

# Overview of the Financial System

## COMPONENTS OF THE FINANCIAL SYSTEM

Malaysia has a modern and comprehensive financial system that continues to evolve in response to the changing domestic and international conditions. Financial reforms, including the structural changes that proceeded after the Asian financial crisis, have evolved a more diversified, broader and deeper financial system, supporting Malaysia's economic growth through a more efficient intermediation process and strengthening Malaysia's interlinkages with the global economy and international financial system.

**Financial reforms have evolved a more diversified, broader and deeper financial system supporting Malaysia's economic growth.**

Bank Negara Malaysia and the banking industry consisting of commercial banks, investment banks and Islamic banks make up the **banking system**. In Malaysia, Islamic and conventional banking systems coexist and operate in parallel. Islamic banking activities are conducted either by Islamic banks that exclusively carry out Islamic banking, or through Islamic banking windows or subsidiaries set up by conventional banks. The ongoing modernisation of the financial system has seen the introduction of investment banks to the banking landscape in 2006 with the integration of discount houses, merchant banks and stockbroking companies.

The **non-bank financial intermediaries** (NBFIs) complement the banking institutions in mobilising savings and meeting the requirements of specific economic sectors. These institutions also play an important role in the development of the capital market and in providing social security. Development financial institutions (DFIs), provident and pension funds, insurance companies, takaful operators, savings

**Table 1.1**  
**Financial Institutions Regulated by Bank Negara Malaysia**

	2006
<b>Banking system</b>	
Commercial banks	22
Investment banks <sup>1</sup>	14
Islamic banks	10
<b>Non-bank financial intermediaries</b>	
Development financial institutions <sup>2</sup>	6
Direct insurers	42
Professional reinsurers <sup>3</sup>	6
Takaful operators	8

<sup>1</sup> Includes merchant banks and discount houses which have been rationalised to become investment banks

<sup>2</sup> The DFIs regulated by Bank Negara Malaysia under the Development Financial Institutions Act 2002 are Bank Pembangunan Malaysia Berhad, Bank Perusahaan Kecil & Sederhana Malaysia Berhad (SME Bank), Export-Import Bank of Malaysia Berhad, Bank Kerjasama Rakyat Malaysia Berhad, Bank Simpanan Nasional and Bank Pertanian Malaysia

<sup>3</sup> Includes two professional reinsurers which have also been granted professional retakaful licences

institutions and unit and property trusts account for the bulk of total assets of NBFIs.

Banking institutions, insurance companies, takaful operators and six DFIs are regulated by Bank Negara Malaysia. DFIs are specialised financial institutions established by the Government with specific mandates to develop and promote strategic sectors of the economy. DFIs complement the banking system by providing financial resources to support activities in areas that have been identified as strategic sectors for socio-economic development purposes. This includes financing for new growth areas such as agro-based industries, as well as lending to support export activities in non-traditional markets and projects with long gestation periods or that are capital-intensive. DFIs are also instrumental in supporting the development of small and medium enterprises by providing access to financing for start-up businesses and entrepreneurs with limited credit history and inadequate collateral. The deposit-taking DFIs mobilise savings of the small savers

and provide financing to individuals, particularly those from the low income groups, as part of their mandates.

Assets of the banking system and NBFIs expanded by 9.3% to RM2,091.2 billion (2005: RM1,912.7 billion), constituting 382.8% of gross domestic product (GDP), at the end of 2006. Changes in the contribution of assets by types of institutions reflected the continuing transformation of the financial system.

### Growth momentum in Islamic banking system expected to continue, supported by new players and strong demand for Shariah-compliant financial products and services.

Notably, the merger between discount houses and merchant banks following the implementation of the investment banking framework resulted in an increase of 28.6% in assets of merchant banks. Consequently, the share of the assets of the merchant banks rose to account for a higher share of 2.9% (2005: 2.5%) of total assets of the financial system. Assets of the Islamic banking system (including Islamic banking windows operated by conventional banks) continued to expand at a strong pace, increasing at an average annual rate of 18.9% since 2000, supported by strong demand for Shariah-compliant financial products and services. As at the end of 2006, assets of the Islamic banking system accounted for RM133 billion or 6.4% (2005: 5.8%) of total assets in the financial system. The growth momentum in this sector is expected to continue with the commencement of operations by a wholly-owned foreign Islamic banking institution and three Islamic subsidiaries of domestic banking institutions in 2006, and the national aspiration to position Malaysia as an international Islamic financial centre.

The expansion in assets of NBFIs mainly reflected the higher increase in assets of the Employees Provident Fund, life insurance funds and DFIs. Improved investment results and growth

**Table 1.2**  
**Assets of the Financial System**

	Annual change		As at end-2006 <sup>p</sup>
	2005	2006 <sup>p</sup>	
RM billion			
<b>Banking system</b>	67.9	135.4	1,415.5
Bank Negara Malaysia	10.6	27.6	323.0
Commercial banks <sup>1</sup>	40.4	83.3	951.5
Merchant banks <sup>2</sup>	4.2	13.4	60.3
Islamic banks	18.6	30.3	73.8
Discount houses <sup>2</sup>	-5.9	-19.2	6.8
<b>Non-bank financial intermediaries</b>	79.9	43.0	675.8
Provident, pension and insurance funds	39.7	44.4	467.5
<i>Employees Provident Fund</i>	23.4	26.4	290.2
<i>Other provident and pension funds</i>	5.7	5.1	61.9
<i>Life insurance funds<sup>3</sup></i>	9.0	11.3	90.8
<i>General insurance funds<sup>3</sup></i>	1.6	1.6	24.6
Development financial institutions <sup>4</sup>	8.4	14.2	114.0
Other financial intermediaries <sup>5</sup>	31.8	-15.6	94.2
<b>Total</b>	<b>147.8</b>	<b>178.5</b>	<b>2,091.2</b>

<sup>1</sup> Includes finance companies and Islamic banking windows operated by conventional banks

<sup>2</sup> These institutions have been rationalised to become investment banks

<sup>3</sup> Includes assets of takaful funds

<sup>4</sup> Including DFIs not directly regulated by Bank Negara Malaysia

<sup>5</sup> Includes unit trusts run by Amanah Saham Nasional Berhad (ASNB) and Amanah Saham Mara Berhad, cooperative societies, leasing and factoring companies and housing credit institutions (comprising Cagamas Berhad, Borneo Housing Mortgage Finance Berhad and Malaysia Building Society Berhad)

<sup>p</sup> Preliminary

Note: Numbers may not necessarily add up due to rounding

in lending and life insurance activity contributed to the increase in assets of NBFIs. As a group, the contribution of NBFIs to total assets of the financial system remained relatively stable at 32.3% (2005: 33.1%).

The financial markets in Malaysia comprise the money and foreign exchange markets, the capital market and the derivatives market. The Malaysian financial markets, recognised as one of the most developed in the region, have shown tremendous growth. In the **money market**, interbank deposits and a broad range

**Table 1.3**  
**Money Market<sup>1</sup>**

	2005	2006
	Volume (RM billion)	Volume (RM billion)
<b>Total money market transactions</b>	<b>1,868.3</b>	<b>2,086.8</b>
Interbank Deposits	887.6	876.1
Mudharabah Interbank Investments	254.7	256.1
<b>Money market instruments</b>	<b>726.0</b>	<b>954.7</b>
Repurchase Agreements	264.4	390.8
Malaysian Treasury Bills	8.5	9.4
Malaysian Islamic Treasury Bills	4.5	6.0
Bank Negara Bills/Bank Negara Monetary Notes <sup>2</sup>	50.4	78.5
Bank Negara Negotiable Notes/ Bank Negara Monetary Notes (Islamic) <sup>2</sup>	36.1	58.2
Bankers' Acceptances	44.2	49.9
Islamic Accepted Bills	9.4	12.2
Negotiable Instruments of Deposits	39.0	50.8
Negotiable Islamic Debt Certificates	8.6	14.9
Malaysian Government Securities	179.4	203.6
Government Investment Issues	43.2	61.9
Khazanah Bonds	20.3	4.0
Cagamas Bonds	16.3	11.4
Cagamas Notes	0.0	0.6
Islamic Cagamas Bonds	1.8	2.4

<sup>1</sup> All data are sourced from the Bonds Information and Dissemination System (BIDS), except for Interbank Deposits, Mudharabah Interbank Investments, Bankers' Acceptances, Islamic Accepted Bills, Negotiable Instruments of Deposits and Negotiable Islamic Debt Certificates, which are sourced from money brokers

<sup>2</sup> Bank Negara Bills and Bank Negara Negotiable Notes will be replaced by the issuance of Bank Negara Monetary Notes

Note: Numbers may not necessarily add up due to rounding

of short-term money market instruments, including Islamic instruments, facilitate the smooth channelling of funds between market participants with surplus funds and participants facing temporary funding shortfalls. Active trading by participants in the money market, which include commercial banks, investment banks, insurance companies, universal brokers and DFIs, resulted in the total volume of transactions in 2006 amounting to RM2,086.8 billion. The volume transacted continued on an uptrend, largely centered on trading of Malaysian Government Securities (MGS) with repurchase agreements increasing significantly since 2005 following the introduction of the

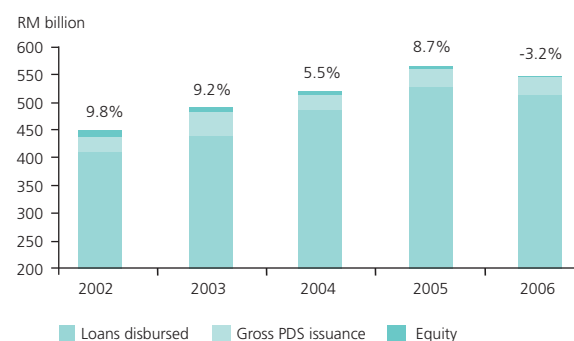
Institutional Securities Custodian Program (ISCAP), the regulated short-selling framework and a securities lending facility for principal dealers that further improved liquidity in the MGS market.

A well-developed **capital market** in Malaysia, comprising the equity and bond markets, provides an alternative and cost-efficient source of medium and long-term capital for corporates. 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 in both the public and private sectors. Total bonds outstanding (public and private) reached RM415.9 billion, or 76.1% of GDP as at the end of 2006, while the total market capitalisation of Bursa Malaysia was RM848.7 billion, or 155.3% of GDP.

### Capital market assuming more significant role, with increased breadth and depth.

Net funds raised in the capital market were lower at RM30.2 billion in 2006 (2005: RM41.7 billion), mainly due to higher redemptions of bonds maturing during the year. Funds raised in the capital market complemented loans extended by the banking system as an important source of financing for the private

**Chart 1.1**  
**Private Sector Gross Financing through the Banking System and the Capital Market**



Note: % refers to annual change

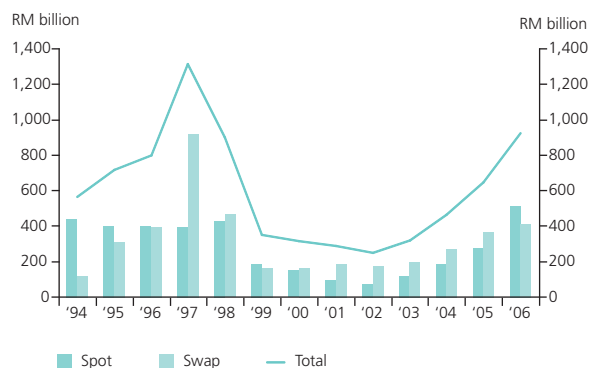
sector. In 2006, fund raising activity in the corporate bond market was sustained at a high level, while financing via the equity market was more subdued. Overall, total gross financing via the equity and private debt securities (PDS) markets for the year amounted to RM32.7 billion (2005: RM37.1 billion) or 6% of aggregate financing by the banking system and capital market.

Both the bond and equity markets have continued to broaden to include new asset classes such as real-estate investment trusts, exchange-traded funds and variations of Islamic securities. The Islamic bond market has been a leading segment of growth in the bond market, accounting for 31.3% of total bonds outstanding as at end-2006. During the year, issuances of Islamic medium-term notes and bonds contributed 50.3% of PDS issued. In recent years, an increasing array of new Islamic financial instruments have been developed and used in financial market activities, including the Bank Negara Malaysia Sukuk Ijarah, Bank Negara Monetary Notes, Islamic residential mortgage-backed securities, and most recently, the Commodity Murabahah Programme by Bank Negara Malaysia. This trend is expected to continue with the presence of new players in the market following the issuance of new Islamic banking licences by Bank Negara Malaysia.

A substantial part of trading activities in the interbank (i.e. wholesale) money and bond markets is arranged through money brokers. As at end-2006, there were eight licensed money brokers in operation. Total transactions executed through money brokers accounted for more than 65% of the total volume transacted in the money and bond markets in 2006.

An active **foreign exchange market** is supported by the continued expansion in economic activity and private investment, coupled with larger portfolio flows. Since the exchange rate was floated in July 2005, the increase in portfolio flows as well as hedging transactions have been key drivers of increased activity in the Kuala Lumpur interbank foreign exchange market. The total volume of spot and swap transactions

**Chart 1.2**  
**Volume of Interbank Transactions in the Kuala Lumpur Foreign Exchange Market**



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

in the Kuala Lumpur foreign exchange market amounted to RM925.9 billion in 2006, representing a significant increase of 42.4% from the previous year, with the bulk of transactions in ringgit against the US dollar.

The **derivatives market**, encompassing both over-the-counter (OTC) and exchange-traded derivatives, coexists with, and complements, the financial markets in offering additional financial products for risk management and investment purposes. Transactions in the OTC market were mainly concentrated in foreign currency and interest rate forward and swap contracts. In 2006, foreign currency forward and swap transactions undertaken with banking institutions in notional terms increased by 30.6% to RM208.4 billion (2005: RM159.6 billion). Total interest rate swaps with banking institutions were also significantly higher by 95.3% at RM364.4 billion (2005: RM186.6 billion). Meanwhile, in the exchange-traded derivatives market, a total of 4.2 million contracts were traded in 2006, up 66.4% from 2005. The Crude Palm Oil (CPO) futures and Kuala Lumpur Composite Index (KLIC) futures were the most actively traded instruments on Bursa Malaysia Derivatives, accounting for over 90% of the total volume traded on the exchange, while Kuala Lumpur Interbank Offer Rates (KLIBOR) futures, MGS futures and palm kernel oil futures accounted for the remaining volume of transactions.

An essential part of the financial infrastructure is the **payment system**. The development of an efficient, reliable and secure payment system has been instrumental in facilitating settlement, custody and delivery of financial products and services. The real time gross settlement system (RENTAS) for large-value interbank funds transfers and scripless securities, and SPICK, the image-based cheque clearing system, were introduced by Bank Negara Malaysia in 1999 and 1997 respectively. These are complemented by other proprietary systems owned and operated by financial institutions. They include the Interbank Giro (the batch-oriented inter-bank funds transfer system), e-Debit (the domestic debit card network) and Financial Process Exchange (the Internet payment system) operated by the Malaysian Electronic Payment System (1997) Sdn. Bhd. (MEPS) which is owned by the domestic banks. There are currently two shared automated teller machine (ATM) networks in Malaysia, the MEPS network for the domestic banks and several development financial institutions, and the HOUSE network for the locally-incorporated foreign banks. Clearing and settlement systems for securities (other than scripless securities settled through RENTAS) and derivatives are operated by Bursa Malaysia Berhad.

### FINANCIAL INTERMEDIATION – SOURCES AND USES OF FUNDS

Deposits placed with financial institutions and contributions to the provident, pension and insurance funds represent the main sources of financing for the financial system. Banking institutions remained the largest mobiliser of total deposits of the financial system, accounting for 77.1% of total outstanding deposits in 2006, while contributions to provident and pension funds continued to be largely dominated by the Employees Provident Fund which accounted for more than 90% of total contributions. Total resources of the financial system are mainly channelled into loans and advances, largely extended by banking institutions, as well as investments in securities.

**Table 1.4**  
**Sources and Uses of Funds of the Financial System**

	Annual change		As at end-2006p
	2005	2006p	
RM billion			
<b>Sources:</b>			
Capital and reserves	13.6	26.6	207.2
Currency	2.0	3.5	37.9
Deposits	87.5	128.0	1,051.1
Borrowings	3.4	2.6	58.6
Funds from other financial institutions <sup>1</sup>	12.5	-8.4	75.8
Insurance, provident and pension funds	35.7	11.5	385.1
Other liabilities	-6.9	14.7	275.4
<b>Total</b>	<b>147.8</b>	<b>178.5</b>	<b>2,091.2</b>
<b>Uses:</b>			
Currency	1.0	-0.4	5.7
Deposits with other financial institutions	11.5	62.8	322.2
Loans and advances <sup>2</sup>	65.9	43.7	765.3
Securities	39.8	16.4	489.3
<i>Treasury bills</i>	1.3	0.0	1.7
<i>Commercial bills</i>	-1.3	-1.1	6.0
<i>Malaysian Government (MGS)</i>	14.2	1.1	154.8
<i>Corporate</i>	20.9	14.5	306.1
<i>Private Debt Securities</i>	10.2	-1.2	139.2
<i>Equities</i>	9.8	15.7	166.9
<i>Foreign</i>	2.1	0.6	7.3
<i>Others</i>	3.7	1.2	13.4
Gold and foreign exchange reserves	15.4	25.7	288.9
Other assets	14.1	30.4	219.8

<sup>1</sup> Includes statutory reserves of banking institutions

<sup>2</sup> Excludes loans sold to Danaharta

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Note: Numbers may not necessarily add up due to rounding

### PERFORMANCE OF THE FINANCIAL SECTOR

#### Banking Sector

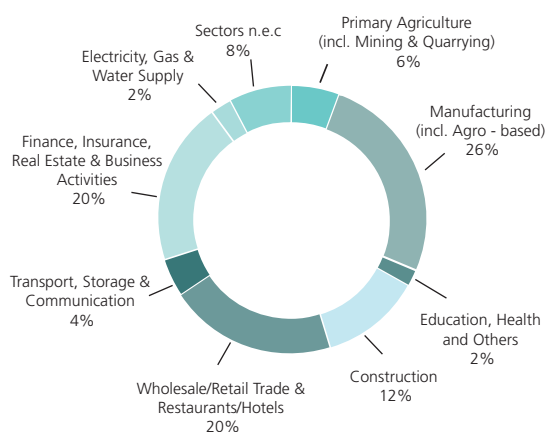
The banking sector, both conventional and Islamic, remains as the mainstay of the intermediation function within the economy and has strengthened further its role as an enabler of economic growth. Developments in the

economic, business, operating and regulatory environment have all contributed to the robust, sound and competitive banking sector that is seen today. Public access to banking and financial services continued to improve via the extensive branch network and modern delivery channels which leverage on advancements in information and communications technology such as the desktop and Internet as well as mobile phones. Growth in deposits mobilised by the banking sector averaged at an annual rate of 9.4% over the past six years, not only in volume terms but also in terms of diversity and product range. Similarly, more diverse and increasingly complex loan packages and financing instruments are being offered to meet the evolving needs of the economy. As at end-2006, deposits mobilised by the banking sector amounted to RM810 billion or 148.2% of GDP, whilst loans and financing remained steady at 108.5% of GDP amidst greater disintermediation by the capital market. The return on equity averaged at 16.1% in 2006. In terms of employment, a total of 100,414 persons (2000: 96,159 persons), representing about 1% of the labour force, were employed in the banking sector.

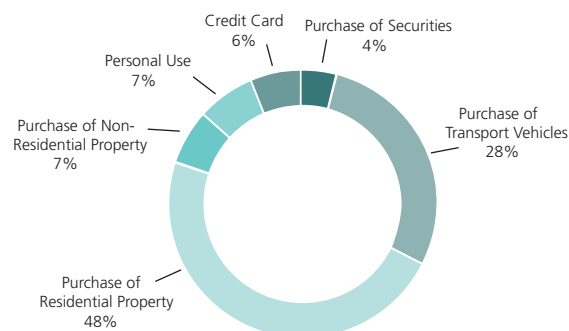
### ***Sustained lending activities***

Lending and financing activities were more moderate in 2006 influenced by the more cautious attitude and sentiments on the demand side during the early part of the year. Outstanding loans by

**Chart 1.3**  
**Lending to Business Sectors**



**Chart 1.4**  
**Lending to Households**



the banking system expanded by 6.3% to RM593 billion as at end-2006 (end-2005: RM558.1 billion). Portfolio rebalancing and strategies aimed at capturing greater market share in the retail sector amidst greater use of capital market funding by large businesses, have resulted in greater concentration in the retail-based sectors. Loans and financing extended to the household sector and the small and medium enterprises (SMEs) now account for 56.2% and 17.6% of banking system loans respectively, with emerging emphasis on micro enterprises. Loans extended to individuals were mainly in the form of mortgages (48%) and car financing (27%) while lending to SMEs was primarily concentrated in wholesale and retail trade (25%), manufacturing (25%), finance, real estate and business-related (14%), and construction-related (13%) industries. Non-performing loans (NPLs) continued to improve, underpinned by higher reclassification of NPLs to performing status and recoveries, as well as efforts to achieve healthier balance sheets via loan write-offs. This resulted in the decline in net NPLs based on the 3-month classification basis by 12.7% to RM27.4 billion to account for 4.8% of net loans as at end-2006.

### ***Strong capitalisation supported by active capital management activities***

Capital ratios remained high and well in excess of the minimum requirement. The risk-weighted capital ratio (RWCR) had consistently exceeded 12.5% throughout the year. The strong capital position also provided a sizeable buffer against

unexpected losses arising from credit and market risks.

Greater capital management activity has been observed in recent periods. With intensifying competition and increased pressures to ensure sustainable and attractive long-term returns to shareholders, many banking institutions have undertaken efforts to diversify and enhance the cost efficiency of capital. This has been facilitated by greater regulatory flexibility and innovations in capital management activities. Higher issuances of Tier-2 subordinated debt capital led to the decline in composition of Tier-1 capital to 71.6% of total capital as at end-2006 from 73.3% two years ago. At the same time, innovation in capital instruments has also seen the emergence of hybrid capital instruments, with characteristics of both debt and equity, which qualify for innovative Tier-1 capital. On aggregate, the core capital ratio was 10.3% as at the end of the year.

### **Improved productivity and efficiency contributed to sustained profitability**

Preliminary unaudited pre-tax profit rose by 4.7% to RM13 billion, driven mainly by higher revenue from lending and financing activities, the provision of remittance and settlement services, as well as trading activities. The higher profit level reflected greater diversification in the business portfolios of banking institutions. Banking institutions have also ventured into new business areas such as the offering of investment-linked products, cross-selling of bancassurance and unit trust products, wealth management and other ancillary financial services. Greater operational flexibility accorded to banking institutions coupled with innovations in products and delivery channels further contributed towards improved efficiency and profitability.

Net interest income improved by 10.8% in line with continued growth in lending and financing activities, interbank transactions, as well as increased treasury activities. Amidst an environment of intense competition and surplus liquidity, coupled with higher interest expense on deposits, the gross interest margin remained almost unchanged at 2.80 percentage points. Meanwhile, the net interest margin (measured in terms of net interest income minus overheads and

provisions expressed as a percentage of interest-related assets) narrowed to 0.39 percentage point.

During the year, banking institutions continued to enhance business efficiency through improvements in IT systems and processes. Higher establishment and marketing expenses relating to rebranding and branch refurbishment strategies led to an increase in the expense ratio (staff costs and overheads to total income) to 41.3% (2005: 40%). The ability of banking institutions to withstand competitive pressures is determined by factors beyond that of asset and capital size. While the higher staff-related expenditures led to the increase in staff cost per employee to RM72,164 (2005: RM65,344), this has translated into improved productivity. Pre-tax profit generated per employee increased to RM131,899 compared to RM130,297 in the previous year.

### **Growing significance of Islamic banking**

Operating parallel to conventional banking, Islamic banking has also grown in size, diversity and importance in the Malaysian financial landscape. The number of players in the Islamic banking sector has increased with the commencement of operations of four institutions during the year. Assets of the Islamic banking system expanded by 20.5% in 2006 to constitute 12.2% of banking system assets. This development has been underscored by growth in financing activities (+12.3%) which now accounts for 13.2% of banking system lending. Deposits mobilised by the Islamic banking system had also grown at a robust rate of 18.2% in 2006 to account for 12.2% of banking system deposits.

The Islamic banking sector remained well-capitalised, supported by higher pre-tax profit and the injection of capital by new entrants and players. The RWCR recorded a strong level of 16.6% whilst the core capital ratio stood at 12.6%. Preliminary unaudited profit before tax for the Islamic banking system amounted to RM1.7 billion, posting a growth of 9.6%. The higher profit was contributed largely by growth in financing income (13%), income from funds placement (75.1%) and recoveries from non-performing assets (22.8%). Consequently, return on assets and return on equity for the



Islamic banking sector was 1.3% and 16.4% respectively.

The Islamic banking sector continues to support various economic activities that contribute to the nation's economic growth. Total financing extended by the Islamic banking sector was RM78.5 billion as at end-2006. Similar to the trends observed for conventional banking, of the 12.3% increase in financing, 57.6% was channeled to the household sector. The level of non-performing financing continued to decline steadily as net non-performing assets as at end-2006 declined almost 25% to RM3.4 billion to account for 4.5% of net financing.

Investment deposits (general and specific) rose by 10.3% to account for 49.6% of Islamic banking deposits, the bulk of which was concentrated in the short-term maturity profile of below one year (95.2%). Meanwhile, savings and demand deposits expanded by 16.7% and 38.8% respectively, mainly attributed to the expanding retail customer base in Islamic banking.

The ratio of staff-related expenses and overheads to gross operating income rose to 42.6%. The increase in staff costs was attributed mainly to higher remuneration packages offered to retain and attract expertise amidst competition from the new entrants, as well as additional resources required to support the expansion of the industry. Meanwhile, higher overheads were due mainly to establishment and administrative expenses incurred in the setting up of new branches by Islamic banking institutions, in particular, by the new market entrants.

### **Insurance and Takaful Sector**

The insurance and takaful industry has gained greater significance in the Malaysian financial landscape both as a provider of risk protection as well as an alternative avenue for savings and investments. This has been achieved against the backdrop of increased awareness and acceptance among the public and businesses at large of the importance of risk protection. At the same time, growing preference among the

more affluent segments of the population for savings and investment-related products such as endowment and investment-linked products which offer increased investment flexibility, has also contributed to the growth of the sector. These developments were further boosted by the growing importance of bancassurance as a channel for marketing of life insurance products. Prospects for further growth in the insurance and takaful sector continue to remain positive given the favourable outlook of the economy and income growth as well as the relatively low level of insurance penetration of 5.1% of gross national product.

The insurance and takaful sector recorded combined premiums and contributions totalling RM26.6 billion during the year. This represented an increase of 6.8%, the bulk of which occurred in the second half of the year as expectations of a further increase in interest rates diminished and households and businesses became accustomed to the higher cost of living.

In the life insurance and family takaful sector, new business premiums and contributions posted a growth of 13.5% to RM8.4 billion (2005: RM7.4 billion) in 2006. Growth was driven primarily by investment-linked business which expanded at an impressive annual rate of 89% to RM3.4 billion to offset the decline in ordinary life business. At the close of the year, investment-linked products accounted for more than 40% of new business.

In terms of distribution channels, new premiums garnered through bancassurance tie-ups accounted for a higher share of 44.2% in 2006 (2005: 41.8%), while the market share of agency business declined to 44.8% (2005: 46%).

The general insurance and takaful sector expanded at a more moderate pace during the year. Gross direct premiums and contributions grew by 4.1% to RM10.3 billion (2005: +9.8% to RM9.9 billion). This was underpinned by lower business volumes in the motor sector as well as softening of premium rates for commercial



property, aviation and cargo risks. Meanwhile, these developments were mitigated by the stronger growth in marine hull, offshore oil-related, medical and health, and personal accident classes of business. The growth in marine hull business was attributed mainly to new business arising from the construction of navy patrol vessels, while the growth in offshore oil-related premiums reflected the increased oil and gas activities following the rise in oil prices.

The solvency position of the insurance industry remained comfortably strong with an aggregate solvency surplus of RM16 billion (on an unaudited basis) as at end-2006. Profitability levels were sustained in tandem with the favourable investment climate which led to higher net income from investment activity and write-back of provisions for diminution in value of investments. Combined with the higher new business premiums, excess of income over outgo for the life and family business expanded 17.8% to RM12.4 billion in 2006 (2005: -7.6% to RM10.6 billion). The surplus for life insurers improved to RM4.8 billion (2005: RM3.6 billion) supported mainly by improved investment returns and favourable experiences in mortality and morbidity. For the general insurance and takaful business, higher claims, primarily from motor business, led to a decline of 43% in underwriting results to RM0.6 billion (2005: RM1.1 billion). Higher investment earnings however, enabled the general insurance and takaful sector to sustain an overall operating profit at RM1.5 billion.

Total assets of the insurance and takaful industry continued to register double-digit growth of 12.6% to RM115.4 billion as at end-2006, supported mainly by the expansion in life fund assets (+14.1%). Of this amount, corporate and debt securities amounted to RM54.3 billion. Investments in foreign assets rose by almost 300% to RM1.2 billion (end-2005: RM0.3 billion) reflecting the strategies by insurers to match liabilities of foreign currency denominated products as well as capital guaranteed products with exposures in foreign markets. However, the share of foreign assets relative to total insurance fund assets remained low at 1% of total assets.

### ***Takaful sector registered robust growth***

The takaful industry continued to record a strong performance during the year. Total assets grew by 17.9% to account for 6.1% of total assets of the insurance industry, while combined takaful contributions rose to RM1.7 billion to account for 6.5% of total premiums of the industry. In the family takaful sector, new business contributions increased significantly by 74.6% to RM1.3 billion (2005: RM725.5 million). This was attributable mainly to growth in the mortgage takaful (+73.7% to RM0.7 billion) and investment-linked businesses (+200.1% to RM0.2 billion) which accounted for 68.2% of new business. The general takaful business maintained its strong growth momentum with gross direct contributions expanding by 29.4% to RM713.7 million (2005: RM551.4 million). This was driven largely by higher business volumes in the motor and fire sectors which recorded a growth of 42.9% and 34.7% respectively.

### **Development Financial Institutions**

The DFIs under the purview of Bank Negara Malaysia strengthened further in 2006, as evidenced by the overall favourable business performance and improved financial health. During the year, overall lending by the DFIs to their targeted sectors recorded a strong growth of 17.9%, with total loans outstanding increasing to RM51.1 billion as at end-2006 (end-2005: RM43.4 billion). In response to the increasing number of development projects in the infrastructure sector, lending extended to this sector increased further by 11.7% to RM14.9 billion, mainly to finance activities in the construction, transport and communication sectors. Financing to the SMEs, including those in the services, manufacturing and agriculture sectors, also expanded further by 9.9% to RM13.2 billion, supporting efforts by the Government to promote and develop the SME sector. As at end-2006, financing by DFIs to SMEs accounted for 25.9% of their combined total loans outstanding.

In support of efforts to revitalise the agriculture and agro-based sectors, lending to the sector recorded a higher growth of 8.5%

during the year (2005: 2.9%), channelled mainly to crops, livestock and agro-based processing activities. Financing to support export activities also remained robust, with 44% of the loans channelled to business ventures in the non-traditional markets. Meanwhile, financing for consumption credit by several DFIs increased by 23.7% (2005: 42.9%), reflecting sustained consumer demand, especially for personal loans from the lower income groups.

The NPLs of DFIs remained manageable, as evidenced by the declining gross and net NPL ratios to 9.4% and 3.9% respectively as at end-2006 (end-2005: 10.4% and 4.5% respectively). The improved asset quality was attributed to progressive efforts undertaken by the DFIs to enhance their credit processes and information systems, which had enabled them to better manage and control their NPLs. In addition, the

participation of almost all the DFIs in the Central Credit Reference Information System (CCRIS) has contributed to better credit assessments, thus resulting in lower incidences of new loans turning non-performing.

Total deposits mobilised by the deposit-taking DFIs to promote savings among small savers and cooperative members increased further to RM40.3 billion as at end-2006 (end-2005: RM36.2 billion). The sustained expansion in business operations continued to generate strong profits for the DFIs, amounting to RM1.3 billion in 2006 (2005: RM1.5 billion). Of this, more than 80% was contributed by operating profits. The favourable results complemented the capital injection by the Government to further strengthen the financial position of the DFIs with total shareholders' funds increasing to RM10.7 billion as at end-2006, from RM8.4 billion as at end-2005.