



The Financial Sector Masterplan

The objective of the Financial Sector Masterplan (FSMP) is **'to provide the blueprint for the development of an effective, competitive, resilient and dynamic financial system with best practices, that supports and contributes positively to the growth of the economy through 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'**. While opportunities have emerged in this new environment, threats of the global marketplace are becoming more intensive, as global players and technology advancements are having an unprecedented impact on the approach of banking and financial businesses. Against this background, it is vital for the financial system, particularly the domestic financial institutions to be resilient and efficient if Malaysia is to ensure that its financial sector remains effective and responsive in the face of a more globalised, liberalised and a more complex domestic economy.

In the new millennium, the future of the financial system lies in its ability to create a

respective building blocks of the various parts of the financial sector need to be put in place to form the solid foundation on which further progress can be built. The recommendations therefore are focused on enhancing domestic capacity and capability before proceeding with the introduction of an increasingly more competitive environment and subsequently towards greater international integration.

Efforts to strengthen and develop the financial system require an assessment of the financial services required as Malaysia moves towards the new economy as well as an assessment of the implications of the forces of change in the global and domestic environment. The future landscape of the Malaysian financial system will be developed against the backdrop of an increasingly global and integrated economic environment and financial markets. The opportunity is now taken to focus on the medium and longer term agenda to build a financial sector that is responsive to the changing economic requirements and a financial system that is strong and resilient in facing the future

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dynamic set of financial players, which are able to provide the support to the domestic economy, and more importantly, that are increasingly more efficient, competitive, sound and stable that would facilitate the economic transformation process. The Malaysian banking institutions need to strive to enhance their capacity and capability so that they will be at par with global players in terms of efficiency, effectiveness and financial soundness. Against the backdrop of the socio-economic objectives of the country, the vision is for the development of a well-diversified financial sector.

In achieving the end game of an effective, efficient and stable financial sector, the

challenges in this new environment. It is within the context of these objectives that the FSMP was formulated to outline the strategies for the development of the financial sector. A well-diversified and competitive financial system is vital for the long-term economic growth development to ensure that risks in the economy are well distributed among the various sub-sectors. The purpose of the FSMP is to set out the plan to chart the future direction of the financial system over the next ten years that will ensure its continued effectiveness, competitiveness and resilience.

The Financial Sector as an Enabler of Economic Growth

The financial sector will continue to be an important determinant of economic performance and thereby the quality of life and prosperity of the nation. The development of the financial sector has thus far been evolving with the changing profile of the domestic economy. The growth of international trade and cross border activities has resulted in the increase of

need for diversified economic structure and a balanced growth, with the objective being to achieve sustainable growth and development.

The Financial Sector Landscape in 2010

While it may not be possible to project accurately how Malaysia's financial sector will be structured in 10 years time, taking into account the forces at work and how the

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the provision of trade financing facilities as well as international banking. Similarly, the need to invest in the massive physical infrastructure and other identified priority sectors had led to the setting up of development financial institutions to serve this purpose. The need for long-term funds from domestic sources by large corporates that are cost competitive has led to the development of the domestic capital market.

Given the gradual process of economic transformation and the economic opportunities that have yet to unfold, going forward, the long-term objectives for the domestic financial sector will continue to take into account the needs envisioned for the economy. The objectives for the financial sector for an emerging economy such as Malaysia are therefore not necessarily similar to those systems that aim to develop as an international financial centre where rapid deregulation and liberalisation is a key part of the process. In an emerging economy, the financial system has a pivotal role in facilitating the growth process and therefore cannot develop independently of the requirements of the real sector. Careful consideration also has to be given to both the objectives of efficiency and stability and that of the social agenda.

To become an efficient and effective enabler of growth, the financial sector will need to recognise the importance of the new areas to growth and the other alternative modes of financing, relevant to the risk of the specific economic sub-sectors. Financial institutions will therefore need to be prepared and be proactive in providing services to such new industries and businesses, recognising the

challenges facing the industry are being met, the future financial landscape can be expected to be characterised by the following:

- An increasingly more diversified financial sectors meeting the requirements of a more diversified economic structure;
- The competitive environment in the banking sector is likely to result in institutions with differentiated strategies based on their strengths and market niches. This implies that:
 - △ Fewer large, broad based institutions will thrive, exploiting their privileged relationships with retail customers and mid-market corporates to provide a full range of financial services to market segments that value banking relationships and/or convenience;
 - △ The successful institutions will be those who continue to leverage on the advancements made in technology, in reengineering work processes and delivery modes, and offering state-of-the-art products and services that serve as complete financial solution for varying types of consumers;
 - △ Employing and retaining highly skilled workers and the re-skilling of existing work forces and promoting a culture of continuous learning and unlearning will be continuously pursued as human factor becomes a defining characteristic of a successful banking institution;

institutional investors and contributing to the development of the venture capital industry.

- Labuan International Offshore Financial Centre (IOFC) will thrive on Islamic finance, insurance activities and business generated through the Labuan International Financial Exchange such as trading of financial and non-financial products, in addition to the traditional and other peripheral activities.

Given the important roles played by domestic financial institutions in ensuring the stability of the financial system and supporting the economy, steps will be taken to:

- Develop the best domestic institutions by:
 - △ Building the capabilities of domestic institutions; and
 - △ Increasing the incentives for domestic institutions to further improve performance.
- Maintain stability of the financial system through an efficient infrastructure, more resilient institutions as well as strong prudential regulations and supervision;
- Meet the socio-economic objectives of Malaysia in ways that cause the least possible distortion to the sector and minimise the burden on its institutions; and
- Promote a more market driven consumer protection infrastructure.

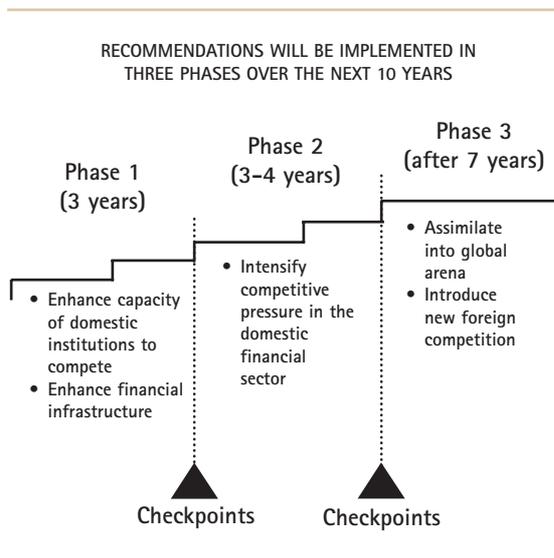
Approach to Implementation

The change programme involving 119 recommendations to be implemented over the next 10 years will undergo three phases of implementation, subject to achieving certain milestones and safeguards. The first phase is focused on building the domestic capacity, the second phase is about increasing domestic competition and the third phase sets the pace for the integration with the international market.

During the early years of implementation of the FSMP, the emphasis will be on capacity building. This will include the implementation of measures to enhance the capability of financial institutions to compete and become more

efficient and effective, as well as measures to promote stability. The regulatory and institutional infrastructure would be further enhanced, while a more efficient consumer protection framework would be instituted.

The next phase of development would involve the gradual deregulation of the domestic financial market, intended to bring about greater competition between the various financial institutions. At this stage, incumbent foreign financial institutions, specifically in the banking sector, would be able to compete on a more level playing field with the domestic institutions. Financial institutions during this phase would be expected to demonstrate a high level of professionalism and expertise, which would be the result of a long process of domestic capacity building initiated earlier. A diverse range of financial institutions, each having their own expertise and capability will compete, and at the same time complement each other to meet the increasingly differentiated demands of the consumers. By then, a strong corporate governance should be well-entrenched among these institutions prompted by the regulatory pressure as well as greater activism from their shareholders and other market participants. Greater exposure and experience in the various financial markets, and the use of hedging instruments over time, would raise the standard of risk management practice among financial institutions. The efficient functioning of various customer protection mechanisms and the framework for achieving socio-economic objectives laid down during the initial stage of FSMP implementation





would be necessary before competition is further intensified during this phase.

The ability of domestic financial institutions to compete meaningfully under a more liberalised environment during this second phase would be a critical factor to decide the degree of further market liberalisation to be undertaken. This is to ensure that liberalisation measures do not bring about destabilising implications on the financial system and economy as a whole. Thus,

institutions to meet the increasingly more complex demands of the changing economy and the retention of their market share will be severely tested as domestic competition intensifies. Therefore, the survival of domestic institutions will be dependent on their ability to improve their efficiency and effectiveness in product offering so as to be at par with world class players. As market forces assume a greater role, domestic banking institutions must be proactive in their strategies in order to

While the financial sector will become increasingly more diversified, the banking sector will continue to be an important source of financing for the domestic economy in the future. The development of the banking system, particularly the domestic banking institutions is therefore vital to facilitate and support the economic growth and transformation process.

liberalisation measures, including the possibility of introducing new foreign competition that would be undertaken during the advanced stage of development of the financial sector would need to be properly sequenced to ensure that they bring about the desired improvement and offer new opportunities and benefits for the domestic financial system while preserving the overall financial stability.

Banking Sector

The banking sector comprises licensed institutions, namely commercial banks, finance companies, merchant banks, discount houses and money brokers, which are licensed under the Banking and Financial Institutions Act 1989 (BAFIA) and supervised by BNM. While the financial sector will become increasingly more diversified, the banking sector will continue to be an important source of financing for the domestic economy in the future. The development of the banking system, particularly the domestic banking institutions is therefore vital to facilitate and support the economic growth and transformation process. Primarily, due to their dominant market share, the strength of the domestic banking institutions is an important element of financial stability that contributes to the long-term resilience of the economy. The advantage of having better knowledge of the local market however does not promise long-term competitiveness for domestic institutions given the trend towards greater globalisation and liberalisation. The ability of domestic banking

compete with global players. Innovation and strategic reengineering will be vital as the process will eventually see domestic banking institutions having to redefine their focus and finding their own niches with broad oversight by the regulatory authorities.

The landscape of the Malaysian banking sector can be expected to evolve and change significantly. Players with strong value proposition will survive and expand while others will eventually exit the market. The aim is for a set of core domestic banking institutions to emerge, out of the competitive process, to become leaders in the financial sector that is able to compete meaningfully with the foreign players.

The presence of foreign banking institutions in Malaysia is currently high, controlling about 25% of banking sector's market share in terms of total assets and total deposits as at end-2000. Moving forward, incumbent foreign banking institutions will be able to operate on a more level playing field with domestic banking institutions as the domestic market is increasingly deregulated. The role played by foreign banking institutions will be assessed in terms of their contribution to the development of the financial industry as well as to the overall economic growth and stability. The introduction of new types of foreign competition, particularly during the advanced stage of development of the financial system, will also be considered with a view to ensuring

that the domestic financial system continues to be effective, vibrant and responsive to the requirements of the economy.

Over time, it is expected that the domestic banking groups, through the process of mergers, acquisitions, asset swaps and alliances, will evolve into more differentiated competitors, spurred by increasingly more demanding customers and shareholders. It is envisaged that the trend towards building meaningful size will be complemented by greater specialisation. Financial institutions are specialising more and more in specific product markets or specific functions along the business chain of traditional services. These institutions develop scale and skills in the particular functions necessary to dominate in the area of focus, reduce costs and increase service quality. As they succeed in one market, these 'specialised institutions' develop other skills and scale necessary to enter new markets, and become globally competitive based on strategic approaches by focusing on specific product markets or specific functions along the business chain.

The regulatory environment will also influence the future landscape of the banking sector. Changes in regulatory philosophies and approaches to be undertaken aim to provide conducive environment for growth and expansion of banking institutions. The key to this is the ability of individual banking institutions to adapt swiftly as well as respond and adjust to the new rules.

On the consumer front, a change in mindset will have to be evolved over time. Consumers must take charge of their own finances to engender a competitive environment and lower the cost of capital. In order to achieve this, a proactive education programme has to be implemented for the consumers to be able to make well-informed financial decisions. Transparency will need to be enhanced, both at the product and institutional levels to promote consumers' awareness of banking and financial products. Similarly, greater flexibility in product pricing that would lead to competitive and differentiated strategies among banking institutions, will eventually benefit genuine customers, in the form of lower costs. The ability of consumers to influence the market to react positively is an important enabler for deregulation within the domestic financial sector.

A **change programme** would be implemented over the next 10 years with the objective of improving efficiency, innovation, flexibility, resilience and dynamism in the banking system. The programme essentially focuses primarily on building the capabilities of domestic banking institutions and increasing the incentive to improve performance. The programme contains recommendations to be implemented over the period to develop domestic financial infrastructure, strengthen domestic banking institutions, promote financial stability, and meet the social objectives of Malaysia in an efficient and effective manner which will cause least distortion or disruption to the financial sector.

The implementation of the recommendations will observe the following approach and safeguards:

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 infrastructure.** All the 'building blocks' for creating stronger domestic banking institutions will be implemented early within the first two to three years, along with steps to create the necessary infrastructure for a more market-based consumer protection framework, which is a vital element before moving to the next phase of development. As the consumer protection infrastructure is in place, the framework to foster further competition will be introduced. The result should be the emergence of domestic players that are stronger, more efficient and innovative and increasingly more competitive and resilient.

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 incumbent foreign players to add further competition to the industry, as well as providing wider choices for the consumers. These steps however will be implemented gradually depending on the overall ability of the financial system to absorb these changes.

Phase III Consider introducing new foreign competition in the third phase of development. Given the degree of global competition and assimilation into the global arena, the banking sector needs to be prepared for greater liberalisation. Introducing new foreign competition would therefore be considered. In addition, there will be expansion of domestic banking institutions to foreign markets. At the same time, the

- greater progress should be made towards the development of skills in the areas of management, information technology and underwriting;
- greater competition should be encouraged to reduce acquisition costs, especially in the life sector, and premiums charged in the general sector;
- the penetration of alternative distribution channels such as independent financial advisers, banks, telephone, direct mail and internet could be further enhanced;
- the quality and productivity of the agency force should be improved; and
- the breadth and standard of insurance products and services in Malaysia should be improved to match that available in more advanced markets.

While Malaysia's insurance industry has achieved significant progress in its financial standing and professionalism in the last decade, there is a need to set benchmarks in order to accelerate the development of the industry towards international best practices and performance standards.

potential 'threat' from new and aggressive non-financial players would also serve as an incentive for incumbent players to remain competitive.

The transition from one phase to another would be based on the achievement of specified milestones and safeguards so as to ensure that new measures to be implemented are timely and the desired strategic direction and objectives are achieved.

Insurance Sector

While Malaysia's insurance industry has achieved significant progress in its financial standing and professionalism in the last decade, there is a need to set benchmarks in order to accelerate the development of the industry towards international best practices and performance standards. Specifically:

- domestic insurers should improve further on economies of scale;
- conducts business through a broad range of distribution channels for the convenience of consumers;

In the longer term, the recommendations in the FSMP aims to build a more efficient, effective and stable insurance sector that can continue to support both the needs of the real economy and the socio-economic objectives of the country in the long-term. This entails an insurance industry that:

- is an effective mobiliser of long-term savings to support economic growth;
- is financially resilient to market volatility and competitive pressures;
- adopts international best business and management practices;
- is at the cutting edge of innovation with a broad range of products for consumers at competitive prices;

- displays high professional ethics and standards; and
- is more productive and cost-efficient.

To this end, the FSMP sets out a programme of change that will build the capabilities of domestic insurers to compete more effectively for a share of the growing insurance market without compromising international commitments to liberalisation of the insurance sector, while ensuring that Malaysian consumers have access to the best products and services

strategically position the industry to enter its next stage of development and expand its significance in the financial landscape of Malaysia. The current market penetration level of 6.9% for Islamic banking and 2% for takaful imply a vast potential still remains to be tapped. Given Malaysia's pioneering efforts in promoting Islamic banking and takaful and the establishment of the financial infrastructure to support Islamic financial operations, Malaysia is strategically positioned to establish a niche in Islamic banking and takaful at the domestic, regional as well as the international markets.

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available to meet their requirements. This will be achieved through a series of measures designed to enhance the capabilities and competitiveness of domestic insurers, promote consolidation and the adoption of best practices and stimulate innovation through progressive liberalisation.

The recommendations for the insurance sector will be implemented in phases, over a 10-year period under a carefully managed transition plan designed to minimise any instability in the industry while ensuring rapid but sustainable reform. Measures in the short to medium-term will focus on improving the performance of incumbent insurers and encouraging industry consolidation. This will be followed by measures to further liberalise the insurance sector in the longer term once incumbent insurers are adequately prepared to participate in the new business environment expected to emerge following liberalisation. The pace and sequencing of these measures will be determined based on the results of periodic reviews of the industry's progress. While the FSMP takes a market-driven approach, emphasis will be given to enhancing capabilities, performance building, performance improvement and industry consolidation.

Islamic Banking and Takaful

Taking cognisance of the encouraging progress of the Islamic banking and takaful industry since its inception, the FSMP is designed to

Against this backdrop, the objective of Islamic banking and takaful is to create an efficient, progressive and comprehensive Islamic financial system that contributes significantly to the effectiveness and efficiency of the Malaysian financial sector while meeting the economic requirements of the country.

It is envisioned that the Islamic banking and takaful industry landscape in 2010 would evolve in parallel with conventional banking and insurance to achieve the following:

- Epitomise Malaysia as a regional Islamic financial centre;
- Constitute 20% market share within the banking system and insurance industry;
- Represented by a number of strong and highly capitalised Islamic banking institutions and takaful operators operating a comprehensive and complete range of Islamic financial products and services; and
- Underpinned by a comprehensive and conducive Syariah, legal and regulatory framework.

To achieve this vision and objective, specific recommendations and strategies have been formulated to focus on three main areas: **institutional capacity enhancement; financial**



infrastructure development; and regulatory framework development. Institutional capacity enhancement involves measures to prepare the Islamic banking and takaful industry players to be among the best managed institutions, capable of capitalising on the unique features of Islamic banking and takaful to achieve significant competitive edge.

The implementation of the recommendations will be undertaken under three phases. Under Phase I, the focus will be to prepare a viable platform for the sound expansion of Islamic banking and takaful. This involves improving the prevailing operational structure of Islamic banking institutions, formulating an effective regulatory framework and preparing a preliminary legal structure. Efforts to balance the capabilities of the Islamic banking institutions and takaful operators will also begin under this phase to prepare them for increased competition in Phase II.

Under Phase II, new licenses will be issued to qualified domestic industry players to stimulate increased competition. In addition, the infrastructure of the Islamic banking and takaful will be further upgraded.

Phase III will involve the issuance of Islamic banking license to qualified foreign Islamic banking players whilst ensuring the development of a comprehensive and effective infrastructure to support financial operations in a more liberalised environment.

Development Financial Institutions

In Malaysia, the development financial institutions (DFIs) have been established and funded by the Government to develop and promote certain strategic sectors of the economy whilst achieving the country's social goals. The sectors currently supported by the DFIs are high-technology industries, export-oriented industries, infrastructure development, and highly capital-intensive investments. At the same time, they also play a crucial role in the development of SMIs, the agriculture and housing sectors.

Recognising the significant roles played by the DFIs in the socio-economic development of the country, the strategic focus for these institutions is to continue meeting the financial requirements of the economy, complementing the banking

sector to ensure that the financing needs of all economic sectors are well served. This vision will be best served by objectives which focus on enhancing the efficiency and robustness of the DFIs so that the objectives are achieved with minimum cost.

The FSMP envisages that the DFIs would continue to progress and assume an important role in addressing the development strategies of the country. In this regard, recommendations for DFIs to increase their capacity, effectiveness and efficiency in providing specialised financial services are presented in the FSMP. In addition, the definition and specification of the functions and roles of a single supervisory authority responsible for DFIs is proposed to ensure that the activities of the DFIs are undertaken prudently, efficiently and effectively in accordance with best practices. In addition to providing access to financing, the value-added services provided by the DFIs to the targeted economic sectors could also be enhanced by encouraging the emergence of the DFIs as lead advisers, consultants and/or management service providers to these sectors.

As part of the strategies to promote improvement in the efficiency and effectiveness of the DFIs, a number of recommendations are proposed, focusing on measures to build the capabilities of the DFIs and to improve the supervisory framework. DFIs will continue to be relevant and important in pursuing Government policy goals for strategic, social and economic development. Towards achieving these goals, the role of DFIs needs to be clearly mandated to ensure such institutions stay focused on their core activities to complement rather than to compete with the existing banking institutions.

Alternative Modes of Financing

As the economy transforms into one in which service and productivity will drive growth, different sources of financing would be required for new activities and industries. Efforts would need to be directed to facilitate financing by non-banks for high-risk ventures as well as knowledge-intensive and technology-intensive start-up enterprises where only ideas (intangible collateral) are principal assets. As such, alternative forms of financing such as venture capital (VC) and

credit enhancements such as financial guarantee insurance and agriculture insurance, would be required to complement traditional financing sources.

- **Venture Capital Industry**

In order for the VC industry to play an effective role in supporting the economic transformation towards an advanced knowledge-based economy, the VC industry would need to be able to provide funding for all stages of financing, from the early stage to the pre-IPO stage and be capable of financing all economic sectors, particularly the high-growth activities identified by the Government. The VC industry would also need to have the necessary expertise and experience to evaluate new ventures and be capable of providing high-quality value-added services to their investee companies. More importantly, the level of coordination of Government initiatives to boost the VC industry would need to be enhanced. A holistic approach would be taken to develop a vibrant VC industry in Malaysia.

- **Establishment of a Financial Guarantee Insurer**

To support the development of the bond market, the financial guarantee insurer (FGI) would be established to provide an unconditional and irrevocable guarantee of an insured obligation's principal and interest payments when due. The insurance would enhance the credit quality of the issue, thereby promoting greater interest cost savings to the issuer. The provision of credit enhancements to PDS issues by the FGI will also have the following benefits:

- △ Mobilise savings to fund long-term infrastructure projects;
- △ Better opportunities for credit enhancement;
- △ Divert systemic risks from the banking system; and
- △ Ensure payment obligations.

- **Financing the Agriculture Sector**

The latter half of the 1980s witnessed a rapid expansion in the manufacturing sector and a decline in the contribution of the

agriculture sector. To restore balanced growth in the economy, the Government has taken steps to revitalise the agriculture sector via the Third National Agricultural Policy (NAP3). The financing requirements to meet the NAP3 targets are significant, requiring a total investment of RM32 billion over the next ten years. BNM has been working with the Ministry of Agriculture and the banking institutions to address the issue of access to credit to finance activities in the agriculture sector. In order to meet the financing requirement under NAP3, efforts would be directed to enhance the operations and efficiency of Bank Pertanian Malaysia to enable the bank to play a more effective role in providing credit to the agriculture sector. In addition, BNM is also working with the insurance industry to identify and ensure the availability of insurance coverage and services required under the NAP3. A task force on agriculture insurance has been set up consisting of representatives from BNM, the Ministry of Agriculture, Bank Pertanian Malaysia and insurers, to develop the appropriate insurance protection and services for the agriculture sector to complement the other efforts on developing sources for financing of agriculture activities.

Labuan International Offshore Financial Centre

Labuan was declared as an International Offshore Financial Centre (IOFC) in October 1990 to complement the activities of domestic financial market in Kuala Lumpur, and strengthen the contribution of financial services to GNP in Malaysia as well as develop the island and areas within its vicinity. In the early years of the IOFC, the strategic focus was on attracting the critical mass of core and top players that can provide services and products to investors investing in this region. Having succeeded in this, the thrust is now to build on the strength and expertise of the existing players, and encourage proactive expansion of the scope and breadth of services and products in the IOFC. In tandem with these developments, a review will be made on the existing rules and regulations to facilitate new businesses, and at the same time allow the offshore service providers to maximise their capabilities and expertise to expand their businesses.



The IOFC in the future would not only be a centre that thrives on the offshore financial services, but also one, which is developed holistically to support the development of the island, and plays an effective complementary role to the domestic financial market. Therefore, efforts would be channelled towards promoting and diversifying the financial players and activities in the IOFC, enhancing the Islamic banking and retakaful business and developing and strengthening the capital market, e-commerce and the ancillary activities.

Conclusion

The formulation of the FSMP is both timely and appropriate to address critical issues related to the future direction and strategic development of the financial sector. It embodies the intention of the Government to ensure that the financial sector continues to be resilient and competitive, and able to meet the increasingly complex demands of the economy.

Recommendations outlined in the FSMP would be implemented through a consultative approach with the objective of speeding up the process where possible. While BNM would be monitoring the overall progress and achievement of the various milestones outlined, it must be emphasised that the success of the overall plans rest on the collaborative and concerted efforts by various parties, both in the public and private sectors.