) compared to only 13.4% in 1999 (RM20.3 billion). Malaysia is now the global leader in sukuk issuance, with 68.9% of the global outstanding sukuk having been originated in Malaysia in 2007, in line with the agenda to develop Malaysia as an international Islamic financial centre and a major centre for sukuk issuance, origination and trading. In the secondary market, the volume of debt securities traded has increased significantly in recent years, with higher sale and purchase transactions amounting to RM387.5 billion in 2007 (1999: RM151.2 billion). Malaysian Government Securities (MGS) still remain the most actively traded papers, accounting for 57.8% of total trading activities and with a turnover ratio of 1.16 times in 2007 (1999: 0.81 times).

Chart 1
Malaysia: Total Outstanding Debt Securities

The corporate sector has increasingly tapped the bond market to raise funds. The finance, insurance, real estate and business services sector has been the main issuer of PDS since 1999, accounting for 37.7% of the total funds raised in 2007 (1999: 21.5%). The transport, storage and communication sector accounted for 31.8% of the total funds (1999: 35.7%), while 15.2% was attributed to the utilities sector (1999: 0.3%). While PDS issuances with tenures between one and 10 years continue to constitute the bulk of new PDS issues, the PDS yield curve has lengthened considerably over the last few years. This provides long-term investment options for investors, especially insurance companies that require long-dated investment instruments to reduce their asset-liability mismatches.

Chart 2
Size of Corporate Debt Securities Market against Corporate Loans

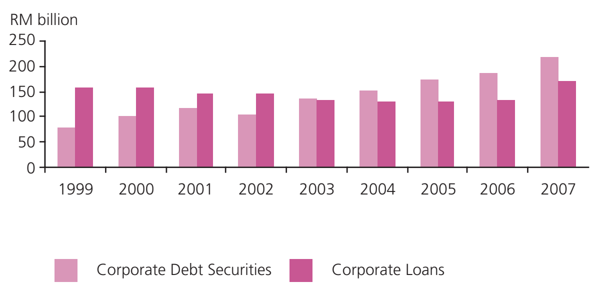
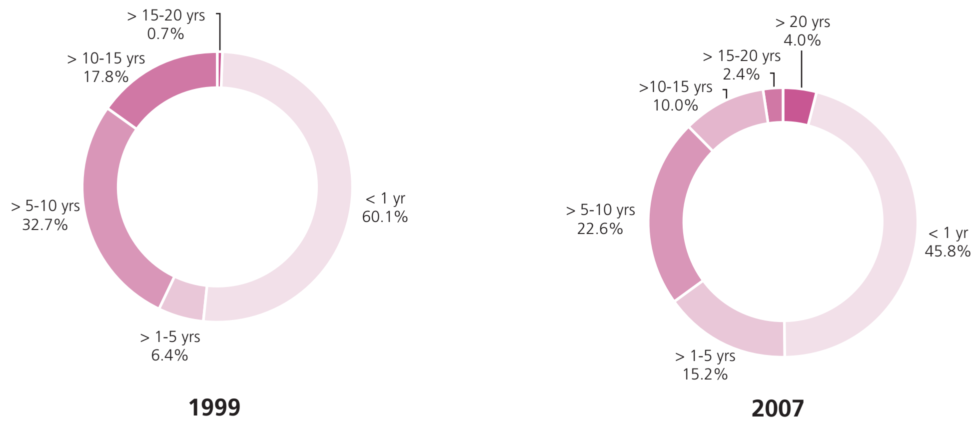


Chart 3
PDS Issues by Tenure



Consequently, life insurance companies are today active investors in the capital market after banking institutions and the Employees Provident Fund. Investments by direct insurers in MGS grew from RM6.2 billion in 1999 to RM18.7 billion in 2007, to account for more than 10% of total MGS holdings as at end-2007. Similarly, insurers' investments in PDS increased from RM6 billion to RM32.3 billion over the same period to constitute more than 16% of total PDS outstanding as at end-2007.

Demonstrating the increased attractiveness of the Malaysian market to foreign institutional investors in view of the conducive operating and legal environment, foreign investor holdings in the debt securities market have risen from RM0.8 billion or 0.3% of total outstanding debt securities as at end-2001, to RM81.4 billion or 14.7% as at end-2007. As larger players in the debt securities market, these investors contribute towards enhancing the overall liquidity of the market through an expanded investor base and by providing an alternative source of demand for papers. The expansion of the Real-time Electronic Transfer of Funds and Securities (RENTAS) settlement infrastructure to include USD-MYR transactions via the implementation of Payment versus Payment and Delivery versus Payment links with Hong Kong in 2006 and 2007 respectively also facilitates the simultaneous settlement of ringgit and US dollar payments and securities during Malaysian business hours. This has allowed market participants to better manage their foreign exchange settlement risk.

The other components of the financial markets, namely the equities, money, foreign exchange and derivatives markets have demonstrated improved performance over the past decade. The total market capitalisation of Bursa Malaysia has risen from RM553 billion as at end-1999 to RM1.1 trillion as at end-2007. The robust development of the money market has also facilitated the channelling of short-term funds between financial institutions to meet their funding and portfolio adjustment requirements, with the total volume of money market transactions in 2007 growing to RM2.8 trillion (1999: RM1.4 trillion). Similarly, the foreign exchange market has witnessed an increase in foreign exchange transactions, including hedging transactions. The narrowing of bid-offer spreads in the foreign exchange market indicate a more refined and maturing market. Derivative contracts, uncommon previously, have increased with the advent of financial innovation that has led to more advanced and sophisticated product offerings in the derivatives market. Apart from being used as hedging instruments, derivatives are also used by financial institutions to further expand the variety of investment products offered to sophisticated clients.

Strong Players with Domestic and Regional Presence

The growing business complexities arising from the increased convergence of activities and intensified competition have compelled financial institutions to reengineer themselves to focus on their core competencies, optimise operational efficiencies and diversify revenue streams in order to increase productivity. Among other things, greater efficiency and productivity have been achieved through the outsourcing of non-core business operations such as data processing, the marketing of products and services and information and communication technology infrastructure to external parties, both onshore and offshore. Domestic and locally-incorporated foreign banking institutions have also established centralised data processing centres in Malaysia which cater to their businesses locally and abroad. This development augurs well towards promoting Malaysia as a shared services and outsourcing centre.

The evolution of the financial system has also been driven by the diversity of shareholders that bring new strategic and management perspectives, new innovations and increased business opportunities. Flexibilities granted for financial institutions to enter into strategic alliances with both foreign and domestic institutions have brought about greater opportunities for synergistic and collaborative arrangements that maximise the potential of domestic institutions. Domestic players are able to leverage on the international expertise and capabilities that these institutions bring, and benefit from the transfer of knowledge, skills, technology and innovation.

The strengthened capacity of domestic financial institutions brought about by the rationalisation exercise and capacity building efforts has enabled the expansion of domestic financial institutions' business operations abroad. To date, six domestic banking groups have a presence in 19 countries in the form of branches, representative offices and subsidiaries. The intensified regional and overseas expansions by domestic banking groups are in recognition of the growing business opportunities within the region brought about by increasing liberalisation and integration amongst the regional economies. Such ventures will diversify their earnings capacity and enhance their business potential beyond the domestic market. Total assets of the overseas operations of domestic banking groups amount to approximately RM111.6 billion, while the average contribution of total overseas profits to total group profits is 10.7% (2002: -4.3%). Revenue and profit contributions from overseas operations are expected to grow further in significance over the next few years with the strengthening of the presence of domestic financial institutions abroad, and as investments in these countries progressively mature.

Comprehensive Range of Products and Services to Support Economic Needs

Deposit products offered by banking institutions have evolved over the years to cater for changes in customers' risk-return and liquidity preferences. Today, deposit products have broadened in range from plain vanilla deposits to structured products that offer returns tagged to the performance of underlying assets, currency movements or indices. In line with robust economic growth, total deposits placed with banking institutions during the period 2000-2007 grew at an average annual rate of 8.5%. Deposits now account for 172.5% of GDP. With the establishment of the Malaysia Deposit Insurance Corporation in 2005, depositors are guaranteed for up to RM60,000 on total deposits placed with a single member institution, that is commercial banks and Islamic banks.

In terms of financing, the growth over the recent decade has been predominantly attributed to lending to the household sector, fuelled by higher consumer spending that is supported by rising incomes and positive labour market conditions. The share of outstanding loans to individuals and the household sector increased from 35% in 1999 to 55.9% of total outstanding loans as at end-2007. As the larger corporates turn to the capital market to meet their funding needs, lending strategies have also focused on capturing a greater share of the market for SMEs. As at end-2007, loans to SMEs accounted for 43.6% of outstanding business loans compared to 30% in 1999. Most banking

Table 3
Sources and Uses of Funds of the Financial System

	1999	2007*p*
	RM billion	
Sources:		
Capital, reserves and profit	113.2	227.6
Currency	30.5	42.2
Deposits	561.3	1,147.1
Borrowings	31.9	112.8
Funds from other financial institutions[1]	69.6	122.7
Insurance, provident and pension funds	213.9	486.2
Other liabilities	153.9	337.2
Total	**1,174.3**	**2,475.9**
Uses:		
Currency	9.4	9.0
Deposits with other financial institutions	178.8	468.8
Loans and advances[2]	489.4	861.4
Securities	261.3	661.2
Treasury bills	*3.7*	*2.0*
Commercial bills	*12.8*	*10.9*
Malaysian Government Securities (MGS)	*75.4*	*202.0*
Corporate[3]	*163.0*	*355.8*
Private Debt Securities (PDS)	*n.a.*	*175.1*
Equities	*n.a.*	*180.8*
Foreign	*1.5*	*5.2*
Others	*4.9*	*85.3*
Gold and forex reserves	113.8	334.4
Other assets[4]	121.5	141.1

[1] Equal savings, fixed and other (NIF, LPHT, etc.) deposits + NIDs + repos.
[2] Includes statutory reserves of banking institutions.
[3] Breakdown of Corporate Securities between Private Debt Securities (PDS) and Equities available from 2003.
[4] Effective 2006, portions of 'Other assets' have been re-classified.

p Preliminary
n.a. Not available
Note: Numbers may not necessarily add up due to rounding

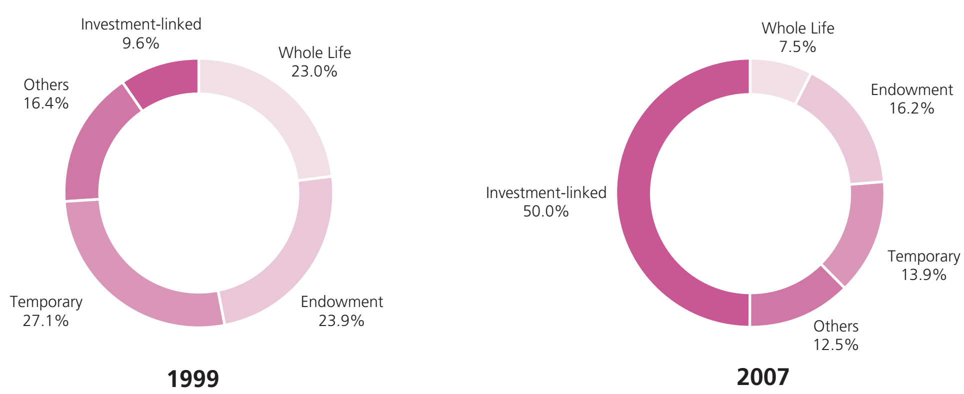
institutions have expanded their financing role to include providing developmental and advisory services to their SME clients, thus contributing towards strengthening the growth potential of the SME sector. Given that about 80% of the SMEs in Malaysia are micro enterprises, several banking institutions have also begun to offer microfinance products to capitalise on opportunities in this untapped market.

Banking institutions have further evolved from their traditional lending role to providing more comprehensive financial solutions that offer end-to-end value added services to their customers. Given the increasingly sophisticated and affluent consumer market, portfolio and wealth management services as well as private banking catering to the needs of high net worth clients, have expanded considerably over the last few years.

In terms of delivery channels, the traditional concept of bank branches has evolved to cater for customised market segments of banking institutions. The reconfiguration of branches into specialised, customer-centric centres now allows banking institutions to serve customers in a more efficient and effective manner. Technological advancements have also provided a further impetus for the evolution of the branch network, with electronic terminals and 24-hour internet banking facilities increasingly substituting the services which were previously performed over the counter. The offering of insurance products through the branches of the banking institutions under bancassurance arrangements has also grown in importance in recent years. More recently, banking institutions have formed strategic alliances with unit trust and wealth management companies to offer a wider array of investment-linked and capital market-related products to customers. Other tie-ups include using retail stores as cheque collection points and providing remittance services in collaboration with specialised service providers. These activities have contributed towards increasing the fee-based income generated by the banking system by an average annual rate of 11.3% since 2000.

Insurance companies have also expanded their product lines to include mortgage financing. The mortgage financing facilities are typically long-term assets of the life insurers, providing them with a natural maturity-hedge for their long-term insurance liabilities. Mortgage loans extended by life insurers grew by 7.4% in 2007 to account for 3.4% share of the total assets of life insurance funds (1999: 2.8%). Insurance products have also advanced from the traditional life products which offer pure protection coverage to those which are investment-linked in nature. As at end-2007, investment-linked premiums account for 50% of total new business premiums written, as compared to 9.6% in 1999.

Chart 4
Distribution of New Business Premiums of Direct Life Insurers



In line with the objective of promoting greater financial inclusion and more equitable growth in the economy, strategies to encourage financial institutions to widen their outreach to consumers have begun to yield encouraging results. Various initiatives have been taken to encourage banking institutions to leverage on alternative modes of bank branches such as mobile units and other service providers to serve a wider segment of the population. Today, the estimated population size served per bank branch nationwide has decreased from 8,262 in 1999 to 7,931 as at end-2007. As at end-2007, 27% of bank branches are domiciled in non-metropolitan areas.

Conclusion

The Malaysian financial system has developed and grown in maturity since the Asian financial crisis. The sector has advanced from being an enabler of economic growth to a source of growth in its own right, sustained by continuous and progressive achievements in institutional development as well as infrastructure building and enhancement. Players in the financial system have continued to innovate and reinvent themselves to better serve consumers and the economy as a whole, as well as to remain relevant in the increasingly competitive financial landscape. Financial markets have also continued to develop in depth and breadth, complementing the role of the banking sector in financing economic activities. As the financial system advances to the next stage of development, this evolution will be important to ensure that it continues to support the needs of the economy, while maintaining financial stability.

Key Developments in the Malaysian Financial Sector

Institutional Developments

- Industry-wide consolidation into nine domestic financial conglomerates
- Rationalisation of commercial banks and finance companies
- 14 investment banks from integration of discount houses, merchant banks, stock broking companies and universal brokers
- Establishment of Islamic banking subsidiaries
- Strategic alliances with foreign institutions/specialised service providers
- Six domestic banking groups with presence in 19 countries
- Restructuring and rationalisation of DFIs
- Growing sophistication and diversification of products and services of financial institutions
- Expanded and more efficient delivery channels

Financial Market Developments

- Third largest bond market in Asia in relative terms to GDP (Asian Bonds Online)
- Largest sukuk issuer globally, accounting for 68.9% of total global sukuk outstanding as at end-2007
- Stronger participation of corporate sector in debt securities market with corporate debt securities accounting for 56.2% of total corporate financing (1999: 36%)
- Foreign investor holdings in debt securities market account for 14.7% of total outstanding debt securities (2001: 0.3%)
- Market capitalisation of Bursa Malaysia: RM1.1 trillion (1999: RM553 billion)
- Volume of money market transactions: RM2.8 trillion (1999: RM1.4 trillion)
- Volume of spot and swap transactions in Kuala Lumpur foreign exchange market: RM1.2 trillion (1999: RM647.8 billion)

Infrastructure Developments

- Access to financing
  - Credit Guarantee Corporation Bhd
  - Cooperatives Commission (2008)
- Access to assistance in financial matters
  - Small Debt Resolution Scheme (2003)
  - Financial Mediation Bureau (2005)
  - Malaysia Deposit Insurance Corporation (2005)
  - Credit Counselling & Debt Management Agency (2006)
- Access to financial information
  - Islamic Interbank Money Market website (2004)
  - Fully Automated System for Issuing/Tendering (FAST) (2005)
  - *Laman Informasi, Nasihat & Khidmat* (LINK) (2005)
  - BNM TELELINK (2007)
  - Bond Info Hub (2007)
  - BankingInfo, InsuranceInfo & SMEInfo portals
- Credit risk management
  - Central Credit Reference Information System (CCRIS) (2001)
- Human capital development
  - International Centre For Leadership In Finance (ICLIF) (2003)
  - International Centre for Education in Islamic Finance (INCEIF) (2006)
  - Financial Sector Talent Enrichment Programme (FSTEP) (2008)
- Review of legislative framework
  - Development Financial Institutions Act 2002
  - Payment Systems Act 2003