

Chapter 1

The Malaysian Financial System

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Learning Objectives

After studying this chapter, you will:

- ◆ understand the Malaysian financial system;
- ◆ learn what comprises the Malaysian financial system;
- ◆ realise what the intermediation function involves;
- ◆ appreciate the components of the banking system;
- ◆ know the differences between commercial and investment banks;
- ◆ differentiate between the roles of the various financial intermediaries;
- ◆ comprehend what comprises the non-bank financial intermediaries;
- ◆ recognise the financial markets under the Malaysian financial system; and
- ◆ be able to appreciate the implications and issues pertaining to the Financial Sector Masterplan.

1. INTRODUCTION

The Malaysian economy has undergone tremendous change against the backdrop of rapid transformation in the economy and international environment. The rapid pace of economic development and transformation that creates new demand as well as opportunities for business has called for a more effective and efficient provision of financial services. The main thrust is to promote a dynamic financial system in line with the country's development; a sound and strong financial system is a necessary precondition for a steady and balanced economic and social development in Malaysia. In achieving a strong financial system, the Central Bank of Malaysia or Bank Negara Malaysia (BNM) has consciously and systematically developed a modern and sophisticated financial system which has effectively mobilised and allocated resources for productive use in tandem with the economy's rapid transformation.

The Malaysian financial landscape has been characterised by rapid changes shaped by the forces of liberalisation and globalisation. This has been further aided by technological innovations in the financial market as well as the development of various financial products. Global forces and advances in technology have redefined the rules of the game and transformed the operational environment in which financial institutions operate. In addition, the 1997-1998 Asian financial crisis further suggested the need to strengthen the domestic financial system and inject greater dynamism and competition into it. The Malaysian response to the Asian financial crisis has produced results earlier and better than initially expected. With stability restored, and the growth process resumed, the stance to now take is to be forward looking, to build the foundation so that the financial sector continues to play its important role in the economy and continues to be strong and resilient in facing future challenges. In the light of all these changes, BNM's main challenge is to promote a sound and competitive financial system while preserving its financial stability.

2. INTERMEDIATION FUNCTION OF THE FINANCIAL SYSTEM

Malaysia has a modern and comprehensive financial system that continues to evolve in response to changing domestic and international conditions. The structure of the Malaysian financial system has two components, i.e., financial intermediaries and financial markets. In order to have a sound financial system, the prerequisite is to have stability in both financial institutions and financial markets. Principally, the financial system aims to facilitate the effective use of funds. It is expected to act as an intermediary for all resources in the economy. The sources of funds are provided by savings in both the private and public sectors as well as by the net inflow of funds from abroad. They are collectively channelled through intermediaries such as banks, provident and insurance funds as well as government agencies. This intermediation function involves mobilising resources by providing the means for savers to hold monetary and financial assets and at the same time allocating these resources for productive investment. Investment involves the use of funds for private sector investments, public sector investments, accumulation of international reserves and payments abroad for education purposes, etc. In simple terms, the intermediation process involves mobilising funds from the economy's surplus units to its deficit units to aid in enhancing economic development. In this regard, the financial system's intermediation function has strong linkages with savings and investment decisions that can influence the pace of economic growth.

STUDENT PRACTICE 1

1. What does the financial system comprise? (para 2)
2. What does the intermediate function involve? (para 2)

3. STRUCTURE OF THE MALAYSIAN FINANCIAL SYSTEM

The Malaysian financial system is made up of two components, the financial intermediaries and the financial market.

BNM and the banking industry consisting of commercial banks, Islamic banks and investment banks make up the **banking system**. In Malaysia, Islamic and conventional banking systems coexist and operate in parallel.

In addition, non-bank financial intermediaries (NBFIs) complement the banking system in mobilising savings and meeting the requirements of specific sectors. These institutions play an important role in the development of the capital market and in providing social security. The NBFIs comprise:

- a. other financial intermediaries, such as
 - i. Unit trusts,
 - ii. Cooperative societies,
 - iii. Leasing and factoring companies, and
 - iv. Housing credit institutions.

The financial markets in Malaysia comprise:

- a. Money market,
- b. Foreign exchange market,
- c. Equity market,
- d. Derivatives market, and
- e. Bond market.

Details of the assets of the financial system are presented in **Appendix I**.

3.1 Financial Institutions

The total assets of the financial system stood at RM2,475.9 billion as at 31 December 2007¹. In terms of structure, financial institutions can broadly be divided into two components, i.e., the **banking system** and the **NBFI**. Of the total assets of RM2,475.9 billion, the banking system accounted for about 67% or RM1651.8 billion of the total assets. NBFIs accounted for the balance of RM824.1 billion (33%).

¹ P preliminary

A brief discussion of the individual institutions within the banking system and non-bank financial institutions is given below.

3.2 The Banking System

Historically, the banking system has been the largest financial intermediary in terms of total assets. The system comprises the following:

- a. BNM,
- b. commercial banks,
- c. investment banks, and
- d. Islamic banks.

Within the banking system, commercial banks accounted for about 42% of the total assets of the financial system as at end-2007^P. The various components of the banking system are elaborated below:

3.2.1 BNM

BNM, as the central bank, is at the apex of the banking system. BNM's objectives are to:

- a. promote monetary stability and a sound financial structure;
- b. act as banker and financial adviser to the government;
- c. issue currency and keep reserves to safeguard the value of the country's currency;
- d. promote the reliable, efficient and smooth operation of national payment and settlement systems and to ensure that the national payment and settlement systems policy is directed to the advantage of Malaysia; and
- e. influence the credit situation to the country's advantage.

In meeting these objectives, BNM is guided by the principle that it should act only in the economic interest of the nation and without regard to profit as a primary consideration.

Hence, the functions of BNM are carried out within the context of the broader goals of promoting economic growth, a high level of employment, maintaining price stability and a reasonable balance in the country's international payments position, eradicating poverty and restructuring society.

In particular, BNM ensures that the availability and cost of money and credit in the economy are consonant with national macroeconomic objectives. In this respect, BNM acts as the banker for currency issue, keeper of international reserves and safeguarding the value of the ringgit, banker and financial adviser to the Government, agency responsible for monetary policy and management of the financial system and banker to the banks.

BNM accounted for 17.2% of the total assets in the financial system as at end-2007^P. As the country's monetary authority, it is responsible for maintaining monetary stability, i.e., the stability of the value of the Ringgit. In addition, BNM conducts its monetary policy by influencing the level of interest rates. BNM is

also responsible for the regulation and supervision of all financial institutions under the Banking and Financial Institutions Act 1989 (BAFIA), with the exception of the Labuan IOFC which comes under the purview of the Labuan Offshore Financial Services Authority (LOFSA). As at May 2008, there were 22 commercial banks (of which 13 are locally incorporated fully foreign-owned), 13 Islamic banks (of which three are foreign-owned), and 14 investment banks. (Please refer to **Appendix II** for details.)

3.2.2 Commercial Banks

a. Role

Initially, commercial banks in Malaysia were governed by the Banking Act 1973. This was subsequently replaced by the BAFIA in 1989. The BAFIA combined the Banking Act 1973 and the Finance Companies Act 1969 under a single legislation. Following the merger of local banks and finance companies into 10 local banking groups (as at May 2008, there were nine local banking groups), the functions of finance companies, such as hire purchase and leasing activities, have been incorporated into commercial banks. The main functions of commercial banks are as follows:

- i) Mobilise savings through current, savings and fixed deposit accounts and other financial instruments;
- ii) Grant loans and advances
 - in the form of providing various credit facilities to business enterprises and private individuals for working capital, investment and consumption;
- iii) Provide trade financing facilities
 - to assist in promoting cross-border international trade and domestic financing facilities;
- iv) Provide treasury services
 - dealing in government securities and treasury bills and other money market instruments as well as foreign exchange transactions;
- v) Facilitate cross-border payment services
 - providing fund transfers and remittance services within Malaysia and overseas for business as well as personal needs;
- vi) Provide custody services, e.g., safe deposits and share custody;
- vii) Provide wealth management services and sales of investment and insurance products and financial planning services,
- viii) Provide hire-purchase and leasing facilities; and
- ix) Provide any other such business that BNM, with the approval of the Ministry of Finance, may prescribe from time to time.

b. Compliance with BNM Requirements

As custodians of public moneys, commercial banks are required to comply with the statutory reserve requirement and other requirements as stipulated by BNM. This includes the following:

i) Statutory Reserve Requirement

The SRR is governed by section 37(c) (1) of the Central Bank Ordinance 1958 (CBO). Commercial banks are required to observe the statutory reserve requirement (SRR) expressed in relation to pre-defined eligible liabilities (EL). The EL components basically comprise all types of deposits and interbank borrowings. Commercial banks' capacity to generate loans and advances will depend on the SRR ratio as determined by BNM. Any changes, i.e., either an increase or decrease in the SRR, will affect the excess cash reserves for lending and thus the liquidity situation in the economic system. The SRR deposited with BNM earns no interest.

ii) Liquidity Framework

In order to service customers' financial needs, commercial banks need to maintain sufficient liquidity. In June 1998, BNM introduced a new Liquidity Framework as a more effective way of managing commercial banks' funds. This new framework recognises banks' weaknesses in managing their liquidity and funding requirements. The framework requires banks to make projections on the maturity profile of their liabilities as well as off-balance sheet commitments so as to assess potential future liquidity requirements.

The new framework aims to:

- create awareness among banks of their funding structures and their ability to handle short to medium-term liquidity problems;
- permit more efficient and on-going liquidity measurement as well as management; and
- provide BNM with a better means of assessing the present and future liquidity position of banks.

iii) Risk-Weighted Capital Ratio

The risk-weighted capital ratio (RWCR) was implemented with the aim of rebuilding and strengthening commercial banks' balance sheets through management of capital adequacy positions. All banks are required to adopt a minimum standard of capital adequacy called the Capital Adequacy Ratio (CAR). The CAR is set at a minimum of 8% to prevent banks from going overboard in granting loans. The RWCR requires capital to be provided for both on- and off-balance sheet assets according to a perceived level of counterparty credit risk. The current rule is, the weightage (ranging from 0% to 100%) increases with the risk level of the bank's assets. When the principles of Basel II Accord are implemented, the weightage can range from 0% to 150%.

With effect from 31 March 1998, banks are required to comply with the RWCR on a consolidated basis every quarter rather than annually. This compliance requirement enables BNM to monitor the banks' capital adequacy position in a timely manner. It also provides banks ample time to plan and work out their recapitalisation solutions.

c. Interest Rates

As a step towards liberalisation of the interest rate regime, an interest rate framework based on the overnight policy rate (OPR) was introduced by BNM in 2004. The OPR is the anchor rate for banks to calculate their own base lending rate (BLR). The OPR is fixed by BNM at the overnight rate. A corridor of plus or minus 25 basis points has been introduced to contain excessive volatility in the overnight rate. Based on this, banks will determine their own BLR. The new framework has been designed to be transparent, simple and efficient, thereby reducing speculative elements in interest rate direction.

3.2.3 Investment Banks

Investment banks are institutions which were transformed from merchant banks, stockbroking companies and discount houses on 1 January 2007. As a point of reference, the conventional role of discount houses can be described as keepers of liquidity for the banking system. Generally, discount houses specialise in short-term money market operations.

As part of the Financial Sector Masterplan to further streamline the financial sector and to create a more dynamic and resilient financial environment, BNM advocated the merger and transformation of merchant banks, stockbroking companies and discount houses into investment banks. This is based on the merger of the following:

- i) A merchant bank and stockbroking company within the same banking group:
or
- ii) Two stand-alone discount houses with one stockbroking company; or
- iii) A universal broker (UB) with one discount house.

Investment banks are a relatively new structure in the Malaysian banking environment. They differ from commercial banks, with focus on the following:

- i) Engage in public or private market transactions for corporations, governments, and investors, in the areas of mergers and acquisitions (M&A), divestitures and issuance of equity and debt securities,
- ii) Advise and assist clients with specialised industries (such as in technology and property sectors), and
- iii) Undertake securities business such as trading, securitisation, financial engineering, funding, investment, management and securities services.

As at 12 May 2008, there were 13 investment banks in Malaysia.

3.2.4 Islamic Banks

Islamic banks are financial institutions that operate within the framework of Islamic principles and laws. The objective is to implement the economic and financial principles of Islam in the banking arena.

‘...An Islamic bank is a financial institution whose statutes, rules and procedures expressly state that its commitment to the principles of *Shariah* and to the banning of the receipt and payment of interest on any of its operations...’ Ali & Sarkar, 1995

The Islamic Banking Act 1983 defines Islamic banking business as banking business whose aims and operations do not involve any element which is not involved by the religion of Islam.

Basically, Islamic banks are founded and based on *Shariah* principles that include but are not limited to the following main principles:

- i) Avoidance of *riba* (interest element),
- ii) Prohibition of *gharar* (uncertainty, risk, speculation),
- iii) Focus on *halal* (religiously permissible) activities, and
- iv) A general quest for justice and other ethical and religious goals.

A more detailed discussion on Islamic banking is given in Chapter 3.

Malaysia’s banking system is unique, as there is a conventional banking system running parallel with the Islamic banking system, thus offering customers a choice. Islamic banking and finance has grown rapidly at an average annual rate of 19.3% since 1993, and as at end-2007, constitutes 15.4% of the total assets of the banking system.

STUDENT PRACTICE 2

1. What are the components of the Malaysian banking system? (para 3.2)
2. Highlight the differences between commercial banks and investment banks. (para 3.2.2 & 3.2.3)

3.3 Non-Bank Financial Intermediaries

The key players within this segment of the financial system are pension and provident funds, insurance companies and development financial institutions. Non-bank financial intermediaries (NBFIs) can be broadly classified into five groups of institutions, namely:

- a. provident and pension funds,
- b. insurance companies (including *takaful*),
- c. development financial intermediaries, and
- d. other financial intermediaries, such as
 - i. Unit trusts,
 - ii. Cooperative societies,
 - iii. Leasing and factoring companies, and
 - iv. Housing credit institutions.

NBFIs as a group, account for 33.3% of the total assets of the financial system as at end-2007^P.

a. Provident and Pension Funds

The provident and pension funds (PPFs) are a group of financial schemes designed to provide members and their dependants with a measure of social security in the form of retirement, medical, death or disability benefits. The major PPFs comprise the Employees Provident Fund (EPF) and other approved private and pension funds. The EPF is the largest PPF, accounting for 60.5% of the PPFs' total assets as at end-2007^P.

The PPFs serve as important mobilisers of long-term savings in the economy for re-channelling into both the public and private sectors to finance long-term investment. They are the second largest group among the country's financial institutions in terms of total assets, i.e., next to commercial banks, accounting for 21.2% of the total assets of the financial system of RM2,475.9 billion as at end-2007^P.

b. Insurance Companies

The insurance companies comprise general and life insurance businesses as well as professional reinsurers and insurance intermediaries, such as insurance brokers and adjusters. In addition, the *takaful* industry or Islamic insurance has also been established to operate alongside conventional insurance businesses. Life and general insurance funds accounted for 4.4% and 0.9% respectively of the total assets of financial system as at end-2007^P.

c. Development Financial Intermediaries

The main objectives of development financial institutions (DFIs) are to promote development programmes in specific economic sectors such as agriculture, industry, international trade, small medium industries, with specific institutions set up accordingly.

They provide financing, vis-à-vis special programmes and loan schemes, often at more favourable rates than those offered by the commercial banks. They provide a range of loan products, from short-term to long-term financing in the form of term loans, guarantees, revolving credit and contract financing among others.

In addition, they also provide technical assistance and help provide a platform for networking and promotion for their clients.

The DFIs as at May 2008 are:

- i) Bank Pembangunan Malaysia Berhad,
- ii) Bank Perusahaan Kecil & Sederhana Malaysia Berhad (SME Bank),
- iii) Export-Import Bank of Malaysia Berhad,
- iv) Bank Kerjasama Rakyat Malaysia Berhad,
- v) Bank Simpanan Nasional, and
- vi) Bank Pertanian Malaysia Berhad (Agrobank).

These institutions are governed by the Development Financial Institutions Act 2002. The Development Financial Institutions Act 2002 was enacted in February 2002 as a comprehensive regulatory and supervisory framework to facilitate the overall policy development of DFIs. The Act provides comprehensive mechanisms to ensure DFIs perform their mandated socio-economic functions. It is also expected that the Act will strengthen the financial and operational soundness of DFIs. Following the enactment of the Act, all the above DFIs are under the purview of BNM's regulatory and supervisory framework.

The other group of savings institutions is the co-operative societies, comprising urban credit and rural co-operatives.

The DFIs and savings institutions accounted for 5.2% of the total assets of the financial system as at end-2007^P.

e. Other Non-Bank Financial Institutions

Other non-bank financial institutions accounted for the remaining 6.9% of the financial system's total assets. They include 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).

It should be noted that the NBFIs are supervised by various government departments and agencies, with the exception of insurance companies and development financial institutions which come directly under BNM's regulation and supervision. However, with the enactment of the BAFIA, companies involved in scheduled businesses (such as leasing, factoring, building credit and credit token businesses) are required to register and submit periodic returns to BNM for monitoring purposes. A list of the financial intermediaries is appended in the footnote of **Appendix II**.

The financial system's total assets comprise that of the banking system (66.7%) and NBFIs (33.3%). A breakdown of the total assets of RM2,475.9 billion as at end-2007^P is shown in **Appendix II**.

STUDENT PRACTICE 3

1. What do the non-bank financial intermediaries (NBFIs) consist of? (para 3.3)
2. Name the six institutions under the DFIs. (para 3.3)

4. FINANCIAL MARKETS

The various financial institutions are involved in the financial markets. The money market, the foreign exchange market, the equity market, the derivatives market and the bond market collectively make up the financial markets of Malaysia.

4.1 The Money Market

The money market is an avenue for channelling short-term funds with maturities typically varying from overnight to those not exceeding 12 months. It provides a ready source of funds for market participants facing temporary shortfalls in funds. At the same time, it also provides short-term investment opportunities and outlets for those with temporary surplus funds. An efficient money market is an intermediary not only for financial institutions but also for firms and non-bank investors to invest their surplus funds. Money market operations comprise two broad categories: placement of short-term funds, and purchase and sale of short-term money market instruments (such as banker's acceptances, negotiable instruments of deposit, Treasury bills, Cagamas notes, etc.). The interbank players in the money market are the commercial banks and investment banks,

4.2 The Foreign Exchange Market

The foreign exchange market is the market for trading in foreign currencies against the Ringgit or against other foreign currencies. Dealings in the foreign exchange market can be undertaken in the spot market as well as the forward market. When the foreign currency transacted has to be delivered immediately, the foreign exchange market is known as the spot market. On the other hand, if the foreign currency that is traded is to be delivered on a future date, (exceeding two working days) the market is known as the forward market. The forward market enables traders and investors to hedge against foreign exchange risk, i.e., a way to reduce the risk of exchange rate fluctuations. Traders and investors could also take a speculative position on the exchange rate movement, with a view to make profits if they read the trend movement correctly in their favour.

Under the current exchange control regime, all forward transactions undertaken by non-bank residents have to be supported by bona fide underlying trade transactions. Typically, the trading activities are dominated by transactions in the Ringgit against the US Dollar, Euro and Japanese Yen for trade-related hedging purposes. Under the Exchange Control Act 1953, all transactions in foreign currencies have to be undertaken through authorised dealers which comprise all commercial banks (including Islamic banks) and some designated investment banks. These authorised dealers and the designated investment banks are participants in the interbank foreign exchange markets.

4.3 The Equity Market

While the money market is for short-term funds, equity markets are for raising long-term funds. The development of the equity market benefits society because it provides a greater variety of channels for borrowing, particularly for medium and long-term financing. The equity market provides an avenue for corporations to raise funds by issuing stocks and shares to be listed on the Main or Second Board of Bursa Malaysia Berhad. The primary market is used to raise new capital for enterprises while the secondary market provides the requisite liquidity for investors to meet their individual needs. Secondary market trading in stocks and shares is conducted through stockbrokers.

Besides the Main and Second Boards, there is also the Malaysian Exchange of Securities Dealing and Automated Quotation (MESDAQ). MESDAQ is a separate exchange established in 1997 for small, high-growth potential and high-technology companies.

4.4 The Derivatives Market

The derivatives market is for trading instruments that provide contingent claims on underlying assets, and whose values depend on the price of the underlying assets or securities. Bursa Malaysia Derivatives (BMD), formerly known as Malaysia Derivatives Exchange (MDEX), came into inception on 11 June 2001 with the merger of the Kuala Lumpur Options and Financial Futures Exchange of Malaysia (KLOFFE) and the Commodity and Monetary Exchange of Malaysia (COMMEX Malaysia). The name MDEX was changed to Bursa Malaysia Derivatives Berhad in April 2004.

BMD offers products that cover three different market segments namely equity, financial and commodities. Currently, the products are the Kuala Lumpur Stock Exchange Composite Index (KLSE CI) Futures (FKLI), Kuala Lumpur Stock Exchange Composite Index (KLSE CI) Options (OKLI), Crude Palm Oil Futures (FCPO), Crude Palm Kernel Oil Futures (FPKO), 3-month Kuala Lumpur Interbank Offered Rate (KLIBOR) Futures (FKB3) and Three-, Five- and Ten-year Malaysian Government Securities (MGS) Futures (FMG3, FMG5 and FMG10). The main use of derivatives is to trade or hedge against volatility in the price of the underlying assets, although it is possible to use derivatives to speculate for capital gains. Both the capital and derivatives markets come under the Securities Commission's supervision.

4.5 The Bond Market

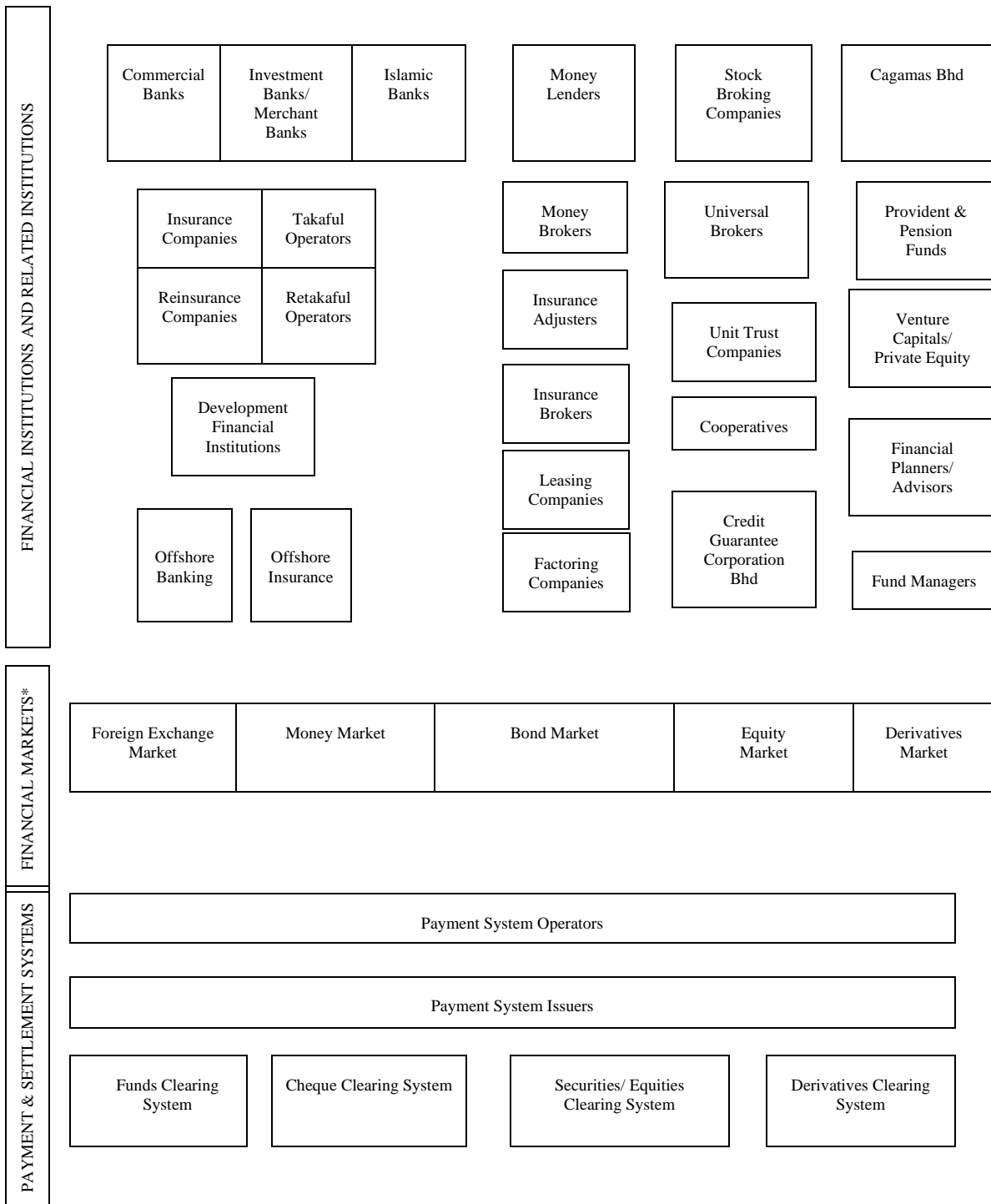
The bond market is the market through which both the private and public sectors can raise funds by issuing private debt securities and Government securities (such as Treasury bills and Government bonds) respectively. Issuance of Malaysian Government Securities is becoming significant as the government sourced the bulk of its financing requirements from the domestic market. The bond market has become increasingly popular, as many companies issue private debt securities as an alternative means for fund raising.

STUDENT PRACTICE 4

1. Name the financial markets under the Malaysian financial system. (para 4)

2. Private debt securities are raised under which market? (para 4.3)

TABLE A: THE MALAYSIAN FINANCIAL LANDSCAPE



*Includes Islamic Financial Markets

Source: *BNM Financial Stability and Payment System Report 2007*

5. SOURCES AND USES OF FUNDS

The intermediation function of the Malaysian financial system is best examined by analysing the sources and uses of funds. The sources of funds highlight the major financial instruments used by the financial system to mobilise financial resources in the economy. Meanwhile, the uses of funds provide a summary of the assets held by various financial institutions, highlighting how they allocate and channel the funds they have mobilised. **Appendix III** summaries the structure of sources and uses of funds of the Malaysian financial system as at end-2007.

The total assets of the financial system (i.e., the banking system and the non-bank financial intermediaries) expanded by RM178.5 billion (9.3%) to RM2,091.2 billion in 2006. The expansion of total assets in 2006 was in line with the improvement in overall economic performance. It is reported that the banking system's total assets increased by 10.5% while assets of non-bank financial intermediaries grew by 6.8%. The bulk of the increase in assets within the banking system was due to the stronger growth in the assets of commercial banks. The major uses of funds were loans and advances (36.6%) and securities (23.4%) and deposits with other financial institutions (15.4%). The assets of NBFIs were driven principally by an expansion in the assets of provident, pension and insurance funds.

6. THE FINANCIAL SECTOR MASTERPLAN

As changes accelerate and the global financial industry continues to evolve in the new millennium, the Malaysian financial system, particularly the domestic banking institutions, faces mounting pressure to become more efficient and competitive, innovative, technology-driven and strategically more focused. In this regard, the financial infrastructure has to be developed accordingly in order to take up the challenges ahead. As a strategy to bring in greater dynamism into the Malaysian financial system, the Financial Sector Masterplan (FSMP) has outlined a number of recommendations to be implemented over a 10-year period (2001-2010). The FSMP aims to chart the financial system's future direction to ensure its continued effectiveness, competitiveness and resilience. To this end, the Malaysian financial sector landscape is expected to evolve in accordance with the FSMP.

The main objective of the Financial Sector Masterplan (FSMP) is to develop a more resilient, competitive and dynamic financial system with best practices, that support and contribute positively to the growth of the economy throughout the economic cycle and has a core of strong and forward looking domestic financial institutions that are more technology driven and ready to face the challenges of liberalisation and globalisation. Despite the domestic financial institutions' dominance, the fully foreign-owned banking institutions as a group have generally been superior in terms of financial preferences as reflected by their higher returns on equity and assets, operational efficiency and product innovation. They have focused on a target market such as high value corporate clients as against the mass consumer and middle market corporate customers targeted by the domestic banking institutions. Other factors contributing to the better performance of foreign banking institutions include their global networks, ability to attract high networth individuals as customers, access to talents and expertise in various markets as well as their superior level of information technology. Obviously, there are significant gaps between foreign and domestic banking institutions which need to be narrowed to achieve the orderly development of a viable and effective domestic banking sector.

It seeks to transform the local financial services industry into one that is dynamic and competitive. It provides the broad plans for the strategic development of the financial sector over a 10-year period to be carried out in three phases.

Phase 1 (2001-2004)

Phase 1 saw the merger of a myriad of local financial institutions (comprising commercial banks and finance companies) into 10 local banking groups. The objective is to nurture a core set of strong domestic banking institutions. During this period, measures were focused on strengthening the capability and capacity of domestic banking institutions, such as encouraging further consolidation through market driven mergers, improvement and enhancement in risk management systems, and greater observance of corporate governance.

Phase 2 (2004-2006)

Phase 2 saw a more level playing field for incumbent foreign banking institutions. These key changes included allowing foreign banking institutions to open more branches and giving them access to payment systems such as the GIRO network.

In promoting Malaysia as an international Islamic banking centre, three foreign Islamic banks were also set up.

During this time, there was an additional consolidation, resulting in nine local banking groups.

There was also reorganisation and restructuring in the other financial sectors involving stockbrokers and discount houses, which saw the emergence of five new investment banks.

Phase 3 (2007-2010)

Phase 3 should see greater liberalisation in the banking sector as well as in foreign exchange administration policies. There will be the entry of more foreign players. At the same time, domestic banking institutions are encouraged to be more regional based and also to forge strategic alliances with international institutions.

In April 2007, there were some major changes, resulting in further liberalisation with the purpose of:

- i. Facilitating the development of the domestic financial market
- ii. Facilitating investments in ringgit assets by non-residents, and
- iii. Enhancing business efficiency and facilitating development of the capital market.

There will be further structural enhancement of a robust bond market.

7. CHANGING FINANCIAL LANDSCAPE

After the mergers of domestic financial institutions in Malaysia in 1997, the number of financial institutions was reduced to 10 anchor banking groups and with a market-driven merger in 2007, there are now nine local banking groups. Notwithstanding this, the domestic banking groups are maximising the benefits of consolidation and mergers, particularly through rationalising and streamlining their internal operations and improving operational efficiency. This had led to the offering of a broader range of financial products and services to meet various customer needs under one roof. In 2003, an important policy initiative was the amendment to the BAFIA to allow the merger of the

commercial bank and the finance company within a domestic banking group into a single legal entity.

A new legislation, known as the Banking and Financial Institutions (Amendment) Act 2003, was enacted. The amended Act allows a bank to hold two licences – one to carry out banking business and the other to carry on finance company business. The amended legal framework provides an opportunity for domestic banking groups to further improve their group structure and rationalise operations towards enhancing efficiency. Subsequently, the operations of finance companies have been merged into the commercial bank within their group and operate as a single entity.

In addition, 2007 saw the streamlining and rationalisation of stockbroking services and discount houses with merchant banks to form full fledged investment banks. It is also BNM's intention to develop all investment banks to be at par with other international investment banks in undertaking trading and brokerage activities, apart from merely providing advisory and consultancy services.

STUDENT PRACTICE 5

1. Describe the main objective and the three phases of the Financial Sector Masterplan. (para 6)

8. THE WAY FORWARD

The financing needs of the economy over the next 10 years are expected to increase significantly and become increasingly more complex and diversified. There would be greater convergence and blurring of lines between the banking, insurance and securities industries. While the banking institutions will continue to be the backbone of the financial system, insurance and other specialised institutions and the capital market will grow in importance. The structure of the economy is also expected to change significantly to become increasingly diversified, with greater emphasis on small and medium-sized industries in the technology and services sectors, and continued growth of skilled knowledge workers.

In the area of Islamic finance, BNM will continue to strengthen the legal and *Shariah* infrastructure to reinforce sound financial practices, whilst encouraging further innovation in products and services to support specialised Islamic fund and wealth management services. The Islamic capital market will also see accelerated development and will play an increasingly important role as conduit to mobilise longer-term funds.

Moving forward, global forces at work, advances in technology and growing sophistication in financial products and services are likely to have an impact on the local financial system. These changes will bring forth new challenges and the FSMP seeks to enable domestic financial institutions to be better positioned to recognise, adapt and operate in this new environment, which include:

- i) Greater competition driven by deregulation, consolidation, new entrants and greater price transparency. This could include the entry of non-traditional players and emergence of virtual marketplaces which transcend national boundaries,

- ii) A growing capital market which will increasingly result in disintermediation. There could be a shift from traditional bank lending as sources of funds to obtaining funds direct from the capital market. Larger domestic corporations could access foreign/regional stock markets for their share listing and placements.
- iii) Financial institutions will become increasingly global and specialised as the new environment is driven by the communications technology revolution. This in turn allows competitive advantage through access to economies of scale and a more globalised approach.
- iv) Financial institutions will be using new organisational structures and more aggressive compensation models to improve efficiency and effectiveness. This in turn could bring about a better pricing model to penetrate and deepen their market share.
- v) Financial institutions will develop strategic alliances with network partners, to strengthen their regional presence and to complement each others' expertise and knowledge
- vi) There will be more investments in technology in order to improve on key capabilities in areas of product development, marketing, credit risk management, pricing models and alternative delivery channels.

9. CONCLUSION

The changing economic and business environment as well as rapid technological advances over the last decade has had significant impact on the development of the financial system, domestically and globally. In fact, they have redefined the rules of the game and changed the playing field. The Malaysian financial system has developed and shown its mantle, since the Asian financial crisis, to be robust and dynamic.

The Malaysian financial system has to continue to evolve in tandem with changing world trends and conditions, to be more dynamic in meeting the changes and the challenges these bring along. Realising the important functions of the financial institutions, the FSMP set its focus on meeting the following challenges envisaged as above. Towards this end, FSMP seeks to develop a robust and resilient financial system. The thrust of banking policies is to focus on enhancing the domestic banking institutions' efficiency and capability while reinforcing their resilience and stability. The main agenda is to create a strong, efficient, competitive and resilient banking system that will better withstand future shocks and be competitive with the international players. To further promote the financial system's dynamism, developmental efforts to broaden and deepen the financial markets as well as the financial infrastructure as outlined in the FSMP have been taken. Under the FMSP, the design of banking policies is to enhance the foundation and environment for banking institutions and NBFIs to efficiently deliver quality customer-driven products and services. As the financial system advances to the next stage of development, this evolution will be important to ensure that it continue to support the needs of the economy, while maintaining financial stability.

Appendix I: Assets of the Financial System

ASSETS OF THE FINANCIAL SYSTEM		
	As at end 2007 ^p	Percentage
Banking system	1651.8	66.7
Bank Negara Malaysia	424.9	17.2
Commercial banks	1,050.2	42.4
Investment banks	94.9	3.8
Islamic banks	81.8	3.3
Finance companies	n.a.	n.a.
Merchant banks ²	n.a.	n.a.
Discount houses ¹	n.a.	n.a.
Non-bank financial intermediaries	824.1	33.3
Provident, pension and insurance funds	526.1	21.2
<i>Employees Provident Fund</i>	318.3	12.9
<i>Other provident and pension funds</i>	76.4	3.1
<i>Life insurance funds</i>	110.0 ²	4.1
<i>General insurance funds</i>	21.3 ²	0.9
Development financial institutions ³	128.3	5.2
Other financial intermediaries ⁴	169.7 ⁴	6.9
Total	2,475.9	100.0
¹	These institutions have been rationalised to become investment banks	
²	Includes assets of <i>takaful</i> funds	
³	Includes FDIs not directly regulated by BNM	
⁴	Includes unit trusts (ASN and ASM 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	

Source: Extracted from *BNM Financial Stability and Payment Systems Report 2007*

Appendix II: List of Financial Institutions as at May 2008

No.	Commercial Banks	Ownership	
1.	Affin Bank Berhad	L	Note: F = Foreign L = Local
2.	Alliance Bank Malaysia Berhad	L	
3.	AmBank (M) Berhad	L	
4.	Bangkok Bank Berhad	F	
5.	Bank of America Malaysia Berhad	F	
6.	Bank of China (Malaysia) Berhad	F	
7.	Bank of Tokyo-Mitsubishi UFJ (Malaysia) Berhad	F	
8.	CIMB Bank Berhad	L	
9.	Citibank Berhad	F	
10.	Deutsche Bank (Malaysia) Berhad	F	
11.	EON Bank Berhad	L	
12.	Hong Leong Bank Berhad	L	
13.	HSBC Bank Malaysia Berhad	F	
14.	J.P. Morgan Chase Bank Berhad	F	
15.	Malayan Banking Berhad	L	
16.	OCBC Bank (Malaysia) Berhad	F	
17.	Public Bank Berhad	L	
18.	RHB Bank Berhad	L	
19.	Standard Chartered Bank Malaysia Berhad	F	
20.	The Bank of Nova Scotia Berhad	F	
21.	The Royal Bank of Scotland Berhad	F	
22.	United Overseas Bank (Malaysia) Berhad	F	

No.	Investment Banks	Ownership	
1.	Affin Investment Bank Berhad	L	Note: F = Foreign L = Local
2.	Alliance Investment Bank Berhad	L	
3.	AmInvestment Bank Berhad	L	
4.	Aseambankers Malaysia Berhad	L	
5.	CIMB Investment Bank Berhad	L	
6.	Hwang-DBS Investment Bank Berhad	L	
7.	KAF Investment Bank Berhad	L	
8.	Kenanga Investment Bank Berhad	L	
9.	MIDF Amanah Investment Bank Berhad	L	
10.	MIMB Investment Bank Berhad	L	
11.	OSK Investment Bank Berhad	L	
12.	Public Investment Bank Berhad	L	
13.	RHB Investment Bank Berhad	L	
14.	Southern Investment Bank Berhad	L	

No.	Islamic Banks	Ownership	
1.	Affin Islamic Bank Berhad	L	Note: F = Foreign L = Local
2.	Al Rajhi Banking & Investment Corporation (Malaysia) Berhad	F	
3.	Alliance Islamic Bank Berhad	L	
4.	AmIslamic Bank Berhad	L	
5.	Asian Finance Bank Berhad	F	
6.	Bank Islam Malaysia Berhad	L	
7.	Bank Muamalat Malaysia Berhad	L	
8.	CIMB Islamic Bank Berhad	L	
9.	EONCAP Islamic Bank Berhad	L	
10.	Hong Leong Islamic Bank Berhad	L	
11.	Kuwait Finance House (Malaysia) Berhad	F	
12.	Maybank Islamic Bank Berhad	L	
13.	RHB Islamic Bank Berhad	L	

Appendix III: Sources and Uses of Funds of the Financial System

	As at end 2007^P	Percentage
	RM' billion	
Sources:		
Capital and reserves	227.6	9.2
Currency	42.2	1.7
Demand deposits	166.1	6.7
Other deposits ¹	981.1	39.6
Borrowings	112.7	4.6
Funds from other financial institutions ²	122.7	5.0
Insurance, provident and pension funds	486.2	19.6
Other liabilities	337.2	13.6
Total	2,475.80	100.0
Uses:		
Currency	9.0	0.36
Deposits with other financial institutions	468.9	18.94
Loans and advances ²	861.3	34.79
Securities	661.2	26.71
<i>Treasury bills</i>	2	0.08
<i>Commercial bills</i>	10.9	0.44
<i>Malaysian Government (MGS)</i>	201.9	8.15
<i>Corporate</i>	355.9	14.38
<i>Private Debt Securities</i>	175.1	7.07
<i>Equities</i>	180.8	7.30
<i>Foreign</i>	5.2	0.21
<i>Others</i>	85.3	3.45
Gold and foreign exchange reserves	334.4	13.51
Other assets ³	141	5.70
Total	2475.8	100.00

¹ Equals savings, fixed and other (NIF, LPHT, etc) deposits + NIDs and repos

² Includes statutory reserves of banking institutions

³ Effective 2006, portions of 'Other assets' have been re-classified

^P preliminary

Note: Numbers may not necessarily add up due to rounding

Source: Extracted from *BNM Financial Stability and Payment System Report 2007*