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).

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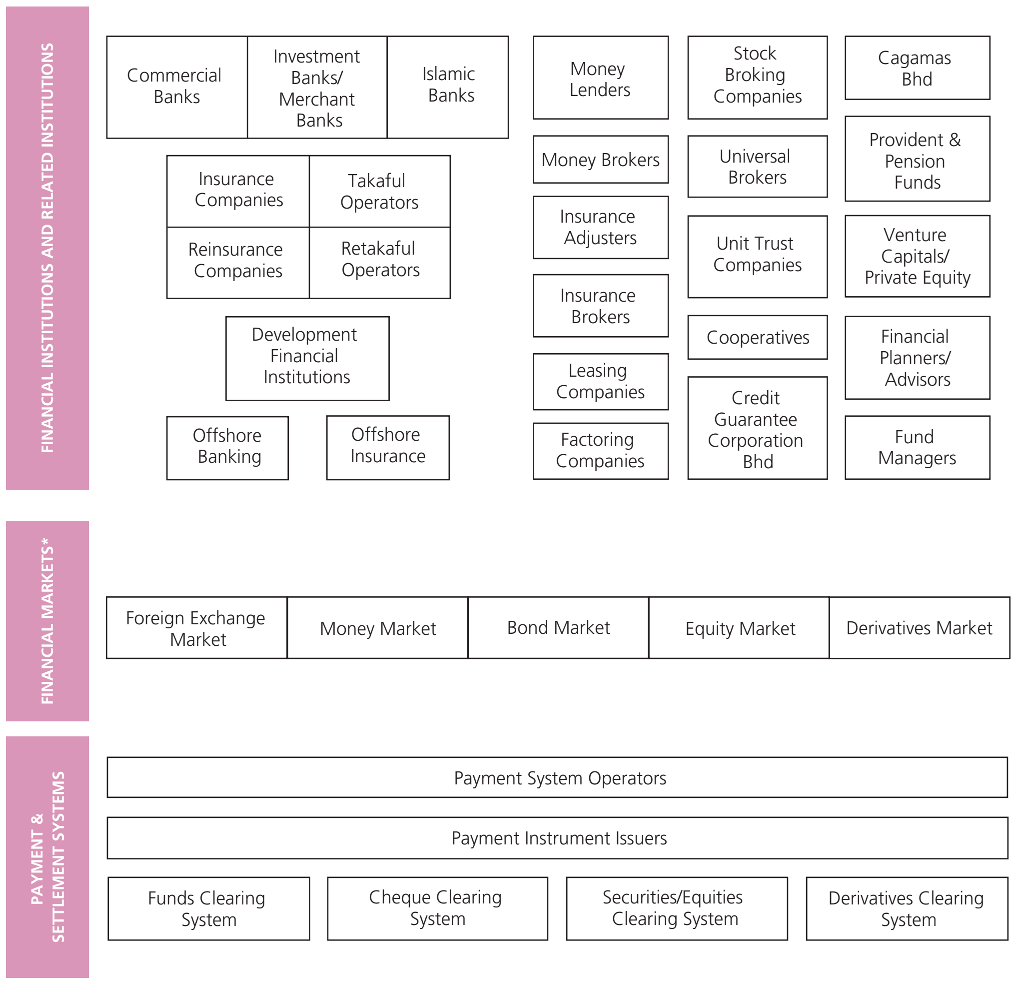

* Includes Islamic Financial Markets

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).

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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.

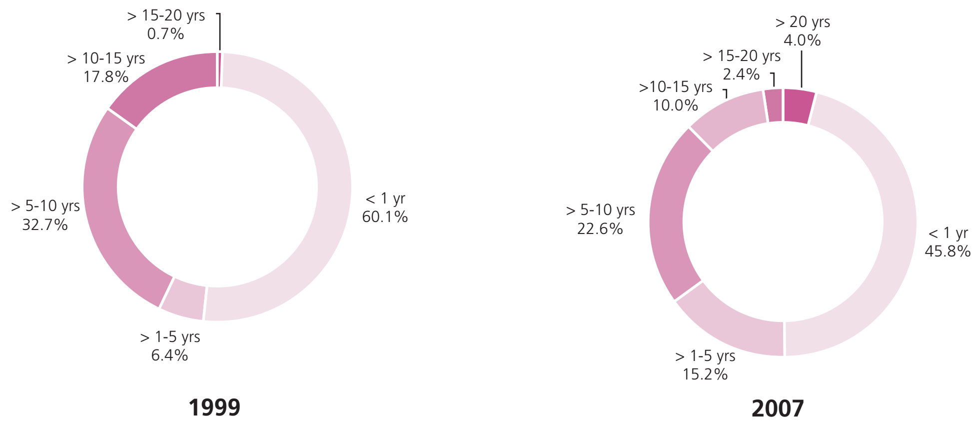
With the evolution of a more diversified financial system, the capital market has assumed an increasingly significant role in mobilising and allocating resources to finance capital expenditures for both the public and private sectors. In the debt securities market, total outstanding debt securities increased 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.

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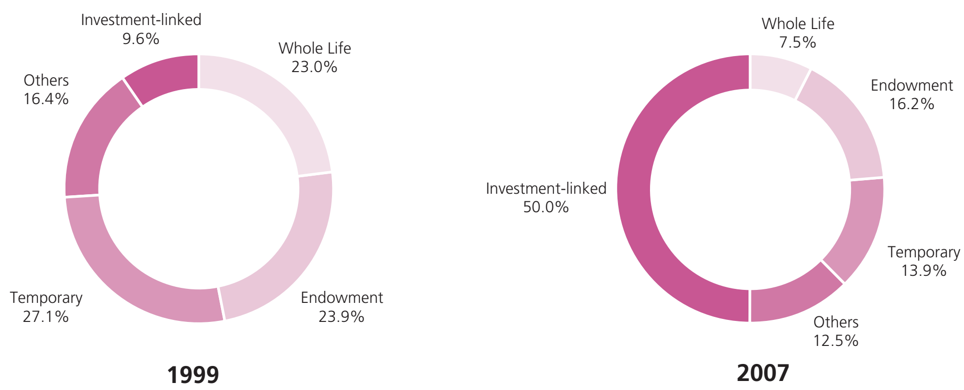
institutions have expanded their financing role to include providing developmental and advisory services to their SME clients, thus contributing towards strengthening the growth potential of the SME sector. Given that about 80% of the SMEs in Malaysia are micro enterprises, several banking institutions 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