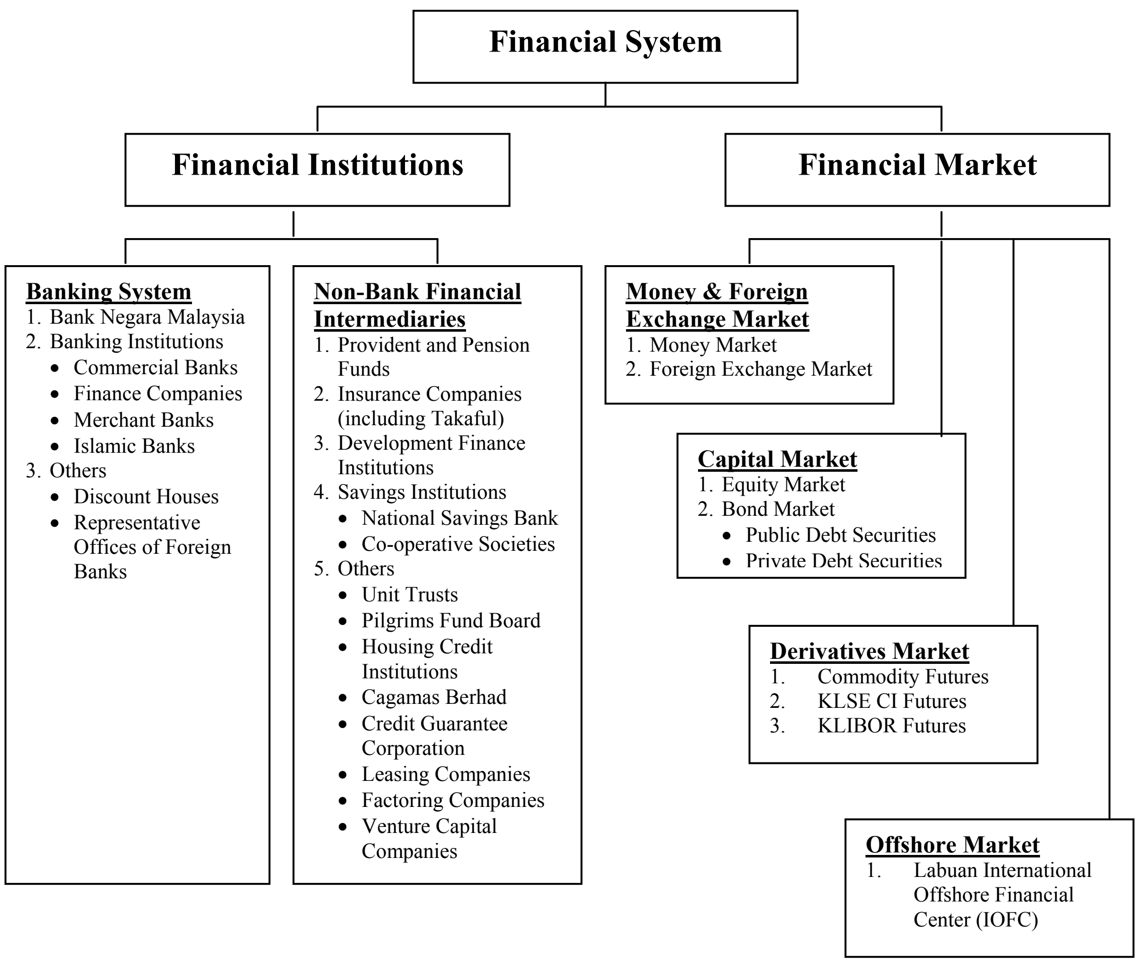
Chapter 5

Financial System of Malaysia

5.1 Financial System Structure in Malaysia

The Malaysian financial system is structured into two major categories, Financial Institutions and Financial Market. The Financial Institutions comprise Banking System and Non-bank Financial Intermediaries. The Financial Market in Malaysia comprises four major markets namely: Money & Foreign Exchange Market, Capital Market, Derivatives Market, and Offshore Market.

Chart 1: The Financial System Structure in Malaysia



5.2 Banking System

The banking system consists of Bank Negara Malaysia (Central Bank of Malaysia), banking institutions (commercial banks, finance companies, merchant banks and Islamic banks) and a miscellaneous group (discount houses and representative offices of foreign banks). The banking system is the largest component of the financial system, accounting for about 67% of the total assets of the financial system.

The summary background information and functions of the institutions mentioned above are set out as follows:-

5.2.1 Bank Negara Malaysia (BNM)

Bank Negara Malaysia (the Central Bank of Malaysia) was established on 26 January 1959, under the Central Bank of Malaya Ordinance 1958. The objectives of BNM are as follows:

- To issue currency and keep reserves to safeguard the value of the currency;
- To act as a banker and financial adviser to the Government;
- To promote monetary stability and a sound financial structure; and
- To influence the credit situation to the advantage of Malaysia.

The objectives of BNM, in essence, encapsulate the importance of promoting economic growth with price stability and maintaining monetary and financial stability.

The introduction of the Banking and Financial Institutions Act 1989 (BAFIA) on 1 October 1989 extended BNM's powers for the supervision and regulation of financial institutions and deposit-taking institutions who are also engaged in the provision of finance and credit.

5.2.2 Commercial Banks

The commercial banks are the largest and most significant providers of funds in the banking system. There are currently 24 commercial banks (excluding Islamic banks) of which 13 are locally incorporated foreign banks. The main functions of commercial banks are to provide:

- Retail banking services such as the acceptance of deposit, granting of loans and advances, and financial guarantees;
- Trade financing facilities such as letters of credit, discounting of trade bills, shipping guarantees, trust receipts and Banker's Acceptances;
- Treasury services;
- Cross border payment services; and
- Custody services such as safe deposits and share custody.

Commercial banks are also authorised to deal in foreign exchange and are the only financial institutions allowed to provide current account facilities.

5.2.3 Finance Companies

Finance companies form the second largest group of deposit-taking institutions in Malaysia. Finance companies were initially governed by BNM through the Finance Companies Act 1969. This was replaced in 1989 with the Banking and Financial Institutions Act 1989. There are currently 12 finance companies. Finance company business is defined as:

- The business of receiving deposits on deposit account, saving account or other similar account;
- The lending of money;
- Leasing business or the business of hire purchase; and
- Any other such business as BNM with the approval of the Minister may prescribe.

5.2.4 Merchant Banks (also known as Investment Banks)

Merchant banks emerged in the Malaysian banking scene in the 1970s, making an important milestone in the development of the financial system alongside the corporate development of the country. They play a role in the short-term money market and capital raising activities including financing, specialising in syndication, corporate finance and management advisory services, arranging for the issue and listing of shares, as well as investment portfolio management. There are currently 10 merchant banks in Malaysia.

5.2.5 Islamic Banking

In Malaysia, separate Islamic legislation and banking regulations exist side-by-side with those for the conventional banking system. The legal basis for the establishment of Islamic banks was the Islamic Banking Act (IBA), which came into effect on 7 April 1983. The IBA provides BNM with powers to supervise and regulate Islamic banks, similar to the case of other licensed banks.

The banking activities of Islamic banks are based on Syariah principles (the Islamic principles). The first Islamic bank established was Bank Islam Malaysia Berhad, which commenced operations on 1 July 1983. On 1 October 1999, a second Islamic bank, namely Bank Mualamat Malaysia Berhad was established. Apart from Islamic banks, other financial institutions also offer Islamic banking services through the "Islamic Banking Scheme".

In terms of products, all Islamic banking entities are offering banking products based on the Islamic principles. Table 2 shows the core Islamic principle in banking, the relevant explanation and examples of banking products offered.

Table 2: Islamic Banking Products

No.	Islamic Principle	Clarification	Purpose	Banking Products
1	Al-Wadiah	guaranteed custody	for deposit-taking products	current deposits, savings deposits
2	Al-Mudharabah	profit-sharing	investment deposits	general and special investment accounts, project financing, sell and buy back agreements
3	Al-Murabahah	cost-plus	for financing facilities	working capital financing, bonds, commercial papers
4	Bai'Bithaman Ajil	deferred payment sale	for house financing	Housing loan, negotiable instrument of deposit, commercial property financing, credit card, umrah financing, project financing
5	Al-Ijarah	Leasing	for leasing and vehicle financing	leasing of machines, vehicle financing, financing syndication, bonds
6	Al-Musyarakah	profit and loss sharing	for project financing	project financing, share financing, unit trust financing, financing syndication

5.2.6 Discount Houses

Discount houses began operations in Malaysia since 1963. Generally, the discount houses specialise in short term money market operations and mobilise deposits from the financial institutions and corporations in the form of money at call, overnight money and short term deposits. The funds mobilised are invested in Malaysian Treasury bills, Malaysian Government Securities (MGS), banker acceptances (BAs), negotiable certificates of deposit (NCDs), Cagamas bonds and Floating Rate Negotiable Certificates of Deposit (FRNCDs), as well as to provide an active secondary market for these activities.

5.2.7 Representative Offices of Foreign Banks in Malaysia

There are 32 foreign banks that have establishing representative offices in Malaysia, with all concentrated in Kuala Lumpur. Most of the banks originate from Europe and Japan. Representative office is merely a liaison office and does not offer banking products directly to the Malaysian market.

5.3 Non-Bank Financial Intermediaries

Non Bank Financial Intermediaries mainly comprise of Insurance Companies, Provident and Pension Funds and Development Finance Institutions. Summary background information and functions of these institutions are appended below: -

5.3.1 Provident and Pension Funds

Provident and Pension Funds (PPFs) are a group of financial schemes designed to provide members and their dependents with a measure of social security in the form of retirement, medical, death or disability benefits. The major PPFs in Malaysia comprise the Employees Provident Fund (EPF), the Social Security Organisation (SOCSO), the Armed Forces Fund and the Teachers Provident Funds. The PPFs funds serve as important mobilisers of long term savings in the economy for rechanelling into both the public and private sectors to finance long-term investment. The PPFs are the second largest group of financial institutions in the country in terms of aggregate assets, next to banking institutions.

5.3.2 Development Financial Institutions

Development Financial Institutions (DFIs) are established by the Government to promote the development of certain identified priority sectors and sub-sectors of the economy, such as agriculture, infrastructure development and international trade. DFIs generally specialise in the provision of medium and long term financing of projects that may carry higher credit or market risk. It is envisaged that in the next decade, DFIs will continue to progress and assume a more significant role in pursuing the Government policy goals for strategic, social and economic development. The following are the main DFIs in Malaysia:-

i) Bank Pertanian Malaysia

The main focus is in developing the agricultural sector of the country. It was established on September 1, 1969 under an Act of Parliament and started operations in 1970.

ii) Bank Industri & Technologi Malaysia

The main activity is to participate in the development and industrialization of the country in strategic and selected industries. The key area of Bank Industri & Technologi's involvement include financing of shipping, shipyard and marine-related activities, high-technology manufacturing industries and technical consultancy services.

iii) Bank Pembangunan & Infrastruktur Malaysia Berhad

The main activity of Bank Pembangunan & Infrastruktur Malaysia Berhad (Development & Infrastructure Bank of Malaysia) is to be the premier financial institution in providing financial facilities to Bumiputras in the manufacturing sector, services-related industries in the manufacturing sector and also financing the country's main infrastructure projects.

iv) EXIM Bank

EXIM Bank was established in August 1995 and commenced operations in September 1995. EXIM Bank was established with the objectives of financing and promoting the country's international trade and facilitating the export of goods and services from Malaysia by means of export credit, financing of capital investment and provision of business information and services.

v) Malaysian Industrial Development Finance (MIDF)

MIDF was set up in 1960 and is a semi-government institution providing medium and long-term loans to manufacturing industries in Malaysia.

5.4 Insurance Industry

Currently, the total number of licensees under the Insurance Act 1996 stands at 141, comprising 64 insurers, 36 brokers and 41 adjusters. The 64 insurers that were licensed under the Act is categorized into the following groups:

- 10 life and general insurance companies (include Motor Insurance)
- 7 life insurance companies
- 36 general insurance companies (include Motor Insurance)
- 1 life reinsurance company
- 9 general reinsurance companies (include Motor Insurance)
- 1 composite reinsurance company

i) Life Insurance Industry

The life insurance industry is classified into four main categories: Whole Life; Endowment; Temporary; and "Others" category.

The life insurance industry is generally the strongest, from both financial and structural viewpoints. The regulatory control over them has always been strict and only the larger and a better managed companies have been allowed to have a license

In the last few years, the investment-linked business is gaining popularity in the local insurance market. In year 2000, five insurers were granted approval to undertake investment-linked business under Section 7 of the Act. The increased number of players saw the establishment of 22 new investment-linked funds during the year, giving a total of 42 funds being offered to the public as at end of 2000. Investment-linked products provide an alternative investment channel to policy owners while maintaining the core protection element. These range of funds, established to meet the investment objectives of the policy owners, have drawn encouraging response from the public, given the shift in consumers' preference from protection based policies to investment type products.

ii) General Insurance Industry

General insurance covers motor, marine, aviation & transit insurance (MAT), fire insurance and miscellaneous insurance.

Motor insurance can be divided into "Act" and "non-Act". The former is the minimalist "third party" cover required under the law for the vehicle to be legally useable on public roads. The latter is a comprehensive motor insurance.

iii) Reinsurance

A substantial amount of the insurance premiums collected used to flow overseas through international re-insurance. In order to increase the insurance premiums retention ratio, the Government has encouraged the setting-up of local re-insurers. The business landscape had since then changed with the setting up of the Malaysian Life Reinsurance Group Berhad and other locally established re-insurance companies.

iv) Insurance Intermediaries

Besides companies that are involved in life insurance, general insurance and reinsurance businesses, there are 37 insurance brokers and 42 insurance adjusters licensed to operate in the Malaysian insurance market. In a move to boost the standard of professionalism in the insurance broking/adjusting sectors, a minimum standard of qualification for employees engaged in broking/adjusting work was introduced as one of the licensing conditions imposed by BNM.

a) Insurance Broker

An Insurance Broker is a professional body which is licensed by BNM to act on behalf of buyers of insurance to arrange their insurances with the insurance companies. An insurance broker also provides expert advice on all insurance matters and at the same time may make recommendation on a comprehensive insurance program which suits its respective client's operations.

b) Insurance Adjuster

An Insurance Adjuster's role is assessing insurance losses for the insurers as well as claimants, play an important part in ensuring that claims are settled properly and serviced efficiently. Almost three-quarters of the 42 adjusters are small players, handling mainly motor claims.

v) Takaful (Islamic Insurance)

Takaful may be defined as a pact to guarantee and assist one another. In commerce, Takaful may operate within the **Mudharabah** (Sharing) and **Tabarru** (Donation) concept. The consensus, contract ("Aqad") and the partnership are all in sync with the Syariah Laws, which prohibits the unlawful taking of other people's property and that any business has to be transacted with the mutual consent of all parties concerned.

Under the Takaful Act 1984, 2 takaful operators have been registered under Section 8 of the Act namely Syarikat Takaful Malaysia Berhad (STMB) and Takaful Nasional Sdn Bhd (TNSB).

In Malaysia, the potential for Takaful business is enormous. This is attributed to two major factors namely, the low market penetration of 28.4% and 55% of the Malaysian population are Muslims. The Islamic insurance industry continued to register a double-digit growth rates since it came into business in the 80s.

In many Takaful products, particularly Family class, the contributions paid by the participants are usually segregated into two accounts for purposes of protection and saving. They are kept in the Participant Account and Participant Special Account. The former account is for saving and the latter for the protection or a sum meant to cover the risks. The ratio of the split is agreed at the time of applying for the participation in the particular takaful cover. The ratio can favour any party except that it must be agreed upon prior to conclusion of the contract. As can be seen in most of the General Takaful schemes the contributions are wholly for the Special Account meant for the risks.

5.5 Financial Regulation

Among the main regulations and guidelines issued by the authorities to govern the financial system in Malaysia are:-

5.5.1 Banking and Financial Institutions Act, 1989 (BAFIA)

The Banking and Financial Institutions Act, 1989 (BAFIA) was passed in Parliament and came into force on October 1, 1989. The BAFIA has effectively replaced the Banking Act 1973 and the Finance Companies Act 1969. The Islamic Banking Act 1983, however, is not affected. The BAFIA is a comprehensive act and extends comprehensive powers to Bank Negara Malaysia (BNM) to supervise a larger spectrum of financial institutions, with the direct responsibilities to regulate and supervise all licensed institutions (commercial banks, finance companies, merchant banks, discount houses and money brokers) and also regulate scheduled and non-scheduled institutions.

BAFIA 1989 is divided into 16 parts and covers a wide spectrum of subject matters related to the banking industry in Malaysia. The Act provides a framework that enables BNM to supervise and regulate three broad groups of financial institutions:

- **Licensed institutions** comprising the commercial banks, merchant banks, finance companies, discount houses, money brokers and foreign exchange brokers;
- **Scheduled institutions** comprising non-bank sources of credit and finance, which include issuers of charge/credit cards and travellers' cheques, operations of cash dispensing machines, development finance institutions, building societies and housing credit institutions, factoring companies and leasing companies. Also included under this group are representative offices of foreign banks or foreign institutions which carry out the business or activities similar to the scheduled institutions; and
- **Non-scheduled institutions** comprising all other statutory bodies and institutions involved in the provision of finance and credit.

The Act also provides BNM the regulatory power to regulate the following:

- Control of establishment or acquisition of subsidiaries or opening of offices in Malaysia by a local or foreign licensed institutions
- Maintenance of reserve fund, capital, net working funds, liquid assets by the financial institutions
- Appointment of auditors, submission of financial statement, exhibition of financial statements, submission of statistics to BNM.

5.5.2 Insurance Act 1996

Under the Insurance Act 1996, BNM retains a substantial degree of regulatory control over the management, control of licensees and the critical aspects of their operations. Among the areas subject to BNM's approval under the Insurance Act 1996 are:

- The appointment of directors and chief executive officers;
- The acquisition or disposal of substantial interests in shares of a licensee;
- The establishment of offices and subsidiaries;
- Appointment of auditors and actuaries; and
- Outsourcing of core insurance activities.

The Insurance Act 1996 which became effective on 1 January 1997, has incorporated amendments made to the Insurance Act 1963. It incorporated changes needed to address deficiencies in the previous legislation. The subsidiary legislation, the Insurance Regulations 1996 (Regulations) saw several changes in 1999 in respect of minimum capital requirement as follows:-

- The minimum paid-up capital prescribed for a licensed local insurer underwriting direct insurance business, or surplus of assets over liabilities in the case of a licensed foreign insurer is set at RM50 million from 31 December 2000; and
- The absolute minimum margin of solvency (before taking into account insurance fund liabilities) for each class of insurance business of direct and local professional reinsurers is set at RM50 million from 1 January 2001."

5.5.3 Anti-Money Laundering Act 2001

The Anti-Money Laundering Act 2001 (AMLA) was gazetted on 5 July 2001. AMLA provides comprehensive new laws for the prevention, detection and prosecution of money laundering, the forfeiture of property derived from, or involvement in money laundering and the requirements for record keeping and reporting of suspicious transactions for reporting institutions.

AMLA addresses the following broad issues:-

- Money laundering offences
- Financial Intelligence Unit
- Reporting obligations
- Powers of investigation, search and seizure
- Powers of freezing, seizure and forfeiture of property

5.6 Exchange Control

Prior to 1 September 1998, Malaysia's liberal and non-discriminatory system of exchange control placed no restrictions on remittances and transfers of any foreign currency to other countries except Israel and the Federal Republic of Yugoslavia (Serbia and Montenegro) where special restrictions apply. However, effective 1 September 1998, the Malaysian Government implemented a series of measures to insulate the economy from the risks and vulnerabilities of the external economic developments and to effect a stable exchange rate regime. These changes do not affect the business operations of traders and foreign direct investors nor the normal conduct of economic activity and continue to allow the following:

- General convertibility of current account transactions
- Free flows of direct foreign investment and repatriation of interest, profits, dividends and capital.

The offshore Ringgit market was eliminated as supply of Ringgit outside Malaysia was curtailed. In addition to restrictions previously discussed, with effect from 1 October 1998, travelers are allowed to import or export no more than RM1,000 per person. No limits were imposed on the import of foreign currencies by resident and non-resident travelers. The export of foreign currencies by resident travelers is permitted, up to a maximum of RM10,000 equivalent. All settlement of exports and imports must be made in foreign currencies.

The main objectives of the exchange control policy in Malaysia are to ensure that export proceeds are received promptly in Malaysia, to assist Bank Negara Malaysia in monitoring the settlement of payments and receipts in international transactions as well as to encourage the use of the nation's financial resources for productive purposes. For monitoring and compilation of balance of payments statistics, residents are required to complete statistical forms, Form P and Form R, for each payment or receipt of more than RM10,000 vis-a-vis non-residents.

BNM has issued 16 Exchange Control Notices to-date. They are:

ECM 1	Definitions
ECM 2	Dealings In Gold and Foreign Currency
ECM 3	External Account
ECM 4	General Payment
ECM 5	Export of Goods
ECM 6	Credit Facilities To Non-Residents
ECM 7	Foreign Currency Accounts
ECM 8	Domestic Credit Facilities to Non resident Controlled Companies
ECM 9	Investments Abroad
ECM 10	Foreign Currency Credit Facilities and Ringgit Credit Facilities from Non-Residents
ECM 11	Inter-Company Accounts
ECM 12	Securities
ECM 13	Import and Export of Currency Notes, Bills of Exchange, Assurance Policies, etc.
ECM 14	Dealings with Specified Persons and in Restricted Currencies
ECM 15	Labuan International Offshore Financial Centre
ECM 16	Approved Operational Headquarters

The main Exchange Control rules, which are of direct relevance to foreign investors, are as follows:

Direct and Portfolio Investment

No permission is required from the Controller of Foreign Exchange (hereinafter referred to as "the Controller" for a non-resident to undertake direct or portfolio investment in Malaysia.

External Accounts

The Ringgit Malaysia accounts of residents of all foreign countries maintained with banks in Malaysia are designated as External Accounts. Approval is required for the transfer of funds between External Accounts. The withdrawal of RM from external accounts requires approval except for the purchase of RM assets. However, the bank accounts of businesses, whether body corporate or not and whether head office or branch, established and operating in Malaysia are not designated as External Accounts.

Remittances Abroad

Payments to countries outside Malaysia may be made in any foreign currency other than the currencies of Israel, Serbia and Montenegro.

Residents are required to seek approval from the Controller to remit funds in excess of RM10,000 for overseas investment purposes.

Export Proceeds

All export proceeds must be repatriated to Malaysia within 6 months from the date of export or the period of payment specified in the sales contract, whichever is earlier. All settlements of exports and imports must be made in foreign currency (other than the currencies of Israel, Serbia and Montenegro).

Exporters are allowed to maintain either one foreign currency account or one multi-currency account with any of the Designated Banks to retain export proceeds, without having to seek specific approval from BNM. The following overnight limits are to be observed:

- up to an overnight balance equivalent to USD10 million for exporters with average monthly export receipts exceeding RM20 million;
- up to an overnight balance equivalent to USD5 million for exporters with average monthly export receipts between RM10 million and RM20 million; or
- up to an overnight balance equivalent to USD3 million for exporters with average monthly export receipts between RM5 million and RM10 million; or
- up to an overnight balance equivalent to USD1 million for exporters with average monthly export receipts of not more than RM5 million.

Inter-Company Accounts

No permission is required from the Controller of a company in Malaysia to maintain inter-company accounts with associated companies, branches or other companies outside Malaysia, provided monthly returns as specified by the Controller and the following are excluded from the inter-company accounts:

- proceeds from exports of Malaysian goods, and
- proceeds from external credit facilities extended to Malaysian companies.

Companies can apply to the Controller to offset the export proceeds through inter-company accounts against payables to their affiliated or parent companies overseas for the supply of raw materials. The companies allowed to offset their export proceeds need only to repatriate to Malaysia the value added in the form of services performed by them.

The companies which have been given permission to maintain offsetting arrangements are required to observe certain procedures in reporting and lodging monthly returns to enable the Controller to monitor their export proceeds which are repatriated to Malaysia in the prescribed manner.

Inward Investment

Investments from outside Malaysia are welcome, provided they are appropriately financed.

Borrowings from abroad that are equivalent to more than RM5 million require the approval of the Controller; approval is normally freely given where the funds are used for productive purposes and if the terms are considered fair and reasonable. Once approved, the terms of the loan cannot be changed without the prior approval of the Controller.

Domestic Borrowing by Non-Resident Controlled Companies Operating in Malaysia

Non-resident controlled companies (NRCCs) operating in Malaysia do not face difficulties in obtaining domestic credit facilities to finance their business in Malaysia. Specific exchange control approval is required only for loans exceeding an aggregate of RM10 million, including Export Credit Refinancing facilities. Permission is readily given for such loans in order to encourage economic growth and investment in the country. However, foreign investors are expected to be adequately capitalised and bring in a reasonable amount of funds of their own.

NRCCs which borrow in excess of RM10 million in Malaysia are required to ensure that their domestic borrowings do not exceed their capital funds (including long-term loans source from aboard with original maturity of at least five years) by more than three times. This is to ensure that NRCCs bring in sufficient amounts of their own funds to finance projects in Malaysia as a long-term proposition, and not merely as a venture for quick profit without any long-term commitment to the economy. Irrespective of the amount of domestic borrowing, at least 50% of the total domestic credit facilities obtained by NRCCs, including trade related facilities, have to be sourced from Malaysian-owned financial institutions in Malaysia. The above rules are, however, implemented pragmatically and flexibly to ensure that NRCCs have ready access to banking facilities at competitive prices to meet their financial requirements.

Borrowings in Foreign Currency from Banks in Malaysia

The commercial banks and the merchant banks operating in Malaysia are allowed to lend or syndicate loans in foreign currency to residents to supplement the latter’s domestic funding requirements to finance productive capacity in the economy. Residents are freely allowed to borrow in foreign currency up to the equivalent of a combined limit of RM5 million (i.e. RM1 million equivalent each from commercial and merchant banks in Malaysia and from non resident) to meet their financial requirements. The permission of the Controller is required for borrowing in foreign currency exceeding RM5 million in the aggregate. Approval is readily granted if the loan is to be used for productive investment within the country, and the resident borrower is able to generate foreign exchange to service the foreign currency loan.

Borrowing from Non-Residents

Residents are required to obtain the permission of the Controller before they can borrow from non-residents in foreign currency equivalent to more than RM5 million in the aggregate. Payment under guarantees are allowed as long as the payment is made in foreign currency. However, in order to encourage the development of the Labuan International Offshore Financial Centre (Labuan IOFC), such offshore guarantees for *any amount* obtained from the licensed offshore banks in Labuan which are :

- without recourse at Malaysian residents; and
- not counter-guaranteed by foreign financial institutions overseas; do not require the permission of the Controller.

A resident is not permitted to obtain any borrowings in Ringgit from any non-resident.

5.7 The Establishment of Danaharta, Danamodal and Corporate Debt Restructuring Committee

Pengurusan Danaharta Nasional Berhad (Danaharta), Danamodal Nasional Berhad (Danamodal) and Corporate Debt Restructuring Committee (CDRC) was established in 1998 by the Malaysian Government during the Asian Financial Crisis. The objective is to further strengthen the resilience of the banking system during the crisis.

Danaharta

Danaharta is a special purpose limited liability company, established on 20 June 1998, which facilitates the:

- transfer of problem assets from commercial banks in exchange for consideration;
- financing and resolution of problem loans and assets;
- expert management of problem loans through reconstruction and rehabilitation;
- specialist management of loan security (real estate, shares, infrastructure, etc.);
- expert and focused management of the process to maximize net returns (i.e. after costs) over a reasonable timeframe.

Danaharta was incorporated under the Companies Act, 1965 but was given statutory backing to enable it to perform its duties expeditiously. The statutory powers come in the form of the Pengurusan Danaharta Nasional Berhad Act 1998 which gives Danaharta the ability to acquire loans via statutory vesting and manage the borrowers through the appointment of Special Administrators (SAs). Consideration for the loans acquired is cash and/or zero-coupon Government-guaranteed tradeable bonds. Subsequent to acquisition, any excess in recovery value over and above Danaharta's acquisition cost plus direct costs will be shared between the selling financial institution and Danaharta on a 80:20 basis unless agreed otherwise. However, the financial institution's share of the upside will be limited to the shortfall value plus a holding cost of 8% per annum. Danaharta's estimated life span is 7 to 10 years.

Danaharta accords priority towards weaker financial institutions, including those institutions seeking recapitalization from Danamodal. In this respect, Danaharta and Danamodal complement each other towards strengthening the banking system and thereby accelerate the pace of economic recovery.

Danamodal

The objectives of Danamodal are to :

i) re-capitalize and strengthen the banking industry; and

ii) To help facilitate the consolidation and rationalization of the banking system to support the next phase of economic development

Danamodal was incorporated on 10 August 1998 as a wholly owned subsidiary of BNM. It operates on commercial and market oriented principles and injects capital in the form of equity or hybrid instruments into banking institutions to help meet their capital adequacy requirements. As a strategic shareholder in the recapitalized banking institutions, Danamodal will be in a position to facilitate the consolidation and rationalization process and expedite the formation of an efficient and competitive banking system.

Corporate Debt Restructure Committee (CDRC)

CDRC was set up by BNM in July 1998 as a platform to enable debtors and creditors to amicably devise and workout debt problems. Corporate workouts are on a voluntary basis with the following objectives:

- to minimize losses to creditors, shareholders and other stakeholders through voluntary coordinated workouts;
- to preserve viable businesses that are affected by the current economic conditions; and
- to introduce and implement a comprehensive framework for debt restructuring.

As of March 2002, CDRC has stopped accepting new cases and is planned to be dissolved by end 2002.

5.8 Financial Market

The Financial Market mainly comprises:-

i) The Money and Foreign Exchange markets, and
ii) The Capital and Derivatives Markets

The money and foreign exchange markets are integral to the functioning of the banking system, firstly, in providing funding to the banking system, and secondly, serving as a channel for the transmission of monetary policy. These are governed by the Malaysian Code of Conduct for Principals and Brokers in the Wholesale Money and Foreign Exchange Markets in January 1994 which set out the market practices, principles and standards to be observed.

The capital markets in Malaysia comprise the conventional and Islamic markets for medium to long term financial assets. The conventional markets consist of two main markets, namely the equity market dealing in corporate stocks and shares, and the public and private debt securities.

Apart from BNM, following are the statutory bodies established by Malaysian Government in regulating and supporting the above mentioned markets:-

Securities Commission

The Securities Commission (SC) is a statutory body entrusted with the responsibility of regulating and systematically developing Malaysia's capital markets. It has direct responsibility in supervising and monitoring the activities of market institutions and regulating all persons licensed under the Securities Industry Act, 1983 and Futures Industry Act, 1993.

Its two main roles under the Securities Commission Act 1993 are:

- To act as a single regulatory body to promote the development of capital markets;
- To take responsibility for streamlining the regulations of the securities market, and for speeding up the processing and approval of corporate transactions.

Its mission is to promote and maintain fair, efficient, secure and transparent securities and futures markets; and to facilitate the orderly development of an innovative and competitive capital market in Malaysia. Among SC's many regulatory functions include:

- Registering the prospectuses for all securities except those issued by unlisted recreational clubs;
- Regulating all matters relating to securities and futures contracts;
- Regulating the take-over and mergers of companies;
- Regulating all matters relating to unit trust schemes;
- Licensing and supervising all licensed persons;
- Supervising exchanges, clearing houses and central depositories; and
- Encouraging self-regulation and ensuring proper conduct of market institutions and licensed persons.

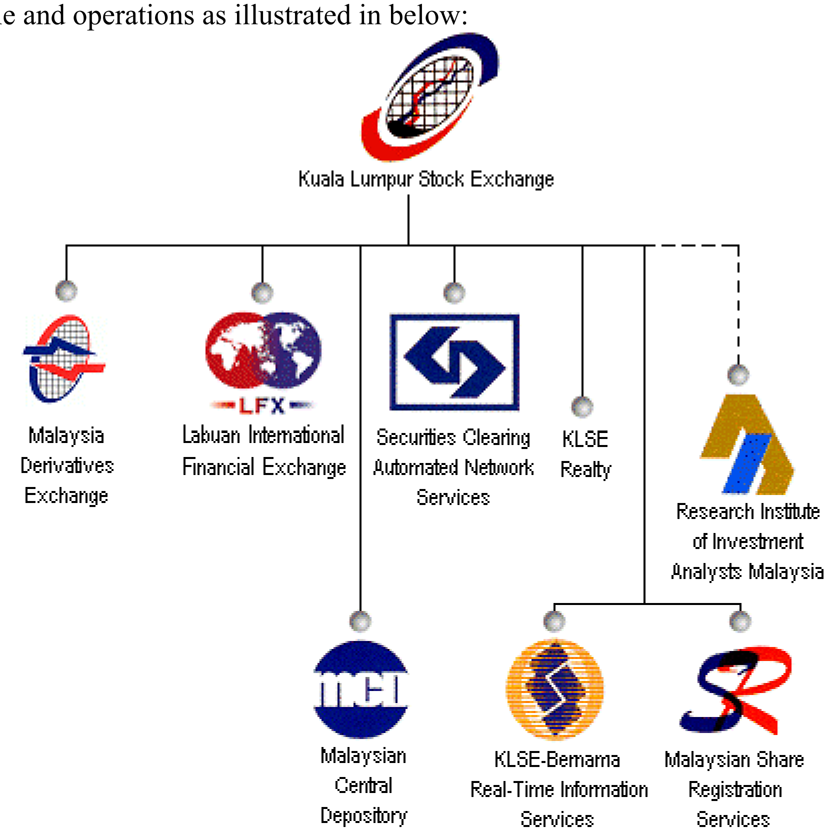
Underpinning this is the ultimate responsibility for the protection of investors. SC is a self-funding statutory body incorporated under the provisions of the Securities Commission Act 1993 with investigative and enforcement powers. It reports to the Minister of Finance and its accounts are tabled in Parliament annually.

At the moment, SC is overseeing three stock exchanges that deal with securities in Malaysia, namely KLSE, Kuala Lumpur Options and Financial Futures Exchanges (KLOFFE) and Malaysian Exchange of Securities Dealing and Automated Quotation (MESDAQ).

Kuala Lumpur Stock Exchange

KLSE is the first stock exchange in Malaysia, governed by the Security Industry Act 1983 and supervised by the Security Commission (SC). It commenced public trading of shares on 9 May 1960. The KLSE is the legal and formal institution for securities trading in Malaysia. Like any other stock exchange, the KLSE provides and maintains a central market-place or facility for buyers and sellers to transact business in the shares, bonds and different types of securities of companies which are listed on the exchange.

KLSE has several subsidiaries and affiliate companies, which collectively serve to expand and enhance its role and operations as illustrated in below:



Malaysia Derivative Exchange Market

Kuala Lumpur Options and Financial Futures Exchanges (KLOFFE) and the Commodity Exchange (COMMEX) merged to form a single derivative exchange, the Malaysian Derivative Exchange (MDEX), under the KLSE. The SC is empowered by the Ministry to regulate all matters relating to the derivatives industry.

Malaysian Exchange Of Securities Dealing And Automated Quotation

MESDAQ offers listing and funding opportunity for high potential companies that does not meet KLSE basic requirements. It was approved as a stock exchange on October 1997 and specializes in bringing high growth, high-tech or knowledge-based companies that do not have sufficient profit track records to be listed on the stock exchange and raise capital. Normally, these companies are newly set-up but with high growth potential.

The Malaysian Bond Market

The Malaysian bond market covers bonds issued by the Malaysian government, known as Malaysian Government Securities (MGS) and bonds issued by private corporations, known as private debt securities (PDS).

The MGS is issued by the Bank Negara Malaysia on behalf of the Government of Malaysia and backed by the credit of the government. The MGS are effectively long-term domestic borrowings, issued for purposes of financing public sector projects owned by the government. The Malaysian government also issued other bonds such as Government Investment Issues (GIIs) that are based on the Islamic principle AL-Qardhul Hasan, Malaysia Savings Bonds, Malaysia Treasury Bills (MTB), Bank Negara Bills (BNBs).

In 1983, the Government set up the Islamic Private Debt Securities. There are a number of Islamic principles that are applied in the structure of Islamic bonds. These Islamic bonds include Murabahah, Bai Al-Dayn, Ljarah, Bai Bithaman Ajil and Bai Al-Dayn.

Rating Agency Malaysia

There are two rating agencies in Malaysia namely the Rating Agency Malaysia Bhd (RAM) and the Malaysian Rating Corporation Bhd (MARC). The role of the rating agencies is to provide investors with credit ratings of private debt securities throughout their tenure.

Islamic Capital Market

The Islamic Capital Market (ICM) is one of the components in the overall capital market in Malaysia. Various capital market products are available for public, especially the muslim community, who only seek to invest and transact in the ICM. Such products include the list of the SC's Syariah Approved Securities, Islamic debt securities, Syariah Indices, warrants (TSR), call warrants and Crude Palm Oil futures contract.

5.9 Capital Market Regulations

Securities Industry Act 1983 (SIA)

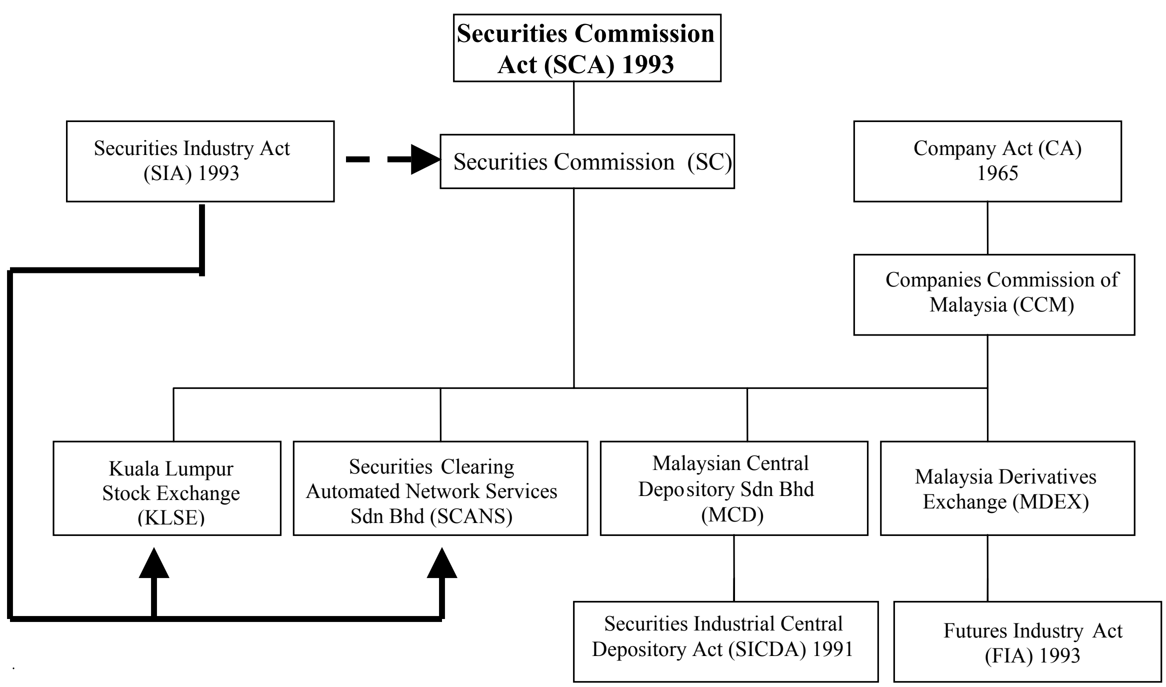
SIA provides the regulatory framework of the securities industry in Malaysia and is responsible to the Ministry of Finance. It lays down provisions relating to stock exchanges, stockbrokers and other persons dealing in securities. The said Act (section 9) enumerates the duties of a stock exchange placing obligation on the exchange to ensure that the Exchange's rules are complied with by members, member companies and corporations. The provisions in the SIA, amongst others, include:

- Power of Minister to approve a stock exchange and to give recognition to a clearing house.
- Power of Commission to approve amendments to the rulers of a stock exchange and clearing house.
- Power to issue licenses to dealers, fund managers, investment advisers and their respective representatives.
- Provisions against false market, market rigging and insider dealing.

Securities Commission Act 1993 (SCA)

The SCA establishes the SC, which is the body that regulates the securities industry as a whole. It sets out the powers and functions of the SC, a body corporate that is entrusted with regulating the securities industry. The Act also contains provisions for Take Over and Mergers. The SC has wide enforcement and investigation powers ensuring the smooth running of a fair and orderly market.

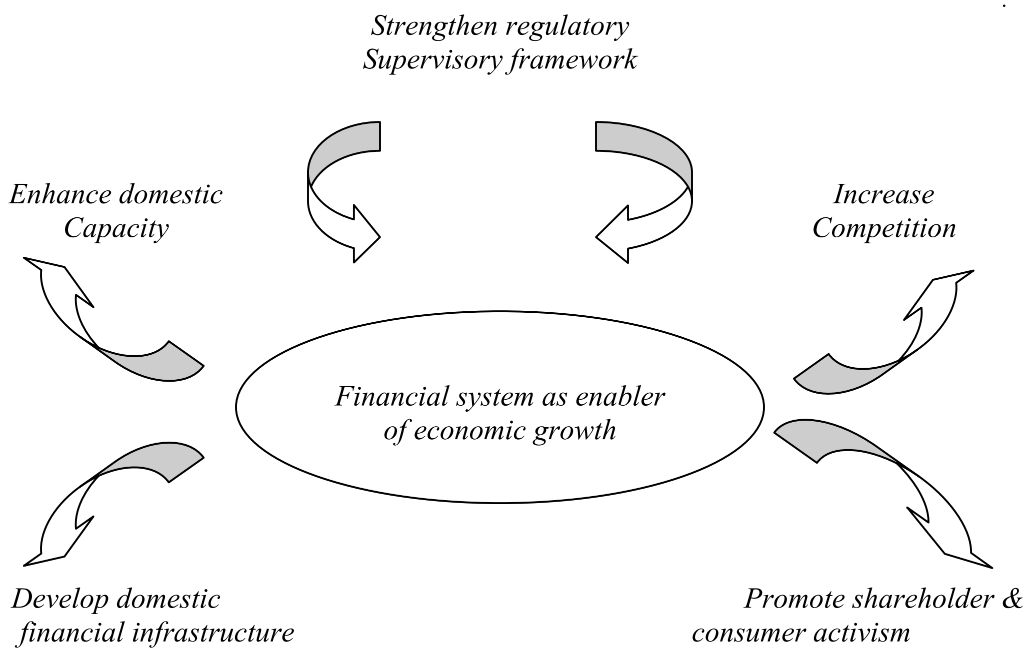
The chart below highlights the structure of the securities regulatory system in Malaysia.



5.10 Financial Sector Master Plan 2001 – 2010

BNM launched the Financial Sector Master Plan 2001 – 2010 on March 1, 2001. The objective of the plan is to develop a more resilient, competitive and dynamic financial system with best practices, that supports and contributes 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 liberalization and globalization.

<u>Financial Sector Masterplan outlines strategies to develop efficient, effective and resilient financial system</u>



The characteristics of the Financial Sector Masterplan are as follows:

- An increasingly more diversified financial sector that would meet the needs of a diversified economic structure. A competitive environment is likely to result in banking institutions and insurance companies with differentiated strategies and market niches. There would be a few broad-based institutions complemented by a few specialists providers successfully leveraging on technology and highly skilled employees
- The insurance industry will be more dynamic and increase in size. A more liberalized environment will be created and the competition among local and foreign insurance will be greater. This will bring down costs and premium, and sizable increase in business volume.
- A more significant Islamic banking and takaful industry with greater global orientation, with Malaysia positioned as the regional Islamic financial center
- A focused set of development financial institutions, strengthened by the formulation of common rules and regulations
- A modern financial infrastructure supported by an efficient and effective payment system, a deep and liquid capital market and a strong consumer protection framework.

The implementation of the Financial Sector Master Plan is summarized as follows:

First Phase 2001 – 2003	Enhance capacity of domestic banking institutions and strengthen financial infrastructure
Second phase 2004 – 2007	Intensity competition pressure in domestic financial sector
Third phase after 2007	Introduce new foreign competition and assimilation into global arena

Banking Industry

The banking sector plays an important role as a financial intermediary and is a primary source of financing for the domestic economy. The landscape of the Malaysian banking industry can be expected to evolve and change significantly. A group of core domestic banking institutions will emerge out of the competitive process to become leaders in the financial sector that are able to compete meaningfully with foreign players.

The implementation of the Financial Sector Master Plan for the banking sector is summarized as follows:

Phase I	The main objective in the transition is to develop a core set of strong domestic banking institutions. Therefore, initial steps shall focus on measures that seek to strengthen the capability and capacity of domestic banking institutions, create an environment where the best domestic banking institutions emerge, and building and enhancing the financial structure.
Phase II	Following the initial phase in which domestic banking institutions have built greater capacity and capability to compete, the playing field for incumbent foreign players will increasingly be leveled. This will begin with the removal of some of the restrictions on foreign players to add further competition to the industry.
Phase III	Given the intensifying degree of global competition and greater assimilation into the global arena, the banking sector needs to be prepared for greater liberalization. As a result, new foreign competitors will be introduced in the third phase development.

The following are some of the main recommendations for the Banking industry:

- Develop industry wide benchmarking in the area of financial and operating statistics, customer needs analysis and satisfaction surveys and risk management processes, to drive performance improvement in domestic banking institutions.
- Improve awareness of best practices and conduct focus training in credit risk management, consumer marketing, electronic commerce and banking, procurement of operational support system. This is to enhance the skills of the personnel in the sector.
- Set up Board Committee to further improve corporate governance.
- Merger allowed between merchant banks, brokers and discount house to create full fledged investment banks.
- Foreign banks allowed to enter the Malaysian market after 2007
- Core local banks to become the financial system's backbone
- Corporations' stakes in banks capped at 20% and individuals' stake to have 10% ceiling
- Encourage the maximization of economies of scale in cost, revenue and customer relationship through rationalization and strategic alliances between financial and non-financial institutions

Insurance Industry

The insurance industry in Malaysia is relatively small by international standard. As a result, significant changes must be made to raise performance standards in the Malaysian insurance industry in tandem with the global advances in order to narrow the gap between the standards and performance of Malaysian insurers with the established international best practices and performance standard.

The implementation of the Financial Sector Master Plan in the Insurance industry can be summarized as follows:

Phase I	Building capabilities of domestic insurers. Greater operational and management flexibility for insurers will be allowed in order for them to develop and optimize on skills, scale and technology.
Phase II	Concerted measures will be taken to establish the foundation necessary to support a greater role for market discipline to complement regulation and supervision of the insurance industry. The focus in this phase will be on strengthening the financial resilience of insurers and enhancing consumer protection.
Phase III	Opportunity for entry into the market will be made available under this phase. The process of gradual liberalization is expected to act as a powerful catalyst to hasten the development of the domestic industry to international standards.

The following are some of the main recommendation for the Insurance industry:

- The re-insurance market to be opened to foreign competition
- Promote the growth of bancassurance. This is to allow the banks to own insurers and distribute insurance and pension products, as well as the ability of banks and insurers to share customer information.
- Cap on foreign equity for new insurers to be eased
- The pricing of fire and motor insurance products to be deregulated.

Islamic Banking and Takaful

The Islamic banking and takaful industry has made steady progress since the establishment of the first Islamic bank in 1983 and the formulation of the first Islamic insurance company (takaful) in 1984. Although the performance of the Islamic banking and takaful industry has been encouraging, it is still relatively insignificant compared with conventional banking and insurance. The ability of the Islamic banking and takaful industry to capture a more significant market share in a rapidly evolving and challenging financial environment is dependent on the strategic positioning of the domestic industry players to maintain a competitive edge and become market leaders. Specifically, the Islamic banking and takaful industry is expected to face challenges from increased competition as a result of globalization and financial liberalization, increasing role of technology in shaping the microstructure of business and financial markets and the new generation of well informed consumers demanding differentiated and sophisticated products. The implementation plan of the Financial Sector Master Plan for the Islamic banking and takaful industry is summarized as follows:

Phase I	Strengthening the operational and institutional infrastructure. Under this phase, the focus of implementation will be to prepare a viable platform for the sound expansion of Islamic banking and takaful.
Phase II	Stimulating competition and upgrading the infrastructure. New licenses will be issued to qualified domestic industry players to stimulate increased competition.
Phase III	Raising performance standards through progressive liberalization and ensuring an effective infrastructure. The market will be opened to qualified foreign Islamic banking players to enhance efficiency and financial innovation in the industry.

Some of the main recommendations of the Islamic banking and takaful industry are as follows:

- Introduce a benchmarking program
- Enhance knowledge and expertise
- Grant incentives to structure Islamic private debt securities (PDS)
- Increase the number of takaful operators
- Strengthening the regulatory framework for Islamic banking
- Deepen the Islamic financial market.
- Create a favourable tax regime

Venture Capital Industry

Malaysia's venture capital (VC) industry is still at an infant stage of development. Going forward, in order to be able to meet the new financing needs of the economy effectively and efficiently, the Malaysian VC industry needs to be further develop the skills and expertise in evaluating start-up ventures, increase their risk appetite and build up their global networks. At end of 2001, 36 VC companies have been established.

Measures taken to develop the VC Industry

- A fund of RM200 millions was launched to finance high-tech project
- A total fund of RM300 millions for start-up companies will be managed by Mayban Ventures Capital Sdn Bhd and Commerce Technology Ventures Sdn Bhd
- A fund of RM120 millions launched by Malaysian Development Corporation Sdn Bhd for information technology and multimedia companies

Some of the main recommendations for the VC Industry are as follows:

- The Government will set up a "one stop center" for VC
- Establish a RM500 million VC fund
- Introduce further tax incentives for the VC industry
- Establish Islamic VC Funds
- Liberalize the MESDAQ listing requirements
- Increase the source of financing to the VC industry

Ringgit Bond Market

The development of the private debt securities market has become urgent as the Malaysian economy is increasingly diversified. While bank borrowings should remain a significant source, the equity and bond market would be an important complement to bank borrowings. To further develop the bond market, BNM proposed to set up a financial guarantee insurer (FGI). A FGI provides an unconditional and irrevocable guarantee of an insured obligation's principal and interest payments when due. The financial guarantee insurance policy provides for regularly scheduled payments of principals and interest. The insurance enhances the credit quality of an issue, with the FGI essentially 'renting out' its claims-paying ability rating to the issuers of PDS.

5.11 Capital Market Master Plan 2001 – 2010

The Security Commissions revealed the Capital Market Master Plan 2001 – 2010 on February 22, 2001. The vision of the Malaysian Capital Market is to be internationally competitive in all core areas necessary to support Malaysia's basic and capital investment needs, as well as its longer-term economic objectives. It must also be a highly efficient conduit for the mobilization and allocation of funds. Underpinning these characteristics should be a strong and facilitative regulatory framework that enables the capital market to perform its functions effectively and provide a high degree of confidence to its users.

The plan envisaged further liberalization of the stockbroking industry, derivatives market, investment management, equity and bond markets and Islamic capital market. The recommendations are expected to be implemented in phases up to 2010.

In order to achieve the vision, six key objectives have been identified to form the basis for the Masterplan's main strategic initiatives and specific recommendations. The first five objectives focus on the respective core areas of the capital market: issuers; investors, market institutions, market intermediaries, and overall regulatory framework. The sixth objectives focuses on an area of immediate comparative advantage that has been assessed to be an area where Malaysia bears substantial potential to occupy a leading international position.

These objectives are as follows:

Objectives	Strategic Initiatives
1. To be the preferred Fund-Raising center for Malaysian companies	• Enhance the efficiency of the fund-raising process • Implement a comprehensive program to develop the corporate bond market as a competitive source of financing • Facilitate the development of the venture capital industry to finance emerging high-growth companies • Foster a liquid and efficient market for the secondary trading of securities
2. To promote an effective investment management industry and a more conducive environment for investors	• Develop a strong framework for corporate governance and shareholder value recognition • Heighten efforts to establish a vibrant and competitive investment management industry • Enhance the role of institutional investors in the provision and management of funds • Facilitate effective risk management by actively developing the derivatives industry • Facilitate the introduction of a broad range of capital market products catering to various risk return profiles

3. To enhance the competitive position and efficiency of market institutions	• Restructure Malaysian exchanges and clearing institutions to strengthen their efficiency and competitiveness • Ensure Malaysian exchange are well positioned to respond to changing market dynamics through the adoption of flexible business structures and commercially oriented strategies • Enhance the efficiency of the trading, clearing and settlement infrastructure
4. To develop a strong and competitive environment for intermediation services	• Foster constructive competition through the deregulation of services, products and fixed fees structures • Develop strong full-service brokers to provide a competitive market for integrated financial services • Ensure Malaysian intermediation services are anchored on appropriate prudential standards, with high levels of business conduct and professional skills • Adopt a pragmatic program for liberalization, supported by appropriate safeguards
5. To ensure a stronger and more facilitative regulatory regime	• Move towards a market-based system of regulation for capital market activities • Ensure regulatory parity and consistency between all institutions and participants conducting similar capital market activities • Ensure strong enforcement of the regulations governing the capital market • Enhance capacity for maintaining systemic and financial stability
6. To establish Malaysia as an International Islamic Capital Center	• Facilitate the development of a wide range of competitive products and services related to the Islamic capital market • Create a viable market for the effective mobilization of Islamic Funds • Ensure that there is an appropriate and comprehensive accounting, tax and regulatory framework for the Islamic capital market • Enhance the value recognition of the Malaysian Islamic capital market internationally

The master plan contains a three-phase development plan for the 10-year period. It starts with strengthening the capital markets, goes on to gradually deregulating and liberalizing, and progresses to expanding the depth and breadth of the markets. The final goal is to build a capital market that is mature and internationally competitive.

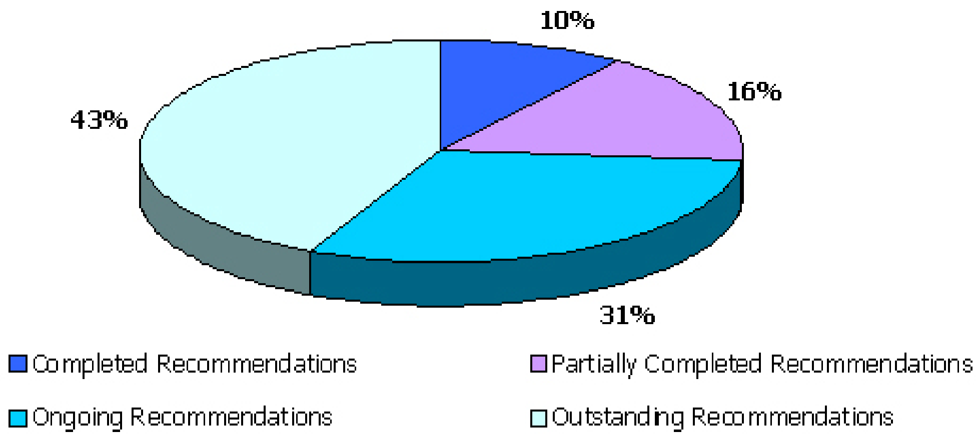
The implementation of the Capital Market Master Plan can be summarized as follows:

2001 - 2003	Expand domestic capacity and strengthen the foundation for further competition through progressive deregulation and selective liberalization, with some relaxation of barriers to entry in certain nascent areas of the capital market in order to accelerate development of these sectors
2004 - 2005	Progressively expand market access and gradually remove barriers to entry across other capital market segments, and further develop the breadth and quality of services and infrastructure
2005 - 2010	Implement further expansion plans towards becoming a mature capital market and developing its international positioning in areas of competitive and comparative advantage

The Plan also spells out 152 recommendations that covers the market institutions, equity market, bond market, derivatives market, Islamic capital market, stockbroking industry, investment management, corporate governance, regulatory framework, technology and e-commerce, training and education. The following are some of the main recommendations:

- A single Malaysian exchange should be established through consolidation of all existing exchanges by 2002;
- Single clearance and settlement institution for all traded products of the single exchange to be created by 2002;
- Malaysian exchange to be demutualized and listed on the stock market.
- Breadth of listing in the Malaysian equity market would be gradually widened to include listing of foreign companies;
- Listing of technology incubators would be allowed in 2001;
- Regulated short selling of Malaysian Government Securities (MGS) and corporate bonds should be allowed;
- Regulated short-selling and securities borrowing and lending activities of derivatives to be re-introduced in 2002;
- Derivatives funds will be allowed to be set up;
- Foreigners allowed to have majority ownership of futures broking firms by 2003;
- A limited number of foreigners allowed to buy existing stockbroking firms in 2003;
- Restrictions on participation of local institutions including the Employees Provident Fund (EPF) and insurance companies in exchange traded derivatives should be deregulated;
- Foreign ownership requirements would be liberalize to allow foreign majority ownership of unit trust companies from 2003; and
- Online trading of unit trust funds would be permitted.

Implementation status of the Capital Market Masterplan as at 31 March 2002



The implementation status of 31% or 47 recommendations of the Masterplan is currently classified as ongoing. Recommendations that are ongoing refer to those that do not have a definitive timeframe throughout the implementation of the Masterplan, such as training and education or the development of new products within various segments of the capital market.