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Foreword

This first OECD Investment Policy Review of Malaysia *presents an assessment of the investment climate in Malaysia, including the institutional and legislative framework for investment. Undertaken in partnership with the Secretariat of the Association of Southeast Asian Nations (ASEAN) it illustrates the growing ties between the OECD and Malaysia, and Southeast Asia as a region.*

The Review *uses the Policy Framework for Investment to chart the investment-related reforms undertaken in Malaysia that have contributed to its economic success. It describes the major role foreign direct investment has played in the growth and diversification of the economy, within an outward-oriented development strategy. Today, Malaysia is a net outward investor, with its companies increasingly becoming regional and global players. The* Review *also highlights ways to address inter-related challenges Malaysia faces in further opening up the economy and in making its regulations more efficient as the country strives to attain developed country status by 2020.*

The Review *is based on a background report that facilitated a review by the OECD Investment Committee of Malaysia's investment policies in December 2012. The Malaysian delegation was led by the Secretary General of the Ministry of International Trade and Industry, Dr. Rebecca Fatima Sta Maria. An early draft of the report was also discussed at a stakeholders' workshop organised by the Government of Malaysia in October 2012 in Kuala Lumpur, with the participation of a wide range of government agencies, the private sector, civil society and OECD delegations.*

The Review *has been prepared by the Investment Division of the OECD Directorate for Financial and Enterprise Affairs. The team comprised Stephen Thomsen, Mike Pfister, Fernando Mistura, Hélène François, Cristina Tébar Less, Dambudzo Muzenda and Mi-Hyun Bang. Secretariat inputs were received from the Financial and Corporate Affairs Divisions. The* Review *was supported by the ASEAN-Australia-New Zealand Free Trade Agreement Economic Cooperation Support Programme (AECSP) and by the Government of Japan.*

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Preface by Dato' Sri Mustapa Mohamed, Minister of International Trade and Industry, Malaysia

Malaysia is an open economy with trade accounting 174.3% of the GDP in 2012. As a result Malaysia is highly-exposed to developments in the global economy. Given the current global scenario, strengthening domestic demand would continue to be the key focus in driving growth.

Our aim is to ensure that the development and growth of the economy contribute to improvements in the lives of all Malaysians and provide a sustainable environment for the future. It's against this backdrop that Malaysia continues to undertake reforms and reinvent itself in the pursuit of moving from a middle income economy to an advanced nation status by 2020 by attaining a per capita income of US 15 000, while maintaining the principles of sustainability and inclusiveness.

In pursuit of the transformation agenda, we will focus on:

- Promoting investments both domestic and foreign in high value added activities and niche areas;
- Liberalizing the services sector and promoting the development of key sectors in order to enhance its contribution to the economy;
- Creating an environment for innovation, research and development;
- Reducing regulatory barriers in order to improve the environment for businesses;
- Enhancing entrepreneurial skills and promoting the development of SMEs;
- Attracting skilled talent from abroad to sustain growth of a knowledge-based and innovative economy; and
- Promoting regional growth and inclusiveness.

Going forward, creating strong, sustainable and balanced growth would be underpinned by productivity improvements and innovation, enabling the transition into a higher value-added and higher income economy. Malaysia will also leverage on new opportunities in the changing global landscape, as exports remain key to the Malaysian economy. Towards this end, Malaysia will promote investment in key strategic sectors to ensure it is positioned

strategically to take advantage of opportunities in new export markets, the global supply chain as well in capitalising on global and regional growth centres.

In this light, the co-operation with the OECD in undertaking the first *Investment Policy Review of Malaysia* is a timely initiative to support the government in achieving its objectives.

Dato' Sri Mustapa Mohamed

Minister of International Trade and Industry, Malaysia

Preface by Angel Gurría, Secretary-General, OECD

Malaysia's economic performance during the last half century has been impressive. From an agricultural economy in the 1950s, the country has now built global competitiveness in high-end manufacturing and is pushing out its technology frontier, an immediate goal of its national vision. This performance is the result of a sustained commitment to improving the business climate. Malaysia is attracting record levels of foreign investment and its companies are becoming increasingly global. The country is also shaping the regional dialogue on numerous policy fronts, from corporate governance to science and technology. These have brought Malaysia closer to the OECD policy community, with co-operation progressing beyond investment policy to areas such as competition, anti-corruption, regulatory reform, global value chains and innovation.

This first *OECD Investment Policy Review of Malaysia* supports the government in its ambitious reform path towards strong growth and greater prosperity. While the *Review* describes Malaysian efforts to make investment policies more open, transparent and non-discriminatory, it also recognises the important steps taken in tackling challenges linked to corporate governance and in promoting responsible business conduct and green investment.

Malaysia has stepped up its liberalisation of foreign investment and has strengthened its institutions for investor protection and corporate governance. Responsible business and environmental sustainability are also high on the agenda. The *Review* highlights areas where the investment policy framework could be improved to help the country reach its goal of becoming a developed economy by 2020. Liberalisation in sectors such as services should be maintained to create more space for private investment to grow, while mechanisms to measure the impact of FDI in achieving development targets should be strengthened to better inform its investment promotion strategy. Aligning with international initiatives that promote responsible business conduct would also cement the steps already under way to instil a responsible business culture.

This *Review* is the result of close co-operation between the Government of Malaysia and the OECD. It is also an integral part of the deepening partnership between the OECD and the Southeast Asian investment policy community. While the OECD provided technical inputs from its various Committees, the Government of Malaysia provided invaluable substantive contributions as well as driving a cross-agency process that also involved the private sector and civil society. Above all, this report offers a repository of Malaysian experiences for the benefit of other countries, including members of both the OECD and of the Association of Southeast Asian Nations (ASEAN). It also paves the way for Malaysia and the OECD to intensify their co-operation.

Angel Gurría
Secretary-General
OECD

Acronyms and abbreviations

AANZFTA	ASEAN-Australia-New Zealand Free Trade Agreement
ACCA	Association of Chartered Certified Accountants
ACIA	ASEAN Comprehensive Investment Agreement
AGM	Annual general meeting
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
BCSRM	Business Council for Sustainability and Responsibility Malaysia
BIT	Bilateral investment agreement
BLESS	Business Licensing Electronic Support System
BNM	Bank Negara Malaysia
CAGR	Compound annual growth rate
CDM	Clean Development Mechanism
CER	Certified Emission Reduction
CGC	Corporate Governance Consultative Committee
CLRC	Corporate Law Reform Council
CMP	Capital Market Master Plan
CMSA	Capital Markets and Services Act
DGTU	Director General of Trade Unions
DNA	Designated national authority
DOE	Department of Energy
EIA	Environmental impact assessment
EPA	Economic partnership agreement
EPF	Employees Provident Fund
EPI	Environmental Performance Index
EPU	Economic Planning Unit
ETP	Economic Transformation Programme
FDI	Foreign direct investment
FET	Fair and equitable treatment
FIC	Foreign Investment Committee
FPS	Full protection and security
FSMP	Financial Sector Master Plan
FTA	Free trade agreement
GBI	Green Building Index

GDP	Gross domestic product
GLC	Government Linked Company
GLCTP	GLC Transformation Programme
GLIC	Government Linked Investment Company
GreenPASS	Green Performance Assessment System
GTFS	Green Technology Financing Scheme
GTP	Government Transformation Programme
ICA	Industrial Coordination Act
ICSID	International Centre for Settlement of Investment Disputes
IFRS	International Financial Reporting Standards
IGA	Investment guarantee agreement
IIAs	International investment agreements
ILO	International Labour Organization
IMF	International Monetary Fund
IMP	Industrial Master Plan
IP	Intellectual property
IPA	Investment promotion agency
IPO	Initial public offering
IPP	Independent power producers
IRB	Inland Revenue Board
ISDS	Investor-state dispute settlement
ITA	Investment tax allowance
JMEPA	Japan-Malaysia Economic Partnership Agreement
KeTTHA	Ministry of Energy, Green Technology and Water
KLIA	Kuala Lumpur International Airport
KLRCA	Kuala Lumpur Regional Centre for Arbitration
KPI	Key performance indicators
M&A	Mergers and acquisitions
MACS	Malaysia Airports Consultancy Services Sdn Bhd
MAFTA	Malaysia-Australia Free Trade Agreement
MAHB	Malaysia Airport Holdings Bhd
MaSRA	Malaysian Sustainability Reporting Awards
MATRADE	Malaysian External Trade Corporation
MCMC	Malaysian Communications and Multimedia Commission
MDTCC	Ministry of Domestic Trade, Cooperatives and Consumerism
MFN	Most-favoured nation
MICECA	Malaysia-India Economic Cooperation Agreement
MIDA	Malaysian Investment Development Authority
MIGHT	Malaysian Industry-Government Group for High Technology
MITI	Ministry of International Trade and Industry
MNE	Multinational enterprise

MOF	Ministry of Finance
MoHR	Ministry of Human Resources
MP	Malaysia Plan
MPC	Malaysia Productivity Corporation
MRT	MY Rapid Transit
MSC	Multimedia Super Corridor
MSWG	Minority Shareholders Watch Group
MyIPO	Intellectual Property Corporation of Malaysia
NAFTA	North American Free Trade Area
NEAC	National Economic Advisory Council
NEM	New Economic Model
NEP	New Economic Policy
NKEA	National Key Economic Areas
NLC	National Land Code
NT	National treatment
ODA	Official development assistance
OECD	Organisation for Economic Co-operation and Development
OFDI	Outward foreign direct investment
PAAB	Water Asset Management Company
PCG	Putrajaya Committee for GLC Transformation
PDC	Penang Development Corporation
PEMANDU	Performance Management and Delivery Unit
PEMUDAH	Special Task Force to Facilitate Business
PFI	Policy Framework for Investment
PIA	Promotion of Investments Act
PPA	Power purchasing agreements
PPP	Public-private partnership
PSDC	Penang Skills Development Centre
PSP	Private sector participation
PTIA	Preferential trade and investment agreements
R&D&C	Research and development and commercialisation
RBC	Responsible business conduct
SCM	Securities Commission of Malaysia
SEDA	Sustainable Energy Development Authority
SME	Small and medium-sized enterprise
SPAN	National Water Services Commission
SREPP	Small Renewable Energy Power Programme
SSM	Companies Commission of Malaysia
TEVT	Technical Education and Vocational Training
TFP	Total factor productivity
TPP	Trans-Pacific Partnership Agreement

TNB	Tenaga Nasional Berhad
TRIMS	Trade-related investment measures
TRIPS	Trade-related aspects of intellectual property rights
UAE	United Arab Emirates
UNCITRAL	United Nations Commission on International Trade Law
UNFCCC	United Nations Framework Convention on Climate Change
USAID	United States Agency for International Development
USTR	United States Trade Representative
VDP	Vendor Development Programme
WBCSD	World Business Council for Sustainable Development
WIPO	World Intellectual Property Organization
WTO	World Trade Organization

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Executive summary

Malaysia stands out as one of the economic success stories in Asia over the past few decades. From a plantation economy at the time of independence, with rubber and tin representing one half of GDP, Malaysia has become a diversified, open economy. Poverty, which was widespread at the time, is now virtually eradicated, except in certain pockets of the country. GDP per capita is now seven times as high as it was in 1980 (in purchasing power terms) and Malaysia has become one of the countries the most integrated into the global economy through trade. The distribution of income among ethnic groups has also improved dramatically since the 1960s. Malaysia is now the second richest economy within the Association of Southeast Asian Nations (ASEAN) after Singapore.

Malaysia has set itself the goal of becoming a high-income economy by 2020. This will require annual growth of private investment of 10.9% or RM 148 billion. Recognising that there are challenges in meeting this goal, the New Economic Model (NEM), inaugurated in 2009, compiled well over 100 different recommendations. A new Performance Management and Delivery Unit was created to ensure that reforms are implemented. Strategic initiatives include the Economic Transformation Programme to stimulate private investment and the Government Transformation Programme to make the government leaner and more consultative, with measurable targets in the form of National Key Result Areas and Strategic Reform Initiatives.

The government has begun since 2009 to liberalise rules for foreign investors in service sub-sectors. Many of these sectors play a key role in the competitiveness of all sectors and of all firms, including small and medium-sized enterprises. Recognising the contribution of services to competitiveness, the government has announced that it will continue to liberalise the rules for the services sector, for both domestic and foreign firms.

Foreign investment has also been facilitated by the removal of the Guidelines of the Foreign Investment Committee which initially governed all foreign acquisitions in Malaysia but is now restricted to certain investments in property. Intellectual property (IP) is recognised, under the Economic Transformation Programme, as a pillar for transforming the economy. IP rights have been strengthened through the National IP Policy, the creation of IP courts

and awareness raising programmes, but investors still complain of weak enforcement of IP rights.

Malaysia has a good track record in investment promotion. The Malaysian Investment Development Authority has been tasked as the lead agency to coordinate activities of all investment promotion agencies to ensure consistency at different levels of government. After-care service is being given greater emphasis by MIDA to facilitate investment. Overall, investment promotion is being geared towards capital- and knowledge-intensive projects, offering high value-added and high technology.

Weak corporate governance is widely recognised as one of the causes of the Asian financial crisis, and Malaysia has done much to improve standards in this area. The Malaysian Code on Corporate Governance was issued in 2012 and new institutions have been created. For GLCs, the government launched the GLC Transformation Programme to improve the performance of GLCs. Corporate governance reforms have included some responsible business conduct initiatives where Malaysia has made laudable progress in many areas, including high-level political endorsement, while co-ordination and oversight remain difficult.

These many and varied reforms are already starting to affect investor perceptions, and foreign direct investment reached an historic high in 2011 in absolute terms. Domestic investment has also shown some improvement. At the same time, private investment has never fully recovered to the levels in real terms seen before the Asian financial crisis in 1997. This Review documents the reforms that Malaysia has undertaken over time and examines areas where further reforms could address remaining shortcomings in the investment environment and place the Malaysian economy of its trajectory towards developed country status by 2020.

Key recommendations

Liberalisation of service sectors

- Consider accelerating and broadening the programme for opening up services to greater foreign competition.
- Boost regional and international financial integration to deepen Malaysia's capital market and to contribute to the growth of related services industries.
- Transcribe the existing degree of openness of the investment regime in international commitments.

Intellectual property rights

- Strengthen the IPR regime, particularly at the border, and continue to build the capacity of the IP courts.

Investment promotion and facilitation

- Enhance the Malaysian Investment Development Authority's (MIDA) role as the government's interface with the private sector.
- Expand Key Performance Indicators to include the impact of investment on Malaysia's economy.
- Undertake a cost-benefit analysis of investment incentives and publish the results.
- Promote better co-operation between business and institutes of higher learning to address skills shortages.

Corporate governance

- Continue the momentum of corporate governance reforms.

Responsible business conduct

- Improve stakeholder consultative mechanisms for RBC.
- Further align Malaysia with international principles concerning RBC.

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Assessment and recommendations

This review assesses the investment climate in Malaysia, including both the institutional and legislative framework for investment and also a broad range of policies in other areas. It documents the reforms implemented by successive government administrations to improve the investment climate, describes the remaining challenges faced by Malaysia in moving towards becoming a high-income economy and discusses what further measures might help to revive both foreign and domestic investment. A good investment climate concerns more than just the rules and regulations faced by investors; it results from complementary policies across almost all of government. Equally importantly, a good investment climate is not static; it requires that governments and firms become more nimble in order to respond to new challenges and opportunities as they arise.

The investment climate in Malaysia is examined using the *Policy Framework for Investment* (PFI) (Box 1), focusing on the following policy areas: investment; investment promotion and facilitation; corporate governance; responsible business conduct; infrastructure and financial sector development; and policies to channel investment into activities which promote green growth.

Through this review, conducted in close collaboration with the government of Malaysia, the OECD can provide an objective assessment of progress in Malaysia and the reform challenges that remain. It can share the experience of how OECD member countries and many emerging economies have tackled the same problems, and it can help to benchmark Malaysia's performance against these countries. It can also explain to an international audience the reform measures that are currently being undertaken and their likely impact on the investment climate. At the same time, the government can also use the PFI assessment exercise to help build consensus and capacity within government and to foster a whole-of-government approach to investment climate reform.

Progress and policy challenges

Malaysia was an early leader in export-led development...

Malaysia stands out as one of the economic success stories in Asia over the past few decades. From a plantation economy at the time of independence, with rubber and tin representing one half of GDP, Malaysia has become a diversified, open economy. Poverty, which was widespread at the time, is now virtually eradicated, except in certain pockets of the country. GDP per capita is now seven times as high as it was in 1980 in purchasing power terms and Malaysia has become one of the countries the most integrated into the global economy through trade. The distribution of income among ethnic groups has also improved dramatically since the 1960s. Malaysia is now the second richest economy within the Association of Southeast Asian Nations (ASEAN) after Singapore.

Foreign firms have played a major role in the process of growth and diversification and foreign investment has been a key part of the outward-oriented development strategies of successive governments. As an early mover in terms of export-led development, Malaysia has traditionally received significant amounts of foreign investment relative to the small size of its economy. Foreign investors are prominent in many parts of the manufacturing sector, including in the electronics sector, which has been the driving force behind exports and where foreign investors represent 82% of the capital in approved projects in 2012.

Box 1. **The Policy Framework for Investment**

The *Policy Framework for Investment* (PFI) helps governments to mobilise private investment in support of sustainable development, thus contributing to the prosperity of countries and their citizens and to the fight against poverty. The *Framework* was developed at the OECD by representatives of 60 OECD and non-OECD governments in association with business, labour, civil society and other international organisations and endorsed by OECD ministers. It offers a list of key questions to be examined by any government seeking to create a favourable investment climate.

The *Framework* is a flexible instrument that allows countries to evaluate their progress and to identify priorities for action in ten policy areas: *i*) investment, *ii*) investment promotion and facilitation, *iii*) trade, *iv*) competition, *v*) tax, *vi*) corporate governance, *vii*) promoting responsible business conduct, *viii*) human resource development, *ix*) infrastructure and financial sector development, and *x*) public governance. Three principles apply throughout the *Framework*: policy coherence, transparency in policy formulation and implementation, and regular evaluation of the impact of existing and proposed policies.

Box 1. **The Policy Framework for Investment** *(cont.)*

By encouraging a structured process for formulating and implementing policies at all levels of government, the *Framework* can be used in various ways and for various purposes by different constituencies, including for self-evaluation and reform design by governments and for peer reviews in regional or multilateral discussions. A Toolkit was created to offer practical guidance on how to implement the PFI.

The PFI recognises that creating a good investment climate involves the interaction of governments, firms and other stakeholders, and concerns both output and factor markets. Too often, governments focus narrowly on the costs of doing business or on investment promotion without paying sufficient attention to the bigger picture. Creating a good business climate requires efforts by government to: expand market opportunities for new entrants; improve public service delivery and policy effectiveness, in part through public consultations; improve the availability and quality of inputs and the efficiency of capital and labour markets; facilitate access to imported inputs, whether through trade policy reform or through targeted import exemptions; foster innovation and technology transfer by making markets more competitive and by protecting intellectual property rights; and encourage firms to play their part through voluntary codes of corporate governance and responsible business conduct, and through training of local employees and linkages with local suppliers.

The objective of a good investment climate is not just to increase investment but also to improve the flexibility of the economy to respond to new opportunities as they arise – allowing productive firms to expand and uncompetitive ones (including state-owned enterprises) to close. The government also needs to be nimble: responsive to the needs of firms and other stakeholders through systematic public consultation and able to change course quickly when a given policy fails to meet its objectives. It should also create a champion for reform within the government itself. Most importantly, it needs to ensure that the investment climate supports sustainable and inclusive development.

The PFI was created in response to this complexity, fostering a flexible, whole-of-government approach which recognises that investment climate improvements require not just policy reform but also changes in the way governments go about their business.

For more information on the *Policy Framework for Investment* and its User's Toolkit, see: *www.oecd.org/daf/investment/pfi and www.oecd.org/investment/pfitoolkit*.

... but has had difficulty sustaining momentum over time

In spite of this enviable performance when seen in a long-term perspective, the Malaysian economy is nevertheless confronting numerous inter-related challenges commonly associated with a middle income trap. The symptoms of this trap are easy to find. Growth, which averaged over 9% in the decade leading up to the Asian financial crisis in 1997-98 has been only 5% since 2000. Net exports as a share of GDP have also declined steadily since 2000. Private investment, which was running at 30% of GDP in the early 1990s, has been only 12% of GDP since 2000, although it grew 22% in 2012, the highest rate of expansion since 2004. Foreign direct investment (FDI) has continued to rise in absolute terms but has declined significantly both as a share of GDP and as a share of total FDI in ASEAN since the pre-crisis 1990s – it is now below the share of Malaysia in ASEAN GDP. A large share of FDI inflows involves reinvested earnings of existing foreign affiliates which suggests that, while established foreign investors are not fleeing the country, there are fewer new arrivals compared to earlier decades.

The government attributes this decline in relative FDI flows in part to a shift towards more knowledge-intensive investment, in line with its promotional efforts and with Malaysia's evolving competitive advantages. Malaysia also continues to rank highly in many investment climate indices, and private investment has picked up recently. These factors, and the numerous policy initiatives described below which are beginning to bear fruit, militate against painting too bleak a picture based on historical trends. But at the same time, achieving developed country status by 2020 will require a significant increase in investment compared to the previous decade.

Investors complain that skills shortages are the top obstacle to doing business (World Bank 2009), at the same time as an estimated half a million Malaysians – up to half with university degrees – now live and work outside the country, and the number of foreign expatriates in Malaysia is declining. Low-skilled, low-wage immigrants from the rest of Southeast Asia sustain the low value-added export model which Malaysia is slowly trying to abandon. In promising sectors, the lack of specialised knowledge in fields such as renewable energy and green technology has slowed the pace of growth and held back financing for projects. Investors also complain of diminishing English proficiency. Labour market dynamics are not covered in this Review, except in relation to skills development and linkages with multinational enterprises.

The government is aware of the challenges and has begun to address them

The Malaysian government is keenly aware of these challenges and has set itself an ambitious goal of becoming a high-income economy by 2020

which will require a doubling of private investment as a share of GDP between 2010 and 2020. Initiatives have proliferated to achieve these objectives, most notably the New Economic Model (NEM) developed by the National Economic Advisory Council (NEAC) which was inaugurated by the prime minister in 2009. Strategic initiatives include the Economic Transformation Programme to stimulate private investment and the Government Transformation Programme to make the government leaner and more consultative, with measurable targets in the form of National Key Result Areas and Strategic Reform Initiatives. There are well over 100 different recommendations outlined in the NEM, with a new Performance Management and Delivery Unit created to ensure that reforms are implemented.

In almost all of the areas covered by this Review, the government has undertaken policy reforms and created or revamped institutions to ensure that the reforms deliver results. A Special Task Force to Facilitate Business (PEMUDAH) was created in 2007, comprising public officials and corporate leaders to simplify business operations and thereby successfully to improve Malaysia's ranking in the World Bank's *Doing Business* report. The Malaysia Productivity Corporation is spearheading a comprehensive review of business regulations to improve processes and procedures. The investment promotion agency was renamed the Malaysian Investment (formerly Industrial) Development Authority (MIDA) to reflect its wider remit to promote services as well as manufacturing. The Putrajaya Committee on GLCs (Government-Linked Companies) High Performance was created to lead the GLC Transformation Programme. A new *Malaysian Code of Corporate Governance* was promulgated in 2012 and a *Competition Act* in 2010. In the financial sector, the government has a Financial Sector Blueprint for 2011-20 and a Capital Market Master Plan 2, following on from earlier Financial Sector and Capital Market Master Plans. Malaysia's National Green Technology Policy (2009), the Renewable Energy Policy and Action Plan (2010), and the creation of the Ministry of Energy, Green Technology and Water are all designed to address environmental concerns.

Reforms in Malaysia have traditionally been gradual and pragmatic

In contrast to many other countries in the region, Malaysia has often taken a long-term approach to reform: sectoral reforms are planned over a long period and outlined in Master Plans; the NEAC was created to prepare the diagnosis and policy recommendations and to present the case for wide ranging reforms through seminars, dialogues and briefings, including with state governments; the private sector and other stakeholders are involved in key commissions such as the NEAC and PEMUDAH, as well as on the board of MIDA; and public consultations have been an integral part of the process, although investors have nevertheless complained that consultations are

sometimes perfunctory and with selective participation. A gradualist approach allows for consultations with stakeholders, provides opportunity for feedback and mid-course corrections, and allows domestic firms time to adjust but, at the same time, requires a firm political commitment to carry through with the reforms to avoid backtracking.

Many of the reforms described above are recent, and it will take time to see their full impact on the investment climate. The proposed and enacted reforms appear to move in the right direction, and inflows of foreign investment are at record levels in nominal terms. The question nevertheless remains of whether the measures go far enough to reverse fully the decline in private investment in Malaysia and its relative under-performance in attracting FDI inflows. Many other countries in the region are embarking on their own reform agenda at the same time as Malaysia, and growing regional integration makes comparisons with neighbouring countries all the more pertinent.

Reducing socio-economic imbalances has been central to Malaysian development strategies for four decades…

The cornerstone of Malaysian policies since the ethnic riots in 1969 has been the New Economic Policy (NEP), an affirmative action policy in favour of the *bumiputera* (ethnic Malay, indigenous people, as well as ethnic groups in Sabah and Sarawak) to redress socio-economic imbalances in the country. These various measures have traditionally implied a much stronger involvement of the government in resource allocation, production and trade. As a first step in the 1970s, the government took over several major foreign-owned corporations in the mining and plantation sectors through mergers and stock market purchases with the aim of transferring ownership eventually to the *bumiputera*. At the same time, the Foreign Investment Committee (FIC) was created to screen incoming investments and to limit foreign equity to 30% for domestic-market oriented projects and for acquisitions of Malaysian firms. Partly as a result of these policies, the foreign portion of share capital declined from 62% in 1969 to 25% by the late 1980s, while the *bumiputera* share rose from 1.5% to 19% over the same period (OECD 1999).

These redistributive policies are widely acknowledged to have contributed to social peace but are increasingly coming under criticism, including within the government itself, for their unintended side effects. It has inadvertently given rise to rent-seeking and patronage.

... but redistributive policies are evolving

As a result, after four decades, the redistributive policies are being retooled to focus more directly on the poor. The first exemptions from equity rules were given to exporters and pioneer industries in the 1980s, and this was temporarily extended to almost all manufacturing sectors during the Asian financial crisis and then made permanent in 2003. Companies located in the Multimedia Super Corridor also received exemptions. The biggest step came in 2009 with the abolishment of the FIC and thus the removal of the FIC Guidelines governing foreign equity limits. The purchase of properties valued at RM 20 million and above that will result in a dilution of *bumiputera* interest nevertheless require the approval of the Economic Planning Unit, Prime Minister's Department. From now on, equity limits will be set by the sectoral regulator, allowing greater flexibility to liberalise certain key sectors. The only remaining equity restriction is subsumed within the public spread requirement under Bursa Malaysia listing rules, implying a minimum *bumiputera* shareholding in a company listed in Malaysia of 12.5%. The new requirement does not apply to foreign companies seeking a listing on Bursa Malaysia where no equity conditions remain.

The recent alleviation of FIC Guidelines is not only a potentially strong signal to investors but may also enhance the scope for further reforms in the future. At the same time, the government remains committed to the goal of redistribution and maintains many measures in support of the *bumiputera*: preferential access to education, housing, jobs, business licences, public sector contracts, government grants, bank credit and share capital (WTO, 2009).

These reforms and proposals enunciated in the NEM and elsewhere represent a significant departure from longstanding policy approaches which have characterised the Malaysian economy for the past four decades. At a time when the *status quo* is being called into question in almost all policy areas, further targeted reforms could provide the critical mass necessary to revive investor confidence and restore the Malaysian economy to its historic growth trajectory before the Asian financial crisis. The following section focuses on the prospects for accelerating the pace of liberalisation of key service sectors.

Malaysia still maintains restrictions on foreign investment in many services...

A country's investment climate cannot be captured in a single indicator, whether on the costs of doing business or a measure of statutory restrictions on FDI. Many different policies and practices impinge on investment decisions, and the way – and whether – policies are implemented is arguably as important as the policies themselves. Quantitative indicators have nevertheless proven highly effective in drawing attention to the burdens of business regulation, identifying priorities for reform and communicating

success and progress. Benchmarking Malaysia's performance in liberalising its investment regime compared to regional peers and to the average for OECD member countries provides a useful external assessment of how Malaysia performs in this area and the results accord well with the relative performance of Malaysia in attracting FDI over time. Just as Malaysia gauges its performance in attracting investment against its peers, so too should it assess how it compares with its peers in terms of restrictions on market access and operational constraints faced by foreign established firms.

The OECD *FDI Regulatory Restrictiveness Index* provides a measure of statutory restrictions on foreign investment across countries. It includes neither the degree to which those measures are actually implemented, nor all other policy areas that might impinge upon foreign investment, but it is a useful benchmark of one key aspect of the investment climate. It is also found to be one of the factors shaping FDI patterns in cross-country studies. The *FDI Index* estimates that Malaysia is now one of the most open in East Asia in terms of statutory restrictions on FDI (based on a sample of nine countries in Asia and the Pacific for which the *Index* currently exists), but a wide gap still exists relative to the levels of restrictiveness found on average in OECD member countries. An historical series based on the *Index* suggests that, while Malaysia may well have been a relatively open economy in terms of statutory restrictions prior to the Asian financial crisis, the more rapid liberalisation of other countries in the region after 1997 may have diverted some investment away from Malaysia.

In terms of foreign investment in specific sectors, Malaysia remains relatively restrictive in distribution and communications, not only compared to OECD countries but also relative to the average for India, China and Indonesia. In financial services, Malaysia has fewer restrictions than China or India, for example, but the level of restrictiveness is still higher than the average of OECD countries. Business services were also "unusually restrictive" according to the NEM before the recent reforms announced in October 2011. If the reforms in this sector are fully carried out, Malaysia will have the same level of statutory restrictions in business services as OECD member countries, on average. Previously it had been more restrictive than both the OECD average and score for individual Asian countries.

Foreign investors are present to varying degrees in all of these sectors but nevertheless face restrictions on mergers with local firms, as well as operational restrictions. The most notable restriction is on foreign equity limits: 30% in domestic banks, 70% in insurance companies and investment banks, as well as a 30% *bumiputera* requirement in retail. In telecommunications, equity limits are being raised to 70%, except for a 30% limit in Telekom Malaysia.

Beyond equity limits, the activities of foreign affiliates are circumscribed in other ways, such as limits on the number of branch offices for foreign banks operating in Malaysia and on floor space and minimum capital requirements in the distribution sector. Foreign investors in both banking and distribution are also required to incorporate locally.[1] Entry barriers for both foreign and domestic potential investors have also arisen at times through a freeze on new licences, as occurred in the conventional banking sector between the early 1980s and 2009 and in the Islamic banking sector between the early 1980s and 2003, and as was initially announced for distribution from 2004 to 2009.

... but progressive liberalisation has begun

The Third Industrial Master Plan for 2006-20, followed by the Tenth Malaysia Plan and the NEM are in favour of liberalising the service sector. Since 2009, Malaysia has made great strides to open up the service sector to foreign investment and once again has begun to offer a more attractive environment for investors. In addition to the elimination of the FDI Guidelines described above, the government liberalised 27 service sub-sectors in 2009 and a further 17 sub-sectors in 2012. In Malaysia's conventional and Islamic financial sectors, gradual and progressive liberalisation has been implemented over the years. Moving forward, under the new Financial Sector Blueprint 2011-20, the approach to financial sector liberalisation will shift from setting hard quantitative limits on equity participation and on the number of licences towards facilitating greater foreign participation in the financial sector based on prudential criteria and where it is deemed to be in the best interest of Malaysia. Moving forward, greater flexibility will also be accorded to financial institutions to establish branch and non-branch electronic terminals.

Many of these reforms have not yet been fully transcribed in Malaysia's growing web of free trade agreements (FTAs). For example, the Malaysia-Australia FTA, which was concluded in March 2012 and entered into force on 1 January 2013, incorporates certain recent liberalisation measures in the schedule of specific commitments, such as in telecommunications and financial services, but Malaysia still reserves the right to screen any acquisition over an aggregate 30% of equity. The text states that approval is normally granted but may be denied where the proposed investment conflicts with the interest of the state. The Malaysian list of reservations to the ASEAN Comprehensive Investment Agreement states that national treatment may not apply in the issuance of a licence or permit, including both numerical limitations and the non-issuance of licences.

In financial services, equity restrictions generally reflect existing national regulations, but no commitment is made for the issuance of licences to allow new foreign-owned commercial banks. However, banking licences for international Islamic banks and international takaful operators have been

granted in 2008 under FTAs, namely Malaysia-Pakistan as well as the ASEAN Framework Agreement on Services Fourth Package of Financial Services Commitments. Liberalisation of business services, which is only scheduled to occur in 2012, is not yet reflected in the commitments. A key milestone will be under the ASEAN Framework Agreement in Services which calls for allowing 70% ASEAN equity ownership by 2015.

Government-linked companies are prominent in many services

Going beyond restrictions on foreign investment, many service sectors are characterised by a strong presence of GLCs. On a broad basis including entities in which the government has controlling and minority stakes, GLCs account for 43% of total assets in agriculture and forestry, principally in oil palm plantations, 67% in telecommunications, 50% in distribution, 56% in the banking sector and 88% in utilities (Menon, 2012), where GLCs operate in roads, airports, air transport, water, power and telecommunications. Estimates of the market share of GLCs in these sectors are often even higher. On an effective controlling interest basis, state participation via government funds in private companies is lower but often not negligible. For instance, in the case of the banking sector, several government-linked investment companies currently hold equity stakes of more than 30% in four out of eight domestic banking groups, representing a share of 23% of total assets of the banking sector on an effective interest basis.

According to the NEM, while GLCs have historically been tasked with providing public goods and services, maintaining government control in strategic sectors and engineering socioeconomic change through wealth re-distribution, investors now feel that GLCs have ventured beyond their mandates and are now competing directly with private businesses, hence crowding out private investments (NEAC, 2010b). The degree of government ownership is less an issue, in itself, than the productivity of many GLCs. The NEM reports that "sectors in which government companies dominate have shown the lowest rates of growth of productivity in recent years" (NEAC, 2010b, p. 18). Several studies have found that GLCs have often underperformed relative to other public listed companies in the past.[2]

Aware of the impact that the performance of GLCs has on the competitiveness of the Malaysian economy, the government has undertaken various initiatives to bring GLC governance closer to private sector corporate governance standards. Most notable is the GLC Transformation Programme, launched in 2004 and which introduced key performance indicators, performance-linked compensation and changes in the composition of boards. Partly as a result, and in spite of a more challenging economic environment in 2008, the 20 most important GLCs reported aggregate earnings that were 53% higher than in 2004.

Under the present institutional set up, various entities are responsible for managing public savings and investment on behalf of the members/contributors, but only the Minister of Finance Incorporated (MOF Inc.) invests on behalf of the government. The rest of the government-linked investment companies (GLICs) invest for the benefits of their contributors, unit holders and depositors. The government basically ensures that the public money is properly invested by these entities and avoids interfering with the investment strategies/decisions of these institutions. Many investments are solely to provide return to the members/contributors/unit holders and are not aimed at contributing to the government's revenue collection.

While governance of GLCs has improved, it is important to ensure they face competitive pressures in each sector in which they operate. Significantly, the mandate of the new Competition Commission covers both private firms and GLCs. The Commission will require high-level political support to implement this mandate and to ensure that equity rules do not constitute barriers to entry. It is also important that other means be found to fulfil the socio-economic policy objectives that GLCs are currently tasked with undertaking.

Key recommendations

Liberalisation of service sectors

- The government should continue the progressive liberalisation of service sub-sectors and consider accelerating and broadening the programme

The government opened 27 service sub-sectors in 2009 and another 18 in 2012 and is examining the need for complementary measures to accompany further liberalisation. Through the Malaysia Productivity Corporation, it is also modernising its business regulations which will contribute to the ease of doing business for all investors. These steps will contribute to enhancing the competitiveness of the Malaysian economy, but obstacles to foreign investment remain in certain services and the prominent role of GLCs in some sectors adds to the uncertainty about market opportunities for new entrants, whether domestic or foreign.

Opening the service sector to greater private – including foreign – involvement is not an end in itself. An efficient and competitive services sector, particularly backbone services, will raise the performance of firms throughout the economy, including in the manufacturing sector. Several studies of other countries' experience cited in Box 2.2 suggest a link between restrictions on foreign entry in the service sector and total factor productivity in the manufacturing sector.

For instance, Malaysia has intensified liberalisation of the financial sector since 2009, but remaining restrictions on FDI are relatively high compared to

the OECD average. The increase in foreign equity limits of investment banks and stock broking institutions undertaken in 2009 is likely to contribute to on-going consolidation in those sectors, but further easing of the remaining restrictions in commercial banks could also be considered. As the Economic Transformation Programme states, "many of our [Malaysian] commercial banks are significantly smaller than regional powerhouses". While foreign and domestic banks do not necessarily focus on the same market segments, foreign-owned commercial banks seem to have been on average more efficient and profitable than domestic commercial banks for most of the past decade. However financial reforms and capacity building efforts undertaken under the Financial Sector Master Plan (FSMP) have substantially strengthened and improved domestic banks' competitiveness and financial performance, narrowing the gap with foreign institutions. Notwithstanding, enhancing existing measures to increase competition in this sector can contribute to further strengthening Malaysia's banking competitiveness *vis-à-vis* large regional players and to improve investment levels in the country.

In addition, the growing integration of the regional market offers an opportunity for Malaysia to become a regional hub for many services. While the government has geared investment incentives towards fulfilling its regional aspirations, the regulatory environment and the degree to which investors will be able to compete on a level playing field will count for more than tax allowances in bringing Malaysia's regional strategy to fruition.

- Regional and international financial integration can help deepen Malaysia's capital market and contribute to the growth of related services industries

Malaysia's equity market remains one the most developed in the region, but market capitalisation as a share of GDP has been rather stable since the Asian crisis, facing greater competition from regional financial centres. Liquidity levels are also relatively low, diminishing Bursa Malaysia's attractiveness to worldwide investors and hindering the development of related service industries. The corporate debt securities market, though rather well developed by regional and international standards with relatively high liquidity levels compared to regional bond markets, has seen its liquidity decline substantially since 2004. A slight recovery has taken place since 2008 but liquidity remains shallow in relation to the public market. Further regional and international integration could contribute to enhance Malaysia's capital market competitiveness by broadening the issuer and investor base, while raising its capacity to support the level of investments required for transitioning to a developed economy by 2020.

Efforts to enhance the efficiency and competitiveness of Malaysia's capital market are already underway with the implementation of key initiatives contained in the Capital Market Master Plan 2 (CMP2) launched in

2011. Efforts to boost regional integration have been undertaken by the Securities Commission and Bursa Malaysia and are expected to provide greater market access to regional players and maximise the growth potential of Malaysia's capital market. Initiatives to facilitate intermediation and increase liquidity, as well as to maximise scale through internationalisation, are also taken into account in the CMP2.

- Commitments in international agreements should transcribe the existing degree of openness

Malaysia has a complex web of international investment agreements, including both bilateral investment treaties and free trade agreements with an investment chapter. Such agreements include those signed as part of ASEAN, with external partners and among ASEAN member states. Malaysia is now also negotiating the Trans-Pacific Partnership Agreement with the United States and others. Within ASEAN, the ASEAN Comprehensive Investment Agreement, which includes commitments in manufacturing and related services, has been ratified. Although liberalisation commitments are often included in the FTAs and regional agreements, these commitments do not always appear to match the existing level of openness in Malaysia.

Intellectual property rights

- Strengthen the intellectual property rights regime

Malaysia has gradually moved towards an enabling regulatory environment for investors, including a sound legal and regulatory framework for intellectual property (IP) rights, but investors have complained about weak enforcement of IP rights. Although Malaysia has made significant and widely acknowledged progress in combating piracy and counterfeiting activities, the government should further intensify its efforts in terms of border enforcement measures and in training customs officials. To achieve a higher level of enforcement at the border, greater involvement of customs authorities in prohibition measures is required. The creation of a dedicated IP court is a laudable step towards a more efficient enforcement system that will further develop judges' capacity and experience in IP-related matters. The government has also made great efforts to allow IP rights to be used as collateral for loans from financial institutions, and provides training to local companies to carry out due diligence on intellectual property.

Investment promotion and facilitation

- Enhance MIDA's role as the government's interface with the private sector

The Malaysian Investment Development Authority (MIDA) is internationally recognised as an effective investment promotion agency, particularly for investors at the establishment phase. It has significant

experience with investment promotion in the manufacturing sector and is increasing its role in promoting services. In 2009, at the time of the first liberalisation moves in the service sector, the government created the National Committee for Approval of Investments in the Services Sector under MIDA.

In a context of reform and proliferating initiatives to improve the business climate, the private sector needs an accessible and responsive interlocutor in the government. In particular, MIDA's after-care services for established investors could be enhanced. This function becomes even more important in light of the government's aim to increase re-investment and expansion by established investor. MIDA's activities also extend to providing the private sector with a channel to give feedback on reform initiatives and measures to further improve the business climate. Enhancing MIDA's policy advocacy role and capacity would help it to engage better with the private sector.

As Malaysia's central IPA, MIDA should set the direction for other states and corridor IPAs to synergise efforts towards common objectives. In working with other key enablers in attracting investment, overlapping tasks and duplication of efforts can be avoided.

- Expand KPIs to include the impact of investment on Malaysia's economy

To support the government's objective to move the economy further up the value chain by producing more sophisticated and high-end technology products, MIDA may consider adjusting its KPIs. The indicators could go beyond target investment volumes and include an evaluation of the impact of investment. Evaluation measures could cover consultative stakeholder processes and technology transfer from foreign investors to Malaysian companies.

Such indicators can be difficult to develop as the necessary data and the capacity may not be available. One way to address this gap, while also increasing the credibility of the KPIs, is to have external parties create and monitor KPIs. KPIs could also be expanded to include measures beyond MIDA's mandate to include areas under the Ministry of International Trade and Industry's overall responsibility and which aim to increase the developmental effects of investment and to better inform policy making.

- Undertake a cost-benefit analysis of investment incentives

Malaysia has been promoting international investment through investment tax allowances and tax holidays for decades, primarily for exporters and pioneer industries. Despite the efficiency with which MIDA disburses incentives, they could be more targeted and should be subject to adequate public review and reappraisal. A review of investment incentives in ASEAN in 2004 noted that the list of promoted activities and products eligible

for "pioneer" status (and hence tax allowances) compiled by MIDA ran to 21 pages.[3] The same point could be made today: the National Key Economic Areas established under the Economic Transformation Programme seem to cover broad areas of the economy.

Incentives offered to investors have become less generous over time but remain pervasive. According to the WTO, no estimates have been made available of total tax revenue forgone as a result of these incentives. One estimate of forgone revenue in the 1980s amounted to 1.7% of GDP. Almost all countries offer incentives in one form or another to attract foreign investment or to channel investment into priority activities or geographical areas. There is also pressure to offer incentives so as to compete with other countries in attracting mobile investment. It is difficult to assess whether an investment would have occurred in the absence of such incentives, but both investor surveys and econometric studies suggest that their importance is marginal in most cases.

Authorities offering incentives to attract investment must periodically evaluate their relevance, appropriateness and economic benefits against their budgetary and other costs, including the long-term impact on resource allocation. To assist governments in this task, the OECD has created a *Checklist for Foreign Direct Investment Incentive Policies* which serves as a tool to assess the costs and benefits of using incentives to attract FDI, to provide operational criteria for avoiding wasteful effects and to identify the potential pitfalls and risks of excessive reliance on incentive-based strategies.

- Improve co-operation between business and institutes of higher learning to address skills shortages

A major challenge facing the government is the need to ensure that skill programmes continue to meet the changing demands of the labour market. Improvements could include closer collaboration between industry and institutes of higher learning on R&D and curriculum development. Such collaboration can contribute to closer alignment of training provisions and industry demands. Malaysia should aim at replicating some of its world-class models in this regard, such as the Penang Skills Development Centre, in other parts of the country. To support the effectiveness of this triangle of co-operation (government, training institutions, industry), training institutions and universities need to be have greater flexibility in curriculum development.

Corporate governance

- Continue the momentum of corporate governance reforms

Good corporate governance of state-owned enterprises is becoming a reform priority in many countries. The OECD *Guidelines on the Corporate Governance of State-Owned Enterprises* provide an internationally agreed

benchmark to help governments assess and improve the way they exercise their ownership functions in state owned enterprises. The *Guidelines* build on a wealth of concrete experience from a large number of OECD and non-OECD countries around the world and offer concrete advice on corporate governance challenges that need to be addressed when the state is a corporate owner.

Responsible business conduct

- Improve stakeholder consultative mechanisms for RBC

Stakeholder engagement by companies often takes the form of testimonials, rather than genuine engagement. More engagement with critical stakeholders is recommended and more structured stakeholder engagement processes and consultations are needed to demonstrate openness and responsiveness to concerns.

- Malaysia should further align itself with international principles concerning RBC

Through both private and government initiatives, Malaysia has undertaken measures to promote RBC, as an extension of efforts to foster a strong corporate governance culture. The past few years have seen a number of policy and institutional advances, in particular in environmental protection and the promotion of green investment. All publicly listed companies in Malaysia are obliged to disclose their RBC activities as stipulated in the Bursa listing requirements. If there are no RBC reports, a statement to that effect is required, thus acting as a form of moral suasion.

Challenges remain in terms of consultative processes when developing policies and in the area of labour relations, where Malaysia faces some gaps in reaching more advanced standards. Another area that deserves some scrutiny is overall co-ordination of RBC related initiatives. No designated ministry within the government has the mandate for such a function, which can hamper the development of a coherent RBC framework.

Participating in international initiatives would support the government in taking advantage of global experience on RBC and its implementation. The government should increase its efforts to align itself with the standards and principles upheld in multilaterally backed instruments, including the OECD *Guidelines for Multinational Enterprises*. Adherence to the Guidelines would help ensure that foreign multinational enterprises operating in Malaysia contribute fully to meeting societal expectations concerning their conduct. Adherence would also send a strong signal to the rest of the world that Malaysian firms, including many GLCs, are acting responsibly as they expand rapidly in Southeast Asia, Africa, and beyond. The Malaysian government would also be better able to share its own experience in promoting RBC with peers in 44 other countries that have already adhered. The creation of a national contact point as part of adherence would also serve as a focal point for RBC initiatives

within government and provide best offices for settling disputes between investors and local communities.

Conclusion

Malaysia is confronting many challenges as it strives towards high-income status, but these challenges need to be kept in perspective. Malaysia has improved its *Doing Business* rankings from 23 in 2011 to 12 in 2013, and its attractiveness as a location for investment has increased, according to surveys. FDI inflows are also at record levels in nominal terms. It is a performance that many other countries aspire to emulate. Over several decades, Malaysia has developed a good record in attracting and retaining investment and it is located in a dynamic and rapidly integrating region which will continue to retain the attention of investors.

There is nevertheless a clear recognition within government and society at large that the *status quo* is no longer tenable, and in the same pragmatic way that Malaysia has approached challenges in the past, it has begun to address its underperformance relative to both some of its peers and to its own historic record. The fact that the Malaysian government has agreed to undertake this first OECD *Investment Policy Review* attests to the government's willingness to learn from the experience of other countries, including OECD members, as it undertakes reforms to reinvigorate its investment climate.

This review builds on the accumulated experience of *Investment Policy Reviews* undertaken in all regions of the world and of countries at different levels of development to focus on certain key recommendations for the Malaysian government. The individual policy chapters cover each area in more detail and include further suggestions where policies or approaches could be modified or expanded.

Notes

1. According to Bank Negara Malaysia, the local incorporation requirement was put in place to ensure adequate capital is dedicated to safeguard the sustainability and continuity of locally-incorporated foreign banks' operations in Malaysia as well as to constitute a separate board structure in Malaysia with direct statutory responsibilities for the Malaysian operations. The requirement also provides an important safeguard to minimise the effects of cross-border contagion.
2. Najid and Rahman (2011), Mohamad and Said (2010) and Chun-Teck Lye (2011).
3. Thomsen (2004).

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Chapter 1

Investment trends

Malaysia was an early mover in export-led development based on multinational enterprises. Until the Asian financial crisis in 1997, it was a leading destination for FDI, particularly in the electronics sector. Its performance since then has deteriorated, and its share of total ASEAN FDI has fallen steadily over time. At the same time, established investors from many different countries and regions are continuing to reinvest. Malaysian firms, particularly government-linked companies, are also becoming major outward investors, and Malaysia is now a net outward investor on an annual basis.

Attracting export-oriented foreign direct investment (FDI) in Malaysia has been a key policy of successive governments for almost three decades and long before many other emerging economies adopted the same strategy. Foreign investors are now ubiquitous in the manufacturing sector, particularly in the electric and electronics sector. These links to the global economy are also reflected in a high share of trade to GDP. As with any relatively open economy, Malaysia's overall performance and its ability to attract FDI have historically been affected by downturns in the global or regional economy. Inflows of FDI fell precipitously in 1998, 2001 and 2009 but recovered quickly in each case. FDI inflows in Malaysia are now at record levels in nominal terms.

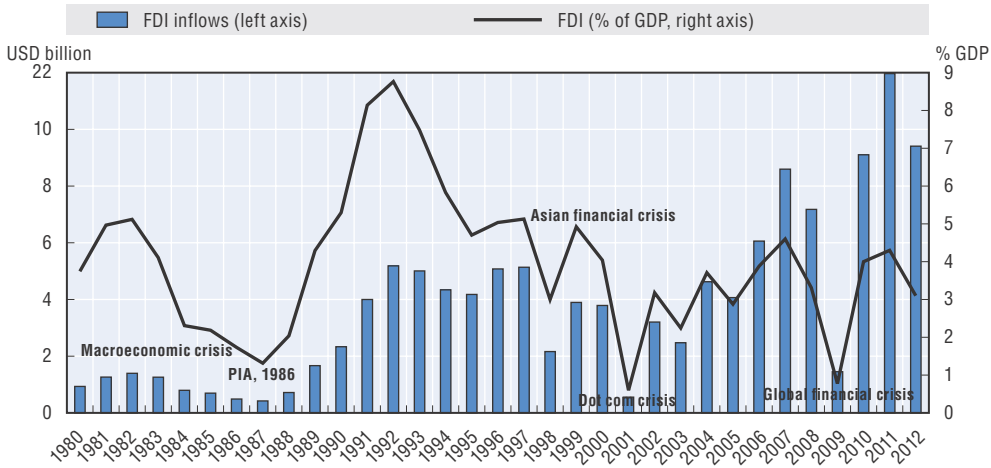
In spite of this enviable record in export-led development built partly on foreign multinational enterprises (MNEs), Malaysia now faces considerably more competition for footloose MNE production than it did over two decades ago, both within the ASEAN region and globally. The Malaysian share of the total stock of FDI in ASEAN has fallen from 28% in 1980 to only 11% today – below even the share of Malaysia in ASEAN GDP (14%). Chapter 2 makes the link between FDI performance and the evolution of investment policies in Malaysia.

At the same time, Malaysian firms have become important outward investors, with outflows exceeding inflows in each of the past five years. The stock of outward investment is now roughly equal to the inward stock. Only a handful of countries outside of the OECD area are net outward investors and even Singapore and Hong Kong, China are still net recipients of direct investment.

FDI trends in Malaysia in a long-term perspective

Inflows of foreign direct investment are at record levels in absolute terms, having recovered quickly from the crisis in 2009 (Figure 1.1). Historically, the trend of inward FDI flows has kept pace with international economic upturns and downturns, given the high export propensity of many foreign investors in Malaysia. Policy liberalisation has also played a role during certain periods, especially from the mid-1980s after the *Promotion of Investment Act* (1986) opened the economy for export-oriented production and introduced a new round of Pioneer status tax holidays, tax allowances for expansion projects, tax exemptions for export-oriented firms, and liberal regulations for firms operating in the Free Trade Zones. Combined with the effect of rising labour

Figure 1.1. **Long-term trends in FDI in Malaysia**



Source: Bank Negara Malaysia and World Bank.

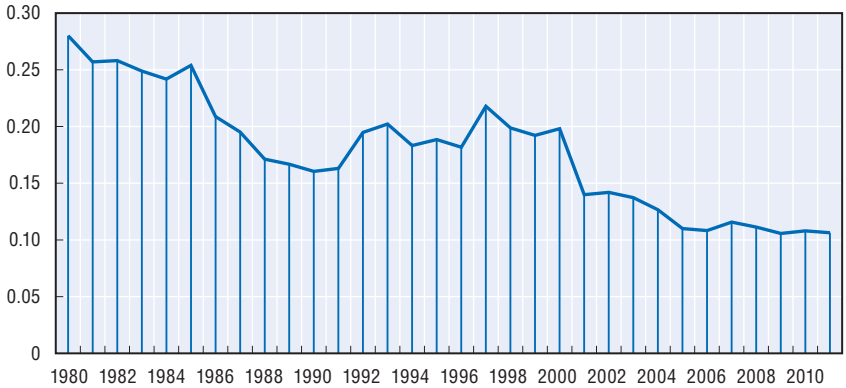
costs and currency appreciation in Japan and the newly industrialising economies of East Asia, inward FDI peaked during the period from 1988 to 1993, recording an historical high of almost 9% of GDP in 1992. Annual FDI inflows grew at an annual average rate of 38% between 1988 and 1996. In the years (1990-97) leading up to the Asian financial crisis, Malaysia received almost as much inward investment as Germany and ranked 15th worldwide in terms of total inflows.

From the mid-1990s, FDI inflows began to moderate, even before the onset of the Asian financial crisis. Malaysia began to lose cost-competitiveness with rising domestic wages caused by labour shortages amidst a labour-intensive manufacturing boom. In addition, some large-scale infrastructure projects reached completion, with no projects of similar scale in the pipeline following the Asian crisis.

Malaysia now faces increasing competition from the rest of ASEAN in attracting foreign investment

In spite of the continuing strength of FDI inflows into Malaysia and the rapid recovery of FDI from the effects of the global crisis, Malaysia's performance in attracting FDI relative both to earlier decades and to the rest of ASEAN is deteriorating. As a share of GDP, recent FDI in Malaysia has not matched the performance in the late 1980s and early 1990s when the government first adopted a strategy of attracting export-oriented investors (Figure 1.1). Comparing the stock of investment in Malaysia with that in the rest of ASEAN tells a similar story (Figure 1.2). Much of the investment in

Figure 1.2. **Malaysian share of the total FDI stock in ASEAN, 1980-11**



Source: UNCTAD, based on authors' calculations.

Southeast Asia in the early 1980s was in natural resource sectors, so it was to be expected that Malaysia and Indonesia both attracted a large share of the total into the region. Nevertheless, Figure 1.2 suggests a secular decline in the overall share, even before the four most recent ASEAN members states (Cambodia, Lao PDR, Myanmar and Viet Nam) appeared on investors' radar screens.

Even during the period of most rapid growth in inflows in Malaysia in the late 1980s, neighbouring countries such as Thailand were attracting even more investment. The only reprieve in this downward trend occurred in the 1990s, particularly during the Asian financial crisis, when Indonesia suffered an exodus of foreign investors. Since then, however, Malaysia's share of the total stock in ASEAN has fallen in almost every year and now stands at roughly 11% – slightly less than Malaysia's share of ASEAN GDP (14%). The share has stabilised since 2005, perhaps partly as a result of reforms of the regime covering foreign investment starting in 2003.

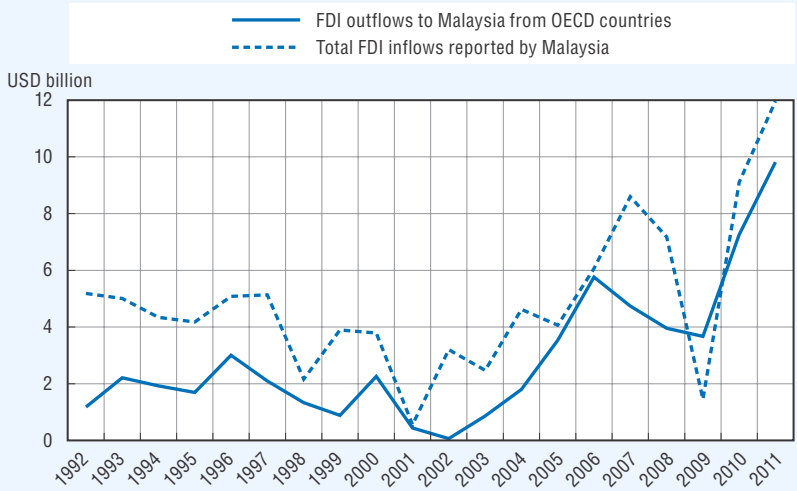
This decline in the Malaysian share is not related to any one group of investors. It can be seen for Japanese, American and European investors where the share of Malaysia in their total stock of FDI in ASEAN has fallen from 15-17% in 2000 to only 8-11% in 2010. The trend in FDI outflows from OECD countries to Malaysia follows closely that for recorded FDI inflows in Malaysia (Box 1.1).

Relative performance based on the volume of investment is not the only measure of the success or failure of Malaysia in attracting investment or of its competitiveness as a location for economic activities. Less is sometimes more. A shift to more knowledge-intensive activities, for example, might in some cases imply less capital actually invested. Many more countries, including in

Box 1.1. **FDI by investors from OECD countries in Malaysia**

Firms from OECD countries are among the largest investors in Malaysia. Their share of total inward investment may be understated to the extent that they invest in Malaysia through their affiliates in Singapore or elsewhere. Figure 1.3 compares reported inflows into Malaysia with what OECD countries report investing there. US data for 2004 are not reported for confidentiality reasons. The overall trend is rather similar but with considerable less volatility in flows reported by OECD home countries.

Figure 1.3. **FDI reported by Malaysia and by OECD countries into Malaysia**



Source: Bank Negara Malaysia, OECD.

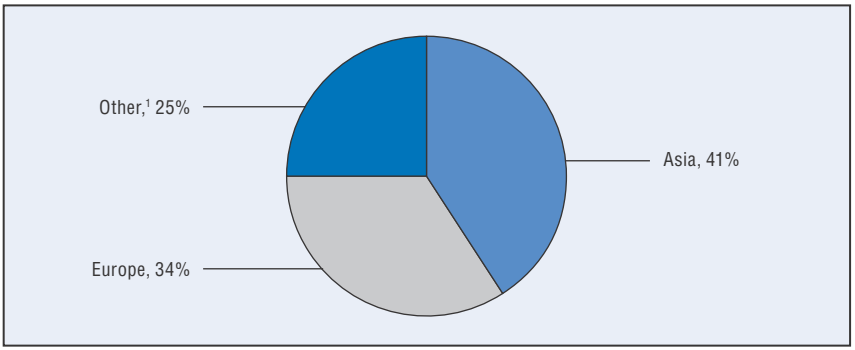
Southeast Asia, now welcome foreign investment, so it is also natural that the Malaysian share should have declined over time. Similarly, the overall volume of investment received does not give an idea of the broader benefits from that investment. Malaysia ranks highly in several indices of the investment climate and continues to receive respectable amounts of investment. There is also little evidence that existing foreign enterprises are leaving the country. But at the same time, these foreign multinational enterprises do appear to be investing more elsewhere, including in neighbouring countries. Bank Negara Malaysia attributes this shift partly to the growing fragmentation of production across many geographic areas brought on by global supply chains.

FDI in Malaysia by country and by sector

FDI in Malaysia is highly diversified in terms of source country

On the whole, Malaysia benefits from diversified sources of FDI, with 34% of funds emanating from Europe and 41% from Asia (Figure 1.4). The largest investor in Malaysia is Singapore, followed by Japan and the United States (Table 1.1). Firms from Chinese Taipei were once the third most prominent investors (15% of paid-up capital reported to MIDA in 1996) but the country no longer figures in the top ten, with only 0.5% of the total stock. Small and medium-sized firms from Chinese Taipei were among the first investors in the second half of the 1980s, faced with currency appreciation at home. They have since moved on to other destinations in search of lower wage costs, as the cost of doing business in Malaysia has grown hand-in-hand with rising per capita income levels.

Figure 1.4. **FDI stock in Malaysia by principal countries/regions, 2011**



1. Excludes investors from Caribbean offshore affiliates.
Source: Bank Negara Malaysia.

Another way to estimate the importance of different investors within the Malaysian economy is to look at cross-border mergers and acquisitions (M&As) involving Malaysian firms as targets. Table 1.2 provides one estimate for the period 2001-11. Singapore and Japan retain the same leading positions as with the FDI data, but many emerging market investors figure more prominently in the M&A data, notably Saudi Arabia, the United Arab Emirates and India.

Inflows of FDI in Malaysia are concentrated in manufacturing and finance

In terms of the sectors, almost one half of investment is in manufacturing and another one quarter in finance (including holding companies). Within manufacturing, the electronics sector has traditionally taken the largest share

Table 1.1. **FDI stock in Malaysia by country, 2011**

	FDI stock 2011, RM million
Singapore	66 438
Japan	46 988
United States	38 400
Netherlands	29 871
United Kingdom	17 350
Germany	16 059
Switzerland	14 595
Hong Kong, China	11 455
Australia	10 259
Korea	8 381
Denmark	3 622
France	3 106
Chinese Taipei	1 846
China	1 126
Caribbean offshore affiliates	28 344
Other	66 100
TOTAL	**363 940**

Source: Bank Negara Malaysia.

Table 1.2. **Cross-border M&As involving Malaysian firms as targets, 2001-11**

Rank	Acquiror nationality	Value (USD m)	No.	% share
1	Singapore	7 670	356	23.2
2	Japan	5 839	85	17.7
3	UAE	3 927	14	11.9
4	Saudi Arabia	3 490	6	10.6
5	Hong Kong, China	2 199	44	6.7
6	South Korea	1 790	16	5.4
7	Australia	1 624	38	4.9
8	Germany	924	20	2.8
9	United Kingdom	866	41	2.6
10	India	708	20	2.1
	Subtotal	**29 037**	**640**	**87.9**
	Total	**33 043**	**835**	**100.0**

Source: Dealogic.

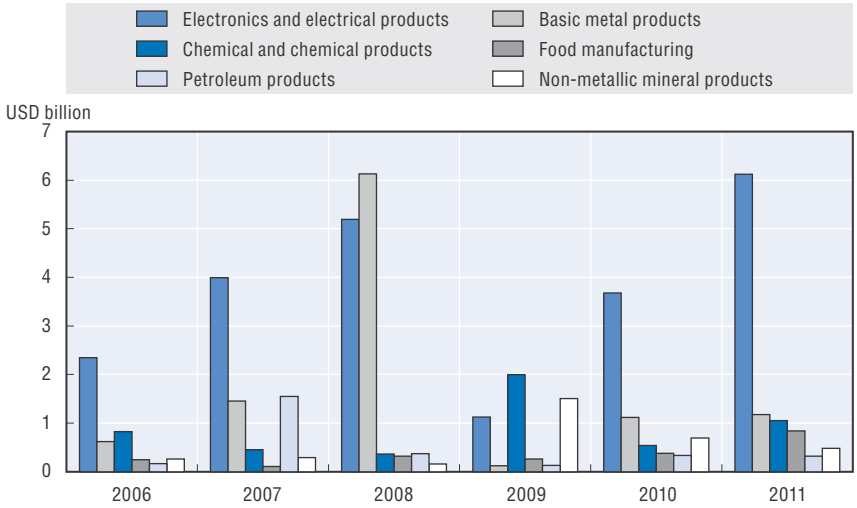
(40% of foreign investment over the past five years and 47% overall). This distribution reflects both the role of Malaysia as a popular location for production in global value chains in the electronics industry, as well as policies which favoured investment in export-oriented manufacturing and which traditionally restricted access to the service sector.

Table 1.3. **FDI stock in Malaysia by sector, 2011**

Sector	RM million	%
Agriculture, forestry, fishing	9 471	3
Mining and quarrying	23 595	6
Manufacturing	172 789	47
Construction	1 385	0
Wholesale and retail trade	30 318	8
Finance, insurance/takaful	81 355	22
Information and communication	25 395	7
Other services	19 633	5
TOTAL	363 940	

Source: Bank Negara Malaysia.

Figure 1.5. **Foreign investment in the manufacturing sector**

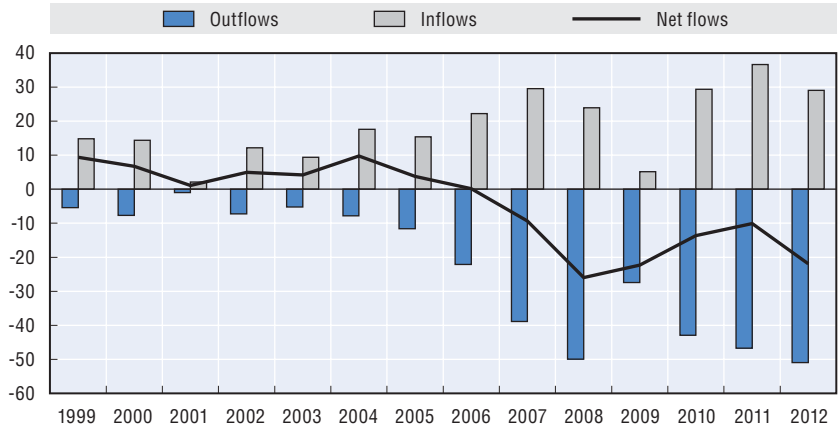


FDI in services has nevertheless seen a sharp increase recently, attracting 42% of total inflows from 2008 to 2010 compared to 15% in the 1990s. Among the subsectors of services, financial services including Islamic banking, have received the largest share of FDI as the government took strong initiatives to make Malaysia a hub for Islamic finance. Foreign investment in mining and quarrying, including oil and gas, is mostly undertaken in the form of production sharing agreements with Petronas, the state-owned petroleum company.

Outflows of direct investment from Malaysia

Outward FDI (OFDI) on an annual basis now exceeds to a considerable extent inflows: by almost USD 30 billion in the past five years (Figure 1.6), and the total outward FDI stock is quickly converging towards the inward one. Trends in OFDI and changes of OFDI policies have been shaped by the interplay of both exogenous and endogenous factors. The volume of outward FDI from Malaysia began to take off after 1992 following a first round of tax incentives, including tax abatement on income generated overseas. This was followed in 1995 by a full tax exemption on income remitted by Malaysian firms investing abroad. This upward trend was interrupted by the Asian financial crisis beginning in 1997 and outflows did not begin to recover until after 2001. In 2003, a strong incentive was implemented to encourage strategic M&As by Malaysian firms: a five-year deduction for the cost of acquisition if the deal was for acquiring foreign-owned firms for high-technology production within Malaysia or to gain new export markets for local products. The government also used investment guarantee agreements in promoting investment outflows (Chapter 3).

Figure 1.6. **Inflows and outflows of direct investment, 1980-11 (RM billion)**



Source: Bank Negara Malaysia.

Outflows by destination

Singapore plays a prominent role for Malaysian investors, as it does as a source of investment in Malaysia, reflecting close economic ties between the two countries. Another 13% goes to neighbouring Indonesia, with investments in banking, telecommunications, palm oil plantations and other sectors. Some of the other countries on the list in Table 1.4, such as the Cayman Islands and the British Virgin Islands, are tax havens. In these cases, the ultimate destination

Table 1.4. **Stock of Malaysian FDI abroad, by country and by region, 2011 (RM million; per cent)**

Singapore	55 785	17	Southeast Asia	126 870	38
Indonesia	44 214	13	Africa	61 369	18
Mauritius	21 995	7	Central and South America	45 350	13
Australia	20 464	6	Europe	35 447	11
British Virgin Islands	19 457	6	Oceania	24 634	7
Cayman Islands	13 376	4	South Asia	20 570	6
Thailand	11 430	3	Northeast Asia	15 717	5
United Kingdom	9 139	3	Middle East	5 518	2
Viet Nam	8 239	2	North America	1 769	1
Total	337 450			337 450	

Source: Bank Negara Malaysia.

of the funds is unknown and could be even back to Malaysia itself. The only other OECD member country besides Australia which has received any significant investment is the United Kingdom, where Proton has acquired companies in the automotive sector partly to obtain technology and brands.

Data on the acquisitions of Malaysian firms abroad tell a similar story in terms of the importance of Singapore and Indonesia (Table 1.5). Many of the countries are the same as with the FDI stocks, with the exception of offshore tax havens which do not usually figure in cross-border M&As.

Table 1.5. **Cross-border M&As involving Malaysian firms as acquirers, 2001-11**

Target nationality	Value (USD m)	No.	% share
Singapore	12 988	245	23.5
Indonesia	7 773	197	14.1
India	6 154	73	11.1
United Kingdom	5 467	52	9.9
Australia	4 007	94	7.3
China	3 213	158	5.8
Hong Kong, China	2 324	132	4.2
Egypt	2 063	3	3.7
Italy	1 490	5	2.7
Canada	1 138	12	2.1
Subtotal	**46 618**	**971**	**84.4**
Total	**55 246**	**1 364**	**100.0**

Source: Dealogic.

Outflows by sector

By sector, the stock of outward investment and much of the recent outflows have been in the service sector, followed by oil and gas. Investment abroad by Malaysian firms in the manufacturing sector has been only a small share of the total and even represented a net inflow in 2011 (Figure 1.6).

Table 1.6. **Stock of Malaysian FDI abroad by sector, 2010 (RM million, per cent)**

Agriculture, forestry, fishing	34 178	10
Mining and quarrying	92 251	27
Manufacturing	21 444	6
Construction	4 720	1
Wholesale and retail trade	8 660	3
Finance, insurance/takaful	97 607	29
Information and communication	33 608	10
Other services	44 981	13
Total	337 450	

Source: Bank Negara Malaysia.

Some of the largest acquisitions by Malaysian firms abroad have been by government-linked companies (GLCs), particularly in banking, telecommunications and natural resources, but private investors have also been active (Table 1.7). The largest banking acquisitions have been in Southeast Asia, but there have been others in Pakistan and China. Malaysian companies in the telecommunications sector have made major acquisitions in both India and Indonesia. In oil and gas, Petronas has made over USD 13 billion of acquisitions in both developed and developing countries since 2001, representing over one fourth of the total value of foreign acquisitions since 2001. Some of the largest acquisitions by private Malaysian companies involved two major acquisitions in the UK and Singapore by YTL Power, part of a large Malaysian conglomerate. The only major acquisition involving the manufacturing sector was by KNM, an industrial services company of the German company Borsig GmbH. In the past, Malaysian companies, including some GLCs, have acquired European companies for their technological skills and well-known brands.

Table 1.7. **Major Malaysian acquisitions abroad, 2001-11**

			Year	USD m
Banking				
CIMB	Bank Thai	Thailand	2008	1 780
	PT Bank CIMB Niaga	Indonesia	2010	1 261
Khazanah	PT Lippo Bank	Indonesia	2005	535
Maybank	PT Bank Internasional Indonesia	Indonesia	2008	7 860
	MCB Bank	Pakistan	2008	2 880
	Kim Eng Holdings	Singapore	2011	4 370
Public Bank Bhd	Asia Commercial Bank	Hong Kong (China)	2006	2 160
Hong Leong Bank	Chengdu City Commercial Bank	China	2007	124
Telecoms	Aircel Ltd.	India	2005	1 080
	PT Natrindo Telepon Seluler	Indonesia	2005-07	224
Axiata (Telekom Malaysia)	Idea Cellular	India	2008	1 698
	PT Excelcomindo Pratama	Indonesia	2004-08	1 726
Oil and gas		Worldwide	2001-11	13 400
Other sectors	Wessex Water	United Kingdom	2002	1 766
	PowerSeraya	Singapore	2008	2 495
Genting	Casinos (2 acquisitions)	United Kingdom	2006, 2009	1 767
Khazanah	Parkway holdings (healthcare)	Singapore	2010	2 893
KNM	Borsig GmbH (industrial services)	Germany	2008	531

Source: Dealogic, Bank Negara Malaysia.

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Chapter 2

Investment policy: Towards greater openness

Malaysia was one of the first emerging economies to welcome foreign investment in export-oriented manufacturing sectors beginning in the late 1980s. Foreign investors in domestic-oriented projects or providing services through local affiliates, on the other hand, traditionally faced numerous restrictions on their activities, notably on the maximum share of foreign equity.

This dualistic approach to regulating foreign investment began to change following the Asian financial crisis in 1997. First, the export obligation tied to full foreign ownership was dropped for manufacturing projects. Then, starting in 2003, the government began to liberalise restrictions in the banking and insurance sectors. This was followed in 2009 by the deregulation of the Guidelines of the Foreign Investment Committee which had previously constrained foreign takeovers of Malaysian companies. At the same time, the government announced the liberalisation of 27 service sub-sectors, followed by another 18 sub-sectors announced in 2011.

The result has been a substantial liberalisation of policies covering foreign investment, particularly over the past decade. Malaysia is now relatively open by the standards of emerging economies in Asia according to the OECD FDI Regulatory Restrictiveness Index, *but still maintains far more restrictions than found on average in OECD member countries. Many of these remaining obstacles are in service sectors which play a key role in the overall competitiveness of the economy, including in manufacturing sectors. Further reforms of restrictions in these sectors could provide the needed impetus to revive private investment and propel Malaysia on a path to developed country status by 2020.*

Attracting foreign direct investment (FDI) has been an integral part of Malaysia's development strategy since at least the mid-1980s. Malaysia was an early mover at that time to attract export-oriented multinational enterprises (MNEs) when many other developing countries were still pursuing import substitution and when firms from Japan and Chinese Taipei were looking to establish export platforms in the region. As a result, Malaysia was one of the leading destinations for such investment for much of the subsequent decade, particularly in the electronics sector. As more and more countries, such as other ASEAN member states and China, switched to export-led development and started to compete for FDI, Malaysia's share of this investment, within both East Asia and ASEAN, began to decline. As seen in Chapter 1, the Malaysian share of the total stock of FDI in ASEAN has reached historic lows over the past five years.

The government has responded to this challenge by revisiting both its redistributive policies in support of the majority *bumiputera* population which started under the New Economic Policy in 1971 and its restrictions on FDI in non-export sectors, particularly services. Liberalisation of FDI restrictions in recent years, as part of an overall reform agenda outlined in the Tenth Malaysia Plan and the New Economic Model, could begin to reverse the decline of Malaysia as a destination for FDI. An initial wave of service sub-sectors liberalisation occurred in 2009, followed by further reforms in 2012. In terms of statutory restrictions on FDI, as measured by the OECD *FDI Regulatory Restrictiveness Index*, Malaysia is now once again more open than some other key economies in Asia. But some important services such as distribution, finance and telecommunications are still relatively restrictive by global standards, and government-linked companies (GLCs) hold sizable stakes in many of these sectors, including utilities, communications and banking (Chapter 5). Restoring Malaysia's competitiveness as a destination for FDI, and improving the investment climate for all firms more broadly, will require further measures to open key services to greater competition.

To understand fully the extent to which recent reforms of investment policies represent a break with the past and to provide a picture of the overall direction of policy reform, it is useful to look briefly at Malaysia's traditional policy approach to foreign investment.

Investment policy reform: Stability and change 1985-2012

In the first decades of independence, as in many developing countries at the time, Malaysia experimented with import-substitution and state-led industrialisation. And like many other emerging economies, Malaysia experienced major difficulties in the first half of the 1980s: current account and budget deficits, a commodity price collapse and a decline in the terms of trade, all culminating in a recession in 1985. The recession exposed a number of structural weaknesses, triggering a round of market liberalisation and a more active promotion of foreign investment. The new policy was defined in the *Promotion of Investments Act* (PIA, 1986).

The PIA encapsulated a dualistic approach to foreign investment that was to remain in place until the Asian financial crisis in the late 1990s. Any firm exporting a high percentage of its output, contributing significantly to technology transfer or offering some other clear economic benefit faced relatively few restrictions on its activities and generally received fiscal and other incentives. At the same time, foreign MNEs interested in the local market were sometimes prohibited from investing if there was already a local producer and even when permitted faced numerous restrictions, such as a limit on foreign equity participation generally equal to 30% designed partly to redress what was seen as a socially unacceptable imbalance in income distribution affecting the *bumiputera*.

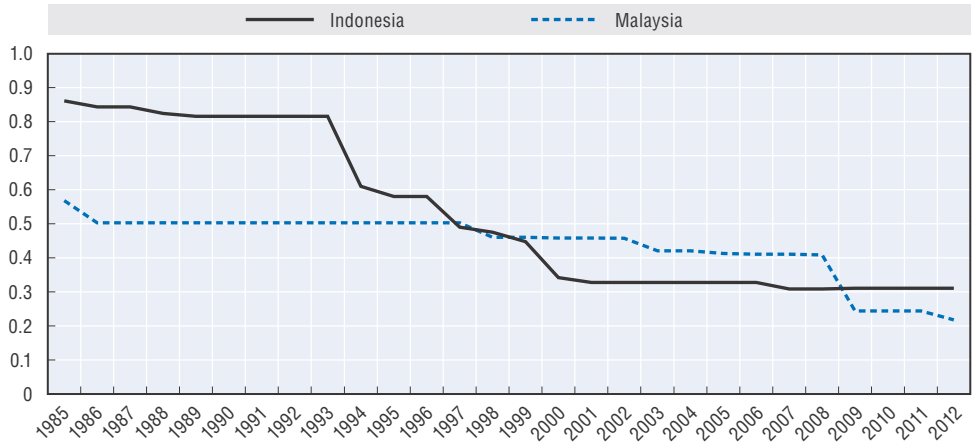
This policy approach was modified somewhat as a result of the Asian financial crisis but otherwise persisted until the reforms announced by the government beginning in 2009. In this sense, the policy trajectory in Malaysia departed from what was seen in some other crisis-affected countries after 1997, such as Thailand and Indonesia. While Malaysia had traditionally been one of the first movers in opening to foreign investment, the crisis may have propelled other countries in the region to open at a faster rate.

Figure 2.1 shows a quantitative estimate of liberalisation of FDI restrictions in Malaysia over time, together with similar estimates for Indonesia, based on the OECD FDI Regulatory Restrictiveness Index (described later and in Box 2.2).[1] The Index captures the speed and depth of liberalisation over time. It shows the initial liberalisation for export-oriented manufacturing firms in the mid-1980s, followed by a long period up to the Asian financial crisis in which there was no significant change in policy. During this same period, Indonesia which had started with far more restrictions in the 1980s had arrived at the same overall level of openness in terms of statutory FDI restrictions before the 1997 crisis following important reforms prior to the crisis.

Indonesia was severely affected by the Asian financial crisis and enacted reforms, partly as a result of IMF conditionality, to stimulate the economy and rescue distressed firms, such as in the banking sector. Malaysia was less affected by the crisis and its subsequent policy response more muted. Certain restrictions in key sectors in Malaysia were partially mitigated on a temporary basis, including on *bumiputera* ownership in the manufacturing sector, but the restrictions were meant to be reimposed at a later date. In the end, much of the liberalisation was made permanent in 2003. These reforms were welcomed by investors, as FDI inflows increased rapidly, but – unlike in Indonesia – the Asian financial crisis was much less of a watershed in terms of FDI policies. By 2003, Indonesia had fewer statutory restrictions on foreign investment than did Malaysia. Partly as a result, once growth returned to Indonesia, it was able to reverse the secular decline in its share of the ASEAN stock of FDI, while Malaysia's continued to fall (Chapter 1, Figure 1.3).

Figure 2.1. **Liberalisation of FDI restrictions in Malaysia and Indonesia over time**

(0 = open; 1 = closed)



Source: OECD calculations based on the OECD *FDI Regulatory Restrictiveness Index*.

Beginning in 2009, the government of Malaysia began to undertake dramatic reforms which were unprecedented in their scope, especially when compared with the crisis response measures in 1997 and 2003. As a result of these reforms, Malaysia now once again has fewer statutory restrictions on FDI than in Indonesia as measured by the *FDI Index*. It remains to be seen what the investor response will be, although FDI inflows in Malaysia were at an all-time high in nominal terms in 2011. Table 2.1 lists major reforms of investment policies since the Asian financial crisis in 1998.

Reforms have been driven by internal rather than external drivers

Although Malaysian reforms have often been associated with economic crises, the approach to reform has been characterised by gradualism and pragmatism. Internal, rather than external, drivers seem to have played the leading role in reforms. Unlike in Indonesia or Thailand, the IMF was not involved in Malaysia during the Asian financial crisis. Trade and investment agreements have largely transcribed the existing level of openness concerning investment regulations (USITC, 2010), although it remains to be seen whether ASEAN commitments and any undertaken within the Trans-Pacific Partnership agreement will continue this trend (Chapter 3).

Reforms, when they occur, are usually the result of a long consultative process. This includes not only sectoral Master Plans such as seen in the financial sector and for the capital markets (Chapter 7), but also a broad discussion of the direction of necessary reforms contained in each Malaysia Plan (most recently for 2011-15) or in the New Economic Model developed by the National Economic Advisory Council under the Prime Minister. This gradual approach allows for consultations with stakeholders, provides opportunity for feedback and mid-course corrections, and allows domestic firms time to adjust. At the same time, a gradualist approach also requires a firm political commitment to carry through with the reforms to avoid backtracking.

Laws and regulations covering foreign investment in Malaysia

Malaysia has no comprehensive law governing foreign direct investment and containing general principles for foreign participation in local business. This policy choice has given the government maximum regulatory space to apply its affirmative action policy and to screen FDI to suit economic needs at a given time (IISD, 2004). In the absence of an all encompassing foreign investment statute, FDI is regulated under sector-specific legislation. Protection of investors is granted in the Constitution and in the many bilateral investment treaties which have been signed (Chapter 3). The regulation of FDI includes the *Promotion of Investment Act* (PIA) 1986, amended in 2007, which provides a spectrum of incentives to attract FDI. The *Industrial Coordination Act* (ICA) 1975, amended in 2010, applies to the manufacturing sector.

Until 2009, all acquisitions of interest, mergers or takeovers were screened by the Foreign Investment Committee (FIC), under the Prime Minister and in the Economic Planning Unit. The FIC Guidelines were a key component of the NEP since the FIC was created in 1974 and the FIC played a key role in shaping foreign investment policies. The FIC Guidelines stipulated that any proposed acquisition should: *i*) result directly or indirectly in a more balanced Malaysian participation in ownership and control compared to the

Table 2.1. **Major liberalisation measures affecting investment, 1998-2012**

1998	(Temporary) relaxation of foreign ownership and export requirements for manufacturing companies not directly competing with local producers (with certain sectoral exceptions).
	Foreign equity allowed in **wholesale and retail** companies raised from 30% to 51% (?).
	Foreign equity allowed in **telecommunications** companies raised from 30% to 49% (61% on a case-by-case basis in mobile telephony), provided that the investor reduces the share to 30% within five years.
April, 2003	Removal of requirement that foreign-controlled companies obtain 50% of their local credit from Malaysian **banks**.
	Insurers with FDI > 51% have greater operational flexibility to open up to two branch offices in one year.
May	Relaxation of guidelines for foreign equity participation in local firms which previously stipulated a 30% limit on foreign equity.
June	Indefinite extension of policy permitting 100% foreign ownership in new investment and expansion of existing investments in **manufacturing** and removal of sectoral exceptions.
September	New guidelines on employment of expatriates in **manufacturing**: companies with paid-up capital of at least USD 2 million receive automatic approval for up to 10 expatriate posts.
	Three new **Islamic banking** licences offered to foreign players, with foreign equity participation up to 100%.
	Four new **Islamic insurance** (takaful) licences offered, with foreign participation up to 49%.
2005	Foreign equity participation in Islamic subsidiaries of domestic **banks** raised from 30% to 49%.
	Foreign equity participation in **investment banks** and **takaful** operators raised from 30% to 49%.
March	Licences for 5 foreign **stock brokerage** firms and 5 global **fund management** firms to operate in Malaysia. **Venture capital** firms can be 100% foreign-owned.
April	Foreign-controlled companies no longer face domestic borrowing requirement or require BNM approval for any amount of ringgit credits.
January, 2006	Locally-incorporated foreign **banks** are to be allowed to open up to 4 additional branches based on a distribution ratio of 1 (market centre), 2 (semi-urban) and 1 (non-urban).
August	Foreign equity participation in **insurance** sector raised from 30% to 49% for new foreign shareholders and up to 51% for the original foreign shareholders of locally incorporated insurance companies.
September	New licences offered for **international Islamic banks** and **international takaful operators**. Foreign equity participation permitted up to 100% and both branches and subsidiaries allowed.
	Government announces intention to allow spouses of foreign expatriates to work.
2008	A further 3 foreign **stockbroking licences** announced.
April, 2009	Two new **Islamic banking** licences offered, with a minimum paid-up capital of USD 1 billion and with foreign equity participation for these new licences permitted up to 100%. Two new **family takaful licences** offered, with foreign equity participation permitted up to 70%. Foreign equity participation increased from 49% to 70% for **investment banks**, **insurance companies** and **takaful operators** and from 70% to 100% for **fund management companies** providing wholesale services. A foreign equity limit above 70% for general insurance companies to be considered on a case-by-case basis to facilitate consolidation and rationalisation of the general insurance industry.
	Flexibility to increase foreign equity participation from 49% to 70% for existing domestic Islamic banks wishing to scale up operations by entering into strategic partnerships with foreign players, and maintaining a paid-up capital of at least USD1 billion.
	Locally-incorporated foreign insurance companies and takaful operators allowed to establish branches nationwide, and to enter into bancassurance/ bancatakaful arrangements with banks, without restriction.

Table 2.1. **Major liberalisation measures affecting investment, 1998-2012** *(cont.)*

	Locally-incorporated foreign banks allowed to establish up to four new branches in 2010 based on a distribution ratio of 1 (market centre): 2 (semi-urban): 1 (non-urban) (additional to the four allowed in 2006 and up to ten microfinance branches).
	Five new commercial banking licences offered to foreign players bringing in specialised expertise and world-class banks offering significant value propositions.
	Elimination with immediate effect of foreign equity restrictions in 27 **service sub-sectors** (incl. health and social services, tourism, transport, business and computer services).
	Some relaxation of rules on **foreign property ownership**: property transactions over RM 500 000 for commercial, industrial and agricultural land no longer require FIC approval.
	100% foreign equity allowed in some **maritime services**.
June	Deregulation of **FIC guidelines**: the FIC no longer processes any acquisitions, mergers or takeovers nor imposes equity conditions.
	Foreign equity guidelines in **air transport** to be set by regulator and no longer fixed at 30%.
August 2011	Flexibility from complying with the distribution ratio requirement for locally-incorporated foreign banks that have fewer than eight branches and have yet to establish new branches.
October-Dec.	Announcement that another 17 service sub-sectors would be liberalised in 2012.
	Equity in stockbroking companies fully liberalised.

Source: Author's assessments.

existing pattern of ownership; *ii*) lead directly or indirectly to net economic benefits in relation to such matters as the extent of Malaysian participation, particularly *bumiputera* participation, ownership and management, income distribution, growth, employment, exports, quality, range of products and services, economic diversification, processing and upgrading of local raw materials, training, efficiency and research and development; and *iii*) should not have adverse consequences in terms of national policies in such matters as defence, environmental protection or regional development. The onus of proving that the proposed acquisition fulfils these conditions was on the acquiring parties concerned.

Reforms announced in 2009 removed FIC oversight for all but certain large property transactions, thereby eliminating a significant obstacle to foreign investment in Malaysia, particularly in service sectors where market entry often involves the acquisition of a local firm. The reform did not remove all obstacles to foreign investment in these sectors but did allow for greater flexibility by allowing each sectoral regulator to decide whether to continue with the 30% foreign equity rule as part of the government's long-standing positive discrimination in favour of the *bumiputera* majority.

Policies in support of the *bumiputera* population continue in the form of government procurement and operational and equity restrictions in sectors where *bumiputera* are prevalent. For Malaysian companies, the equity condition has become subsumed within the public spread requirement under Bursa Malaysia listing rules: one half of the 25% public spread for initial public offerings (IPOs) must now go to *bumiputera* investors, implying an effective

equity condition of 12.5% (or one half of 25%). The new requirement does not apply to foreign companies seeking a listing on Bursa Malaysia where no equity conditions remain.

Profits, dividends, interest, royalties and fees, as well as capital repatriation, are freely allowed, once withholding taxes have been paid. Even during the Asian financial crisis when Malaysia imposed some controls on capital outflows, the government was careful not to impede outflows associated with direct investment.

Key personnel

Locally incorporated companies must have at least two directors who have their principal residence in Malaysia. Companies are also bound by the provisions of the *Guidelines on Employment of Foreign Personnel*, the requirements of which differ depending on the type of post: foreign personnel might permanently hold key positions; while executive and non-executive positions are respectively open to expatriates for a maximum of 10 and 5 years. New guidelines on employment of expatriates in manufacturing were issued in 2003, allowing companies with paid-up capital of at least USD 2 million to receive automatic approval for up to 10 expatriate posts

Acquisition of land and other property

Malaysia has relaxed its rules on foreign ownership over the past decade in an effort to stimulate its stagnant property market. The FIC Guidelines, which had previously required that foreigners establish a local company with 49% Malaysian equity in order to buy a commercial property, were deregulated in 2009. Any property bought by non-Malaysian must be priced at a minimum of RM 250 000. Under the 2010 Guidelines on Acquisition of Property, foreign interests are no longer required to apply for approval to the FIC for the acquisition of properties, except for transactions involving the dilution of *bumiputera* or government interest in properties valued at RM 20 million and above. Foreigners can acquire commercial and residential properties above RM 500 000 without approval from the EPU but cannot acquire properties below these limits.

Sector-specific regulations are discussed in more detail below. As in many countries, Malaysia no longer has any statutory restrictions on foreign investment in the manufacturing sector. Remaining restrictions are predominantly in the service sector.

Manufacturing

The *Industrial Co-ordination Act* 1975 requires persons engaging in manufacturing activities to obtain a licence, in order to ensure co-ordinated and

orderly development of manufacturing activities. This licence requirement concerns only manufacturing companies with shareholders' funds above RM 2.5 million or engaging a minimum of 75 full-time employees. Applications for manufacturing licences shall be made with MIDA. According to the ICA, "manufacturing activities" means the "making, altering, blending, ornamenting, finishing or otherwise treating or adapting any article or substance with a view to its use, sale, transport, delivery, or disposal and includes the assembly of parts and ship repairing but shall not include any activity normally associated with retail or wholesale trade". Additionally, all manufacturing projects must comply with the requirements of the *Environmental Quality Act*, 1974 and obtain approval from the Department of Occupational Health and Safety. Moreover, businesses operating in sectors such as the electrical and electronic industry, wood-based industry and the chemical industry, must comply with sector specific licensing and registration requirements.

The manufacturing sector was the first to see departures from the 30% foreign equity limit applied uniformly across sectors. As a result of the PIA in 1986, foreign equity conditions were relaxed for exporters and for firms producing high technology goods or priority products for the domestic market. No equity conditions were imposed on firms exporting 80% or more of their output. This was extended to all new projects at the time of the financial crisis, initially on a temporary basis, but in 2003, all equity restrictions on foreign ownership in manufacturing were removed, as were requirements that foreign companies source one half of their local credit from Malaysian banks. As a result, there are almost no remaining restrictions on foreign investment in manufacturing in Malaysia, beyond those applying to all sectors.

Services

The service sector in Malaysia has traditionally been relatively restricted for foreign investors, with a general 30% foreign equity limit imposed. Unlike in other countries affected by the Asian financial crisis, Malaysia did not radically change its policy approach in this sector, preferring instead to rely on temporary measures in certain key sectors. This situation changed in 2009, beginning with the opening up of 27 service sub-sectors to full foreign ownership. Liberalisation in another 17 sub-sectors was announced in the Prime Minister's 2012 budget presentation in October 2011.

As part of the 2009 liberalisation, the government announced the creation of a National Committee for Approval of Investments in the Services Sector under MIDA. The Committee will receive and process investment applications for all services except the following: financial services, air travel, utilities and distributive trades, investor in the Economic Development and Multimedia Super Corridors and in Bionexus status companies.

Service sector liberalisation can have a strong impact on the competitiveness of the overall Malaysian economy. A number of studies summarised in Box 2.2 attest to the importance of such liberalisation on the total factor productivity of firms in the manufacturing sector.

Distribution

According to the *Guidelines on Foreign Participation in the Distributive Trade Services*, all applications involving foreign investment, including expansion of existing outlets, require approval from the Committee on Distributive Trade. Foreign investors are also required to incorporate locally. For hypermarkets and superstores, existing business operators are not allowed to open a new branch unless the requirement of 30% *bumiputera* ownership has been fulfilled. The equity requirement for department stores and specialty stores has been liberalised. No foreign involvement is allowed in supermarkets and mini-markets under 2 000 m^2, as well as in convenience stores which are open 24 hours, newsagents and petrol kiosks. Investors also face minimum capital requirements which vary according to the type of retail outlet. All major retailers are required to source 30% of sales from SMEs, principally *bumiputera*-owned.

From 2004 to 2009, there was to be a five-year freeze on the development and construction of any hypermarkets in the Klang Valley, Penang and Johor Bahru, but this was lifted soon after it was imposed.

In late 2008, foreign retailers were allowed to open small outlets through a franchise system with the approval of the Ministry of Domestic Trade and Consumer Affairs.

Telecommunications

Telecommunications services were a state monopoly until 1987, when Telekom Malaysia Berhad was corporatised and then privatised. The government, via government-linked institutions, retained a 75% share at the time (direct and indirect ownership of 57% as of 30 September 2012 based on top 30 shareholders) The government also has "special shares" which enable it, through the Minister of Finance, to ensure that certain major decisions of the company are consistent with government policy. Over time, licences were issued to private companies in both fixed and mobile telephony, but Telekom Malaysia remained the dominant provider in both segments, prior to its demerger in 2008. The sector is regulated by the Malaysian Communications and Multimedia Commission set up under the *Malaysia Communications and Multimedia Commission Act* 1998 (Chapter 8).

Foreign investment in the sector was hampered both by the market power of the incumbent and by the 30% foreign equity limit imposed on service providers. As a result of the Asian financial crisis, the foreign equity limit was increased to 49% in February 1998 and then to up to 61% in April on a case-by-case basis, provided the purchase brought in foreign exchange. This liberalisation was intended to be temporary, with foreign investors expected to bring their share down to 30% within five years.

The government announced in October 2011 the liberalisation of 18 service sub-sectors, including telecommunications, with foreign equity now allowed up to 70% for network facilities and service providers and 100% for application service provides (primarily Internet access). The maximum aggregate foreign ownership in Telekom Malaysia is 30%, or 5% for individual investors. These limits are confirmed in the schedule of commitments under the Malaysia-Australia Free Trade Agreement signed in May 2012.

Financial services

The gradual liberalisation of foreign equity restrictions in the financial sector based on the Financial Sector Master Plan is discussed in Chapter 7. Existing restrictions on foreign investment in the financial sector have declined sharply over time (Table 2.2) and are generally below those found in the largest emerging markets in East Asia on average, but they remain higher than those found in OECD member countries (Figure 2.3). In commercial banking, full foreign ownership in locally-incorporated foreign banks is permitted, as all locally-incorporated foreign banks in Malaysia are 100% foreign-owned, but not in the eight domestic commercial banking groups which represented almost 80% of total banking system assets at the end of 2011 (Chapter 7). Pursuant to the requirement of the *Banking and Financial Institutions Act 1989*, all branches of foreign banks operating in Malaysia were required to incorporate locally by 1994.

Foreign investors have also faced operational restrictions on their banking activities in Malaysia. Unlike domestic banks, foreign commercial banks have not until recently been allowed to establish new branches. For regulatory purposes, offsite ATMs are considered to be separate branches, thus limiting the ability of foreign banks to compete by offering the same range of services as their domestic competitors (OECD, 1999). In 2011, foreign banks operating in Malaysia were allowed to connect to Malaysia's ATM network owned by domestic banks, lifting an important barrier for foreign banks to compete in the retail banking market.

Over time, branching restrictions have been eased, and in 2006, locally-incorporated foreign banks were allowed to open four additional branches. In 2009, they were permitted to open four new branches in addition to those permitted in 2006, thus raising the total number of

branches to eight. Locally-incorporated foreign banks were also allowed to open up to ten microfinance branches. In 2011, flexibility was accorded to locally-incorporated foreign banks that have fewer than eight branches and have yet to establish new branches from having to comply with the distribution ratio of 1(market centre): 2(semi-urban): 1(non-urban) requirement. In the past, foreign banks were also restricted to providing no more than 40% of the domestic borrowing by foreign companies. Banks operating in Malaysia are allowed to outsource certain operational functions to service providers located outside Malaysia, but this is subject to prior approval from Bank Negara Malaysia on a case-by-case basis. Consideration in this matter is based on prudential safeguards and ability of the bank to have oversight on these functions. Foreign-controlled banks are nevertheless granted the same treatment as domestic banks with regard to money market instruments and access to the Bank Negara Malaysia discount window.

Table 2.2. **Equity restrictions in financial services**

	Actual foreign equity limit (%)	Earlier reforms
Banking		
Commercial banks	30	
Foreign-owned banks	100	
Domestic Islamic banks	70	Up from 49% in 2009.
Foreign Islamic banks	100	
Insurance		
Insurance companies	70 (Higher limit beyond 70% considered on case-by-case basis for general insurance companies)	Up from 30% in 2006 and 49% or 51% in 2009.
Islamic insurers (takaful operators)	70	Up from 30% in 2005 and 49% in 2009.
International takaful operators	100	With effect from September 2006.
Islamic reinsurers (retakaful operators)	100	
Other finance		
Investment banks	70	Up from 30% in 2005 and 49% in 2009.
Venture capital firms	100	As of March 2005.
Fund management companies	100	Up from 70% in 2009.
Stockbroking companies	100	70% until 2011 and 49% before 2009.
Financial leasing companies	100	49% before 2009.

Source: Author's assessments.

Business services

Until the liberalisation measures announced in 2011, foreign investors were severely circumscribed in their ability to offer business services in Malaysia. Foreigners were permitted to hold only up to 30% of the equity in

law, architectural and engineering services and 40% in accounting. Foreign directorships were not permitted in firms providing either architectural or engineering services. Liberalisation measures announced in October 2011 stated that full foreign ownership was to be permitted in accounting and taxation services and in architectural and engineering services (pending amendments to the relevant acts). In legal services, joint ventures with foreign investors are now permitted in peninsular Malaysia for permitted areas of practice (advice on home country and international law).

Malaysia's ranking under the OECD FDI Regulatory Restrictiveness Index

A country's investment climate cannot be captured in a single indicator, whether on the costs of doing business or a measure of statutory restrictions on FDI. Many different policies and practices impinge on investment decisions, and the way – and whether – policies are implemented is arguably as important as the policies themselves. Quantitative indicators have nevertheless proven highly effective in drawing attention to the burdens of business regulation, identifying priorities for reform and communicating success and progress. Benchmarking Malaysia's performance in liberalising its investment regime compared to regional peers and to the average for OECD member countries provides a useful external assessment of how Malaysia performs in this area and the results accord well with the relative performance of Malaysia in attracting FDI over time. Just as Malaysia gauges its performance in attracting investment against its peers, so too should it assess how it compares with its peers in terms of restrictions on market access and operational constraints faced by foreign established firms. What follows provides one such assessment.

The OECD *FDI Regulatory Restrictiveness Index* (*FDI Index*) seeks to gauge the restrictiveness of a country's FDI rules (see Box 2.1). The Index is currently available for 34 OECD countries and 22 non-members, including China, Indonesia and India. The *FDI Index* does not provide a full measure of a country's investment climate as it does not score the actual implementation of formal restrictions and does not take into account other aspects of the investment regulatory framework, such as the extent of state ownership, and other institutional and informal restrictions which may also impinge on the FDI climate. Nonetheless, FDI rules are a critical determinant of a country's attractiveness to foreign investors and the *FDI index*, used in combination with other indicators measuring various aspects of the FDI climate, contributes to assessing countries' international investment policies and to explaining variations among countries in attracting FDI.

The Asian countries covered by the *Index* typically have higher scores, on average, than OECD member countries and non-member adherents to the

Box 2.1. **Calculating the OECD *FDI Regulatory Restrictiveness Index***

The OECD *FDI Regulatory Restrictiveness Index* covers 22 sectors, including agriculture, mining, electricity, manufacturing and main services (transport, construction, distribution, communications, real estate, financial and professional services).

For each sector, the scoring is based on the following elements:

1. the level of foreign equity ownership permitted;
2. the screening and approval procedures applied to inward foreign direct investment;
3. restrictions on key foreign personnel; and
4. other restrictions such as on land ownership, corporate organisation (e.g. branching)

Restrictions are evaluated on a 0 (open) to 1 (closed) scale. The overall restrictiveness index is a weighted average of individual sectoral scores.

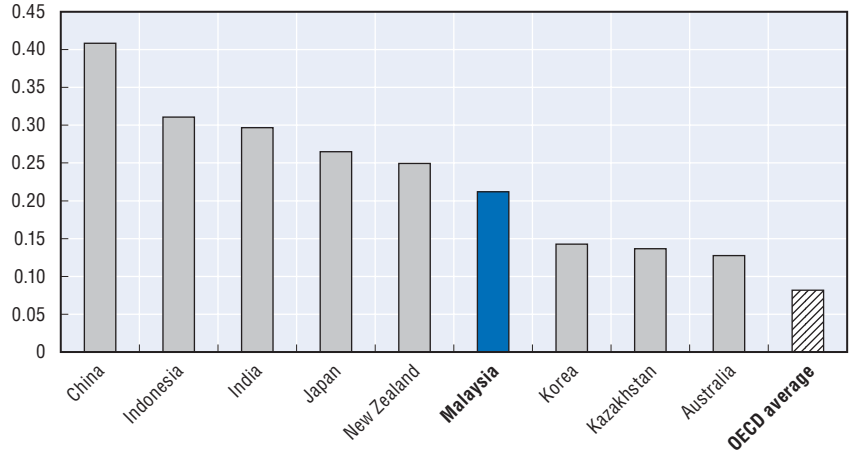
The measures taken into account by the index are limited to statutory regulatory restrictions on FDI, typically listed in countries' lists of reservations under FTAs or, for OECD countries, under the list of exceptions to national treatment. The Index does not assess actual enforcement. The discriminatory nature of measures, i.e. when they apply to foreign investors only, is the central criterion for scoring a measure. Thus in the case of Malaysia, a requirement of 30% *bumiputera* ownership, to the extent it applies to all private investors, would not be scored. Similarly, state ownership and state monopolies, to the extent they are not discriminatory towards foreigners, are not scored.

For the latest scores, see *www.oecd.org/investment/index* and for a discussion of the methodology: *OECD Working Paper on International Investment* No. 2010/3 *OECD's FDI Restrictiveness Index: 2010 Update* available at *www.oecd.org/dataoecd/32/19/45563285.pdf*.

OECD *Declaration and Decisions on International Investment and Multinational Enterprises*. Malaysia is not an outlier in this respect (Figure 2.2). With a score of 0.212, it performs better than the largest emerging economies in Asia but has significantly more statutory restrictions than the average for OECD countries, including Korea. The current score nevertheless represents a significant improvement over that which prevailed until 2009. Equally significantly, there has been no backtracking in the gradual approach to liberalisation adopted by successive governments over the past 15 years.

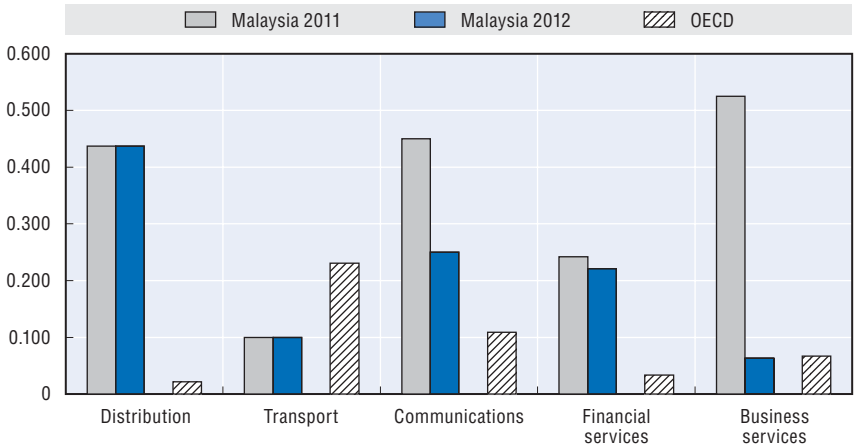
Figure 2.3 shows the Malaysian scores under the Index for certain key service sectors described earlier. The current Malaysian score is compared

Figure 2.2. **OECD FDI Regulatory Restrictiveness Index, selected countries, 2012**



Source: www.oecd.org/investment/fdiindex.htm.

Figure 2.3. **OECD *FDI Regulatory Restrictiveness Index*, key service sectors**



Source: www.oecd.org/investment/fdiindex.htm.

with that for 2011, before the most recent liberalisation measures were implemented, as well as with the average OECD member countries. Comparing 2011 and 2012 for Malaysia, the importance of the reforms in the communications and business service sectors in terms of the removal of statutory barriers to foreign investment is apparent. At the same time, Malaysia remains far from the level of openness found in OECD countries in the financial, distribution and telecommunications sectors.

Many of these service sectors are key inputs into all other sectors of the economy, whether financial, professional, logistics or network services. Hence, the competitiveness of firms in other sectors such as manufacturing will depend on their ability to procure high quality, low cost services within the economy. Several empirical studies have established a link between services and overall export competitiveness, including the relationship between restrictions on foreign investment in services and total factor productivity in manufacturing (Box 2.2).

Box 2.2. **The benefits of services liberalisation for the manufacturing sector**

The case for liberalising trade in goods is now widely accepted. Many countries that have liberalised foreign trade in goods have enjoyed greater economic growth. Trade liberalisation has proven to be an important channel for raising the performance of manufacturing industries through increased competition in industries competing directly against imports, thereby stimulating innovation and technological diffusion and lowering costs, including for industries relying on imported inputs.

In contrast, services liberalisation has received much less attention. Until the mid-1990s, many countries, notably developing ones, were reluctant to open service sectors to foreign competition. Since then, however, more and more countries have acknowledged the potential benefits of services liberalisation to economic growth and have thereby begun to open their services sectors. Nevertheless, many countries still maintain restrictions on foreign investment in service sectors as indicated by the OECD *FDI Regulatory Restrictiveness Index*.

In this context, there is an emerging interest in understanding how service reforms affect the economic performance of countries. One fruitful topic of research is the effect of service liberalisation on the export competitiveness and productivity of manufacturing firms by treating service sector inputs to manufacturing sectors as factors of production alongside labour, capital and other inputs. Services liberalisation is expected to facilitate the exit of low productivity firms from the market and the entry of new competitors, as well as stimulating competition among services providers. Manufacturing industries relying on these services as inputs would thereby benefit from the improved quality and lower cost of service inputs which would increase the marginal productivity of other inputs. Indeed, research described below shows that policies enhancing competition in service sectors, such as through FDI liberalisation, can have significantly positive effects beyond any direct effect on the service industry itself.

Box 2.2. **The benefits of services liberalisation for the manufacturing sector** *(cont.)*

A recent study by Duggan et al. (2013) employs the OECD *FDI Regulatory Restrictiveness Index* to assess the effects of restrictions on FDI in services on the manufacturing productivity of Indonesian firms from 1997 to 2009. The study finds that services sector FDI liberalisation, notably related to equity limits and screening and prior approval requirements, accounted for 8% of the observed increase in Indonesian manufacturers' total factor productivity (TFP) over the period. In a similar study, Arnold et al. (2012) analyse the effects of India's policy reforms in banking, telecommunications, insurance and transport services and find that they have all had significant and positive effects on the productivity of 4 000 Indian manufacturing firms from 1993 to 2005. Both foreign and domestic firms benefited from services reforms, but the effects were stronger for foreign-owned firms. A one standard deviation increase in the aggregate index of services liberalisation used in the study resulted in a productivity increase of 11.7% and 13.2% for domestic and foreign manufacturing firms respectively.

Likewise, Arnold et al. (2011) show that increased foreign participation in services provision improved manufacturing productivity in the Czech Republic from 1998 to 2003. A one standard deviation in foreign the presence in services is associated with 7.7% increase in the productivity of Czech manufacturing firms relying on services inputs. Shepotylo and Vakhitov (2012) analyse the impact of services liberalisation on the productivity of manufacturing firms in Ukraine from 2001 to 2007 and find that a one standard deviation in services liberalisation is associated with a 9% increase in the TFP of manufacturing firms. The authors also find that the effect of services liberalisation is stronger for domestic and small firms. Fernandes and Paunov (2012) conduct a similar study on the effects of FDI in services sectors on the productivity of Chilean manufacturing firms between 1995 and 2004. A one standard deviation increase in service FDI would increase Chilean firms' TFP by 3%, and forward linkages from FDI in services explain 7% of the observed increase in the TFP of Chile's manufacturing firms during the period.

Forlani (2011) looks at the case of France and finds that increased competition in network services improves the productivity of manufacturing firms. Berulava (2011) finds that liberalisation in telecommunications, electric power, railway transport, road transport, water distribution sectors and banking have stimulated the expansion of export activities of manufacturers in 29 transition economies from 2002 to 2009.

The role of government-linked companies

Government-linked companies (GLCs) are predominant in several economic sectors in Malaysia and constitute an important instrument of national development (Box 2.3). GLCs emerged with the advent of the New

Box 2.3. **Definitions and importance of government-linked investment companies (GLICs) and government-linked companies (GLCs) in Malaysia**

Government-linked investment companies (GLICs) refer to investment companies in which the federal government has influence over the management by appointing and approving board members and senior management, who in turn report directly to the government. The government may also provide funds for operations or to guarantee capital (and some income) placed by unit holders. The Ministry of Finance or the Prime Minister's office are usually the government representatives on the board of GLICs and thereby play a role in the governance and investment decisions of these companies. Representatives of GLIC beneficiaries (investors and pensioners) complement the board of directors.

GLICs allocate some or all of their funds to investments in government-linked companies (GLCs). Currently, there are seven GLICs in Malaysia?* that directly control many listed GLCs and have minority stakes in several other listed companies. GLICs are also significant investors in a number of non-listed GLCs.

GLCs are defined as companies that have a primary commercial objective and in which the Malaysian government has a direct controlling stake, i.e. the ability to appoint board members and senior management, make major decisions (e.g. contract awards, strategy, restructuring and financing, acquisitions and divestments) for GLCs either directly or through GLICs. Hence, GLCs include companies where the government controls directly or collectively a controlling stake through state agencies, such as the Ministry of Finance Inc. or through GLICs, such as EPF and Permodalan. It also Includes companies where GLCs themselves have a controlling stake, i.e. subsidiaries and affiliates of GLCs.

GLCs and their controlling shareholders, GLICs, constitute a significant part of the economic structure of Malaysia. GLCs employ an estimated 5% of the national workforce and account for approximately 36% and 54% respectively of the market capitalisation of Bursa Malaysia and the benchmark Kuala Lumpur Composite Index. Even with active divestment and privatisation, GLCs remain the main service providers to the nation in key strategic utilities and services including electricity, telecommunications, postal services, airlines, airports, public transport, water and sewerage, banking and financial services.

* The seven GLICs are: Employees Provident Fund (EPF), Khazanah Nasional Bhd, Kumpulan Wang Amanah Pencen (KWAP), Lembaga Tabung Angtakan Tentera, Lembaga Tabung Haiji, Menteri Kwanagan Diperbadankan, and Permodalan Nasional Bhd (PNB).

Source: GLC Transformation Programme Manual (July 2005) and IMF (2013).

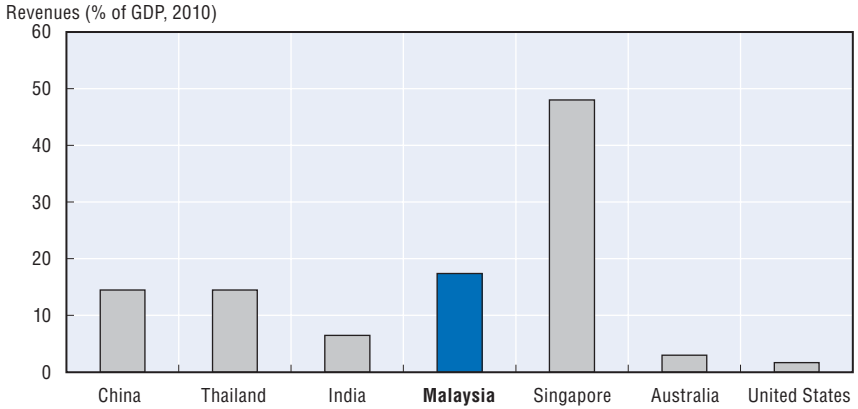
Economic Policy (NEP) 1971 via market acquisition of foreign owned assets (mostly British plantation companies) to meet national development objectives, as well as to promote the restructuring of the Malaysian society, and enable greater equity among the ethnic Malays (*bumiputera*) and the Chinese and Indian population. Through a range of affirmative policies established in the NEP, the government sought to create a *bumiputera* commercial and industrial community. One of such initiatives was a specific goal of ownership distribution: the *bumiputera* population should have at least 30% participation in all commercial and industrial activities in terms of ownership and management positions within two decades. With this purpose, government-linked investment companies (GLICs) usually acquired 20% to 50% equity stake in listed companies, becoming a major shareholder in what are now referred to as GLCs (Gomez, 2009). While the traditional role of GLCs was to engineer such socioeconomic change through wealth re-distribution, their growth in terms of revenues, investments and range of activities is now perceived by many as a barrier for private investment (NEAC, 2010b; Gomez, 2011; Menon, 2012).

Notwithstanding their importance for achieving Malaysia's socioeconomic goals, the perception of private investors is that GLCs have ventured beyond their mandates. GLCs play a particularly important role in the utilities sector with 88% of the sector total assets. In other key economic sectors, GLCs account for 67% of total assets in the telecommunication sector, 56% of the banking sector (23% based on the effective interest of the four domestic banking groups);[2] 50% of retail trade and 43% of agriculture and forestry, principally in oil palm plantations (Menon, 2012). GLCs are also present in roads, airports, air transport, and water and power sectors (see Chapter 8). Estimates of their market share in these sectors are often even higher.

The heavy participation of GLCs in the economy is also estimated to be above that of GLCs in many other emerging economies in Asia, including China (Figure 2.4). The exercise conducted by Chakravarty and Ghee (2012) compares the total revenues of GLCs in different countries as a percentage of their countries' economies. GLCs included in the analysis refer only to those in which the government has a stake of 50% or more. The actual list of GLCs is higher as some government agencies control GLCs by being the largest controlling shareholder though having a minority stake. Based on this sample, total revenues of Malaysia's GLCs are estimated to account for 17.4% of GDP, while revenues of GLCs in China and Thailand account for 14.5% of the respective GDPs. Among the countries benchmarked, only Singapore's GLCs have a more prominent role in the economy.

The high degree of government ownership represents a *de facto* constraint for private sector investment, but it is less of an issue in itself than the productivity of many GLCs in the past. Many GLCs continued to underperform

Figure 2.4. **GLCs participation in the economy of selected countries**



Note: GLCs included in the analysis refer to those in which the government had a stake of 50% or more.
Source: Chakravarty and Ghee (2012).

in terms of operational and financial indicators even after privatisation in the 1990s and the sectors in which GLCs were dominant had seen the lowest productivity growth (NEAC, 2010, PCG, 2005).

In the early 1990s, limitations of Malaysia's state led investment model became evident. While some progress had been made over time in achieving the social outcomes of such policies, the performance of GLCs was below expectations. They had become dependent on government funds and associated with inferior services, low productivity and limited innovation. Private-sector oriented reforms came under the Privatisation Master Plan of 1991 in order to diminish the participation of GLCs in the economy and promote growth and competition through the private sector. In an initial phase, privatisation involved the corporatisation of GLCs and later their listing on the stock exchange. During this process, the government partially divested but maintained a controlling stake in several GLCs. Important GLCs were listed and privatised during this period, including Malaysia Airlines, Tenaga, Telekom, and the Heavy Industries Corporation of Malaysia. New infrastructure projects were also privatised in a later stage through privatisation contracts.

Together with the change in policy orientation towards the development of the private sector, the government implemented a number of initiatives to improve the performance and corporate governance standards of GLCs, with the most important programme being the GLC Transformation Programme launched in 2004 (see Chapter 5). While governance of GLCs has generally improved as a result of reforms and privatisation, there is still room for enhancing competition and raising the performance of GLCs as a few recent studies suggest that GLCs' performance has been below expected levels (Razak et al., 2011; Lye, 2011; Mohamad and Said, 2010).

In this context, the new Competition Commission can play an important role in ensuring that competition stimulates private sector investment in Malaysia and that GLCs continue to face pressures to raise their productivity and performance. The mandate of the new Competition Commission covers both private firms and GLCs (see Box 2.4). The Commission will require high-level political support to implement this mandate and to ensure that equity rules do not constitute barriers to entry. It is also important that other means be found to fulfil the socioeconomic policy objectives, particularly with respect to *bumiputera,* that GLCs are currently tasked with undertaking.

Box 2.4. **Strengthening the competition framework**

The primary objective of competition policy is to enhance consumer welfare by promoting competition and controlling practices that could restrict it. More competitive markets lead to lower prices for consumers, more entry and new investment, enhanced product variety and quality, and more innovation. Overall, greater competition is expected to deliver higher levels of welfare and economic growth. The strength of competition law, as perceived by investors, has been found to influence significantly the distribution of FDI across countries (APEC, 1999).

As outlined in the blueprint for the ASEAN Economic Community, all member states are to endeavour to introduce competition policies by 2015. Malaysia began discussions in the early 1990s and a first draft of a Competition Law appeared in 1993 but was never enacted (Rajenthran, 2002). In the absence of a Law, competition issues were covered to some extent in sectoral regulations, depending on the nature of the sector, e.g. when issuing licences and permits or signing contracts with private producers and through price controls. In general, however, restrictive business practices in the form of collusive tendering, market allocations or quotas, refusals to supply and cartel price fixing were common (Rajenthran, 2002).

Renewed efforts in recent years resulted in the *Competition Act* (2010) which came into force at the beginning of 2012 and the *Competition Commission Act* (2010) which established the Malaysian Competition Commission in April 2011. The new Act covers both horizontal and vertical anti-competitive agreements and abuse of dominant position, but not merger regulation. Significantly, the scope of the Act covers both private companies and GLCs.

Box 2.4. **Strengthening the competition framework** *(cont.)*

It is too soon to evaluate the effectiveness of the new Commission which will depend on several factors:

- its degree of independence within government;
- the political support it receives at the highest levels;
- the financial resources at its disposal;
- the quality of its staff;
- whether there are clear lines of communication within government;
- the transparency of rulings and of procedures both when seeking approval and when contesting a ruling; and
- the extent to which the Commission is able to comment on competition aspects of rules and regulations, both actual and proposed, and more generally, its role in policy advocacy.

Notes

1. The choice of Indonesia for comparison is based partly on the availability of a similar time series as a result of an earlier *OECD Investment Policy Review* (OECD, 2010).
2. Menon's (2012) calculation includes one Islamic bank (BIMB Holdings Berhad) to the group of commercial banks. Excluding BIMB Holdings Berhad, the four GLCs in the banking sector held 50% of total commercial banking assets in 2011.

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Chapter 3

Property rights and investor protection

Strong protection of land ownership and intellectual property, effective compensation for expropriation, dispute settlement mechanisms accessible to all investors, and a protective network of international investment agreements are the building blocks of Malaysia's efforts to improve the quality of its investment environment. Malaysia has gradually moved towards an enabling regulatory framework for investors and more effective investors' rights. It has also made continuous efforts to improve the land ownership registration system. The electronic system has shortened registration times for land titles and transfers and has made formal recognition of land rights easier, but there remains a lingering problem of fraud of titles.

The country is endowed with an enabling legal framework for the protection and promotion of intellectual property (IP) rights and has ratified the main IP-related conventions, bringing itself in line with international standards. As a complement to the legal framework, the government has made concerted efforts to ensure that the protection of IP rights is effectively implemented, through the establishment of specialised IP courts as well as various awareness programmes.

Investors are also fairly well protected in the event of expropriation. Protection against illegal expropriation is soundly provided for both at a domestic level and in Malaysia's investment treaties. The country's standards of compensation for expropriation are consistent with international best practices.

Malaysia has reformed its judiciary in order better to meet the needs of business. With the recent creation of commercial courts and the modernisation of the caseload management system, the government aims to address the lengthy and complex procedures for enforcing contracts. In parallel, Malaysia has actively and successfully promoted alternative dispute settlement (ADR) mechanisms through mediation, conciliation and arbitration. Kuala Lumpur has been promoted as a venue for arbitration, and Malaysia, which has enacted a fine-tuned Arbitration law, is now regarded as one of the top promoters of ADR in the region.

Malaysia's legal framework for FDI comprises a web of investment agreements, including an extensive network of bilateral investment treaties, broad preferential trade and investment agreements and its membership of ASEAN. Malaysia has not yet developed a consistent approach in its agreements but is clearly moving over time towards sounder investment protection and liberalisation. In a number of respects, Malaysia's treaty programme is at the forefront of very innovative practices. It contains detailed investor-state dispute settlement provisions and commits Malaysia to consent to arbitration in the main international arbitration fora.

Effective land ownership registration

The government of Malaysia acknowledges the importance of an effective land registration system and efforts to improve the system have started to pay off, as has been widely acknowledged by international observers. The 2013 *Doing Business* Report lauded Malaysia for having achieved the most significant improvements on the ease of registering property. In 2012, Malaysia managed to dramatically cut the time required to register property transfers – thus enabling buyers to use or mortgage their property earlier.

The main regulations governing access to land in Malaysia are the *National Land Code* 1965 [Act 56] (NLC), which sets out the laws relating to land acquisition, land tenure, and registration of title; and the *Guidelines on the Acquisition of Properties by Local and Foreign Interests* which govern the acquisition of real property by local and foreign interests. The NLC provides a uniform system of land tenure and transactions as well as of registration of title throughout Malaysia. Land administration is shared among federal and state governments. State governments have their own rules for the regulation and ownership of land.

Transactions recognised under the NLC are divided into two categories: those that must be registered, such as transfers, charges and leases; and those which do not require registration, such as tenancies and statutory liens. Malaysia's legal framework is based on the Australian system of land ownership, the Torrens system, under which no title to, or interest in, land can be transferred or created without the instruments effecting the deals being registered, thus giving more certainty to land transactions. It implies that the registration of land transfer under the NLC prevails over all prior unregistered transactions, except in cases of fraud.[1] Enshrining the concept in the Code has prompted difficulties with regards to the conflicting interests of the original owner and third party *bona fide* purchasers. According to the 2012 *Investing Across Borders* Report, Malaysia ranks below the regional average in matters relating to access to land. The land title system also faces a serious problem of fraud, with a high number of reported fraud or forgery cases.[2]

Concerted efforts have been made to improve the registration of land rights

To overcome such challenges, many initiatives have been taken at both federal and state levels to establish more timely, secure and effective methods for registration of ownership for land and to provide formal recognition of land rights. Technology-based initiatives in improving the service delivery of land administration at all Land Offices are in place to speed up transactions. In 2011, a computerised system was put in place to permit land titles to be issued within one day through an online stamping system. The property registry has been digitalised and the requisite forms simplified. The eTanah system provides for an online registration of land transactions and ownership. State and district law offices also function as one-stop-shops for all land transactions. As a consequence of these various efforts, the time for registration has been shortened from 41 days to two days. When a property is transferred, the transferee must pay Stamp Duty, based on the price for the property or its market value, whichever is higher.[3] Completing a stamp duty valuation takes from one to five working days, or a longer period of time for shopping or industrial complexes or a multi-story office buildings.

The Malaysian land law is also influenced by Islamic and customary laws. The expression "customary land" means ancestral land, as opposed to acquired land – but does not necessarily refer to land held by aboriginal people.[4] Customary land can be transferred to any person or body eligible under respective laws. Apart from Customary Lands, there are specific laws relating to Malay Reservation and Aboriginal reserves. The Malay Reserved Lands, Customary Lands and Aboriginal Reserved Lands make up less than 35% of total land area in peninsular Malaysia.[5] Any acquisition by the government in respect of this type of land will be compensated according to the act, similar to the compensation awarded to any party having land title.

Foreign ownership remains restricted

Land in Malaysia can be transferred freely, unless a specific restriction is expressed on the Issue Document of Title, but the NLC contains specific provisions on land ownership by foreigners, who must obtain prior approval of the state authority for any acquisition of agricultural, residential and commercial lands. Approval is not required in cases where the land will be used for industrial purposes. Alternatively, state authorities may lease industrial land to investors on the basis of 33, 66 and 99 year leases. State authorities may also impose conditions, such as a threshold for foreign purchasers that is not standardised between states, or a levy in giving their approval to any acquisition by non-Malaysians. In alienating state land to foreigners, the state authority may impose certain restrictions on the title

such as, "this title shall not be transferred except with the consent of the State Authority".

The categories of land that can be alienated to foreigners depend on the policy of the respective state. If there is any zone earmarked for development such as for tourism, the state authority may categorise the lands as residential or commercial lands to enable any foreigner to participate in the development. Each state authority has the discretion to consider the acquisition based on the location and the type of property, and land rules vary from state to state. Additional conditions may therefore be imposed at a state level. For example, in the state of Selangor, foreign companies must have at least 49% Malaysian interest (with a minimum of 30% of shares held by *bumiputeras*) to be allowed to acquire agricultural land, and solely if it is to be used for so-called "Promoted Agricultural Activities". In the state of Johor, agricultural land cannot be acquired by foreigners but is available for lease. Foreign companies wishing to lease public land from the government must go through a burdensome process and first obtain approval from the District Land Office and the National Economic Planning Unit. Obtaining the two approvals can take from one to two years.[6]

Intellectual property rights

Over the past decade, the government has emphasised the protection and enforcement of intellectual property rights through legislative reform, enforcement initiatives and the launching of IP policies. The government has committed to put in place a suitable IP infrastructure in order to meet the needs of the business community and rights holders and to help the country to become a more competitive and attractive destination for foreign investment. Intellectual property is recognised, under the Economic Transformation Programme, as a pillar for transforming the economy, allowing Malaysia to escape its middle-income trap (see Overview).

Recent efforts have received international recognition, such as when the Office of the United States Trade Representative (USTR) removed Malaysia from its watch list for intellectual property rights protection and enforcement issues (PEMANDU, 2012).

Malaysia is a signatory to many international treaties and conventions related to IP rights (Box 3.1) and also intends to accede to the Singapore Trademark Law Treaty, the Hague System, the Madrid Protocol and the Budapest Treaty.

Intellectual property laws in Malaysia are generally in line with international standards, especially since Malaysia has amended its legal framework to comply with the obligations in the TRIPS agreement. Recently

Box 3.1. **IP Conventions ratified by Malaysia and year of entry into force**

- Paris Convention for the Protection of Industrial Property, 1989.
- Berne Convention for the Protection of Literary and Artistic Works 1990.
- Nice Agreement concerning the international classification of Goods and Services for the Purposes of the Registration of Marks, 1997.
- Vienna Agreement Establishing an international Classification of the Figurative Elements of Marks, 2007.
- WIPO Convention, 1989.
- WIPO Copyright Treaty, 2012.
- WIPO Performances and Phonograms Treaty, 2012.
- Patent Cooperation Treaty 2006.
- TRIPS Agreement, signed under the auspices of the WTO, 1995.

Malaysia is not a member of the following:

- Rome Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organisations.
- Singapore Treaty on the Law of Trademarks.
- Trademark Law Treaty.
- Hague Agreement Concerning the International Registration of Industrial Design.
- Lisbon Agreement for the Protection of Appellation of Origin and their International Registration.
- Locarno Agreement Establishing an International Classification for Industrial Designs.
- Strasbourg Agreement Concerning the International Patent Classification.
- UPOV Convention for the Protection of New Varieties of Plants.

amended IP-related laws are shown in Box 3.2. Malaysia's domestic legislation on intellectual property was reviewed by the TRIPs Council in 2002.[7]

Both at a domestic level and through its international commitments, Malaysia has developed a comprehensive legal framework for the protection of patents, copyrights and trademarks.

Patents

Patent protection is governed by the *Patents Act* 1983 and the *Patents Regulation* 1986. In accordance with the provisions of the TRIPS Agreement, the *Patents Act* stipulates protection for 20 years from the date of filing the

Box 3.2. **Malaysia's laws and regulations related to intellectual property rights**

- Copyright Act 1987 (Act 332).
- Protection of New Plant Varieties Act 2004 (Act 634).
- Patents Act 1983 (Act 291).
- Trademark Act 2002 (Act 1138).
- Geographical Indications Act 2000 (Act 602).
- Layout-Designs of Integrated Circuits Act 2000 (Act 601).
- Industrial Designs Act 1996 (Act 552).
- Trade Descriptions Act 2011 (Act 730).
- Consumer Protection Act 1999 (Act 599).
- Optical Discs Act 2000 (Act 606).

application. The owner of a patent has a right to exploit the invention, to assign and transmit the patent, and to conclude a licensed contract. By virtue of the act, the government can prohibit commercial exploitation of patents for reasons of public order or morality. A foreigner must file a patent application only through a registered patent agent in Malaysia acting on behalf of the applicant. Since Malaysia's accession to the Patent Cooperation Treaty in 2006, patent right owners are able to benefit from the treaty filing system, which provides a single procedure to prosecute patent applications and therefore protect inventions. Accession to the treaty has also enabled patent owners in Malaysia to carry out patent searches internationally. It has also simplified the protection of patents in Malaysia for foreign applicants via a single international filing application instead of multiple filing. In 2011, the Patent regulation was amended to shorten the pendency period and reducing the backlog, thereby facilitating the granting of patents. According to the Managing Intellectual Property Report,[8] further amendments to the legal framework for patents will introduce provisions on innocent infringement and groundless threats of patent infringements by owners.

Trademarks

Trade Marks protection is regulated under the *Trade Marks Act* 1976 and the *Trade Marks Regulations* 1997, which provide protection for registered trademarks and service marks in Malaysia. The initial period of protection runs for ten years and can be extended for subsequent ten-year periods. Foreign applicants must file applications through registered trademark agents. Malaysia signed the Nice Agreement on the International

Classification of Goods and Services for registering marks and the Vienna Agreement in 2007. The *Trade Marks (Amendment) Regulations* 2011, as well as the *Patent (Amendment) Regulations* 2011, allow applicants to request expedited examination of their application.

Copyrights

The *Copyrights Act* 1987 was updated by the *Copyrights Amendment Act* in February 2012 to meet the requirements for accession to the WIPO Copyright Treaty and WIPO Phonograms and Performances Treaty. More broadly, the amendment updates the legal framework for copyright to better take into account global developments in the digital area.

The legal framework has been complemented by efforts to improve enforcement

Efforts to improve the administration system have streamlined procedures and reduced timelines for registration. As a result, Malaysia now ranks 9th among 24 countries in the region in the 2012 *Property Rights Index*, issued by the Property Rights Alliance.[9] The protection and registration of IP rights and the implementation of the IP legislative framework are administered by the Intellectual Property Corporation of Malaysia (MyIPO), an agency within the Ministry of Domestic Trade, Cooperatives and Consumerism (MDTCC). MyIPO is the legal custodian of IP rights. It provides facilities for filing trademark, patents and industrial designs applications; reviews and updates the current legislative framework; and examines trademark and patent applications.

The Enforcement Division of MDTCC is responsible for enforcing various laws related to IP and is therefore in charge of combating copyright piracy, monitoring the production of optical discs and curbing counterfeiting activities. Criminal enforcement can be sought by filing a complaint with the MDTCC. The MDTCC can conduct raids and seize the offending goods, but when criminal prosecution of offenders is undertaken, it is often reported to be slow. Even though Malaysia has made significant progress in improving its legal framework, a number of complaints about law enforcement of IP rights have been pointed out in reports such as the 2012 *Property Rights Index*. According to the EU-Malaysia Chamber of Commerce and Industry, the MDTCC has been very active over the past few years in combating piracy and counterfeiting activities, although piracy, notably over the Internet, remains a significant problem. The enactment, in 2011, of the *Trade Description Act*, has resulted in a substantial increase in the amount of penalties for offences.[10]

Specialised IP Courts have recently been established to better manage the caseload related to IP rights and to ensure effective implementation of IP

regulations. IP courts comprise the IP session courts, which deal with criminal matters, and IP High Courts which have civil and appellate jurisdiction.[11] Since the establishment of IP Courts in 2007, 15 Session Courts and 6 High Courts have been designated to deal with IP matters. Various observers have reported that the courts were facing a backlog of cases within less than a year. While the establishment of IP courts is a laudable step, these are still relatively new. Capacity and experience in IP related matters need to be developed further. Also, the fact that there are only two IP Courts in Kuala Lumpur to date poses capacity constraints for handling cases effectively. While there are training programmes for judges under way that have continuously improved judges' IP expertise over the past years, some private sector representatives perceive them as not being well attuned to industry realities. The government seems to be increasingly aware of these challenges and has starting making use of the experience available within the ASEAN region to improve judges' capacity.[12]

Enforcement of IP at the border is a difficult area for many countries and one where Malaysia still exhibits weaknesses. Malaysian customs rarely get involved in prohibition measures, as these are not explicitly part of their mandate through the *Customs Act*. To address trademark counterfeiting, Malaysia has introduced the Basket of Brands Initiative to facilitate registration of brands at risk of being infringed and to allow prompt action upon receipt of a complaint by the trademark owner. Before the Initiative, the Enforcement Division of MTDCC faced difficulties due to the lack of co-operation from brand owners as well as difficulties in obtaining proof of ownership of an allegedly infringed mark. This promising initiative seems to have had limited success so far, as participation from brand owners has been low, owing partly to a lack of qualified customs officials to ensure effective inspection.[13]

Further efforts have been made to raise public awareness and build institutional capacity

Various awareness raising programmes have been put in place, including a National IP Day to increase public awareness of the risks of violating intellectual property rights. The National IP Policy, launched in 2007, aims to achieve a high standard of protection and to promote the commercialisation of IP, foreign investment and technology transfer. The overall objective of this initiative is to "strengthen the role of intellectual property as an engine of growth for the enhancement of social and economic prosperity". The strategy for creating the highest standard of IP protection includes developing a sound institutional framework to simplify the registration process for IP rights, strengthening the government's capacity to enforce sanctions of IP

infringements, and creating dedicated IP courts. By launching the IP Policy, the government also sought to ensure that IP would be able to generate the maximum return for research and development activities.

Despite this progress, the government still faces important challenges in ensuring the Malaysian IP rights framework is truly conducive to promoting business development, innovation, and generally boosting investor confidence.

Expropriation procedures

Clear and predictable legal provisions on expropriation, ensuring that it can only be done for public purposes, in a non-discriminatory manner, on payment of compensation, and in accordance with due process of law, are key protections for investors. Such rules, when clearly provided for, minimise the risk of arbitrary government action to expropriate established investments and ensure that expropriation is appropriately compensated when it occurs.

The Federal Constitution of Malaysia protects both domestic and foreign investors against expropriation of property without fair compensation. Under Article 13 of the Constitution, no person may be deprived of property in accordance with the law and no law may provide for compulsory acquisition or for the use of property without adequate compensation.

In Malaysia, the state authority is vested with the power to acquire land by compulsory means for public interest purposes, in accordance with Section 3 of the *Land Acquisition Act* 1960 [Act 486]. Compulsory taking by public authorities is allowed for any public purpose or by any person for a purpose which, in the opinion of the state authority, is beneficial to the economic development of Malaysia, or for mining, residential, agricultural, commercial, industrial, recreational purposes. The term "public purpose" is not defined in Act 486 or by the courts. The act only provides for compulsory acquisition and does not mention compulsory use of private property. The act requires for any acquisition of land that the state pay adequate compensation as awarded by the Land Administrator. Any party affected by an expropriation may refer the matter to the court which then decides the amount of compensation with the aid of two assessors: one public and one from the private sector.

Moreover, in the absence of a legal definition of the notion of "adequate compensation", it is unclear how adequacy is determined. Public authorities have used the concept of market value, meaning the value of the land at the date of publication in the Gazette of notice to acquire. According to a study published in the *Pacific Rim Property Research Journal*,[14] the quantum of compensation is perceived by the local population as inadequate to fulfil the notion contained in the Federal Constitution.

Before the acquisition, public enquiries are held and the market price of the property is discussed. The practice of judicial review of the case and valuation is statutorily provided in the Rules of Court 2012. This means that any person who is adversely affected by the decision of any public authority shall be entitled to make an application to have that decision quashed.

In the absence of an overarching foreign investment law that would provide a blanket protection to foreign investors, Malaysia relies extensively on bilateral investment treaties (so-called investment guarantee agreements) and FTA investment provisions to protect foreign investors against expropriation, including indirect expropriations. These agreements regulate details of expropriation procedures in line with international law: nationalisation and measures tantamount to expropriation must be for public purposes, under due process of law, non-discriminatory, and against prompt, adequate and effective compensation (for more details on expropriation clauses in Malaysia's agreements, see the section on International Investment Agreements).

Foreign investors are also offered some coverage in case of losses arising out of expropriations by the Multilateral Investment Guarantee Agency, to which Malaysia is a member.

There is no known arbitration case related to expropriation of foreign-owned assets. In the event of a dispute between the investor and the government over the amount of compensation, the issue is referred to Malaysian courts. If the government and the other party have agreed to submit their dispute to arbitration, the injured investor may bring the case to international arbitration. The arbitral tribunal will then have to decide whether the measure taken by the government is lawful.

Access to justice for investors and alternative dispute resolution

The Malaysian legal system is based on common law tradition and is also inspired by Islamic law. The administration of justice is a federal concern, and the Federal Constitution grants the independence of the Malaysian judiciary. The Judiciary is divided into Superior and Subordinate Courts. Superior Courts include the Federal Court, the Court of Appeal, and the High Court. Subordinate courts consist of the Sessions Courts and the Magistrate's Courts. The Federal Court is the highest court and may hear appeals of civil decisions of the Court of Appeals. The Court of Appeal hears civil appeals against decisions of High Courts. There are two High Courts, one located in peninsular Malaysia and one in Sabah and Sarawak, which have general supervisory and revisionary jurisdiction over the subordinate Courts as per Article 121 of the Federal Constitution. They also have jurisdiction to hear appeals from Subordinate courts. With few exceptions, High Courts have unlimited civil

jurisdiction where the cases exceed a certain value. High Courts have jurisdiction to hear matters relating to bankruptcy; injunctions, specific performance, or rescission of contracts; grants of probate, and letters of administration of estate. Subordinate Courts consist of the Session Courts and the Magistrate's Courts, which both have criminal and civil jurisdiction. There is a parallel system of Shariah Courts, which have jurisdiction limited to matters involving Muslims.

Business law is governed by a combination of commercial laws, such as the *Companies Act* and the *Bankruptcy Act*, and common law principles. In accordance with the constitutional principle of non-discrimination (Article 8 of the Federal Constitution), the right of access to justice is the same for foreigners and Malaysian nationals. However, going before local courts may be a costly and slow process, and there have been some reported cases of political interference in judicial matters.[15]

Under the 2013 *Doing Business* indicators, Malaysia ranks 33rd out of 183 economies on the ease of enforcing contracts, performing better than the regional average. According to this report, enforcing a contract in Malaysia requires 29 procedures, takes 425 days and costs 27.5% of the claim, although individual cases can sometimes take much longer.[16]

The government has taken many steps to render the domestic dispute settlement system more attractive to investors, including in setting up two specialised commercial courts with effect from September 2009. They deal with the following matters: banking transactions (bill of exchange, letter of credit, negotiable instruments); applications under the *Companies Act* (winding up, debentures, shares); finance (factoring, hire purchase, leasing, money lending); insurance; partnership; maritime; sales of goods and business agencies. These new commercial courts do not deal with some Islamic financial transactions and intellectual property cases. Their purpose is to take charge on the management of cases soon after filing, to reduce waiting periods by fixing early dates, and to go digital from registration to hearings to increase efficiency and effectiveness. Steps have also been taken to improve the efficiency of the overall court system, by implementing a fast track system for case management, digitalising proceedings and the electronic filing of claims.

Efforts towards alternative dispute resolution mechanisms

In recent years, alternative dispute settlement mechanisms have been increasingly utilised. Continuous efforts have been made to promote and develop conciliation, consultations, mediation, and especially arbitration. To avoid lengthy procedures before Malaysian courts, foreign investors frequently include mandatory arbitration clauses in their contracts. If parties

to a dispute choose to resort to arbitration in Malaysia, the applicable law is the 2005 *Arbitration Act*, which was substantially amended in 2011.

The active promotion of the Kuala Lumpur Regional Centre for Arbitration (KLRCA – see Box 3.3 below) and the adoption of an *Arbitration Act* reflect Malaysia's efforts to become one of the preferred venues for international commercial arbitration in the region. If a dispute arises between the government and an investor, there is no all-encompassing investment law providing for a dispute settlement mechanism but disputes can be brought before an ICSID arbitral tribunal depending on the provisions of the applicable investment treaty (see Box 3.4).

In 2005, Malaysia adopted an *Arbitration Act* based on, but not identical to, the 1985 Model Law on International Commercial Arbitration set out by UNCITRAL. The enactment of the law superseded the 1952 *Arbitration Act*, which was regarded by the arbitral community as outdated and unsuitable for efficient methods of commercial dispute resolution. With the new act, Malaysia adopted a holistic and integrated approach, encompassing both domestic and international disputes in a single act, and therefore brought its arbitral regime in line with international and regional standards. The 2005 act, which codified many arbitration law principles that were previously governed by common law principles, was amended in 2011 to clarify numerous ambiguous provisions. It now applies to all arbitration proceedings with their seat within the Malaysian jurisdiction. Disputes related to consumer claims, criminal offences, labour grievances, intellectual property rights, as well as any matters that are contrary to public order are not arbitrable.

There is no domestic court specialised in dealing with arbitral awards, but the High Court of Malaysia has jurisdiction in reviewing the validity of an arbitral award. Judicial interventions in arbitration proceedings are limited to cases of "patent injustice" or in the exercise by the courts of their "inherent jurisdiction". This provides parties in international arbitration seated outside of Malaysia with the guarantee that national courts have limited powers of intervention.[17] Section 8 of the amendment provides that "No Court shall intervene in matters governed by this act, except where so provided by the act".[18] These improvements of the law are part of the government's strategy to reinforce its role as a seat of international arbitration.

Arbitral awards are final and binding upon the parties. In particular circumstances (if the arbitration agreement is not valid under the relevant substantive law, in case of improper appointment of arbitrators, etc.), a party may apply to the court for the arbitration award to be set aside. Where a foreign arbitral award has been set aside by the competent court in the country in which it was rendered, Malaysian courts may refuse its enforcement. Except for disputes arbitrated under the ICSID Convention, which are enforceable

without judicial review, enforcement of international awards is not automatic. According to the World Bank's 2010 *Investing Across Borders* Report, it takes an average of 24 weeks to enforce an arbitration award in Malaysia, from filling an application to a writ of execution attaching assets, in cases where no appeal has been lodged. According to the government, the time taken to enforce arbitration awards varies depending on the mode of execution chosen by the applicant[19] and is often limited to no more than seven weeks.

By virtue of the *Reciprocal Enforcement of Judgments Act* 1958, foreign judgments can be locally enforced by a mere registration if they are for a monetary sum and were rendered by a superior court of a country listed in the first schedule of the act. Foreign judgments that were rendered in other jurisdictions than those listed can only be enforced by obtaining a judgment in a local court. As for the enforcement and recognition of international arbitral awards rendered in Malaysia, it has been facilitated by the 2011 amendment to the *Arbitration Act*, which now allows the enforcement of awards in respect of arbitrations where the seat of arbitration is in Malaysia.

Settling investment disputes through arbitration between the government and foreign investors can be facilitated through the KLRCA. The government has actively promoted the use of KLRCA, which settles disputes through consultation, negotiation, and arbitration for the benefit of parties engaged in trade, commerce and investment with and within the region. Over time, the KLRCA has become the main arbitral institution in the region. In parallel with the KLRCA, the Malaysian Institute for Arbitrators acts as an arbitration body within the Malaysian jurisdiction.

Malaysia Mediation Centre

Mediation has also been promoted as an effective alternative method of dispute settlement. The Malaysian Mediation Centre was set up in 1999 under the auspices of the Bar Council to promote alternative dispute resolution. The Centre provides mediation services and training for future mediators. Its scope was initially limited to commercial matters but was subsequently extended to embrace civil and other matters. To date, no foreign investors have used the Malaysian Mediation Centre. The Centre has its own mediation rules, covering the process of initiating mediation, the appointment, disqualification and authority of mediators, the mode of settlement agreement, confidentiality and the interpretation of the rules. In parallel, the KLRCA has developed a set of Mediation Rules and provides a structure for mediation and conciliation proceedings, based on the UNCITRAL Conciliation Rules 1980. The words "conciliation" and "mediation" are deemed interchangeable by the KLRCA's rules. KLRCA's Mediation Rules were revised in 2011 in modification of the UNCITRAL Conciliation Rules. New provisions were introduced, notably to prevent unnecessary delay by parties in the

Box 3.3. **The Kuala Lumpur Regional Centre for Arbitration**

The KLRCA was established in 1978 under the auspices of the Asian African Consultative Committee. The Centre serves the Asia Pacific Region and provides a system to settle disputes between parties engaged in trade and investment with and within the region. The Malaysian government committed to respect its independence and explicitly excluded any supervisory jurisdiction of the High Court over the KLRCA. The KLRCA is an international arbitration institute, which follows its own rules for arbitration. It is not a national arbitration centre, although it benefits from state support. It is a non-profit, non-governmental organisation providing a forum to settle commercial disputes. Its procedural rules are flexible in the conduct of proceedings of the arbitration. It provides a list of 600 arbitrators and leaves wide discretion to the parties with regard to the choice of arbitrators, the place of arbitration and the applicability of the procedural rules. The *Arbitration Act* 2005 gives statutory authority to the Director of KLRCA to appoint arbitrators independent of the courts.

The KLRCA provides the venue for arbitration, technical facilities, advises parties on applicable rules and appoints arbitrators, in the event parties are not able to find an agreement. According to the KLRCA Arbitration rules 2010, all awards are to be given within three months of settlement. KLRCA also provides assistance in the conduct of *ad hoc* arbitrations, notably those held under the UNCITRAL rules, and offers other ways to resolve disputes, such as mediation and conciliation. Malaysia's International Investment Agreements often mention KLRCA as one of the available fora for investor-state dispute settlement.

KLRCA also plays an increasingly important role as a forum for Islamic commercial arbitration in the region, particularly in the growing area of Islamic finance.

submission of documents relevant to their case, and to ensure the full confidentiality of the proceedings, even after the termination of the case. This prevents parties from being prejudiced by evidence disclosed during the proceedings.

The *Mediation Act* 2012, which came into force on 1 August 2012, provides for the process of mediation in Malaysia and aims to promote and encourage mediation as a method of alternative dispute resolution. Disputes regarding proceedings under the *Land Acquisition Act* 1960 cannot be settled through mediation. The *Mediation Act* is also expected to promote Malaysia as an international dispute resolution centre and to create public awareness on the viability of mediation.

International arbitration instruments

Malaysia has committed itself to the two main international instruments dealing with international arbitration and enforcement of foreign awards. It has been a member of the Convention on the Settlement of Investment Disputes between States and National of other States (ICSID) since 1966. So far, Malaysia has been involved in three ICSID cases, two of which were widely commented high-profile cases (Box 3.4). It is also a party to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958, which provides a legal mechanism for enforcing awards that are not rendered under the auspices of ICSID. Specifically, the New York Convention requires courts of contracting parties to give effect to an agreement to arbitrate in a matter covered by an arbitration agreement and to recognise and enforce awards made in other states.

Box 3.4. **ICSID cases involving Malaysia**

Malaysia has been involved in three known investor-state disputes. The three cases were settled before ICSID tribunals:

Philippe Gruslin *v* Malaysia ARB/94/1, arose out of a construction contract. After registration before ICSID, the case was settled between the parties.

Philippe Gruslin *v* Malaysia ARB/99/3 was initiated in 1999 and concluded in 2000 in favour of Malaysia. It involved a Belgian national and was therefore brought under the Malaysia-Belgo-Luxembourg Economic Union IGA. It related to the imposition by the government of Malaysia of exchange controls. The claimant alleged that its investment, made in securities listed on the Kuala Lumpur Stock Exchange, was entirely lost as a result of the imposition of exchange controls. The dispute raised the question of whether such a portfolio investment is covered under the ICSID Convention and the IGA. The tribunal agreed with Malaysia, which argued that the Claimant's investment was not an investment in Malaysia as required under the IGA: "mere investments in shares in the stock market, which can be traded by anyone, and are not connected to the development of an approved project, are not protected". The award was rendered in 2000 in favour of the state.

Malaysian Historical Salvors Sdn Bhd *v* **Malaysia ARB/05/10** was initiated in 2005 by Malaysian Historical Salvors (MHS), a British-owned company incorporated in Malaysia seeking damages amounting to USD 1.4 million. The case, which is now concluded, was brought under the United Kingdom-Malaysia BIT.

Box 3.4. **ICSID cases involving Malaysia** *(cont.)*

The dispute arose out of a salvage contract concluded between the government of Malaysia and MHS to salvage the cargo of a ship that sank off the coast of Malaysia in the 19th century, carrying antique Chinese porcelain. The contract provided that MHS would receive a percentage of the sales of the salvaged items. MHS alleged that the share it received was smaller than stated in the contract.

In an award rendered in 2007 in favour of Malaysia, the ICSID sole arbitrator declined jurisdiction, finding that the salvage operation did not constitute an investment under the ICSID system. In particular, the tribunal held that the benefits which the contract brought to Malaysia had not led to significant contributions to Malaysia's economic development in the sense envisaged by the ICSID jurisprudence. The arbitrator stated that "the project did not benefit the Malaysian public interest in a material way or serve to benefit the Malaysian economy in the sense developed by ICSID jurisprudence, namely that the contributions were significant". Following this very controversial award, MHS applied to ICSID for an annulment award. In 2009, the ad hoc Annulment Committee held that the decision on jurisdiction should be annulled. The Committee concluded that the previous tribunal exceeded its powers by declining jurisdiction and by failing to apply a broad and encompassing definition of investment. The Committee held that the previous tribunal's insistence on a monetary floor to define an investment was contradictory to the spirit of the ICSID Convention. Moreover, the panel noted that the award was incompatible with the specifications and intentions of the UK and Malaysia. One of the panel's members dissented.

Before bringing the claim to ICSID, the claimant first referred the dispute to domestic arbitration before KLRCA. Following the dismissal of the claim by the sole arbitrator, the claimant applied to the High Court of Kuala Lumpur in order to set aside the arbitral award. The application was also dismissed. The claimant ultimately brought the case to ICSID, after having unsuccessfully filed a complaint to the Charter Institute of Arbitrators, for internal review of awards. Following the annulment, MHS did not bring a new arbitration before ICSID. MHS and the government of Malaysia are currently exploring the possibility of an amicable settlement of the dispute.

Malaysia has also adopted a holistic and integrated approach to arbitration, encompassing both domestic and international disputes in a single *Arbitration Act* (see previous section). The enactment of the act confirmed the regional trend towards a less interventionist approach with regard to arbitration.

International investment agreements

While domestic regulations provide sectoral rules for investment within Malaysia, international investment agreements seek to promote a better investment climate through a set of general rules and to provide foreign investors with a protection guaranteed by a set of commitments. Two main types of agreements are used by Malaysia: bilateral investment treaties, alternatively called investment guarantee agreements, and preferential trade and investment agreements. Preferential trade and investment agreements encompass investment provisions contained in regional trade, free trade and economic partnership agreements. Malaysia is one of the top signatories of agreements in the region, having signed 73 bilateral investment treaties (out of which 59 have been ratified), 19 of which are with OECD countries, and six bilateral free trade agreements containing investment chapters. The ratification rate is fairly good and well above the regional average. Malaysia has also entered into broader comprehensive trade and economic agreements and, by doing so, has committed to liberalise access to its market for goods and services. Malaysia gives considerable importance to such agreements, notably those signed through its ASEAN membership. ASEAN has concluded Comprehensive Economic Partnerships with Australia and New Zealand, China, Japan, Korea, and India. These Agreements are built on the respective bilateral FTAs signed between the partner country and individual ASEAN countries, including Malaysia. Malaysia is also bound by five FTAs with investment chapters concluded by ASEAN with third partner countries. Malaysia has also signed double taxation treaties with over 70 countries,[20] which usually go hand in hand with BITs.

Malaysia's bilateral investment treaties, the so-called investment guarantee agreements (IGAs), aim to encourage foreign investment and protect foreign investors against non-commercial risks such as nationalisation and expropriation, as well as to provide national treatment and most-favoured-nation treatment standards, free transfer of profits, capital and other fees, and to ensure settlement of investment disputes between foreign investors and the government, notably under ICSID. Malaysia started entering into IGAs in the mid-1960s, in order to increase FDI inflows and outflows primarily with European countries, and later on with developing countries. Box 3.5 below investigates the impact of BITs on FDI inflows.

Box 3.5. **Do bilateral investment treaties promote FDI inflows?**

Investors face risks when investing abroad relating to the treatment they will receive in the host country. In this context, bilateral investment treaties (BITs) have emerged to promote certain standards of treatment for foreign investors. BITs usually provide for non-discrimination through National Treatment (NT), Most-Favoured Nation (MFN) and fair and equitable treatment provisions, as well as security for investors and protection against expropriation. BITs also usually contain provisions on the transfer of funds. Since the mid-1990s, the inclusion of Investor-State Dispute Settlement (ISDS) provisions in BITs has offered investors recourse to international arbitration to settle disputes with the host country.

To the extent that BITs succeed in making the investment framework and environment of signatory countries more predictable, stable and safe for investors, it is expected that they will help countries to attract more FDI. BITs might also lead to an indirect increase in FDI inflows if they are associated with good institutional quality or signal a country's commitment to reinforce property rights, not only for the treaty partner but for the entire international community.

Econometric studies have examined the relationship between BITs and FDI inflows. Viewed as a whole, results are contradictory, with some recent studies indicating that BITs encourage FDI and others finding little such evidence. Despite data and methodological limitations, these contradictory findings underscore both the importance and the difficulty of doing cost-benefit analysis of BITs (including potential impacts on fiscal positions and on policy making flexibility).

These studies have become more sophisticated over time, narrowing the scope of research to more carefully take into account the conditions under which BITs are expected to have a more pronounced economic effect. One dimension considered is the stage of development of signatory countries. BITs between developed and developing countries are expected more substantially to affect FDI flows than BITs between similar countries.[1] To some extent, this reflects the view that developing countries have difficulty making credible commitments often due to the lack of sound domestic institutions which increase the risks for investors. The evidence on the promotional effects of BITs on FDI inflows into developing countries is mixed, however, with a few studies finding little or no support whatsoever[2] and others finding a positive relationship.[3, 4] Reverse causation, i.e., the possibility that existing flows of FDI between countries actually lead them to enter into BITs, has also been considered but without any clear results.[5]

Box 3.5. **Do bilateral investment treaties promote FDI inflows?** *(cont.)*

Another question is whether BITs substitute for weak investor property rights, political risk, the quality of domestic legal system and respect for the rule of law, or whether they complement domestic institutions in attracting FDI. Governments might be tempted to enter into BITs as a shortcut to improved institutional quality, expecting that they will increase FDI, while refraining from engaging in costly and time consuming domestic reforms. Here again the empirical evidence provides little convincing guidance on the matter. Two studies reviewed here report that BITs sometimes substitute for poor institutional quality,[6] but others find that only countries with relatively strong domestic institutions and lower political risk are likely to benefit from BITs.[7]

More recent studies have begun to take into account the differences in BIT provisions to assess whether BITs with stronger dispute settlement mechanisms or containing market access provisions potentially lead to higher FDI inflows. According to Berger et al. (2010a), BITs with stricter investment protection measures do not necessarily result in higher FDI inflows. With regard to market access rules such as National Treatment at the pre-establishment phase, Berger et al. (2010b) find that investors respond positively to BITs whether or not they contain such measures. The authors find that Regional Trade Agreements containing market access provisions play a significant role in promoting foreign investment.

More anecdotally, a recent survey of General Counsels of the top 200 US multinationals sheds light on why there is a possible loose link between BITs and FDI.[8] The vast majority reported that BITs are not an important consideration in the typical FDI decision and did not view BITs as particularly effective protection against adverse regulatory measures and expropriation. Many were also unfamiliar with BITs. Similar results have been found in larger surveys by the World Bank (2005) and Shrinkman (2011). Even if BITs might not influence investment decisions, they might influence how the investment is structured once the decision to invest is made. Sachs (2009) notes that treaty shopping cases, where a company invests in one country via a third country in order to benefit from a BIT between those two countries, suggest that at least some firms deliberately seek the protection of a treaty.

Despite these ambiguous findings on whether BITs help to attract FDI, developing countries continue to enter into BITs. Sachs (2009) argues that governments sign BITs in the belief that at the very least it will not harm FDI flows and because they are afraid that investors may avoid countries without them. They may also face pressure from companies that have already invested and that wish to protect their assets (including domestic enterprises investing in the other country) or may want to signal that they are willing to bind domestic policies to international agreements. To the extent that these agreements cannot be changed unilaterally, foreign investors will be more comfortable in investing.

Box 3.5. **Do bilateral investment treaties promote FDI inflows?** *(cont.)*

Countries should be mindful, however, of the possible costs – monetary, political and reputational – associated with entering into BITs. Monetary costs include the legal costs of defence and possibly major compensation in the event that the country is found liable for treaty breaches, with taxpayers bearing the liability of such costs. A recent OECD survey (2012) shows that legal and arbitration costs for the parties to investor state arbitration have averaged over USD 8 million, with costs exceeding USD 30 million in some cases. Claims for compensation if the country is found liable can run into the billions of dollars. The reputational costs of noncompliance with BIT commitments can also be severe. Allee and Peinhardt (2011) find that BITs increase FDI flows to signatory countries but only if those countries are not subsequently challenged before ICSID. Upon becoming a respondent in an ICSID case, countries face large declines in FDI inflows regardless of arbitration results. If the case is lost the magnitude of the decline in FDI inflows is larger. The careful evaluation of the implications of a BIT, possibly by high-quality legal advisors from outside the government, should thereby be standard practice before entering into a BIT, as the costs associated with a bad treaty can be very significant, particularly considering that BITs are generally concluded for an initial period of 10 years and, due to "survival clauses", often remain in force for another 10 years after termination.

Signatories also reduce their policy-making flexibility. Signing a BIT implies partially sacrificing some domestic regulatory autonomy as any measure affecting foreign investors can eventually be challenged through the dispute settlement provision included in the BIT. Much depends on the exact treaty language in a BIT and on the ability of host countries to adopt public management practices that promote treaty compliance and, when facing an investor claim, to organise and finance an effective defence. Developing countries often face asymmetries in their bargaining power in BIT negotiations and may have problems implementing government-wide treaty compliance programmes. For these countries, legal risks associated with BITs may be considerable. Traditional BIT proponents that have recently been sued have to some extent rebalanced treaties to accommodate more policy space. BITs also favour foreign investors over domestic ones by providing foreign investors with the possibility of recourse to international arbitration for disputes, to which domestic investors do not have access.

Box 3.5. **Do bilateral investment treaties promote FDI inflows?** *(cont.)*

Looking broadly at the full range of studies of the costs and benefits of BITs, BITs appear to play a secondary role in promoting FDI inflows after economic and institutional fundamentals. To the extent that the positive effects of BITs on FDI inflows are conditioned on economic and institutional characteristics, it might often be better to invest in reforms to improve economic fundamentals and institutional quality. Evidence of the positive effects of good institutional quality in attracting FDI inflows is rather consistent.[9] BITs should be considered as a complementary instrument to help sustain momentum for reform, by locking in domestic policies when appropriate, and perhaps even contributing to magnify the effects of economic and institutional policies in attracting FDI. Governments should not rely on BITs as a substitute for long-term improvements in the domestic business environment. Careful evaluation of whether a country is in a position to benefit from a BIT, given its institutional and economic characteristics, and the risks associated with such a treaty, should be a standard government practice before entering into BITs, as these conditions may determine the success of the BIT in achieving its proposed objectives.

1. Essentially, it is assumed that developed countries, which normally have predictable and stable domestic judicial systems, do not need BITs because investors in these countries feel sufficiently comfortable with the domestic regulatory framework. BITs between two developing countries are usually of a more symbolic nature for several reasons, but new trends in international investment might be change the importance given to these in future research work.
2. Hallward-Driemeier (2003), Tobin and Rose-Ackerman (2005), Aisbett (2007) and Yackee (2007).
3. Busse et al. (2008), Tobin and Rose-Ackerman (2006), Neumayer and Spess (2005) and Banga (2003).
4. There is however rather consistent evidence that, in the case of transition countries from Central and Eastern Europe, BITs have contributed to attracting FDI in these countries. See: Busse et al. (2008), Berger et al. (2010) and UNCTAD (2009).
5. Berger et al. (2010a and 2010b), Busse et al. (2008) controls for endogeneity and find that BITs attract FDI, while Aisbett (2007) finds opposite results.
6. Busse et al. (2008) and Neumayer and Spess (2005).
7. Tobin and Rose-Ackerman (2005 and 2010) and Hallward-Driemeier (2003).
8. Yackee (2010).
9. For instance: Anghel (2005), Daude and Stein (2007), Arbatli (2011), Walsh and Yu (2010), Battat, Hornberger and Kusek (2011) and Wagle (2011).

Malaysia's early treaties contained much less detailed provisions than those more recently concluded. A key feature of such treaties was the guarantee for investors of obtaining fair compensation in the event of expropriation or nationalisation. These early treaties also contained some minimum standards of treatment, such as fair and equitable treatment, full protection and security, accorded to foreign investors. Other common features of early IGAs were a guarantee of treatment no less favourable than that accorded to investments of any third state, as well a guarantee of free transfer of funds related to investments.

Malaysia continues to pursue investment promotion and liberalisation through regional and bilateral agreements. FTAs recently concluded by Malaysia seem to be the preferred way to address traditional investment protection provisions and to include a newer investment liberalisation and promotion aspect in the broader context of such economic integration agreements.[21] Malaysia has moved away from traditional approach to investment in BITs towards investment liberalisation and closer regional integration through new FTAs. This change of approach in treaty practice is a reflection of domestic reforms liberalising FDI restrictions (see Chapter 2).

As an ASEAN member state, Malaysia benefits from the provisions on liberalisation and facilitation contained in the ASEAN Comprehensive Investment Agreement. The regional agreement goes much further than Malaysia's existing IGAs in liberalising its investment environment (Box 3.6 below).

Box 3.6. **The ASEAN Comprehensive Investment Agreement**

The ASEAN Comprehensive Investment Agreement (ACIA), concluded in 2009 and entering into force in April 2012, is a more comprehensive investment agreement than existing ASEAN IGAs. It reaffirms the relevant provisions of ASEAN IGAs and integrates liberalisation elements. It includes four pillars: promotion, protection, facilitation and liberalisation and provides a progressive liberalisation to achieve a free and open investment environment by 2015, with a single reservation list. ACIA undertakes progressive liberalisation of investment in five sectors and the services incidental to these sectors i.e. manufacturing; agriculture; fishery; foresty; and mining and quarrying. The agreement also gives flexibility to ASEAN member states to modify their commitments with a compensatory adjustment mechanism to ensure a balance of benefits. Compared to the former ASEAN Investment Area, ACIA also includes a more comprehensive dispute settlement mechanism which promotes conciliation, consultation, and negotiation mechanisms as a complement to already existing dispute mechanisms. The facilitation pillar aims to provide more user-friendly services to investors.* Previously, the 1987 ASEAN Agreement for Promotion and Protection of Investment introduced some basic investment protection for intra-ASEAN investments. In 1998, it was supplemented by the Framework Agreement for the ASEAN investment Area, which covered investment originating inside or outside of ASEAN. Its primary objective was to liberalise and facilitate new investment flows.

Box 3.6. **The ASEAN Comprehensive Investment Agreement** *(cont.)*

The 1987 Agreement focused on protecting established investment, while the 1998 Agreement concentrated on eliminating barriers to new investments. Key provisions of the 1998 Agreement included the progressive opening of industries to foreign investment, NT progressively granted, and transparency of investment policies and procedures.

* R. Indomo, Indonesian Investment Coordination Board, intervention at the OECD Symposium on International Investment Agreements, December 2010.

Malaysia is currently negotiating a Trans-Pacific Partnership Agreement, notably with APEC members, with the objective of further reducing barriers to trade and investment among negotiating countries (Box 3.7).

Box 3.7. **The Trans-Pacific Partnership Agreement**

The TPP, a Trans-Pacific Partnership Agreement, is currently being negotiated among nine countries: Australia, Brunei Darussalam, Chile, Malaysia, New Zealand, Peru, Singapore, the United States and Viet Nam. The agreement builds on the Trans-Pacific Strategic Economic Partnership agreement (P4), to which Malaysia was not party. This agreement is expected to be based on a NAFTA approach, in the sense that it will adopt a negative list approach and high standard disciplines. It aims substantially to reduce barriers to trade and investment, further than what is provided for in traditional FTAs. The negotiations cover a comprehensive set of areas and focus on cross-cutting "horizontal issues" such as regulatory coherence.

Malaysia already has FTAs with most of the TPP members. The TPP should represent a positive step towards deeper integration in the Asia Pacific region and would allow Malaysia to engage with new partners, such as the United States, that are expected to become TPP members after its ratification by original member states. The TPP will be open to new members.

As a member of APEC, Malaysia also engaged itself to observe various non-binding principles on investment and to include them in its international investment principles and national policy. Such principles cover the following key elements of investment agreements: MFN, national treatment, prohibition of performance requirements, expropriation and compensation, repatriation and convertibility, settlement of disputes and transparency.

Malaysia has also concluded, or is currently negotiating, a number of Trade Agreements that do not cover investment areas but are nonetheless part

of the same process of liberalisation: the Trade Preferential System among member states of the Organisation of the Islamic Conference; the Developing Eight Preferential Trade Agreement, and the ASEAN-India FTA in goods.

Notes

1. See Case PJTV Densons (M) Sdn Bhd & Ors v Roxy (Malaysia) Sdn bhd (1980) 2 MLJ 136.
2. 15th Malaysian Law Conference 2010.
3. This is provided for under the First Schedule of the Stamp Act, 1949 (Act 378). The authority administering, computing and collecting the duty is the Inland Revenue Board (IRB). The Valuation and Property Services Department of the Ministry of Finance (JPPH) is responsible for valuing the property to establish its market value. The IRB refers the prescribed forms dealing with the transfer to the JPPH; the JPPH then values the property and reports back to the IRB, which in turn informs the transferee of the duty payable.
4. Wu (2011).
5. Malaysia has constitutionally recognised customary land tenure, notably Orang Asli (aboriginal people) traditional lands. The rights of indigenous people over their traditional lands are provided under the Aboriginal Peoples Act 1954, and this land is considered by public authorities as state land. However, following the Sagong bin Tasi & Ors v Kerajaan Negeri Selangor & Ors (2002) judgement, any traditional land belonging to the indigenous people is considered as "land occupied under customary right" according to the Land Acquisition Act (1960).
6. *Source:* Accessing Industrial Land, Investing Across Borders, 2010.
7. *Source:* EUMCCI Trade Issues and recommendations 2011.
8. *www.managingip.com/Article/2920122/Trade-marks-Malaysia-Jurisdiction/Q-A-Trade-marks-in-Malaysia.html*.
9. *www.internationalpropertyrightsindex.org/profile?location=Malaysia*.
10. In the case of false trade descriptions, a corporation may face a fine of up to RM 15 000 for each goods bearing the false trade description and for the second and subsequent offences, to a fine of up to RM 30 000 for each goods bearing the false trade description. An individual may face a fine of up to RM 10 000 for each goods bearing the false trade description or imprisonment of up to 3 years or both and for the second and subsequent offences, to a fine of up to RM 20 000 for each goods bearing the false trade description or to imprisonment of up to 5 years or both.
11. *Oxford Business Group Country Report*.
12. Interviews with EUCCI members in Kuala Lumpur, January 2012.
13. Company interviews, Kuala Lumpur, February 2012.
14. *Pacific Rim Property Research Journal*, Vol. 12, No. 3.
15. Heritage Foundation, *2011 Freedom House Report: www.freedomhouse.org/report/freedom-world/2011/malaysia?page=22&country=8084&year=2011*; US Department of State 2010 Investment climate Statement; Global Competiveness Report 2010-2011.; Business Anti-Corruption Portal: Malaysia Country Profile: *www.business-*

anti-corruption.com/country-profiles/east-asia-the-pacific/malaysia-version-10/corruption-levels/judicial-system/.

16. One embassy official in Malaysia mentioned an ongoing case in which the investor claimant reported that it took 44 months, and 26 hearings before domestic courts addressed the merits of his case.

17. See *Asia-Pacific Arbitration Review 2012*, available at: *www.Globalarbitration review.com*.

18. *www.skrine.com/index.php?option=com_content&view=article&id=416&Itemid=625*.

19. There are various method of execution to enforce the enforcement order, namely winding up the petition (if the respondent is a corporation), bankruptcy proceeding (if the respondent is an individual), or attachment proceeding (seizure and sale). Uncontested winding up petitions take about 3 months to complete whilst bankruptcy proceedings take about 5 to 6 months for adjudication. For writ of seizure and sale, the date of auction is fixed within a month.

20. See List of DTTs provided by UNCTAD: *http://archive.unctad.org/sections/dite_pcbb/docs/dtt_Malaysia.PDF*.

21. See APEC (2007).

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ANNEX 3.A1

Main features of Malaysia's investment agreements

This examination is not based on a review of all international investment agreements to which Malaysia is party but rather highlights distinctive features of Malaysia's recent treaty practice, covering both bilateral and regional preferential trade and investment agreements (PTIAs),[1] recent investment guarantee agreements and the 2009 model IGA.

Malaysia's model BIT follows internationally recognised standards in treaty practice by including most-favoured-nation and national treatment relative standards, protection against expropriation, guarantee of free transfer, the absolute standard of fair and equitable treatment, and mechanisms for dispute resolution. Malaysia's PTIA practice is also in line with recent regional and global trends. Investment chapters contained in bilateral and regional FTAs (concluded by ASEAN) include, in addition to the traditional investment protection elements, provisions relating to the liberalisation of investment. Such provisions relate to the entry of key personnel, the prohibition of performance requirements, the elimination of barriers to the entry of investments, plus more detailed provisions on co-operation and lengthy guidance on dispute settlement.

Scope issues

The definitional section of IGAs and investment chapters of PTIAs has a crucial impact on the effectiveness of the treaty. A treaty will typically define its scope of application by defining its subject matter, territorial, temporal jurisdiction, and the type of investments and investors benefiting from its provisions.

Investment

All agreements typically contain a definitional section detailing those investments covered by the treaty. Malaysia's BITs follow a traditional approach, using a broad asset-based definition of investment, followed by a non-exhaustive list of protected investments. This open-ended approach aims to provide protection to the largest set of assets. Typically, the BIT between Malaysia and Indonesia brings under its scope: "any kind of asset invested by investors (…) including, but not exclusively: *i*) movable and immovable property and any other property rights, such as mortgages, liens and pledges; *ii*) shares, stocks and debentures of companies or interests in the property of such companies; *iii*) a claim to money or a claim to any performance having financial value; *iv*) intellectual and industrial property rights (…); *v*) business concessions conferred by law or under contract, including concessions to search for, cultivate, extract or exploit natural resources".

Malaysia's PTIAs encompass a broad spectrum of assets and explicitly extend their protection to indirect investments. In line with a recent treaty practice that introduces new limitations to the definition of investment, the model BIT, as well as a certain number of PTIAs, also give some broad indications of what characteristics an investment must have, such as "the commitment of capital, the assumption of risk, and the expectation of profit". This restrictive approach to the definition of covered investments was introduced in arbitral practice in a high-profile ICSID case involving Malaysia (see Box 2: *Malaysian Historical Salvors Sdn Bhd v Malaysia* ARB/05/10) The latter characteristic excludes assets used for non profit purposes (e.g. the purchase of a secondary residence) from the scope of the definition of investment. The emerging trend of excluding portfolio investment from the coverage of agreements does not seem to be reflected in Malaysia's practice.

Investor

The definition of investor contained in all agreements indicates which natural persons and legal entities investing in the country are entitled to benefit from the treaty protection. Malaysia's treaty practice is consistent with the dominant trend in defining an investor and extends protection to both natural and juridical persons. Malaysia has adopted a broad definition of natural persons, encompassing not only citizens, but also persons having the right of permanent residence in the country.

With respect to legal entities, BITs identify the place of incorporation as the determinative criterion, while FTAs adopt majority ownership in the country of origin of an enterprise for determining the nationality of enterprises. The Economic Partnership Agreement (EPA) concluded with Japan goes further in restricting its scope, as it explicitly excludes the "branch of an

enterprise of a third state which is located in the country". This limitation appears to target treaty shopping structures that are located in a jurisdiction for the sole purpose of benefiting from its investment protection policies. Lastly, some PTIAs cover investors who are seeking to make an investment, thus covering potential investors at a pre-establishment level, while other PTIAs, as well as the totality of the BITs, restrict their scope to investors who are making, or have made an investment.

Temporal scope

A treaty's temporal scope determines the duration of the agreement and whether its protection is extended to investments made before its entry into force. Malaysia's agreements apply to both already existing investments and investments made after their entry into force. Furthermore, it is stated in FTAs that the investment chapter does not apply to claims or disputes in relation to events which occurred before their date of entry. With regards to their duration, Malaysia's BITs define their temporal scope of application in a manner consistent with dominant international practice by applying the treaty protection over an initial period of ten years. They also state that if not terminated at the end of the initial period of application, BITs shall continue to be in force for a subsequent ten-year period. Such an approach provides investors a high level of legal certainty. Treaties can be denounced at the end of the initial period, allowing countries to regularly renegotiate their treaties.

Investment liberalisation

Liberalisation objectives have been increasingly dominant in PTIAs negotiations, while BITs focus mostly on investment protection. A gradual commitment to openness is achieved through provisions guaranteeing a right of establishment, free transfer of funds and free movement of senior personnel, restrictions on performance requirements and traditional non-discrimination principles (national treatment and most-favoured-nation treatment).

Admission and establishment of foreign investment

Traditionally, investment agreements do not grant foreign investors unrestricted entry to the host state's territory and the admission of foreign investments remains subject to domestic regulations. This traditional approach is called the "admission model". However, treaty practice has evolved towards more liberalisation, and an increasing number of agreements, especially PTIAs, provide investors with the right of establishment.

Malaysia's BITs follow the traditional "admission" model and cover investment only at the post-establishment stage. They do not commit the

government to open its market. Therefore, admission is a subject matter left to domestic regulatory framework, and Malaysia has no obligation to apply non-discrimination principles at the establishment phase.

Recent PTIAs are more ambitious and cover a broader spectrum than earlier BITs, covering the pre-establishment stage and thus providing a right of establishment. Malaysia's PTIAs do not provide a right of establishment through direct language but rather through granting national treatment (NT) and MFN treatment standards at the pre-establishment stage. This indirect granting of a right of establishment is the most common approach in APEC and ASEAN agreements. Pre-establishment NT and MFN treatment clauses are key provisions of PTIAs, as they determine the level of investment liberalisation. Some PTIAs provide pre-establishment NT on a positive list basis, while others are based on a negative list. The majority of Malaysia's PTIAs do not contain up-front commitments on market access, but rather outline work programmes for the negotiation of market access commitments. Liberalisation is progressively provided for by placing in an annex those sectors where foreign investors are treated equally with domestic investors.

Most-favoured-nation treatment

MFN treatment is a core obligation which prohibits discrimination among foreign investors on the basis of nationality. It provides investors from the contracting state party the best treatment given to investors from any third country. Therefore, the level of protection accorded by this relative standard is dependent on treatment accorded to third parties. Such a clause is consistently included in Malaysia's agreements.

Malaysia adopts a detailed approach to MFN, by articulating the stages of an investment to which MFN treatment applies and providing a negative list of exemptions to MFN treatment. A typical MFN provision can be seen in Article 3 of Indonesia-Malaysia BIT: "Each Contracting Party shall not in its territory subjects investors of the other contracting party, as regards their management, use, enjoyment or disposal of investment, as well as to any activity connected with these investments, to treatment less favourable than that which it accords to investors of any third State". The Saudi Arabia-Malaysia BIT contains a rarely found MFN provision, as it conditions MFN treatment on domestic legislation: the standard of protection is provided "In accordance with its laws and regulations".

Other noticeable variations in language and drafting can be found in Malaysian agreements. The 2009 model BIT explicitly limits the intended scope of MFN and contains a clarification that MFN treatment does not extend to procedural matters (the so-called "Maffezini footnote"). The same clarification is found in a footnote to the MFN Article of the Malaysia-Australia

FTA (MAFTA). This comes in response to the recent jurisprudence finding that that the more favourable dispute settlement clause of another agreement can be invoked through the MFN provision.

In some BITs, MFN treatment is combined with other standards of treatment. For example, the Malaysia-Viet Nam IGA combines MFN with Fair and Equitable Treatment and compensation for losses, while the best treaty practice consists in differentiating relative and absolute standards of treatment.

Although there is no MFN provision yet in the AANZFTA, the negotiation of an MFN clause is included in the ASEAN FTA forward work agenda. Similarly, MAFTA contains a clause on MFN treatment of future market access commitments, which will be the subject of a work programme.

National treatment

The national treatment provision is a core investment protection principle that grants foreign investors, in like circumstances, treatment no less favourable than the treatment accorded to nationals and aims to create a level playing field between foreign and domestic investors. Although the NT standard is part of the standard repertoire of bilateral investment treaties, Malaysia does not automatically grant national treatment to foreign investors in its BITs. In particular, the 2009 model IGA contains no NT provision.[2]

Investment chapters of PTIAs concluded by Malaysia include a national treatment clause, which covers "the establishment, acquisition, expansion, management, conduct, operation, liquidation, sale, transfer or other disposition" of the investment (Malaysia-India Economic Cooperation Agreement – MICECA). PTIAs examined in this study all provide NT at pre- and post-establishment stages on a negative-list basis. Pre-admission NT refers to any requirement placed upon the incoming investment or investor as a prerequisite for admission into the host state.

Moreover, the NT provision in MICECA includes a paragraph catering to the treatment granted by a state or a regional level of government to its investors. Such language, bringing all levels of decision, including sub-national governments, under the scope of the NT standard grants foreign investors additional protection against discrimination and is therefore at the forefront of treaty innovation and best practices.[3] The same treaty contains a specific article on Access to Courts, granting national treatment to foreign investors with respect to access to courts of justice. However, in Malaysia, not all levels of local courts have the jurisdiction to hear international treaty-based claims.

Another noticeable variation in Malaysia's approach to national treatment is the explicit exclusion of portfolio investment from the scope of the NT treatment standard in the Japan-Malaysia Economic Partnership

Agreement (JMEPA). Moreover, NT provisions in JMEPA and the Malaysia-Pakistan EPA (MPCEPA) include a balance-of-payments safeguard.

Limitations to performance requirements

Performance requirement limitations restrict the imposition by the host country of certain obligations, such as local content regulations and export requirements, as a condition for entry. The model BIT has retained a traditional approach and therefore contains no provision on performance requirement limitations. Nevertheless, in the past two decades, a trend towards more limitations to performance requirements has appeared in investment treaty practice, following the adoption of the WTO Trade-Related Investment Measures (TRIMs) Agreement. In line with this liberalisation approach, all PTIAs signed by Malaysia restrict the use of performance requirements but do not provide any further limitations than those contained in the TRIMs Agreement. They also suggest that state parties might further review the performance requirement provision and include more detailed obligations.

Provisions on key foreign personnel

Provisions on the entry and sojourn of foreign personnel regulate the entry of expatriate personnel in connection with the investment. Malaysia's BITs examined for this study do not contain any provision on key foreign personnel, thus leaving the matter to domestic regulations. This is consistent with the most common BIT practice, which rarely goes beyond including a best endeavour commitment in this regard. Three of the PTIAs have a senior personnel provision granting authorisation to work to key personnel, with variations in drafting. The EPA between Malaysia and Japan contains a rather flexible provision, stating that, although Malaysia is bound by the obligation to grant authorisations to foreign personnel, the obligation is subject to Malaysian immigration policies.

Scheduling exceptions

Malaysia's PTIAs have scheduling exceptions to their market access commitments. For example, the Korea-ASEAN Investment Agreement provides that a schedule of exceptions should be concluded in the work programme within five years from the date of entry into force of the agreement. National and MFN treatment do not apply until the schedule of reservations has entered into force. Similarly, MAFTA does not contain market access commitments on investments in non-service sectors but provides for a work programme to enter into discussions on market access schedules. The development of these schedules should be based on MFN and NT obligations and a two-annex "negative-listing" approach to scheduling.

Investment protection

Protecting foreign investments is the primary goal of bilateral investment treaties, while the main objective of PTIAs is to strengthen economic ties. Nonetheless, all of Malaysia's PTIAs contain core standards of investment protection. Protection of investment is provided for through the following:

Fair and equitable treatment, full protection and security

The fair and equitable standard of treatment (FET) prescribes an absolute standard of treatment to be accorded to foreign investors, i.e. the level of treatment is not contingent on treatment accorded to third parties. FET provides a standard of protection independent from the host country's domestic legal framework. Typically, the obligation to grant foreign investors FET requires host states to act with good faith, to protect foreign investors against denial of justice, and against arbitrary and abusive treatment.

However, the level of protection accorded by the FET standard has not been clearly defined in international treaty making. There is considerable debate over where the threshold of treatment must be set, in particular in relation to the minimum standard of treatment as defined by customary international law.[4] Malaysia has limited the potential for controversial interpretations of its treaty language by clarifying the scope and the content of the standard. With some variations in language, Malaysia's treaty practice appears to be fairly consistent in this regard and approaches the fair and equitable treatment standard as synonymous to the minimum standard of treatment in customary international law. For example, the model BIT, as well as various PTIAs, such as MICECA, MAFTA and AANZFTA, clarify that FET and full protection and security standards equate to what is required under the customary international law minimum standard of treatment of aliens. Specifically, the model BIT embraces the same approach as the one endorsed by NAFTA Free Trade Commission and provides for "the customary international law minimum standard of treatment of aliens, including fair and equitable treatment and full protection and security". Adopting the same approach, but with an alternative wording, the Malaysia-New Zealand FTA states (MNZFTA), in its Article 10.10 para.2(c), that: "the concepts of "fair and equitable treatment" and "full protection and security" do not require treatment in addition to or beyond that which is required under customary international law, and do not create additional substantive rights".

As to the scope of the FET standard, some agreements, such as JMEPA, merely mention the FET and FPS standards with no further precision, while MNZFTA and MAFTA clarify what kind of measures are prohibited under the FET standard. Article 12.7 para.2 of MAFTA states as follows: "For greater certainty: (a) "fair and equitable treatment" requires each Party not to deny

justice in any legal or administrative proceedings; (…)". Such a clarification clause restricts the leeway given to arbitrators when interpreting the scope of the FET standard.

With regards to the full protection and security (FPS) standard, which is usually combined with the FET standard, it requires the host state to exercise due diligence in protecting foreign investments. Such a protection standard is provided for in all of Malaysia's agreements. Most frequently, they merely mention the FPS standard and merge it into the minimum standard of treatment clause, which encompasses both FET and FPS standards. In the MAFTA and MNZFTA, which contain the most detailed wording, the minimum standard of treatment article clarifies that "full protection and security requires each Party to take such measures as may be reasonably necessary to ensure the protection and security of the covered investment".

Expropriation and compensation

Expropriation clauses traditionally recognise the host state's sovereign right to expropriate or nationalise private properties but subject the lawfulness of the process to a number of conditions. All of Malaysia's agreements comprise a provision protecting foreign investment against both direct and indirect expropriation, as they extend protection to measures that have an effect equivalent to expropriation. The inclusion of indirect expropriations has raised some apprehension that this protection would conflict with a host state's right to regulate (see above for a description of the domestic legislation on expropriation). In response to this concern, Malaysia has recently started including more detailed treaty text in Annexes, in order specifically to address situations where direct and indirect expropriations may occur. This is part of a global treaty practice trend of providing guidelines to determine whether indirect expropriations have occurred. Such annexes contain safeguard language against broad interpretations of the expropriation provision. For example, MAFTA contains an Annex clarifying that the determination of an indirect expropriation "requires a case by case, fact-based inquiry that considers, among other factors […] the economic impact of the government action […]; the character of the government action, including, its objective and whether the action is disproportionate to the public purpose […]. This practice is also in line with ASEAN FTA practice which includes safeguards to preserve the government's legitimate regulatory prerogatives and to minimise the government's exposure to frivolous expropriation claims. This innovative practice differs from the more traditional and less detailed approach taken in older BITs and reflects the efforts recently made by Malaysia to enhance its domestic climate for foreign investment.

As for the conditions for lawful expropriation, the language is fairly consistent and conforms to the customary international law requirement that

the host state's right to expropriate must be taken under due process of law, for a public purpose, in a non-discriminatory manner and against the payment of compensation.

The standard of compensation is expressed, with some variations in drafting, in terms of the Hull Rule: it must be prompt, adequate and effective. This protection standard adds to the constitutional obligation not to expropriate private property without fair compensation. Detailed provisions regulate the details of expropriation procedures and use market valuation as a standard for valuation, which must be determined "in accordance with internationally acknowledged practices and methods" (as found in the BIT with Indonesia). An additional requirement found in two FTAs is that the compensation must be "effectively realisable" (AANZFTA), or "fully realisable" (MAFTA).

Compensation for losses

The provision related to compensation for losses resulting from war or civil disturbance has historically been included in investment treaties in order to ensure non-discriminatory treatment of foreign investors in such circumstances, since the compensation for expropriation, FET and FPS do not apply in exceptional situations. The provision provides for equal treatment, meaning that if domestic investors are compensated for their losses in exceptional circumstances, foreign investors should also receive compensation. All of the reviewed agreements, including the most recent ones, provide such protection against damages resulting from war or civil strife, with some variations in language. In many of them, the protection against losses provided has an explicitly broad coverage. For example, the article of compensation for losses contained in MICECA encompasses "losses due to armed conflict or state of emergency, such as revolution, insurrection, civil disturbance, or any other similar event". In such situations, Malaysia follows the most common approach and commits to grant MFN treatment as regards restitution, indemnification, compensation or other settlement.

Transfer of funds

Free transfer of payment is a fundamental aspect of investment protection. Provisions providing for free transfer of payments operate to enable investors to repatriate capital and returns on investment. Malaysia's agreements surveyed in this study provide for free transfer of funds. They typically include a non-exhaustive list of protected transactions, with the notable exception of the Malaysia-Viet Nam BIT which provides a closed list of protected transfers. The generality of the terms used to describe the scope of the transfer provision implicitly covers both inward and outward transfers of funds. For example, the BIT with Saudi Arabia covers "the free transfer of payment [...] in connection with investments and investments returns".

Provisions providing for free transfer of funds are in line with Malaysian domestic regulation, which does not provide any restriction on capital repatriation for foreign direct investors.

A noticeable feature of Free Transfer provisions found in all Malaysian PTIAs, as well as in the 2009 model BIT, is the explicit reference to safeguards in case of balance-of-payment difficulties. This provision, which is not contained in the majority of the existing BITs, preserves some flexibility for Malaysia to tackle situations when currency reserves are at a low level.

Umbrella clause

Umbrella clauses elevate investor-state contract breaches into breaches of international law.[5] Although approximately 40% of existing BITs contain such a provision, no umbrella clause is included in the Malaysian agreements reviewed in this survey. According to the government, Malaysia does not include umbrella clauses due to the inconsistency in interpreting the scope and effect of umbrella clauses, particularly whether they elevate contract breaches to international law.

Dispute settlement

Dispute settlement clauses are a key element of international investment agreements as they make effective the enforcement of the obligations provided for by the agreement. Therefore, they enhance the level of legal certainty given to foreign investors in a given host state. Investment disputes comprise disputes arising between contracting state parties, or between the host state and a foreign investor. With one notable exception, all of Malaysia's agreements contain provisions for the settlement of disputes between the states parties to the agreement and additionally provide investors with access to international arbitration in various fora.

State-to-state dispute settlement

State-to-state dispute settlement is always mentioned, although it is rarely used and has not been the subject of innovative treaty practice. Malaysia's IGAs contain traditional State-to-State dispute provisions. As for PTIAs, they contain a Dispute Settlement Mechanism Chapter that is applicable when a state party initiates a dispute for non-compliance of treaty obligations against another state.

Investor-to-state dispute settlement

Investor-state dispute resolution clauses are arguably the most important feature of investment treaties. They provide investors with means to directly assert the rights and benefits accorded under the treaty. Malaysia treaty practice is relatively homogenous in terms of the scope of, and conditions under which, investor-state dispute settlement is provided for. All but one of

Malaysia's agreements provide for investor-state dispute settlement. MAFTA contains no ISDS provision, in accordance with the Australian government trade policy statement of April 2011.

The scope of the dispute resolution clause is critical to the arbitral process, as the jurisdiction of arbitral tribunals is limited to matters that fall within the consent of arbitration as expressed in the arbitration clause. Malaysian IIAs typically define investment disputes as "a dispute that has incurred loss or damage by reason of, or arising out of, an alleged breach of any right conferred by [the investment chapter or the agreement] concerning a covered investment of the investor". The ISDS article of the Pakistan-Malaysia EPA contains a clarification note, providing that its scope is limited to situations where "any breach expressly and directly arises or occurs between the parties in relation to breaches of any provisions of [the] Chapter".

Arbitration requires prior consent from both parties to have their disputes heard by an arbitral tribunal. Consequently, a certain number of investment treaties have started, from the 1990s, to contain clauses containing an explicit consent to arbitration. This trend is not reflected by Malaysia, which does not systematically include such consent to arbitration clauses.

All of the agreements reviewed, in line with general trends, pre-condition recourse to arbitration on an attempt to reach amicable settlement, through negotiations or consultations. Most also require a 6-month cooling-off period before the investor can exercise his right to submit his request. In its treaty practice, Malaysia also provides foreign investors with non-discriminatory access to its domestic judicial system and gives them the option of settling disputes either through domestic dispute resolution mechanisms or through international arbitration. Although investors can always have access to domestic courts, some of Malaysia's agreements do not mention the availability of domestic remedies. Likewise, there is no homogeneity with regard to the inclusion of a "fork in the road" clause, i.e. whether resort to international arbitration and to domestic judicial procedures are mutually exclusive. Explicit "fork in the road" provisions can be seen in some recent IGAs, such as the 2009 Syria-Malaysia Agreement, but the 2009 model BIT does not contain an exhaustion of local remedies clause and permits investors to refer their disputes either to national courts or to arbitration.

Consistent with global practice, Malaysian agreements include a choice of venue clause. Typically, they provide for ad hoc arbitration, notably under the UNCITRAL Rules; arbitration and conciliation under the auspices of ICSID; and arbitration at the KLRCA.

Malaysia's recent agreements adopt the most innovative approach with regard to procedural matters. They provide for detailed and lengthy guidance on procedural issues, such as the content of the award, the composition of the arbitral tribunal and the appointment of arbitrators. Dispute settlement

provisions contained in PTIAs provide even further details on the procedural aspects, notably on interpreting the agreement and the award and the transparency of arbitral proceedings.

Malaysia also appears to be at the forefront of an ISDS innovation, consisting in requiring state parties to the agreement to get involved in the arbitration process in providing a joint interpretation of the agreement, seen in both MNZFTA and MICECA. This approach gives state parties greater control over the arbitration, allowing Malaysia to keep track of treaty negotiations to ensure a correct interpretation of the meaning given to the treaty provision at the time of the negotiations.

Provisions on third-party participation and consolidation of claims and on transparency of the proceedings, which are other novel features emerging in recent treaty practice, are not well reflected in Malaysia's agreements, although articles on consolidation of claims and transparency of arbitral proceedings are to be found in MNZFTA and MICECA.

Lastly, all of Malaysia's recent agreements stipulate a three-year prescription period that restricts the timeframe within which the claim may be brought, starting from "the date on which the investor first acquired, or should have first acquired knowledge of the alleged breach and knowledge that the investor has incurred loss or damage".

Promotion of investments

Promotion and facilitation

Malaysia's treaty practice appears to follow the global recent trend of including general language on investment promotion either in the Preamble or in a separate article, but the wording generally remains vague. Most IGAs mention the promotion of investment in their Preamble as one of their direct objectives, but this language remains purely declaratory and has no legal effect. Although many IIAs contain specific language on investment promotion, they rarely set out specific measures or commitments in this area. For example, Article 2 of the Malaysia-Viet Nam IGA reads as follows: "Promotion and Protection of Investment: Each contracting party shall encourage and create favourable conditions for investors of the other contracting party to invest in its territory and subject to its rights to exercise powers conferred by its laws, regulations and administrative practices shall admit such investments". Recent PTIAs, notably JMEPA and MNZFTA, tend to go a step further and provide for more detailed provisions on "Co-operation in Promotion and Facilitation of Investment", containing specific and detailed measures aiming to promote investment flows.

Co-operation on investment

The model BIT merely refers to economic and industrial co-operation in its Preamble, with no detailed provisions. Co-operation provisions, which most frequently go hand-in-hand with the promotion and facilitation provisions, often amount to a mere best endeavours commitment. PTIAs go much further and typically contain a separate provision on co-operation, thus imposing a more specific obligation. For example, MAFTA has an article on "institutional arrangements for investment", which provides for the creation of an FTA Joint Commission in charge of exchanging information, and discussing issues related to the investment chapter, reviewing and monitoring the implementation and operation of the chapter and overseeing the negotiations".

Transparency

Transparency requirements are a novel feature of the newest generation of agreements. The obligation relates mostly to the investors, contrary to most of the obligations traditionally contained in investment treaties. Malaysia's general treaty practice does not include any article on the promotion of transparency. One notable exception is to be found in MNZFTA, which includes an article on "Special Formalities and Disclosure of Information", providing that NT and MFN protections shall not prevent parties from requiring an investor to provide information concerning its investment, solely for informational or statistical purposes.

Specific provision on environment and public policy concerns

There is no specific language safeguarding public policy measures in Malaysia's IGAs, but Malaysia aligned itself with international treaty practice by including such language in its FTAs. Provisions referring to public policy concerns in these agreements typically focus on environmental matters. Both JMEPA and MNZFTA contain explicit language on not lowering environmental standards for the purpose of attracting investment. Other FTAs, such as MAFTA and MNZFTA, expand the scope of this safeguard provision to matters related to, *inter alia*, national security, public morals, public health, and conservation of natural resources (see Chapter 9, Box 9.3).

Notes

1. PTIA is an acronym used to cover all Trade Agreements comprising investment provisions (Free Trade Agreements, Economic Partnership Agreements, Comprehensive Economic Agreements, and Comprehensive Investment Agreements).
2. The national treatment obligation contained in IIAs aims at ensuring that government measures do not disadvantage foreign investors *vis-à-vis* local investors. It prevents the host country from making nationality-based discrimination in treatment received by domestic and foreign investors. Tribunals

have constantly taken into consideration, in determining whether investments are "in like circumstances", the existence of policy objectives underlying a discriminatory measure and find national treatment violations only in cases where the discrimination is based on the nationality.

3. This seems to be inspired by the NAFTA approach.
4. See Yannaca-Small (2005).
5. According to C. Schreuer (2004), "Umbrella clauses have been added to some BITs to provide additional protection to investors beyond the traditional international standards. They are often referred to as "umbrella clauses" because they put contractual commitments under the BIT's protective umbrella. They add the compliance with investment contracts, or other undertakings of the host state, to the BIT's substantive standards. In this way, a violation of such contract becomes a violation of the BIT".

ANNEX 3.A2

Investment agreements concluded by Malaysia

Contracting party	Year of signature	Year of entry into force[1, 2]
Model BIT 2009	Not applicable	Not applicable
USA	1959	1965
Germany	1960	1963
Canada	1971	1971
Netherlands	1971	1972
France	1975	1976
Switzerland	1978	1978
Sweden	1979	1979
Belgo-Luxembourg	1979	1982
United Kingdom	1981	1988
Sri Lanka	1982	1995
Romania	1996	1997
Norway (*Terminated in December 2001*)	1984	1986
Austria	1985	1987
Finland	1985	1988
Kuwait	1987	1990
Italy	1988	1990
South Korea	1988	1989
China	1988	1990
United Arab Emirates	1991	1992
Denmark	1992	1992
Viet Nam	1992	1992
Papua New Guinea	1992	–
Republic of Chile	1992	1994
Laos	1992	–
Chinese Taipei	1993	1993
Hungary	1993	1995
Poland	1993	1994
Indonesia	1994	1994
Albania	1994	1994

Contracting party	Year of signature	Year of entry into force[1, 2]
Zimbabwe	1994	1996
Turkmenistan	1994	2013
Namibia	1994	1996
Cambodia	1994	1997
Argentina	1994	1996
Jordan	1994	2002
Bangladesh	1994	2003
Croatia	1994	2008
Bosnia Herzegovina	1994	–
Spain	1995	1996
Kyrgyz Republic	1995	–
Mongolia	1995	2001
India	1995	1997
Uruguay	1995	2002
Peru	1995	1995
Kazakhstan	1996	1997
Malawi	1996	–
Czech Republic	1996	1998
Guinea	1996	1997
Ghana	1996	1997
Egypt	1997	2002
Botswana	1997	–
Cuba	1997	1999
Uzbekistan	1997	2000
Macedonia	1997	2001
North Korea	1998	1998
Yemen	1998	2002
Turkey	1998	2000
Lebanon	1998	2002
Burkina Faso	1998	2004
Republic of Sudan	1998	2008
Republic of Djibouti	1998	–
Republic of Ethiopia	1998	1999
Senegal	1999	2001
State of Bahrain	1999	2002
Algeria	2000	2002
Saudi Arabia	2000	2001
Morocco	2002	2009
Iran	2002	2006
Syrian Arab Republic	2009	2009
Slovak Republic	2007	2012
San Marino	2012	2013
Malaysia-Japan Economic Partnership Agreement (JMEPA)	2005	2006
Malaysia-Pakistan Closer Economic Partnership Agreement (MPCEPA)	2007	2008
Malaysia-New Zealand Free trade Agreement (MNZFTA)	2009	2010
Malaysia-India Comprehensive Economic Agreement (MICECA)	2010	2011

Contracting party	Year of signature	Year of entry into force[1, 2]
Malaysia-Australia Free Trade Agreement (MAFTA)	2012	2013
ASEAN-Japan Comprehensive Economic Partnership (AJCEP)	–	Ongoing negotiations
ASEAN-Korea Investment Agreement, contained in the ASEAN KOREA Framework Agreement on Comprehensive Economic Cooperation (AKFA)	2009	2009
Trade in Investment Agreement, contained in the broader China-ASEAN FTA (CAFTA)	2009	2010
ASEAN-Australia-New Zealand Free Trade Agreement (AANZFTA)	2009	2010
ASEAN Comprehensive Investment Agreement (ACIA)	2009	2012

Notes

1. As of April 2013.
2. The date of entry into force differs from the date of ratification. Treaties enter into force only after ratification by both parties. In the event the partner country did not ratify the treaty, it is not yet effective, even if it has been ratified by the Malaysian legislature.

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Chapter 4

Investment promotion and facilitation

Within an overarching strategy for improving the investment environment, investment promotion and facilitation can help to increase both domestic and foreign investment and to enhance their contribution to national economic development. Success in promoting investment requires a careful calculation of how to employ resources most effectively and how to organise investment promotion activities within the government so that the overriding goal of economic development through improvements in the investment climate remains at the forefront of policymaking. Investment promotion and facilitation measures, including incentives, can be effective instruments to attract investments provided they aim to correct for market failures and are developed in a way that can leverage the strengths of a country's investment environment.

This chapter describes the various steps Malaysia has taken to reduce red tape and integrate the role of business in its development strategies. Particular attention is paid to dedicated measures to improve government efficiency for business, as well as to its investment promotion efforts and how they have become a global reference. The analysis draws out some lessons learned from Malaysia's experience with industrial clusters and business linkages, which are at the core of the Malaysia's private sector development strategy. Malaysia's challenge in achieving Vision 2020 also entails addressing a skills-mismatch to meet the demands of a high-end technology and knowledge based economy, and this chapter highlights some areas for improvement in this regard.

Malaysia's economy has undergone a remarkable transformation since the 1960s (see Overview). The shift from a predominantly agricultural economy to a globally integrated hub for a number of high-end products and services is the result of the interplay of various factors, among which are consistent and long-term policies as manifested through the development of multi-year industrial master plans. It is within such a framework that investment promotion and facilitation can be most effective in achieving investment-related objectives. Investment promotion depends by and large on the quality of the investment-related policies. Once potential investors have manifested an interest, they need to be assisted through facilitation measures. The latter can only be undertaken effectively in an environment where the private sector's concerns are taken on-board and acted upon swiftly by government and public institutions.

The government has strengthened the business climate through initiatives driven by the Economic Transformation Programme (ETP) and the PEMUDAH task forces. Malaysia currently ranks 12th out of 183 economies according to the 2013 *Doing Business* Report (World Bank, 2012). The quality of Malaysia's investment promotion and facilitation is internationally recognised and often considered to represent best practice. Promotion measures have traditionally been closely integrated and aligned with the government's overall development policy.

The investment promotion agency, Malaysian Investment Development Authority (MIDA) enjoys a positive reputation within the private sector and ranks amongst the best agencies in Southeast Asia (World Bank, 2009). The country also offers a number of successful models for the promotion of clusters and business linkages between domestic small and medium-sized enterprises (SMEs) and large investors. The experiences at the state level, such as in Penang and the Klang Valley, offer interesting insights in this regard.

Malaysia nevertheless faces important challenges to support its push to a higher income country driven by high-end technology and a knowledge-intensive economy. A careful alignment of business climate reforms to Malaysia's strategic policy objectives needs is essential. This requires closer interaction between the private sector and government in policy development. Also, the national key economic areas (NKEAs) that are to drive the ETP are rather broad, covering a large part of the economy, and could benefit from greater focus.

In terms of actual investment promotion, Malaysia could benefit from a more competitiveness-based strategy which would entail a series of adjustments to the current framework. Based on its rich experience in working closely with the private sector, MIDA could increase its efforts to target specific investors that would contribute to reaching its strategic objectives, such as high-end technology transfer from MNEs to domestic enterprises. This would require a fresh look at the Key Performance Indicators (KPIs), to go beyond mere investment attraction figures to include more qualitative measures, ranging from job and enterprise creation, to technology transfer. The capacity and the necessary data to develop such KPIs need to be addressed.

Some institutional reforms to support the government's current trends and aspirations of liberalising the economy further, especially in the area of services, through investment promotion may be required. The recent inclusion of the promotion of investments in the service sector in MIDA's mandate reflects such possible advances. This move needs to be accompanied by the appropriate adjustments, including in terms of staff capacity, to promote more effectively investments in the new sectors covered by the agency.

New policies and programmes have proliferated, making it more difficult for enterprises, domestic and foreign, to easily access information related to their investments and operations, especially for post-establishment needs. This calls for an improvement of the one-stop shop and after-care services for investors at the federal level to assist investors effectively in addressing issues that may arise once they are established.

There are also differences between states in terms of competitiveness and industrial cluster development, and the development gaps between regions and states remain a matter of concern to the government (New Straight Times, 2012). In this context, extending the successful linkages programmes and cluster models in selected parts of the country to other areas could be particularly relevant. Malaysia has traditionally relied on incentives as an integral part of its investment promotion strategy. While the government argues that they are effective, their overall impact on the economy needs further scrutiny through a thorough cost-benefit analysis of incentives and forgone tax revenue, revenue that could be invested to further strengthen support pillars of the economy, such as skills.

The structural transformation of the economy sought by the government entails a shift from a production-based to a knowledge-based economy. This inevitably creates a change in the demand for different types of labour and has resulted in skills shortages and mismatches. The Review identifies some measures the government could consider to tackle this challenge effectively. These include closer collaboration between industry and institutes of higher learning on R&D and curriculum development to align training more closely

with industry demands. This is crucial to develop new sectors for investment, such as in the field of medical equipment and pharmaceuticals, which could contribute to the increasing attractiveness of Malaysia as a destination for investment in new and higher-end sectors, like medical tourism.

The government could also reflect on some innovative models to attract advanced foreign expertise to help upgrade management and production processes where needed. Efforts, such as Talent Corp., to attract high-skilled Malaysians from the diaspora should be kept up, if not enhanced. Facilitation of Malaysian professionals from abroad through the Returning Expert Programme; making it easier for top foreign talent to stay and contribute in the longer term to Malaysia through the Residence Pass-Talent; and implementing the Scholarship Talent Attraction and Retention Programme to optimise government scholars by allowing them to serve their scholarship bond with top Malaysian companies are laudable steps in this regard.

Role of business in government policy

Investment policy and its related promotion and facilitation measures have been central to Malaysia's overall development policy for decades. Previous sections of this Review have charted the evolution of the economy and associated policy measures, including recent steps towards promoting outward investment.

The Malaysian government has adopted a pro-business approach to policy, which is designed to serve the country's industrial promotion and development efforts. The New Economic Model identifies investment as the main driver for growth through 2020 (National Economic Advisory Council, 2010). Under the Third Industrial Master Plan (2006-20) strategies have been outlined to maintain Malaysia's business competitiveness and to attract FDI, particularly in the manufacturing and services sectors – strategies that bore some fruits as highlighted in Chapter 2. This includes a series of measures to improve the operating and business environment for investors as is seen further below.

MITI is the designated line ministry for investment and industrial development. Its main functions are:

- To plan, formulate and implement policies on industrial development, international trade and investment.
- To encourage foreign and domestic investment.
- To promote Malaysia's exports of manufacturing products and services by strengthening bilateral, multilateral and regional trade relations and co-operation.
- To enhance national productivity and competitiveness in the manufacturing sector.

MITI delivers its mandate through eight agencies; the Malaysian Investment Development Authority (MIDA), SME Corp. (formerly, SMIDEC), the Malaysian External Trade Corporation (MATRADE), the Malaysia Productivity Corporation (MPC), the Malaysian Industrial Development Finance Corporation, SME Bank, Halal Industry Development Cooperation and Malaysia Automotive Institute.

Malaysia is frequently cited with regards to best practices in investment promotion and facilitation, in particular for the promotion of business linkages between local enterprises and MNEs (UNCTAD, 2011). Its most recent policy advances are the Government and Economic Transformation Programmes (the GTP and ETP) launched by the Prime Minister in December 2010. The aim of these programmes is to instil new dynamism in Malaysia's efforts to become a high-income economy by 2020 (NEAC, 2010).

Towards this end, an Investment Committee was established in 2010 to identify and implement programmes under the ETP and to ensure greater co-ordination in the area of investments between all arms of government and the private sector to achieve the objectives and targets of the ETPs. This includes the immediate targets set under the Tenth Malaysia Plan (2011-15) of economic growth of 6%, private investment of 12.8% and average annual investment totalling RM 115 billion. The committee plays an important role in:

- focusing on overall investments in the country by collecting and collating data on both proposed and actual investment;
- assessing the gaps and identifying the strategic and operational impediments in achieving the annual RM 115 billion private investment targets; and
- channelling issues to the appropriate implementing agencies and ministries to address the bottlenecks.

The Investment Committee meets every month with members from MITI, PEMANDU (Performance Management and Delivery Unit) and other related key agencies to discuss issues related to investment including data collection, promotional activities and implementation of key projects. It is co-chaired by the Minister of International Trade and Industry and the Chief Executive Officer of PEMANDU, the unit that oversees the implementation of programmes and activities as identified under the ETP in order to meet the set targets.

To drive the ETP, the government, together with the private sector, has identified 12 NKEAs based on the sectors that are expected to generate the highest growth over the next decade. These cover eleven industries and one geographical territory: oil, gas and energy; palm oil; financial services; tourism; business services; electronics and electrical; wholesale and retail; education; healthcare; communications content and infrastructure; agriculture; and the Greater Kuala Lumpur/Klang Valley (Pemandu, 2011).

The environment for investment in knowledge-based capital is a determining factor in attracting such investment, a primary objective of the government. For example, through ensuring a good investment framework, covering skills supply and intellectual property protection, governments can encourage firms to invest in high value activities (OECD, 2011a).

The government has also embarked on a corridor-driven strategy to address some regional imbalances and gaps. In 2010, five growth corridors were identified to spur growth and economic development around respective important cities: Georgetown and the Northern Corridor Economic Region; Johor Bahru and Iskandar Malaysia, Kuantan and East Coast Economic Region; Kuching and Sarawak Corridor of Renewable Energy; and Kota Kinabalu and Sabah Development Corridor (Malaysia, 2011). Nevertheless, the government should take care not to implement regional policies at the cost of the focus on the overall enabling environment and policy framework that would support the ETP approach in reaching the respective objectives.

Promotion of outward investment

As seen earlier, Malaysian companies have become major international investors. While this generally reflects a growing economy, which is gradually liberalising, thus opening financing channels for companies to venture into new business abroad, it is also the result of a number of policies. The fact that Malaysian outward foreign direct investment (OFDI) has surpassed FDI inflows since 2007 deserves attention (see also Chapter 6 on Policies for *promoting responsible business conduct*).

Various factors lead companies to invest abroad, including limited home market size and the search for efficiency. Trade liberalisation also contributes to cross-border investment. In Malaysia, the rise of labour costs also pushed companies towards lower cost destinations for their operations. While a great deal of the outward investment is driven purely by market considerations, government policies can play a very important role in promoting OFDI. Some of the most important policies that have contributed to the steady increase of Malaysian OFDI since the early 1990s include the liberalisation of the capital account by Bank Negara Malaysia (BNM). This included easing capital outflow restrictions, as reflected in the Financial Sector Master Plan and the Capital Market Master Plan 1, launched in 2001 (Goh and Wong, 2010).

Tax exemptions and tax incentives have also played an important role in promoting Malaysian OFDI. Since 1995, all foreign income by Malaysian companies investing abroad is fully exempted from tax. In an effort to support the move of Malaysian companies up the value chain, a special incentive, equivalent to five years acquisition costs, was introduced in 2003 for the production of high-technology products in Malaysia or to seek new markets for local products abroad (Yean, 2007).

In 2005, EXIM Bank of Malaysia was merged with Malaysia Export Credit Insurance Bhd. As a result, EXIM Bank is now an important financier for Malaysian outward investors, as well as a credit insurance guarantee provider (Table 4.1). The government promotes OFDI both by private companies and government linked companies (GLCs), with MATRADE being the focal point within MITI for OFDI related policies and implementation.

The geopolitical aspirations of the government during the Mahathir regime sent important signals and were at the heart of many of the above policies. The government aimed to promote South-South co-operation and saw investment and technology co-operation as important elements of that agenda. The creation of organisations such as the Malaysian South-South Association and Malaysian South-South Cooperation Berhad are illustrations of this drive.

Table 4.1. **OFDI instruments offered by EXIM Bank**

OFDI instruments	Objective
Buyer Credit Facility	To provide opportunities to the Malaysian exporters and contractors in bidding for overseas jobs and contracts. The loan is extended directly to a foreign buyer or a lending institution to facilitate the import of Malaysian goods and services. Loan disbursements are made directly to the Malaysian exporter/contractor.
Overseas Project Financing Facility	Support to companies active overseas. Available to Malaysian companies or joint-venture companies established overseas to purchase Malaysian goods.
Guarantee Facility	To facilitate the issuance of bonds or guarantees such as advance payment bonds or performance bonds for overseas contracts implemented by Malaysian contractors.
Buyer Credit Guarantee	Guarantee of repayment of fixed or floating rate loans lent to foreign buyer for Malaysian goods. The minimum credit term is one year up to ten years.
Overseas Investment Insurance	To cover non-commercial risks of Malaysian companies investing abroad (including capital transfer restrictions, expropriation, civil conflicts and breach of contract).

Source: Malaysian External Trade Corporation (2012).

MIDA: Malaysia's investment promotion agency

Numerous institutions across the country have an investment promotion and facilitation mandate, with the Malaysian Investment Development Authority (MIDA) being the most important investment promotion agency (IPA) with a federal mandate. Established in 1967 under an Act of Parliament, MIDA is responsible for the promotion, co-ordination and facilitation of investments in the manufacturing and services sectors (except utilities and

finance) in Malaysia. It is also the lead agency in the co-ordination of the activities of the other investment promotion agencies. In line with efforts to better focus MIDA's functions, the agency changed its name on 18 August 2011 from the Malaysian Industrial Development Authority to the Malaysian Investment Development Authority. The change of name is partly to convey to investors its broader scope and centrality in promoting investments in the manufacturing and services sectors (MIDA, 2012).

MIDA was created to support the government's move away from the post-colonial import-substituting industrialisation strategy towards export-oriented industrialisation. Since then, it has evolved into an autonomous agency with a global network of 24 overseas offices and 12 branch offices in various states throughout Malaysia to assist investors in the establishment of their business and operations. The agency is guided by a 14-member board of directors, composed mostly of CEOs of major private companies and the heads of the largest chambers of commerce in Malaysia (USAID, 2009). Box 4.1 highlights the main functions of MIDA.

Its structure and functions reflect global best practice, such as serving as a one-stop-shop for investors and the establishment of a Client Charter. As a one-stop-shop, MIDA hosts representatives from the Immigration Department, Tenaga Nasional Berhad (Malaysia's main power provider), Royal Malaysian Customs, Telekom Malaysia Berhad, the Department of Labour Peninsular Malaysia, and the Department of the Environment (MIDA, 2012).

Its Client Charter, for example, is updated on a monthly basis and serves as an effective monitoring tool of the agency's responsiveness and professionalism in addressing investors' enquiries, information provision and project implementation assistance. Table 4.2 below shows MIDA's Client Charter achievement for 2011 for the issuing of manufacturing licences.

Table 4.2. **MIDA's Client Charter results, manufacturing licences (2011)**

Activity	Client charter		Approved applications				Total	Achievement
			Conforming to charter		Not conforming to charter			
			No.	%	No.	%		
Manufacturing Licence	Fast track	7 working days	287	99.3	2	0.7	289	99.6
	Normal track	4 weeks	88	97.8	2	2.2	90	97.6

Source: Malaysian Investment Development Authority (2012).

Some investors claim that MIDA's strength lies particularly in helping companies to establish in the manufacturing sector. Weaknesses remain in post-establishment services for investors, such as after-care services, which could benefit from more formalised industry-IPA feedback mechanisms. This

becomes even more challenging in a context of fast-paced reforms, with new policies and agencies being established, as is the case in Malaysia, making it difficult for enterprises to keep up with developments. This also increases the need for a strong private sector focal point within the government.

Beyond promotion, MIDA regulates investments by issuing manufacturing licences. These are granted automatically unless the projects are deemed to be sensitive or require environmental impact assessments, and thus do not generally present an impediment through investment screening (see Chapter 2 on Investment Policy). The agency also decides on and administers investment incentives, which are addressed in more detail below.

MITI sets outward investment policies for Malaysia and MIDA has been involved in promoting and facilitating cross border investments and assisting Malaysian companies to identify markets and investments abroad in the past. MATRADE, which had already been undertaking the bulk of this promotion through activities like trade missions, has now taken the lead in this function (USAID, 2009 and MIDA, 2012). The co-ordination of Malaysian overseas investment promotion programmes nevertheless still features as part of the Investment Committee meeting agendas.

To support reaching high investment targets into different sectors of the economy, the agency is strengthening its policy advocacy function, such as by acting as the secretariat of the Investment Committee meetings. Boosting domestic private investment to three quarters of total private investment in the country is another ambition and is supported by targeted incentives as will be seen below (*New Straits Times*, 2012).

Investment promotion at the sub-national level

Part of Malaysia's investment promotion framework encompasses a number of agencies, in addition to MIDA, that undertake some sort of investment promotion, including state-level investment promotion agencies. The state of Penang for example has its own IPA, investPenang, which spun-off from the Penang Development Corporation's industrial office in 2004 to enhance investment promotion efforts at the state level. Its functions include enhancing Penang's business environment, administrating land for business purposes and supporting companies in their due diligence, as well as promoting SMEs in Penang where the agency promotes business linkages through match-making events and an elaborate database of suppliers for larger companies.

The agency co-operates closely with MIDA as the federal IPA, particularly on incentives, which are under MIDA's sole responsibility. Examples of such co-operation include the attraction of big brand name electronics and medical device companies, which were able to benefit from Multimedia Super Corridor status for incentives.

Contributing 25% of Malaysia's electrical and electronics exports, Penang also currently attracts 50% of Malaysia's medical tourism, which is one of the areas the government sees as a growth sector for the economy. Penang has also developed a number of dynamic clusters, an issue that is discussed in more detail below. These achievements are partly the result of a pro-business attitude from the state government. In fact, Penang's Chief Minister is the Chairman of investPenang (investPenang, 2012).

Investment promotion also occurs at the city level. Kuala Lumpur has its own IPA, InvestKL, mandated by the federal government to attract and service large MNEs in Greater Kuala Lumpur and Klang Valley.

MIDA's performance and perceptions

MIDA is fully funded by the government as its key agency for promoting investment in the manufacturing and service sectors in Malaysia. The performance of MIDA in terms of attracting quality investments is reviewed based on global economic conditions and benchmarked against its key performance indicators (KPIs), which are essentially the value of annual investment targets for both domestic and foreign investments in the NKEA and non-NKEAs.

The majority of MIDA's management staff has significant experience with the private sector and the agency has an internal review process to determine promotions and awards. The private sector's perceptions of MIDA are positive, and the agency has a good reputation for transparency and competence (USAID, 2009). The agency was ranked among the top IPAs in East Asia and the Pacific by IFC's Global Investment Promotion Benchmarking in 2009 (World Bank, 2009).

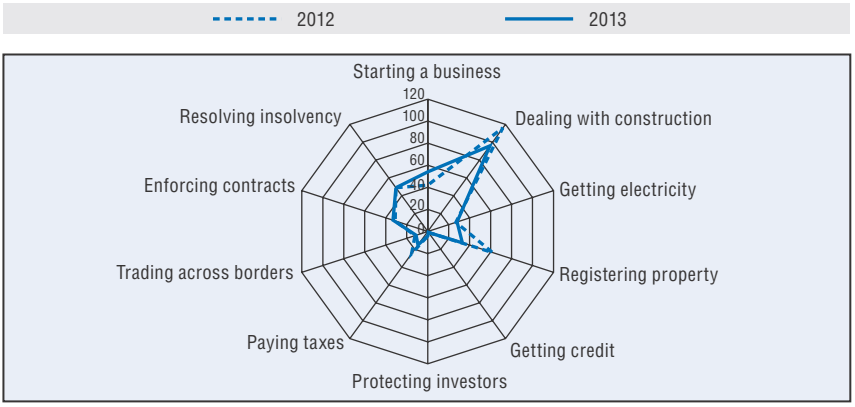
MIDA's organisational structure reflects a clear strategy of dividing the responsibilities of promotion and facilitation into dedicated units where resources and expertise differ, Promotion requires effective outreach and marketing while facilitation implies supporting companies in addressing difficulties in dealing with regulation. The agency also has sectoral expertise, divided into resource and non-resource industries. MIDA's website was recently improved, as part of the overall enhanced communication efforts (MIDA, 2012). Nevertheless, in order to match the government's desire to move the economy further up the value chain by producing more sophisticated and high-end technology products, MIDA could consider adjusting its KPIs. The indicators could go beyond target investment volumes and include an evaluation of the impact of the investment projects. This would include measures covering consultative stakeholder processes and technology transfer from foreign investors to Malaysian companies.

Such indicators can be difficult to develop as the necessary data and the capacity within government may be limited. One way to address this, while also increasing the credibility of the KPIs, is to have external parties create and monitor KPIs. On a more general note, such KPIs may be expanded to include measures beyond MIDA's mandate. These may thus fall under MITI's overall responsibility in an effort to increase the developmental effects of investment and to better inform policy making, such as when setting incentives.

Government measures to improve the business climate

The government recognises the constant need to improve conditions for the private sector to operate and hence to contribute to economic growth. Malaysia ranks 12th out of 183 economies according to the *Doing Business* Report 2013 – a steady improvement from 23rd in 2011 and 18th in the 2012 report (World Bank, 2012). While this does not portray a comprehensive image of the business climate in Malaysia, it does illustrate a commitment from the government to address operational impediments to business. Outstanding issues that still dampen investors' perceptions, such as starting a business, registering property and dealing with construction permits (Figure 4.1) are being addressed, as seen below. Overcoming these continuing constraints is vital for Malaysia to have an edge over its regional competitors for investment, in particular Singapore and Thailand (NEAC, 2010).

Figure 4.1. **Ease of Doing Business improvements in Malaysia, 2012-13**

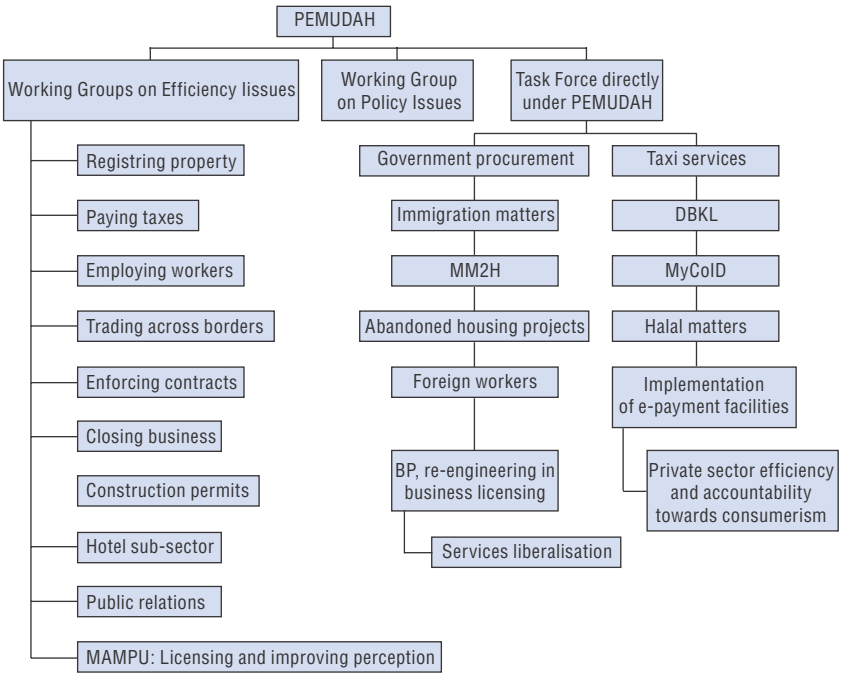


Source: World Bank, *Doing Business* (2012).

In 2007, the prime minister formed the Special Task Force to Facilitate Business (PEMUDAH) to simplify business operations in Malaysia by improving the government delivery system. PEMUDAH is also the government's primary vehicle for addressing issues arising from Malaysia's *Doing Business* indicators.

It is composed of 14 heads of selected ministries and departments and 10 corporate leaders, and co-chaired by the Chief Secretary to the Government and the President of the Federation of Malaysian Manufacturers. The task force oversees different working groups, by and large reflecting the *Doing Business* categories (Figure 4.2) and acting as a private sector feedback mechanism (PEMUDAH, 2010).

Figure 4.2. **PEMUDAH task forces**



Source: Special Task Force to Facilitate Business (PEMUDAH).

PEMUDAH has introduced various initiatives, including innovative measures to improve government delivery and foster collaboration between the public and private sectors. One of the most notable efficiency improvements derived from the PEMUDAH working groups is the Business Licensing Electronic Support System (BLESS), which offers a total of 102 licences/approvals/permits online, as well as a simple and user-friendly 6-step online business licence application system (BLESS, 2012). Other initiatives include:

- enhancing services at the district and local levels, integrating services across agencies and increasing public confidence in electronic services, mainly through the use of ICT;

- streamlining processes and procedures as well as establishing commercial courts to reduce the cost of doing business;
- establishing one-stop centres to expedite approvals;
- streamlining immigration procedures to facilitate employment of high skilled expatriates and reduce processing time for employment visas;
- reducing the time for the approval of licences; and
- greater use of ICT for government services through the "myGovernment" portal.

These efforts have shown results, as can be seen in Figure 4.1 above. For example, the Focus Group on Business Process Re-engineering in Business Licensing under PEMUDAH embarked on the "Modernising Business Licensing' initiative to review all procedures related to the application of business licences in 23 ministries. As of October 2012, 548 licences were streamlined into 323 licences, while 8 were eliminated. The initiative is expected to reduce an estimated RM 729 million in business licence compliance cost by project completion in November 2013 (MPC, 2012).

Also, the PEMUDAH Focus Group on Dealing with Construction Permits has conducted a study to identify regulatory and non-regulatory options that could reduce burdens on business in dealing with construction permits. As result of the study, the government introduced a speedy approval process, which will now require only 10 procedures and take 100 days to process permits compared to the previous 37 procedures which required 140 days (MPC, 2012). Box 4.2 highlights some more specific efficiency improvements initiated by PEMUDAH, all of which have contributed to Malaysia's steady improvement in the *Doing Business* indicators.

Given PEMUDAH's role in improving the business environment, its mandate has recently been expanded to reflect the priorities set in the New Economic Model. In particular, the task force will be expected to further:

- enhance transparency and accountability of the public and private sector;
- drive services liberalisation;
- collaborate with TalentCorp – an initiative by the government to address human capital issues faced by investors – in retaining talent and expertise in the country, and in attracting back the estimated 700 000 Malaysian professionals working abroad;
- improve Malaysia's *Doing Business* ranking and reach the goal of being ranked among the top 10 nations by 2015;
- reduce the number of business-related licences in all sectors; and
- effectively monitor the efficiency of improvements implemented.

Box 4.2. **Selected efficiency improvements in doing business, 2011**

Starting a business

- improve BLESS phase I and extend the coverage to 73 agencies and 350 licenses/permits/approvals.

Registering property

- minimise the time taken for data entry by counter clerks in land offices with the introduction of myForm at all Land Offices; and
- introduce e-mail notification services to notify applicants/lawyers on registration of applications or to pick-up documents and/or titles issued in the land office.

Enforcing contracts

- introduce a Client's Charter to further improve the Court's delivery system and transparency.

Trading across borders

- standardise the Import and Export Process Flows; and
- initiate a project to improve efficiency of Logistics stakeholders using Six Sigma Tools.

Implementation of e-payment facilities

- embark on the mobile channel of e-payment via hand phones and computer tablets;
- develop Mobile Government (MyMobile) pilot projects in Kuala Lumpur City Hall and National Higher Education Fund Corporation; and
- drive the public sector e-payment in the coming years towards the usage level of 90%.

Business process re-engineering in business licensing

- continue to enhance the business licensing process.

Private sector efficiency

- improve credit facilities, business conducts and protection of consumer rights;
- simplify and standardising loan application forms; and
- improve the efficiency of Water Utility providers.

Medical tourism

- facilitate the delivery of Malaysia Healthcare Travel Council.

Source: Special Task Force to Facilitate Business (PEMUDAH) (2011).

Recognising the impact that regulations can have on the economy, the Malaysia Productivity Corporation (MPC) has produced a draft of the National Policy on the Development and Implementation of Regulations as well as the Best Practice Regulation Handbook to ensure the adoption of best regulatory practices by all federal government agencies. These two documents provide guidelines to ensure the implementation of the Best Practice Regulation system. The government has since then adopted the "National Policy on Development and Implementation of Regulations, Best Practice Regulation Handbook" and will formalise the requirement of Regulatory Impact Assessments (RIAs) to be adhered by all ministries and agencies.

Engagements were also done with international organisations, including the Organisation for Economic Cooperation and Development (OECD), the Dutch Office of Best Practice Regulation (OBPR) and Ministry of Finance and Deregulation, the Australian Productivity Commission (AGPC) and the Regulatory Impact Assessment Team (RIAT), as well as the New Zealand Treasury and Jacobs, Cordova and Associates to acquire expertise assistance.

Promotions on Good Regulatory Practice (GRP) were carried out since June 2012 through trainings, seminars, workshops, briefings, engagement with stakeholders and pilot projects. MPC has continued its efforts to promote RIAs among Ministries and agencies through pilot projects. Five agencies are currently participating in RIA pilot project. All have been given specific training and guidance to carry out the RIA process with assistance by experts from Jacobs, Cordova and Associates.

Going beyond the broader efficiency improving initiatives from the government to address the bureaucratic bottlenecks companies may face, MIDA as the IPA provides comprehensive hand-holding assistance to investors from the pre-establishment stage (e.g. in obtaining approvals and incentives) through to the post-establishment stage (e.g. overcoming any bottlenecks that may arise in implementation and operations). At district levels, the District Industry Implementation Units provide assistance to companies from application to project implementation through elaborate after-care services.

As part of its dialogue with investors, MIDA actively undertakes briefings on its investment policies through investment seminars locally and abroad, regular public-private sector dialogues, and meetings with investors, chambers of commerce, industry associations and incoming trade and investment delegations. This includes consultations with relevant government agencies regarding the impact of policy initiatives on investment. While investment volumes, as manifested through the KPI mentioned above, have been a priority target for the government, future policies should and will focus more on attracting quality investment with higher desired impact for the economy. Some illustration of this focus is shown in the incentives discussion below.

The government is committed to improving the private sector enabling environment, and in this regard, the push induced by PEMUDAH and its working groups has been fruitful. These measures must be closely aligned with the broader policy directions aimed at tackling remaining challenges such as the difficulties of obtaining construction permits, the availability of skilled labour and English language deficiencies. The latter two areas are particularly important to improve Malaysia's regional investment competitiveness (NEAC, 2010).

Some investor feedback points to weaknesses in the post-establishment services. Co-ordination between different ministries and agencies that are relevant to investors' operations could be improved, in particular through an able private sector focal point within the government. MIDA's efforts to improve the one-stop services at the federal level are steps in the right direction, which should also include pro-active after-care services. These could include formalised private sector feedback mechanisms and would contribute to improving the effective use of KPIs as discussed above.

Malaysia's investment attraction strategy: The central role of incentives

The 1958 *Pioneer Industries Ordinance* was one of the first incentive-based policy measures to attract investment, providing tariff protection and tax allowances to pioneer firms (UNCTAD, 2011). This was followed by the *Investment Incentives Act* of 1968, and more recently the *Promotion of Investment Act* of 1986. Since then, incentives have been used by the government to promote FDI and domestic investments in targeted industries and sectors.

The government sees incentives as an effective investment promotion tool to attract high technology, high value-added, knowledge- and capital-intensive projects and investments in new growth areas. An ultimate objective is to build integrated clusters of foreign and domestic enterprises, with adequate support services, including logistics and R&D (Ministry of Finance, 2012). Incentives are offered to selected and promoted industries on a non-discriminatory basis to:

- nurture industries which are in their infancy, as well as to develop new growth areas, such as investments in solar energy, aerospace, medical devices and biotechnology;
- encourage technology transfer to develop high-technology and high value-added products and industries;
- enhance local R&D and innovation, and increase collaboration with local research institutes, universities and colleges;
- create a pool of knowledge-based workers and upgrade the technical skills among Malaysian workers; and

- support the integration of domestic companies into global supply chains by supplying to MNEs.

Malaysia began to offer incentives at an early stage, primarily tax holidays to import substituting firms. Tariff protection was also conferred, but the market was too small to allow viable infant industries to develop. The only lasting attempt to nurture a local industry has been in the automotive sector, with Proton Holdings Berhad. In the late 1960s, incentives were expanded to include an investment tax credit, which was aimed both at increasing employment and at pioneer industries, including capital-intensive projects. During this period, foreign firms accounted for over one half of the manufacturing sector, which for its part represented only 13% of GDP. In the 1970s, labour-intensive and export-oriented firms were favoured, including through the creation of export processing zones where firms were exempt from most of the restrictions on other investors (Thomsen, 2004). In the early 1980s, the government embarked on an industrialisation strategy based on local capital, but this strategy was curtailed by the recession in the mid-1980s, at which time a Reinvestment Allowance was introduced for foreign and domestic firms.

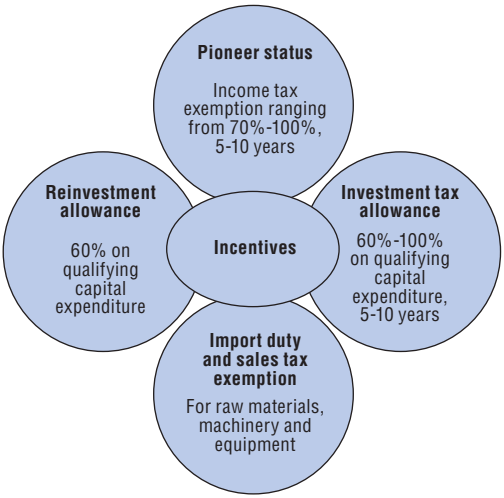
In the early 1990s, both the tax holiday and the investment tax allowance were made less generous for pioneer industries and their approval became more contingent on the fulfilment of certain criteria. After 1995, labour-intensive projects were no longer eligible for promotion unless they were located in certain areas or satisfied other narrow conditions. This tightening of incentive practices in traditional parts of the economy was accompanied by an expansion in other areas: high-technology, R&D, training, industrial linkages and multimedia (the development of the latter is supported through the establishment of the Multimedia Super Corridor – MSC). Since 2000, the government has offered customised incentives (both fiscal and financial) for investment perceived as "high quality" and in certain sectors deemed strategic. Incentives have also been tied less to economic performance (e.g. exports) and more to innovation and responsible business conduct: up-skilling of workers, R&D, and environmental protection (Thomsen, 2004).

According to the government, the granting of incentives has enabled Malaysia to attract substantial amount of investment and generated numerous benefits, spin-offs and multiplier effects for the economy (MIDA, 2012). While the use of incentives should be scrutinised carefully with respect to the revenue forgone, especially through fiscal incentives, Malaysia has on occasion managed to use incentives effectively in its clusters policy. For instance, pioneer status, labour utilisation relief, investment tax credits, export refinancing facilities and accelerated depreciation allowances were all types of incentives the government used to successfully attract MNEs in export-oriented activities.

The semiconductor cluster in Penang and nearby areas such as the Kulim High Technology Park, have served as sites for global companies, while support services and R&D facilities have grown around these clusters. These have generated significant spillovers such as technology transfer to local suppliers and improved skills and employment in firms linked to the electronics industry (Zainal and Bhattasali, 2007).

The main fiscal incentives available to investors in Malaysia are highlighted in Figure 4.3 below. Incentives for investments in new priority sectors, such as biochemicals and the MSC, can be observed through the bionexus status company and the MSC status company schemes, entailing a 100% tax exemption for 10 years, investment tax allowances of 100% for 5 years, and a concessionary tax rate of 20% for another 10 years upon the expiry of the tax exemption period. These seem to have shown some success in supporting MIDA's targeting of high-end investors into new strategic areas, such as healthcare provision and medical devices manufacturing, and aerospace technology where Malaysia is host to a number of major MNEs and their maintenance, repair and overhaul activities, including GE Engine, Hamilton Sundstrand and Parker Haniffin (*New Straits Times*, 2012).

Figure 4.3. **Fiscal incentives in Malaysia**



Source: Malaysian Investment Development Authority (2012).

The pioneer status scheme is the most widely used form of incentives. From 2007 to 2011, 85% of the approved projects with incentives were under this scheme, while 15% were under the investment tax allowance (ITA) scheme (MIDA, 2012). The current trend is to move towards more ITAs and to

reduce the number of incentives and ITA rates (Ministry of Finance, 2012). Also, the government has set aside special funds to be used as grants and loans to attract high impact and strategic projects. These funds are approved based on Economic Council decisions.

To promote investments by domestic companies, the government has established a Domestic Investment Strategic Fund of RM 1 billion, to be managed by MIDA. This fund aims to accelerate the entry of Malaysian-owned companies in high-value added and knowledge-based industries (*New Straits Times*, 2012).

The National Committee on Investment, which meets every week, is one of the prime mechanisms to evaluate investment projects admitted into the country and the incentives granted. This evaluation is undertaken jointly by MITI, MIDA, the Ministry of Finance, Bank Negara Malaysia, the Economic Planning Unit and the Inland Revenue Board (IRB). The eligibility for investment tax incentives is based on specific priorities, including the levels of value added, the technology used, industrial linkages, employment of management, technical and supervisory staff, and staff with science and technical qualifications, and degree of capital intensity. Estimates of tax revenues forgone from tax incentives are calculated by MIDA.

While Malaysia's use of incentives follows regional trends, the government could rely more on other policy options to strike the balance between retaining and attracting investment, particularly in strategic sectors. While, the potential for backward and forward linkages are taken into account in the appraisal of applications for incentives, additional measures to anchor investors into competitive clusters, thereby strengthening their supply base further should be considered. The latter is a timely issue considering the increasing regional competition for Malaysia from both low-cost investment destinations and those targeting high-value and technology-intensive investments, posing the risk of MNEs with little linkages with the local economy moving out.

The rationale for reviewing the provision of incentives becomes even more relevant as the effectiveness of fiscal inducements as a tool to attract investment remains unclear (Box 4.3). Also, incentives must be equally accessible to larger foreign investors and smaller domestic enterprises. While this may be reflected in policies, and incentives are available for SMEs, smaller domestic companies sometimes find it harder to access these.[1]

Regarding the investment incentives themselves, a thorough and informed cost-benefit analysis of the overall effectiveness of incentives would be beneficial and the results should be made publicly available. While the IRB keeps figures on forgone tax revenues through the granting of incentives, these are confidential. Disclosing information on overall forgone revenue

Box 4.3. **Do incentives attract more FDI?**

Incentive packages, including fiscal and financial incentives, have long been used as instruments to attract FDI.[1] While their effectiveness in attracting FDI remains uncertain, the competition among countries for foreign capital has led to the escalation of such incentives over the past two decades. UNCTAD (2000) surveyed tax incentive regimes in 45 countries from all regions and found that nearly all the countries offered such incentives to investments in targeted sectors. Around 85% of such incentives were in the form of tax holidays or tax reductions for projects in specific targeted sectors. A consensus exists in the literature that tax incentives are a secondary determinant after economic and political fundamentals such as market size, availability of natural resources and skilled labour, political stability and a sound regulatory environment (Oman, 2000; UNCTAD, 2000).

The use of incentives as a substitute for fundamental determinants is therefore likely to have limited effects. Incentives are tempting because they are easy to implement but they cannot substitute for fundamental reforms and can be quite costly, particularly to developing countries that tend to face budgetary constraints.[2] Once a decision to engage in FDI is made, incentive packages can play a significant role in MNEs' decision on the choice between alternatives with similar fundamentals, mostly within the same region (Morisset, 2003; Devereux and Griffith, 1998). Policies that improve market opportunities by focusing on creating a sound regulatory environment, and offering a low and transparent tax regime tend to be more effective in attracting FDI.

The strengthening of competition among countries with similar fundamentals and sometimes even between developed and developing countries may lead to a "race to the bottom" by governments in relation to tax incentives. The escalation of incentives can pose a challenge for host countries if it leads to incentive levels that exceed or weaken considerably the benefits of FDI (Oman, 2000). The costs of incentives are not only associated with the fiscal cost of lost revenues, but also with a potential indirect cost associated with crowding out local investment and the costs of administering incentives. Blomström and Kokko (2003) observe that this is particularly a matter of concern if incentives are focused exclusively on foreign firms, as the main benefits of FDI – technology and skills spillovers – are not an automatic consequence of FDI. Domestic companies need to be able to absorb technology and skills for such benefits to occur, which may also require additional investments by the host country to develop such competencies. Furthermore, Halvorsen (1995) shows that targeting the right investment projects, i.e. those more sensitive to special tax incentives, can be very difficult. As a result, highly profitable investments that would take place anyway may end up receiving incentives.

Box 4.3. **Do incentives attract more FDI?** *(cont.)*

Research reveals that the efficiency of incentives also differs according to investment motives. Local market oriented firms are less likely to be responsive to tax incentives, whereas export-oriented firms are more prone to be attracted by such incentives and import duty concessions (Reuber et al., 1973; Rolfe et al., 1993; Bergsman, 1999). Looking at Hong Kong, Chinese investments in ASEAN, Yeung (1996) found evidence that investment incentives *per se* were ineffective in attracting foreign investment overall, but played a significant role only in a number of specific industries, mostly export-oriented, including food and electronics in Indonesia, metal manufacturing in Thailand and miscellaneous manufacturing in Malaysia, the Philippines and Thailand. Incentives may also affect the composition of FDI rather than increase its level as governments use incentives to target specific investment and their efficacy depends on the characteristics of the investor. Oman (2000) finds that large foreign companies, such as auto makers, are more capable of negotiating the terms of such incentives and thereby receiving additional special tax treatment. Rolfe et al. (1993), based on a survey of American multinationals, show that the effects of incentives may also vary between new and existing investors. While new investors are more responsive to incentives which alleviate investment expenditures, existing firms prefer incentives that enable higher profits. The authors also show that manufacturing industries that typically rely more than service industries on fixed assets prefer incentives that allow fast depreciation.

James (2009) argues, based on World Bank experience, that in general incentives that allow a faster recovery of investment costs, such as investment tax credits and accelerated depreciation, tend to be more effective in attracting capital. Having incentives based on tax laws helps avoid selection on a case-by-case basis, enhances transparency and facilitates monitoring and assessment of incentive efficiency. Further, incentives should have a time limit to make sure that unnecessary revenue losses do not occur.

1. FDI incentives are measures designed to influence the size, location or industry of a foreign direct investment project by affecting its relative cost or by altering the risks attached to it through inducements that are not available to comparable domestic investors (OECD, 2003). Fiscal incentives relate to measures that reduce the tax burden for foreign investors, such as full or partial tax holidays or tax rate reductions for specific activities. Financial incentives refer to direct contributions from the host government to foreign companies, such as subsidised loans, dedicated infrastructure and direct capital subsidies and grants.
2. In several cases, the costs are over USD 100 000 per job. See for instance Morisset (2003), Christiansen et al. (2003), Chai and Goyal (2008).

through tax incentives would greatly support the government in its efforts to move away from incentives-based investment promotion to a competitiveness-based strategy to attract and retain investment. In addition,

the current system of granting incentives, without an informed public debate on the issue, hampers clear and transparent processes. The OECD *Checklist for Foreign Direct Investment Incentives Policies* may offer useful insights to address such challenges.

Policies to promote Malaysian SMEs

An enabling environment for the private sector to thrive and develop to its full capacity requires differentiated measures, including targeting small and medium-sized enterprises (SMEs), typically the drivers of domestic innovation and growth in an economy. The SME dimension of private sector development calls for carefully tailored actions, ranging from appropriate and SME proportionate regulation, to flexible and easy access to finance, matched with business development services and other support measures. SMEs can also enter into linkages with MNEs and larger domestic enterprises, offering avenues for technology and knowledge transfer. For this to occur effectively, appropriate policies need to be in place, both to enhance the absorptive capacity of SMEs and to encourage large enterprises to seek closer partnerships with SMEs.

While the government actively promoted SME-MNE linkages as a way to tap new and higher-end technologies for its domestic SME sector as far back as its Vendor Development Programme in the 1980s, a more holistic approach to SME promotion only took shape in the late 1990s. Since then, the government has developed and implemented programmes aimed at assisting SMEs to gain greater market access, improve their capacity and capability, and enhance their overall competitiveness. This is in recognition, that while on the one hand SMEs are the backbone of the economy, larger investors need a competitive supply base that SMEs can provide, often developed through clusters.

The government has launched the SME Master Plan, based on the following policy goals: *a*) enhancing the productivity of SMEs; *b*) increasing the rate of business formation; *c*) increasing the number of high growth SMEs; and *d*) increasing the rate of formalisation. The Master Plan aims to address the constraints in six focus areas (innovation and technology adoption; access to financing; human capital and entrepreneurship development; access to market; legal and regulatory environment; and infrastructure) through 32 initiatives, six of which are high impact programmes.

Malaysia has a clear definition for SMEs (Table 4.3), which facilitates the development of SME policy and targeted measures, such as access to finance, an area in which Malaysia scores highly in global rankings, such as the *Doing Business* indicators (World Bank, 2012).

In 2004, the National SME Development Council was established as the highest policy-making body to formulate sector-wide strategies for SME

Table 4.3. **Definition of SMEs in Malaysia**

	Micro-enterprise	Small enterprise	Medium enterprise
Manufacturing, manufacturing-related, agro-based industries	Sales turnover < RM 250 000 or < 5 full-time employees	Sales turnover between RM 250 000-RM 10 million or 5-49 full-time employees	Sales turnover between RM 10 million-RM 25 million or 50-149 full-time employees
Services, primary agriculture, ICT	Sales turnover < RM 200 000 or < 5 full-time employees	Sales turnover between RM 250k-RM 1 million or 5-19 full-time employees	Sales turnover between RM 1million-RM 5 million or 20-49 full-time employees

Source: SME Corp (2012).

development and to co-ordinate activities with related ministries and the private sector. Since 2009, SME Corp is the focal agency for information and advisory services for all SMEs in the country (SME Corp, 2012).

In Malaysia, SMEs have had affordable access to finance, partly as a result of policies implemented after the Asian crisis. For example, the interest rates for SMEs were below 5% from 1998-2005. Malaysia ranks top in the world in "getting credit" according to the *Doing Business* 2013 report (World Bank, 2012). SMEs are actively seeking more funding, as seen by the increased share of SMEs in total corporate lending by banks from 27% in 1998 to 40% in 2009. A recent development in this area is the SME Credit Bureau established in 2008 to provide creditors with information on SMEs (see Chapter 7 on Financial Sector Development) (UNCTAD, 2011). Bank Negara Malaysia also assists SMEs through strengthening the financial infrastructure, establishing financing/guarantee schemes, debt resolution mechanisms and continuous outreach and awareness programmes to disseminate relevant information to SMEs.

The Malaysian Industrial Development Finance Corporation, another agency under MITI, also manages nine SME financing schemes, and in 2005, the government created the SME Bank, offering standard banking and advisory services tailored to the needs of SMEs. Some financial institutions have also established a dedicated SME Unit to engage with SME customers. The role and function of the unit includes providing advice on financial management, identifying and structuring appropriate financial requirements and other ancillary services such as insurance protection for SMEs. At the same time some large companies provide recommendations to banks for their suppliers, many of which are SMEs, to access funding.

Malaysia has done well over the past decade, including after the onset of the financial crisis in 2008-09, to support SMEs in accessing credit, particularly by easing of the collateral requirements for manufacturing firms (World Bank, 2009). Nevertheless, there is room to foster the growth of private equity venture capital funds and capital market instruments to improve the capacity of SMEs to take on commercial risks. This is especially relevant for SMEs

seeking to expand and tap regional and global markets (NEAC, 2010). A great deal of attention is paid to SME financing, but this should not dilute the efforts to strengthen important non-financial support measures, especially related to vocational training.

In addition to broader government assistance for enterprise commercialisation (Box 4.4), industry start-ups in new growth sectors also receive specialised assistance. For example, the Malaysian Industry-Government Group for High Technology (MIGHT), a think tank under the purview of the Prime Minister's department, supports start-ups in high-technology sectors. MIGHT develops strategies for companies to grow during their first three years and it has been offering consulting services for companies in biotechnology, nanotechnology, and sensor technology.

Box 4.4. **Malaysia's public R&D&C programmes**

The government supports research, development and commercialisation (R&D&C) activities which act as a facilitator by providing funding across the value chain of R&D&C. To encourage companies to innovate by participating in R&D&C, the government provides funds under the 10th Malaysia Plan as follows:

Research & Development (R&D)

1. Cradle Fund – Ministry of Finance
2. Science Fund – Ministry of Science, Technology & Innovation
3. MSC Malaysia Research and Development Grant Scheme – Multimedia Development Corporation
4. R&D funds provided by the Ministry of Higher Education

Commercialisation

1. Pre-Commercialisation Fund
2. Technology Acquisition Fund – Malaysia Technology Development Corporation
3. Commercialisation of Research & Development Fund
4. Business Growth Fund
5. Biotechnology Commercialisation Fund – BiotechCorp
6. Soft Loan Scheme for Automation & Mechanisation – Malaysian Industrial Development Finance
7. Soft Loan Scheme for Services Sector – MIDF
8. Malaysia Micro Enterprise Programme – SME Corp
9. SME Financing – SME Corp
10. Venture Capital – MOF

Source: Ministry of International Trade and Industry (2012).

SME-MNE linkages policies and practices

Malaysia has a long tradition of public policy towards fostering supplier relations between its SMEs and MNEs. Early measures included ITAs for companies to contribute to local skills development through supporting the set up of vocational or technical training institutions. The second Master Plan launched special efforts towards linkage and cluster development. Special programmes exist to promote backward linkages, including tax incentives, specific institutional arrangements, and vendor development schemes (Giroud and Botelho, 2008).

The Vendor Development Programme (VDP) was introduced in 1988 to help *bumiputera*-owned SMEs develop into suppliers of quality industrial components, machinery and equipment to MNEs. It was most prominently associated with the national car project. The programme was then extended to the electronics industry and, by the mid-1990s, made available to all Malaysian companies, and remains one of Malaysia's most important linkages development measure. An example of its success is Proreka Sdn Bhd, which started operations under the programme in 2000 building prototypes and supplying small plastic automotive parts. It has since developed into a specialised car parts designer with RM 50 million sales in 2007 (UNCTAD, 2011).

Being one of the first linkages programmes, the VDP had limited success as the capacity of the selected SMEs manifested supply capacity weaknesses that were not addressed by the programme. Subsequent initiatives adjusted and learned from the VDP experience, such as by encouraging MNEs to engage more in capacity building for SMEs and supporting them in accessing finance, to being more involved in the SME selection process.

Among more recent core programmes is the Industrial Linkage Programme (ILP, see Box 4.5), created in 1996, under which both large buyers and small local vendors benefit from income tax reductions when they contribute to improving the production and service quality of local vendors. The ILP is accompanied by other initiatives, such as the umbrella strategy where a lead firm financially and technically supports the production of other firms. As of 2007, 906 SMEs were registered under the ILP, with 128 supplying to MNEs or large companies. The sectors vary, but one of the most recent successes of the ILP was the increased sourcing of global supermarket, such as Tesco, from local food processors.

Another way of supporting linkage creation is by training suppliers and potential suppliers according to MNE needs and standards. It is vital for such training measures to involve MNEs in curriculum development, a point that will be discussed further below when the issue of the skills mismatch in Malaysia is addressed. One programme that has applied this approach is the Global Supplier Programme, which in its first year alone trained 813 employees from 225 SMEs, guided by 23 MNEs. It is particularly effective in

Box 4.5. **The Industrial Linkage Programme (ILP)**

Objective:

To develop domestic SMEs into competitive manufacturers and suppliers to MNEs and large companies.

Activities:

Matching services supported by SME Corp's (former SMIDEC) financial and developmental programmes.

Incentives for SMEs:

Pioneer Status with 100% tax exemption on statutory income for 5 years and ITA of 60% on qualifying capital expenditure within a period of 5 years. To qualify for the incentives, SMEs must manufacture products or undertake services in the List of Promoted Activities and Products in an ILP. They should also be supplying to MNEs and large companies.

Incentives for MNEs:

MNEs can deduct from their income tax expenses incurred in developing SMEs through activities like training, product testing and development, auditing and other forms of technical assistance.

Source: SME Information and Advisory Centre and UNCTAD.

linking up with local institutions, such as the Penang Skills Development Centre (PSDC) described in more detail below (UNCTAD, 2011). Government linked companies also have a range of vendor development programmes.

Matchmaking and connecting investors with potential suppliers is another area that can contribute to linkages creation. investPenang keeps an elaborate database of Penang-based suppliers available online, and regularly organises "supplier days." (investPenang, 2012) MIDA and SME Corp have SME databases for foreign investors looking for local partners.

It should be noted though that many linkages initiatives occur outside the scope of public action. MNEs usually do their own due diligence, which includes local partner identification and may not contact MIDA or SME Corp for assistance. Also, many MNEs have their own supplier development programmes, such as Bosch's "Fit for Global Approach" programme (UNCTAD, 2010).

While MIDA, as the IPA, considers linkages and cluster formation in attracting investors, it could be more involved and solicited in linkages formation, especially since this is closely linked with some of its key functions. A stronger supply base for investors is an important factor in investment decision making. Also, targeting foreign investors that are prone

to upgrading their suppliers and that have established supplier development programmes could be a strategy for the agency to consider.

Cluster development

While many economies have opted for the establishment of Special Economic Zones or Export Processing Zones to attract investment, to promote linkages with local SMEs and hence develop local industries, several states, including Penang, Johor, and Klang Valley, have followed a more elaborate and comprehensive strategy of cluster development. While a zone-based strategy may be effective in attracting investors in the short-run by offering adequate infrastructure, services and incentives, such zones have often stagnated in terms of sustaining innovation and competitiveness, failing in technological upgrading and new firm creation. Economic activities within free trade zones, allowing for import and export cost reduction measures, have proven to have weak linkages with the rest of the economy.

Industry clusters are an integral part of Malaysia's industrial policy, as clearly stipulated in the three Industrial Master Plans. Dynamic clusters rely on the smooth interaction of a number of pillars, combining public policies and initiatives at the firm-level. In addition to being agglomerations of companies in a geographical area, clusters typically exhibit the following characteristics, critical for their generation of new technology, innovation, and firm creation:

- Strong role of government (federal or state) in promoting stability and basic infrastructure.
- An institutional environment that stimulates technological acquisition and transfer, including through high intellectual property rights standards.
- Global connectivity of clusters through value chains and markets.
- Competent intermediary organisations in place to promote the horizontal connectivity and co-ordination of economic agents.

While Penang hosts Malaysia's most developed technology cluster, particularly in the manufacturing of semiconductor-based electronic components – Penang exports 25 % of Malaysia's electric and electronics production (investPenang, 2012) – other industry clusters have emerged in Klang Valley, in the ICT and machinery sectors, and in Johor, in the furniture and palm oil industries. The latter has proven to be an attractive source of renewable energy and a cost-competitive alternative to crude oil (Ariff, 2007).

The only two microprocessor assembly and test plants in the country are located in Penang. The electronics cluster in Penang shares characteristics of a dynamic cluster. For example, basic infrastructure was improved rapidly through effective co-ordination between the state, through the Penang Development Corporation (PDC), and companies. This was illustrated by the

development of Penang's airport into a world class facility in 1979, which was partly attributed to good co-ordination between the Free Trade Zone Penang Companies Association and PDC (Rasiah, 2008). The state also has its own IPA, investPenang.

More recent effective public-private co-operation can be seen in the establishment of the Penang SME Centre and the Penang Science Council. The Centre, established in 2012 to act as an incubator for SMEs, is strongly supported by the Penang State Government, which provides rental subsidies to support SMEs to take advantage of the facility. It is the result of effective collaboration between the Penang Skills Development Corporation (PSDC), investPenang and the Penang Science Council.

Good systemic co-ordination resulted in close links and relationships between companies and institutions in Penang. Although the federal government aimed to promote closer government-industry co-operation through the second Industrial Master Plan, more effective complementary policies in Penang gave it an edge over other states with similar objectives (Rasiah, 2008). All computer and component firms in Penang are integrated in global markets, with companies not only exporting, but also participating in regional customisation and improving operations abroad, such as by providing technological support to companies in Thailand, Philippines and Indonesia and the states of Kedah, Perak and Klang Valley (Rasiah, 2008).

The geographical proximity of the companies, investPenang and other support agencies, such as the PSDC, all located in the Bayan Lepas industrial zone, have helped economic agents develop strong ties and networks. This has greatly facilitated the exchange of information and feedback circles, even informally.[2]

In Penang, public-private partnerships and other collaborative efforts have led to a number of spin-offs and to the creation of new enterprises by former employees of MNEs. Some prominent examples include Globetronics and Shintel, established by former Intel employees, and Loshta and BCM Electronics, set up by former Motorola employees (UNCTAD, 2010). Also, Malaysia saw the rise of Composite Technology Research Malaysia, from a small local company to a global player supplying Airbus and Boeing (The Prospect Group, 2012). Despite these success stories, participation in product research and development by local enterprises is generally low, even in Penang (Rasiah, 2008). To some extent, this illustrates weaknesses in local companies' capacity to contribute to cutting-edge technological innovation.

Skills shortages and mismatch

The quality of labour force skills is a crucial factor in overall economic competitiveness. Foreign investors need skilled labour to produce quality

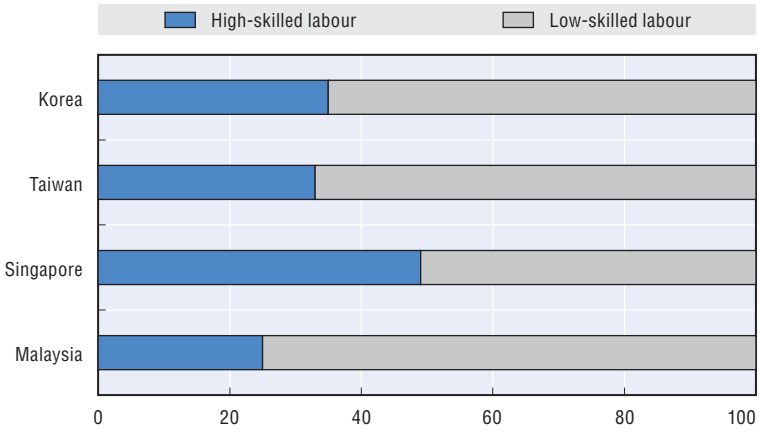
products and services, maintain a competitive supply chain and reduce costs linked to training and upgrading. While this Review will not address skills in depth, it nevertheless presents some findings in this area in the context of Malaysia's overall competitiveness as an investment destination.

The challenge of addressing the skills mismatch between industry demands and skills supply is a common issue for economies that have rapidly industrialised. It is also not uncommon in the OECD area. Some governments have tackled the issue by creating "demand-pull" in industry, such as through voucher programmes. The Netherlands for instance has developed a Knowledge Voucher Programme to encourage knowledge transfer from institutes of higher learning to SMEs (OECD, 2011a).

Malaysia's skills are lower than some of its regional competitors (Figure 4.4 below) (NEAC, 2010). Structural issues, such as the easy access to low-skilled migrant workers, have contributed to an over-reliance on low cost unskilled foreign labour, which has sustained the profitability of low value added businesses (OECD, 2011c).

Part of the challenge of improving the availability of skills in Malaysia is the emigration of qualified personnel. For example, Universiti Sains Malaysia and the University Kebangsaan Malaysia recently reported that 15% of their best 2010 graduates in medicine moved to Singapore, due to better salaries and working conditions. Between 1990 and 2000, there was a 41% increase in Malaysians with tertiary education migrating to OECD countries. Today there are some 350 000 Malaysian working abroad, half of them with a tertiary education (OECD, 2011b).

Figure 4.4. **Skill composition in Malaysia vs. regional competitors (%)**



Source: New Economic Model for Malaysia (2010).

The government recognises the need for better co-ordination between industry, educational and training institutions to address the mismatch between skills produced and industry requirements (New Strait Times, 2012). In order to speed up adjustments to meet business needs, the government has launched ambitious policies and encouraging local initiatives. For example, it has stepped up efforts to enhance co-operation between business and higher learning institutions to address skill shortages such as the Industrial Skills Enhancement Programme and the Graduate Employability Management Scheme.

Education and training managers have established local partnerships with the business sector in order to quickly identify new needs and deliver new courses. Malaysia has scored some impressive advances in this regard, such as through the PSDC (Box 4.4), which offers a wide variety of training for both member companies (from whom it receives fees) and the unemployed (through government grants) (OECD, 2011c). The result of a partnership between industry and government, the PSDC has had some positive results, including:

- building the calibre of the Penang talent pool;
- increasing the employment chances of unemployed recent graduates by narrowing the skills gap through training;
- increasing the labour pool for industry by providing affordable education and training to rural students; and
- providing vocational training for the less academically inclined students.

The PSDC business model can be applicable to developing countries facing rapid industrialisation and a workforce which is under-equipped to support the changing industrial needs. The underlying success factors are an industry-driven approach and government commitment. To date, PSDC has consulted for countries such as Madagascar, Bangladesh and Brazil through its affiliation with the World Bank and various other international consulting agencies.

One of the prime vehicles for achieving the government's Vision 2020 is through the country's human resources. In this respect the government has raised literacy levels to 100%, expanded enrolment at all levels and encouraged skills development in the workplace. This also reflects the government's drive to support a value-added approach to production by the development of a highly educated and skilled workforce, and to avoid a low wage, low skill route to development. However, recent assessments have shown that Malaysia faces skills shortages in knowledge-intensive sectors, which are seen as the pillars of its future economy (UNCTAD, 2010).

The government intends to raise skill levels using a number of policy options. It aims to continue to develop employability skills, especially in

Box 4.6. **The Penang Skills Development Centre (PSDC)**

The Penang Skills Development Centre (PSDC) was established in May 1989 as a not-for-profit training and development centre. At initial start-up, the PSDC received support from the Penang State Government in the form of subsidised rental of premises and an annual training grant for the centre. As it grew in relevance it attracted the attention of the federal government. Starting from 1993, the PSDC received capital grants to assist with its capacity building expenditure such as equipment and machinery. The PSDC invites membership from the manufacturing and related industries and to-date has a member base of 130 companies. With strong support from the government and industry, the PSDC undertook the facilitation of effective resource utilisation amongst the manufacturing and service industries.

The PSDC does not target any specific group and is accessible to all who wish to pursue lifelong learning. Its staple programmes such as those conducted on behalf of the government and the degree and diploma programmes offered under continuous education tend to attract: *i*) secondary school (high school) leavers; *ii*) unemployed graduates; and *iii*) the existing workforce which requires re-skilling and skills upgrading.

The success of the PSDC is also attributable to its tripartite business model which draws on the involvement of its three key stakeholders: industry, academia and government. The PSDC is managed and led by the industry and is supported by national academic bodies and the government.

Six government agencies were involved in launching the PSDC: *i*) the Ministry of Entrepreneur & Cooperative Development (has since then been dissolved); *ii*) SME Corp; *iii*) the Standard and Industrial Research Institute of Malaysia; *iv*) the Penang Regional Development Authority; *v*) the Penang Development Corporation; and *vi*) the Penang State Secretariat. These agencies represent the various interests of the government such as local enterprise development, research and development and both state and national level development initiatives. More importantly, their involvement in the PSDC council enables the PSDC to understand the policy directions of the government and therefore, to implement and introduce new human resource development initiatives which complement national policies.

Source: OECD, LEED Programme.

relation to investments in high quality technical and vocational skills, in line with its New Economic Model proposal to "increase emphasis on reintroducing technical and vocational training…" (NEAC, 2010). The significance of these skills relates to their important role in attracting foreign investment, enabling the country to continue moving up the value chain. In addressing this need there has been a shift towards employers taking a greater

responsibility for training via a levy system and for individuals to take greater responsibility for their own continuing and professional development. As a consequence this has resulted in Malaysia adopting a much more market-oriented and stakeholder-driven approach to skills development.

Progress in legislation, such as the *National Skills Development Act* in 2006, has led to over 1 000 public accredited private and public training centres in the country. The government also developed the National Occupational Skills Standard, which stipulates the required competency level expected of a skilled employee who is employed in Malaysia in a specific trade. It also defines the level of employment and the path required to achieve the stated competency level. Moreover, it is important to note that all programmes fit the country's National Qualification Framework (Table 4.4).

Table 4.4. **Malaysia's National Qualification Framework**

The Malaysian NQF	
SKM 1 -	Level 1 (Basic certificate/semiskilled)
SKM 2 -	Level 2 (Intermediate certificate/skilled)
SKM 3 -	Level 3 (Advanced certificate/advanced skill level)
SKM 4 -	Level 4 (Diploma/supervisor level)
SKM 5 -	Level 5 (Advanced Diploma/manager level)
Level 6 -	Bachelors Degree
Level 7 -	Masters Degree
Level 8 -	Doctoral Degree

Source: OECD (2011), *Higher Education in Regional and City Development: State of Penang, Malaysia, http://dx.doi.org/10.1787/9789264089457-en.*

A key mechanism to encourage employer involvement in training is the Human Resources Development Fund set up in 1993. Under the Pembangunan Sumber Manusia Berhad Act, 2001, specified groups of employers from services and manufacturing sectors are required to pay a levy of 1% of their monthly payroll into it. When they have paid into the fund for six months the employer can claim a reimbursement or a training grant, resulting in an increase in training. This scheme enjoys support among the investor community for its effectiveness. In spearheading skills training more towards skills upgrading or up-skilling, the employers can claim for HRDF financial assistance up to 110% of their levies contribution effective 1st January 2013 (EPU, 2013).

Another important vehicle for skills development is the country's apprenticeship system. A National Dual Training System was established in 2004, based on the German system, with around 70% of the training provided on-the-job and 30% off-the-job in a training institution.

The Malaysian model offers a number of good practices, but it also faces a number of significant challenges. Government policy has been pro-active and skills are used as vehicle to help the economy move up the value chain. Within the sphere of public policies to promote skills, the emphasis appears to be shifting towards a market-based and stakeholder-driven system. A major challenge facing the government is the need to ensure that all skill programmes continue to meet the changing demands of the labour market. Improvements could include closer industry-institute of higher learning collaboration on R&D and curriculum development. This can contribute to closer alignment of training provision and industry demands. Malaysia's efforts in replicating the PSDC concept in other parts of the country, such as in the Selangor Human Resources Development Centre for Kedah, are a good step towards addressing this challenge.

MIGHT, mentioned earlier for its services for start-ups, can offer a good platform for industry-government exchanges, especially in new growth areas like the aerospace industry. The group also co-manages, together with the New York Academy of Sciences, the Global Science and Innovation Advisory Council, formed by the Prime Minister in 2011 to bring forward initiatives in the area of education, ICT applications, and green technology solutions (The Prospect Group, 2012).

To support the effectiveness of this triple helix type of co-operation (government, training institutions, industry), training institutions and universities need to be have greater flexibility in curriculum development. This remains a challenge in Malaysia, where the education policy is a federal matter with the states having little responsibility over higher education (OECD, 2011a). While such an approach promotes uniformity in a system, it hinders adaption to needs which may be specific to regions. Some universities, such as Universiti Sains Malaysia have achieved Apex status, which does allow them some more freedom in developing courses, such as in the form of specialised electives, but these are only incipient efforts to tackle the challenge of skills mismatch.

At the same time, there is a proliferation of private institutions that compete with the more established public institutions. While, in principle, such competition is good as it should ultimately lead to greater flexibility and more choices for students, there is a risk of some students choosing second tier routes through institutions that can offer certain training privately without these services having been publicly sanctioned. Such a situation can be redressed through a unified regulatory education system, which oversees the standards of both public and private institutions. The Malaysian Qualification Agency under the Ministry of Higher Education, responsible for governing the quality of public and private higher education institutes, carries

out ratings of higher education institutions in order to improve the quality of institutes of higher learning (OECD, 2011b and BNM).

Also, the government could reflect on some innovative models to attract advanced foreign expertise to help upgrade management and production processes where needed, closely involving the immigration department and MIDA's immigration unit. This should include efforts to attract high-skilled Malaysians from the diaspora; the Talent Corp initiative has generated some positive feedback in that regard. The government should also consider attracting skills from the mostly untapped regional talent pool from neighbouring countries. These talents would bring some cultural familiarity while being a cost-effective alternative to supplementing the locally available skills (PSDC, 2012).

In addition, SMEs find it harder to hire the skilled labour they need for their R&D activity since graduates and skilled professionals tend to join MNEs due to their reputation and higher salaries. Balancing the demands of MNEs and SMEs for skilled labour, which is one of the keys to moving up the value chain in terms of economic activities for Malaysia, needs to be addressed. This should be done partly by consulting existing industry players on the anticipated impact of new investment, especially FDI, on the current skills and manpower requirements (PSDC, 2012).

According to some investors, the command of English has also been deteriorating in Malaysia, and some MNEs provide English language training for their staff. Addressing these language shortages is critical. This becomes especially relevant if Malaysia aims to strengthen its position as a regional hub for distribution and management, and becoming a host to regional headquarters of major MNEs, along the lines of its operational headquarters, international production centres, and regional distribution centres strategies.

Investors have been urging the government, on the one hand, to improve the science education in Malaysia to equip the labour force with a sound knowledge of the fundamentals that companies can then tailor into more specific expertise, and, on the other, to improve technical education and vocational training. The government should thus be encouraged to turn its awareness of the gap between its vision for an innovation-driven Malaysian economy and its current skills framework into ambitious reforms. Steps to improve performance in education and technological capacity are challenging to implement, yet they are pressing – Malaysia ranks a low 51st in technological readiness according to the World Economic Forum's *Global Competitiveness Report*, in sharp contrast with other areas of competitiveness (WEF, 2012). The National Education Blueprint 2013-15 with its reform strategies for the country's education system aims to address these challenges.

Malaysia's international initiatives to build investment promotion expertise

Malaysia actively participates in capacity building programmes organised by the World Bank and other inter-governmental organisations such as ASEAN, APEC, OIC, OECD and UNCTAD. Through this collaboration, MIDA conducts at least two capacity building programmes every year: Familiarisation Programme for Officials of Investment Promotion Agencies of the South-South Countries and Familiarisation Programme for Officials of Investment Promotion Agencies of the Organisation of Islamic Countries (OIC) member countries which are aimed at sharing information and experience between IPAs in promoting and co-ordinating industrial development issues.

Malaysia has benefited from information exchange networks through the sharing of best practices. For example, MIDA is a member of World Association of Investment Promotion Agencies which provides the opportunity for IPAs to network and exchange best practices on investment promotion.

Notes

1. Company interviews, Penang, June 2012.
2. Company interviews, Penang, June 2012.

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Chapter 5

Corporate governance

The degree to which corporations observe basic principles of sound corporate governance helps to determine investment decisions, influencing the confidence of investors, the cost of capital, the overall functioning of financial markets and ultimately the development of more sustainable sources of financing.

Malaysia has taken significant steps to strengthen its corporate governance framework, especially after the Asian financial crisis. This chapter analyses some of the government's far-reaching reforms ranging from strengthening minority shareholder rights to enhanced enforcement measures. The role of government-linked companies (GLCs) and the associated GLC Transformation Programme as part of the government's overall drive to increase competition and opportunities for private investment is also addressed. Given the recent momentum of corporate governance reforms, Malaysia and its private sector could now benefit from consolidation of the various initiatives.

Corporate governance reform is an important aspect of broader reforms aimed at securing an environment attractive to both domestic and foreign investors and that enhances the benefits of investment to society. The degree to which corporations observe basic principles of good corporate governance is an increasingly important factor for investment decisions. By improving disclosure and transparency, corporate governance helps channel capital to those firms with the most profitable opportunities, thus improving the allocation of capital within the economy. It also gives greater confidence to all investors, small and large, domestic and foreign, that their rights will be protected, thus potentially increasing the supply of capital available.

The government has made significant reforms in the area of corporate governance since the Asian financial crisis of 1997-1998. The weaknesses of the regulatory frameworks for business and finance are often pointed to as key contributors to the crisis (World Bank, 2000). In response, the government created the High Level Finance Committee which prepared a report in 1999, launched the Malaysian Corporate Governance Code and created the Minority Shareholders Watchdog Group (MSWG), both in 2000. Their main objective was to rectify and strengthen weak legal and regulatory frameworks, particularly for smaller shareholders and businesses, who suffered hard from the Asian crisis.

Since this initial reform wave, the government has kept up momentum, including preparing the Capital Market Master Plans (CMP1 in 2001 and CMP2 in 2011) (see Chapter on Financial sector development), revising the Code of Corporate Governance in 2007, and issuing the Corporate Governance Blueprint 2011, which outlines strategic initiatives aimed at reinforcing self- and market discipline, and most recently, the Malaysian Code on Corporate Governance 2012 (MCCG, 2012). As of May 2012, Malaysia's stock market capitalisation stood at RM 1 320 billion with a total of 929 listed companies, more than in its ASEAN peers (SCM, 2012 and OECD, 2011).

Especially interesting is the country's framework for its state-owned enterprises or government-linked companies (GLCs) as they are generally referred to in Malaysia. GLCs are subject to high standards of governance, notably since the crisis. In that respect the GLC Transformation Programme launched in 2005 is showing results in terms of raising the governance standards in GLCs.

Malaysia's progress in strengthening its corporate governance framework is recognised internationally. The World Bank's Corporate Governance *Report on the Observance of Standards and Codes* (CG ROSC), which draws on the OECD *Principles of Corporate Governance*, awarded the highest score to Malaysia in 2006 for its compliance with International Financial Reporting Standards (SCM, 2011). Malaysia has recently also received strong ratings from the World Bank CG ROSC 2012: out of the six OECD principles, Malaysia scored highest in terms of equitable treatment of stakeholders, enforcement and institutional framework, as well as disclosure and transparency.

The government nevertheless needs to tackle a number of challenges to be able to benefit fully from its corporate governance related reforms. While the framework aims to promote greater internalisation of the culture of good governance, the practice of box ticking continues to persist, as well as a corporate tendency to stick to minimum requirements. The government's role in facilitating shareholder participation and protection also needs to be stepped up, such as through public awareness campaigns. Also, efforts underway to improve GLC governance and to expose GLCs to open competition with the private sector on a level-playing field need to be maintained, given the important role GLCs play in the economy. These need to be considered in an overall competition policy framework to increase private sector participation in the economy, which is a government priority.

Main features of Malaysia's corporate governance framework

Asia today is, in terms of corporate governance, almost unrecognisable from the Asia of 1997. The 1997 Asian financial crisis led many Asian countries to reform financial and corporate institutions. One key facet of this structural change was corporate governance reform. Indeed, since the crisis many countries in Asia have enhanced and transformed their corporate governance systems, resulting often in stronger regulation, better resourced regulators, new institutions and an increasingly involved shareholder base. Malaysia has undertaken a great deal of reforms in these areas.

The government has promoted a more coherent and consistent regulatory framework with both self-regulation and statutory provisions. Figure 5.1 highlights some of the major corporate governance milestones in Malaysia since 1999. Furthermore, various measures have been taken by regulators to ensure that the existing corporate governance framework continues to promote overall economic performance and transparent and efficient markets. Table 5.1 contains the major laws and regulations that make up the corporate governance framework and shape practices in Malaysia.

The Securities Commission Malaysia issued the Corporate Governance Blueprint in July 2011, which represents one of the first deliverables of CMP2

Table 5.1. **Major laws and regulations affecting corporate governance**

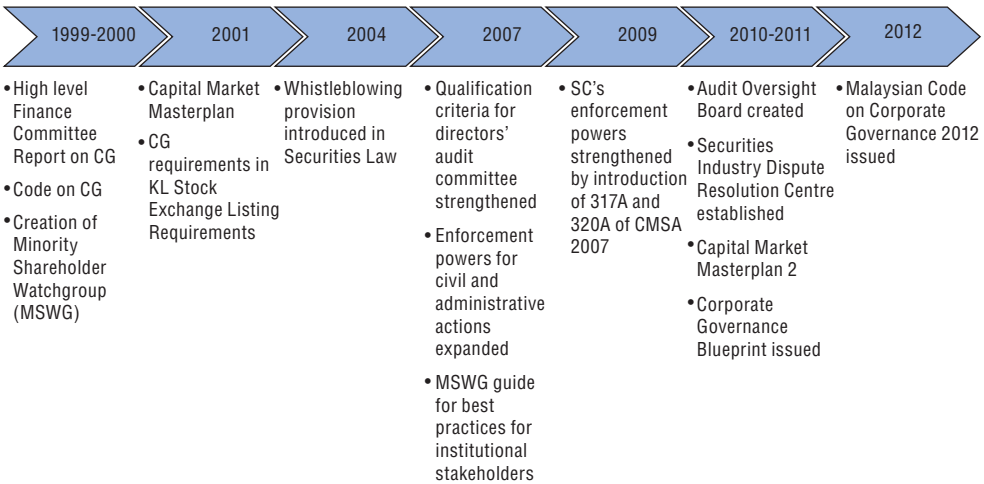
The Companies Act 1965 and amendments in 2007 (*www.ssm.com.my*)
Banking and Financial Institutions Act 1989 (*www.bnm.gov.my*)
Development Financial Institutions Act 2002 (Act 618) (*www.bnm.gov.my*)
The Financial Reporting Act of 1997(*www.masb.org.my*)
The Bursa Malaysia Listing Requirements (*www.bursamalaysia.com*)
Securities Commission Act 1993. This legislation covers all amendments made including the most recent Securities Commission Amendment Act 2010
Capital Markets and Services Act 2007 (*www.sc.com*)
Malaysian Code on Corporate Governance released in 2012 (SCM)

Source: OECD (2011), *Reform Priorities in Asia: Taking Corporate Governance to a Higher Level*, Paris. and Securities Commission of Malaysia (2012).

and uses the OECD *Principles of Corporate Governance* as a reference, as well as priorities agreed by the OECD-Asian Roundtable on Corporate Governance. The Blueprint is an affirmation of the Commission's commitment to achieve excellence in corporate governance through strengthening self- and market discipline and promoting the internalisation of a good corporate governance culture. Boards and shareholders are encouraged to embrace the idea that good business includes ethical and sustainable behaviour, going beyond the desired financial bottom line (SCM, 2012).

While the Code of Corporate Governance in 2001 was a significant step in establishing a more appropriate regulatory framework, its revision in 2007 went further to improve self-regulation by strengthening the roles and responsibilities of the board of directors, particularly independent directors

Figure 5.1. **Corporate governance reform timeline in Malaysia (1999-2012)**



and the audit committee. Whistle-blowing provisions were also introduced in 2004. Since 2007, Malaysia requires auditors who resign or are removed from office to disclose to the regulators the reasons, except in cases where the auditor does not wish to seek re-appointment or is not re-elected at the annual general meeting (OECD, 2011).

The Malaysian Code on Corporate Governance released in March 2012 supersedes the revised Malaysian Code on Corporate Governance. The new Code, which follows international best practices, is a key deliverable of the Blueprint and is aimed at enhancing board effectiveness through strengthening board composition, reinforcing the independence of directors and fostering the commitment of directors. It also encourages companies to put in place corporate disclosure policies that embody principles of good disclosure. Companies are also encouraged to make public their commitment to respect shareholder rights (SCM, 2012).

In addition to the 2012 Code, a number of regulations that frame corporate governance in Malaysia, including the *Companies Act* (1965), the *Securities Commission Act* (1993), and the *Capital Markets and Services Act* (CMSA, 2007). The texts, as well as their recent updates and applications, are presented in more detail below.

The Companies Act (1965)

Corporate law in Malaysia is primarily set out in the *Companies Act* (1965) which is based on the UK *Companies Act* (1948) and the Australian *Uniform Companies Act* (1961) and which incorporates the following provisions:

- functions and powers of the board;
- duty and liability of directors and officers;
- meetings and members' rights at meetings; and
- regulation of related-party transactions.

In 2007, the Act was amended so as to:

- clarify directors' duties;
- strengthen as well as clarify regulation of related party transactions;
- enable shareholders to take derivative action;
- allow the use of technology to facilitate members meetings in more than one venue;
- extend notice duration of AGMs. Now, a minimum of 21 days of prior notice must be given by a public company before it convenes its AGM;
- enhance auditor's duty by imposing a statutory obligation on auditors of public companies or companies controlled by a public company to report to the Registrar, should they become aware of a serious offence committed

involving fraud or dishonesty against the company when carrying out their duties as auditor; and

- provide statutory protection to whistleblowers.

Securities Commission Act (SCA – 1993)

The *Securities Commission Act* 1993 was amended by the *Securities Commission Amendment Act* 2010 which established an Audit Oversight Board. The Commission, through the Board, provides independent oversight and regulation over external auditors of public interest entities to improve compliance with auditing standards. In this regard, the Board is responsible for registering individuals and firms who wish to audit the financial statements of such entities. The Board also takes enforcement action against registered auditors for non-compliance with auditing and ethical standards. The Board can impose sanctions of up to RM 500 000 and can suspend registrations. It began operations on 1 April 2010. On 28 February 2011, the Auditor Registration Application System was launched, allowing auditors to submit applications for registrations electronically. This aims to make registration more efficient while easing the creation of a database for the benefit of the Board and auditors.

The Capital Markets and Services Act (CMSA – 2007)

In 2007, the government streamlined the corporate governance framework by consolidating several laws, namely the *Securities Industry Act*, *Futures Industry Act* and Part IV of the *Securities Commission Act,* into a single legislation: the *Capital Markets and Services Act* (CMSA). It also incorporates several new provisions that enhance corporate governance standards, such as by giving the Securities Commission the right to intervene where interest is prejudiced and by enhancing its ability to take civil action for market misconduct offences for both securities and futures contracts. Previously, the Securities Commission could only take civil action for offences relating to securities and not for futures contracts. The Commission can now also bar unfit persons from becoming a CEO or director of a public company.

Bursa Malaysia has also issued a new set of listing requirements for its Main Market and ACE Market (Bursa Malaysia's secondary market, short for "Access, Certainty, Efficiency"). These new listing requirements came into effect on 3 August 2009. The Main Market replaces the first and second board of Bursa whilst the ACE market replaces the MESDAQ Market. The listing requirements oblige listed companies to disclose material information to the market in a timely manner and to comply with the requirements pertaining to related party transactions and to corporate governance. On the latter,

Malaysia, together with Hong Kong (China), Singapore, Pakistan and Chinese Taipei, is one of the few Asian countries with such a requirement (OECD, 2011).

The board of a listed issuer is also required to provide a statement in the annual report on how it has applied the best practices set out in the Corporate Governance Code. In case of non-compliance with the Code, the statement must identify the areas and reasons for the non-compliance.

Enforcement

A number of agencies are in charge of enforcing different aspects of corporate governance in Malaysia (Table 5.2). Co-ordination has been addressed through both formal and informal mechanisms, e.g. joint investigations, sharing of findings and joint charges (SCM, 2011). A series of reforms to improve enforcement have been introduced over recent years, including the establishment of the Oversight Board mentioned above. Also, the SCM was allowed to pursue civil action and its powers were enhanced in 2010 to be able to prosecute company directors and officers for causing wrongful losses to the company.

There continue to be some constraints, however, with regards to the capacity of public agencies to effectively enforce Malaysia's corporate governance standards. The Securities Commission in its *Corporate Governance Blueprint* recommended that private sector initiatives be explored further and that related funding issues be addressed (SCM, 2011).

Table 5.2. **Corporate governance enforcing agencies in Malaysia**

Laws/Regulations	Enforcing Agency
Capital Markets and Services Act	Securities Commission Malaysia
Companies Act	Companies Commission of Malaysia
Banking & Financial Institutions Act	Bank Negara Malaysia
Penal Code	Police
Malaysian Anti-Corruption Act	Malaysian Anti-Corruption Commission
Bursa Listing Requirements	Bursa Malaysia

Voluntary corporate governance initiatives and training

Despite some shortcomings in corporate reporting that will be highlighted below, many companies are adopting standards and best practices beyond the minimum imposed by the law. This is evident from the Securities Commission's own findings, as well from the MSWG's *Corporate Governance Index* reports. The challenge lies in encouraging more companies to follow suit. In view of promoting and developing an ethical and healthy corporate culture, various corporate governance awards have been given, including the *National Annual Corporate Report Awards* and the Malaysian *Corporate Governance Index* Award.

It is hoped that these awards will incentivise more listed companies to go beyond the minimum compliance in form.

Various organisations have been established to promote a good corporate governance culture, such as the MSWG (mentioned above) and its *CG Index* and the Malaysian Investor Relations Association, which was established in June 2007 by the Stock Exchange of Malaysia and the Capital Market Development Fund. It is the first and only professional association for investor relations in Malaysia. Its membership comprises public-listed companies, investment banks, brokerages and intermediaries and investor relation service providers. Its objectives and functions include supporting members through seminars, workshops and policy briefs; conducting education and training programmes to raise the levels of investor relations in Malaysia; and "hand holding" companies who are keen on establishing an investor relation function and programme.

The Association offers an incentive programme to help public-listed companies to set up investor relations programmes internally. It has also hosted Investor Expo briefings and produced an Investor Relations Manual & Workbook to guide public-listed companies on principles and management of investor relations.

In Malaysia, directors' training is required where the individual is appointed as a director of a listed issuer for the first time or is a director of a company that is seeking listing on the exchange. In its efforts to improve the effectiveness and capacity of the boards of its GLCs, the government launched a number of initiatives, leading i.a. to the establishment of the Directors Academy in Malaysia (Box 5.1) (OECD, 2010).

Malaysia has several programmes focusing on continuing education for directors. On June 2009, Bursa Malaysia issued the *Corporate Governance Guide: Towards Boardroom Excellence* and collaborated with several organisations such as the Malaysian Institute of Accountants, the Institute of Internal Auditors and the Malaysian Institute of Corporate Governance to hold training programmes for directors. The Companies Commission of Malaysia also organises training programmes specifically for non-listed directors. In 2009, the Malaysian Alliance of Corporate Directors was established by directors to provide education, information and networking opportunities for corporate directors.

Other voluntary initiatives to promote good corporate governance include the Bursa/SCM CG week, during which participants are exposed to various corporate governance initiatives and are able to network with corporate governance practitioners. Bursa Malaysia also released its CG Guide and established a CG department to work with public-listed companies to raise corporate governance standards.

Box 5.1. **The Malaysian Directors Academy**

One of the main policy thrusts of the GLC Transformation Programme (see below) is the need to upgrade the effectiveness of GLC Boards through learning. This led to the establishment of the Malaysian Directors Academy to address board performance by equipping directors of GLCs with world class knowledge, skills and a mindset to perform to a consistently high standard. To be an effective director, a number of performance criteria are critical, including understanding the boundaries between the board and management, and active problem solving with both the board and key management on strategic issues, whilst leveraging networks and managing multiple stakeholders proactively.

For new and potential directors, the transition from a management role to a director's role has to be addressed in a holistic manner. With the evolving strategic, operational and geographic priorities of many GLCs, directors with deep commercial, functional, geographical or relevant industry skills, knowledge and experience are required.

The Academy seeks to address this by delivering four integrated functions in a distinctive way, namely: facilitate sharing of learning through forums, linkages and databases of best practices to build directors' capabilities; research and develop Malaysian-related case studies to assist directors in building knowledge on how to handle specific situations; arrange "on-the-job" learning and coaching which will be customised to an individual director's needs; and enhance existing training and development programmes to meet the needs of directors.

The Academy recognises the different types of directors and the complexities of their roles and relationships: learning interventions cater to the differing roles and issues relevant to each category. The Academy seeks to provide world-class programmes. To achieve this, it will collaborate with leading international institutions that specialise in designing and deploying programmes at Director's level, including the International Institute for Management Development based in Lausanne, Switzerland. It is also in discussions currently with other local and international institutions to identify potential areas for collaboration.

Source: OECD (2010), *Policy Brief on State-Owned Enterprises in Asia – Recommendations for Reform.*

Malaysia and the OECD Principles of Corporate Governance

Malaysia has undergone a voluntary assessment by the World Bank, i.e. the Report on Standards and Codes (ROSC) in 2005, based on the OECD *Principles of Corporate Governance*. Malaysia has also been an active participant in the OECD Asian Corporate Governance Roundtable, most recently in

October 2012 in Tokyo. The Roundtable report *Reform Priorities in Asia: Taking Corporate Governance to a Higher Level* includes the Securities Commission's responses to an OECD questionnaire on corporate governance development and progress in Asia which served as a useful stock-taking exercise on how Malaysia and other Asian economies have implemented the OECD *Principles of Corporate Governance*.

Other regional initiatives can also contribute to raising corporate governance standards at company level in Malaysia. A pilot programme of an ASEAN Corporate Governance Scorecard, based on the OECD *Principles of Corporate Governance*, was launched in 2012 to rank the top 30 public companies in participating ASEAN member economies: Malaysia, Indonesia, Philippines, Singapore, Thailand and Viet Nam (SCM, 2012).

Shareholder rights in Malaysia

Framework to ensure equitable treatment of shareholders

In order for investors to buy shares, they need to be confident that their property rights are properly recognised and protected. The ownership structure has important implications for the corporate governance framework. In many economies, major shareholders control most companies, in some cases through differential voting rights or complex ownership and control structures that allow them to maintain control with relatively little equity. In other cases, ownership is controlled by the state, raising additional governance challenges, as will be seen below.

Controlling shareholders have strong incentives to monitor closely the company and its management and can have a positive impact on the governance of the company, but their interests may also conflict with the interest of minority shareholders. This conflict is most destructive when the controlling shareholders extract private benefits at the expense of minority shareholders. The OECD *Principles* provide that "[t]he rights of stakeholders that are established by law or through mutual agreements are to be respected." Companies should raise awareness of stakeholders' legally protected rights and should translate this awareness into everyday actions.

The effectiveness of minority shareholders' rights form part of the framework for attracting foreign investors, especially if this investment is promoted through joint ventures with local partners. This is of particular relevance in Malaysia, where, in some sectors (see Chapter 2 on investment policy), foreign participation in domestic companies is restricted to a minority share.

Various provisions in the *Companies Act* of Malaysia ensure that shareholders are treated fairly and equitably and are able to exercise their rights. These include the right:

- to requisition general meetings;
- to attend, vote and speak at general meetings;
- to appoint a proxy to attend, vote and speak on behalf of the shareholder at general meetings;
- to put forward any resolution e.g. appointment and removal of directors when a certain threshold is reached;
- of members to give their approval for disposal by directors of a company's undertaking or property;
- for shareholders to demand poll voting, especially for certain types of resolutions such as related party transactions and remuneration of directors; and
- of members to give their approval for related-party transactions.

Moving forward, the Securities Commission recognises that there are other areas that can be further improved, such as proxy and poll voting. As of 3 January 2012, Bursa Listing Requirements (provision 7.21 A) allow a member to appoint any person as a proxy to attend and vote at the meeting. There is no restriction as to the qualification of the proxy. The Commission chairs the Working Group C of the Corporate Law Reform Committee that has reviewed the general meeting provisions in the *Companies Act* and has made various recommendations (Box 5.2) to reform the law on general meetings.

Furthermore, with a view to enhancing the corporate governance framework, the Securities Commission recently announced the establishment of a Corporate Governance Consultative Committee which will provide strategic direction, views and advice in the development of a new five-year Corporate Governance Blueprint outlining an action plan to further raise the standards of corporate governance in Malaysia. The Committee is chaired by the Chairman of the Securities Commission and comprises 11 senior industry participants and experienced professionals from Malaysia and abroad. The new blueprint aims to be comprehensive and forward-looking, covering strategic priorities to further enhance Malaysia's corporate governance standards and identity. In this regard, treating shareholders equitably and enhancing shareholders' participation in the decision-making process feature particularly high on the committee's agenda.

The blueprint was released in July 2011, containing 35 recommendations to be implemented over a five-year period. In developing the blueprint, according to the government, extensive research and international benchmarking, such as the OECD *Principles of Corporate Governance*, were

Box 5.2. **Recommendations for reform of the Companies Act by the Corporate Law Reform Committee**

- The act should allow for other modes of communications (apart from the requirement that notices of meetings should be given personally or be sent by post to shareholders) if shareholders agree;
- Section 149(1)(b) of the act which currently provides that only qualified persons such as an advocate, an approved company auditor or persons approved by the Registrar may be appointed as a proxy be deleted;
- the act should be amended to facilitate direct absentee voting/postal voting/electronic voting; and
- Section 149 which currently provides that proxies can only vote by way of a poll be amended to allow proxies to vote by a show of hands, but where a member appoints more than one proxy, the proxies should not be allowed to vote by a show of hands.

Some of these reforms have already been implemented, such as enabling the use of technology to facilitate the holding of general meeting in more than one venue.

Source: Securities Commission of Malaysia (2011).

undertaken to ensure that the recommendations are sufficiently robust to bring about positive changes to the Malaysian corporate governance landscape. The reasonableness, efficacy and validity of the recommendations discussed with both local and international stakeholders.

Procedures and institutional structures to protect shareholder rights

Although there are no specific bodies in Malaysia to mitigate or arbitrate disputes related to corporate governance, the Kuala Lumpur Regional Centre for Arbitration does arbitrate and deal with any disputes arising out of contracts, provided that there is an arbitration clause in the contract. This could include corporate governance matters (OECD, 2011) (see also Chapter 3). There are also four Sessions Courts in Malaysia dealing with commercial and capital market-related cases. In September 2009, the High Court set up two new commercial courts dedicated to hearing commercial cases in banking, finance and insurance. The Securities Industry Dispute Resolution Centre was also established in 2011 to facilitate small claims resolutions by investors (Bursa Malaysia, 2011).

Beyond the courts and other bodies, Malaysia disposes of various legal remedies that can be sought by shareholders when their rights are violated, including the right to sue the company. These remedies include:

i) Right provided under the Memorandum and Articles of Association

Where a right provided for under the company's Memorandum and Articles of Association is breached, the shareholder can sue the company by virtue of breach of contract.

ii) Statutory Derivative Action

Where a wrong is committed by a company, but the company is controlled by the wrongdoer, the shareholder may bring an action on behalf of the company, by initiating a statutory derivative action.

Essentially, these provisions allow a shareholder to bring, intervene in, or defend an action on behalf of the company notwithstanding that the matter before the court is ratified by the company and leave of the court is obtained. The provisions provide that the court in granting leave will take into consideration that the complainant is acting in good faith; and it appears *prima facie* to be in the best interest of the company that the application for leave be granted.

iii) Oppression Remedy under the Companies Act

Where the affairs of the company or the powers of the directors are considered to reflect unfair prejudice against a shareholder, the aggrieved shareholder can seek a remedy for oppression or unfair prejudice. The court has wide discretionary powers as to the type of remedial order it can make, including winding up the company. Other orders that the court may make include:

- directing or prohibiting any act or cancelling or varying any transaction or resolution;
- regulating the conduct of the affairs of the company in the future;
- providing for the purchase of the shares or debentures of the company by other members or holders of debentures of the company or by the company itself; and
- in the case of a purchase of shares by the company, providing for a reduction accordingly of the company's capital.

iv) Injunction

The *Companies Act* also provides that, where a person contravenes the act or attempts to do so, the Registrar or any person whose interest is affected by the contravention, may apply to the court to restrain the conduct of the first mentioned person.

The government has also implemented measures to monitor and prevent corporate insiders and controlling owners from extracting private benefits.

The *Companies Act* clearly states that a director of a company must act in the best interest of his company. Therefore, where a director furthers personal interests at the expense of the company, it is considered a breach of duty to the company. This obligation lists the situations where a director is said not to have acted in the best interest of the company, including:

- using the property of the company;
- using any information acquired by virtue of his position as a director or officer of the company;
- using his position as a director or officer;
- using any opportunity of the company; or
- engaging in business which is in competition with the company to gain directly or indirectly, a benefit for himself or any other person, or cause detriment to the company, without the consent of a general meeting.

v) Provisions pertaining to insider trading

Where any person, including a director who is in possession of price sensitive information, uses that information to buy and sell securities, that person can be convicted for the offence of insider trading under the CMSA, punishable by imprisonment for a term not exceeding 10 years and a fine of not less than RM 1 million. Any person who suffers loss or damage by relying on the conduct of a person who has breached these provisions is allowed to recover the amount of loss or damages by instituting civil proceedings. The Securities Commission may take a civil action against an insider or other person involved in the contravention.

Asian jurisdictions continue to experiment with introducing specialised courts and other mechanisms to strengthen enforcement. Malaysia has created new bodies within existing institutions focusing on strengthening enforcement capacity. For example, the government has set up an enforcement division in its stock exchange (OECD, 2011).

As mentioned above, the government has put in place various procedures to ensure that shareholders have the ability significantly to influence the company in both the *Companies Act* 1965 and the Bursa Listing Requirements. Amendments to the company's memorandum and articles of association require that the proposed amendments be passed by a ¾ majority of shareholders who have attended and voted at that meeting. Various measures could nevertheless be considered in order to increase the influence of shareholders on companies in Malaysia, such as by encouraging electronic voting which can promote shareholder participation in general meetings and can address some traditional problems associated with proxy voting, such as

proxy votes not being counted. The establishment of a credible electronic voting platform could be considered.

More generally, companies should be encouraged to show greater commitment to shareholder rights. Making information on shareholder rights publicly available can be effective in that regard, including by posting information on company websites and organising awareness campaigns. These manifest a commitment by companies to respect shareholder rights, while increasing the awareness of shareholders of their rights in a transparent manner.

The Malaysian Minority Shareholder Watchdog Group (MSWG) has been pivotal in providing a platform for collective shareholder activism on unethical or questionable practices by the management of public listed companies (Box 5.3). Such groups can be valuable in contributing to transparency and hence attractiveness of the investment climate.

Box 5.3. **The role of the Minority Shareholder Watchdog Group in Malaysia**

The Minority Shareholder Watchdog Group was established in 2000, sponsored by the capital markets regulator to enhance shareholder activism and to protect minority interests. Its mission is to help develop knowledgeable and active minority shareholders.

The Watchdog's more concrete objectives are to:

- become the forum on minority shareholders' experiences in the context of the Malaysian Code on Corporate Governance and the Securities Commission's Disclosure Based Regime and the Capital Market Master Plan;
- become the think-tank and resource centre for minority interest and corporate governance matters in Malaysia;
- develop and disseminate the educational aspects of corporate governance;
- become the platform for collective shareholder activism on unethical or questionable practices by management of public listed companies;
- influence the decision-making process in public listed companies as the leader for minority shareholders' legitimate rights and interests;
- monitor breaches and non-compliance in corporate governance practices by public listed companies; and
- report to regulatory authorities on activities against the interests of minority shareholders.

Each year, the MSWG publishes a Company Meeting Survey, a Dividend Survey and a Corporate Governance Survey.

Source: OECD (2010), *Policy Brief on State-Owned Enterprises in Asia – Recommendations for Reform.*

The MSWG and Bursa Malaysia launched the Corporate Governance Index in conjunction with the Corporate Governance Week in 2009. The Index is an extension of the annual MSWG CG Survey and aims to provide a reliable gauge for investors to rate local public listed firms based on their level of adherence to globally accepted corporate governance standards. It includes all listed companies on Bursa Malaysia and measures i.a. their level of compliance with the exchange's listing requirements and the Malaysian Code on Corporate Governance standards. The index, which is the first of its kind in the country, is designed to track and identify not only companies that comply with the disclosure standards and requirements and are fair and transparent to their stakeholders, but also companies that demonstrate strong financial performance.

The board's role guiding corporate strategy in Malaysia

As discussed earlier, the *Companies Act* clearly provides that the board is responsible for managing the affairs of the company and has powers to supervise the management of the business. Every director of a company must act in the best interest of the company, including nominee directors. The board should also apply ethical standards supported by a code of ethics. In this regard, Malaysia has firmer regulations than its regional peers such as Chinese Taipei, Indonesia, Korea or Thailand. In Malaysia, the Code of Ethics is issued by the Companies Commission, a statutory body. Though implementation is voluntary, it provides companies with a reference for developing better standards.

To encourage board members to devote sufficient time and energy to their work, governments can establish caps on the number of directorships any one person can hold. In Malaysia, an individual may hold no more than 10 directorships in public listed companies, and 15 directorships in non-listed companies (OECD, 2011). As stated in the OECD *Principles*, service on too many boards can interfere with the performance of board members. Companies may wish to consider whether multiple board memberships by the same person are compatible with effective board performance and disclose the information to shareholders.

The Corporate Governance Blueprint (2011) recommended limiting the number of listed company directorships held by an individual director to five. The Malaysian Code of Corporate Governance (2012) further suggested that boards set out expectations on the time commitment for their members and protocols for accepting new directorships. Directors should notify the chairman before accepting any new directorships and the notification should include an indication of time that will be spent on the new appointment.

Boards and members of board committees should have clear and broad authority to demand information that board members believe is relevant to their work. Bursa Malaysia has instituted specific rules stipulating the right of directors to have access to information that is necessary and reasonable to perform their duties. So long as the determination of "necessary and reasonable" rests with directors or is very liberally interpreted by courts and regulators, such a provision should help provide the kind of information access required for effective board performance (OECD, 2011).

Malaysian standards and procedures for timely, reliable and relevant disclosure

Disclosure and transparency are long established corporate principles in Malaysia and are stipulated in laws and regulations, including in the *Companies Act* and the *Financial Reporting Act* 1997. A continuous disclosure obligation on listed corporations is imposed by Chapter 9 of Bursa's listing requirements (Box 5.4), defined as the timely and accurate disclosure of all material information by a listed issuer to the public. Non-compliance with these requirements can result in the listed company and its officers being sanctioned by Bursa.

Box 5.4. **Bursa's disclosure requirements**

- corporate disclosure policy;
- preparation of announcements;
- immediate disclosure requirements;
- periodic disclosure requirements;
- circulars and other requirements; and
- disclosure requirements for specific listed issuers.

Source: Bursa Malaysia.

The *Companies Act* provides for certain disclosure requirements that must be satisfied by substantial shareholders of a company, including notifying in writing the company of his or her interest. Further, where there is a change in the interest of a substantial shareholder, the latter shall notify in writing the full particulars of the change, including the reason for which that change occurred. Where a person ceases to be a substantial shareholder in a company, he or she shall also notify the company and share a copy of the notice with the Securities Commission. The act also provides for the powers of the Court with respect to defaulting substantial shareholders.

In this regard, the Court may make various orders including to:

- restrain the substantial shareholder from disposing of any interest in shares of the company;
- restrain the exercise of any voting or other rights attached to any share in the company;
- direct the company not to make payment, or to defer making payment, of any sum due from the company in respect of any share in which the substantial shareholder has or has had an interest; and
- direct the sale of all or any of the shares in the company in which the substantial shareholder has or has had an interest.

It is also useful for the relevant regulators to issue guidance to supplement the mandatory requirements on disclosure. In Malaysia, this guidance aids listed companies to better understand and comply with disclosure obligations by clarifying and illustrating how the disclosure requirements should be applied in practice. The government has also taken advantage of international co-operation with authorities in the region to promote more effective disclosure and transparency. For example, Malaysia is a signatory to IOSCO's Multilateral Memorandum of Understanding, designed to facilitate cross-border enforcement and exchange of information among regulators. Nevertheless, while there is recognition that Malaysia has made significant strides in improving financial reporting and is converging with international best practices, challenges remain at the company level. For example, poor understanding of the merits of greater disclosure and of the significance of disclosure in enhancing value has been identified as a weakness of Malaysian companies, as well of many of their regional peers (OECD, 2011).

The SCM also noted in 2011 that companies "tend to adopt an approach whereby compliance with the CG Code is merely declared, with little or no explanation being provided on the extent of compliance" (SCM, 2011). Hence, companies are said to be following the minimum requirements, rather than using guidelines for improving their own governance standards. Listed companies are however required to report on their compliance with the CG Code in their annual reports, and the Code advocates adopting standards that go beyond the minimum prescribed by regulation (SCM, 2012).

Rights of stakeholders as established by law or through mutual agreements

As for the rights of stakeholders, case law has established that where the company is solvent, the interest of the company is synonymous with the interest of shareholders, but where the company is insolvent or near insolvency, the interest of the company is synonymous with that of creditors.

Furthermore, the Corporate Law Reform Committee has made numerous recommendations to reform corporate insolvency laws set out in *Company Liquidation: Restatement of the Law* and *Reviewing the Corporate Insolvency Regime: The Proposal for the Corporate Rehabilitation Framework* which recommends that the corporate insolvency regime for Malaysia should provide an option of subjecting a financially distressed company to judicial management. It also recommends that a Company Voluntary Arrangement which is modelled on the UK approach be added in the *Companies Act*. The arrangement offers a procedure for a financially distressed company to initiate a rehabilitation scheme by itself through the appointment of a qualified insolvency practitioner who will supervise the implementation of this scheme.

To further enhance creditors' rights, the Corporate Law Reform Committee also recommended abolishing any preference given in the winding up of a company to the government in respect of any unpaid taxes of a company under liquidation. The Committee recommended excluding "payment of gratuity for termination of employment" from the definition of "wages and salary of employees" in the *Companies Act* 1965.

As for the rights of employees in Malaysia, these are provided for under several pieces of legislation, including the *Employment Act* 1955 and *Industrial Relations Act* 1967. Further, Article 135 of the Federal Constitution provides for the right of an aggrieved civil servant to be given a reasonable opportunity to be heard.

Various initiatives have been undertaken to encourage companies to promote their reputational goodwill through investor relation and corporate social responsibility programmes (see Chapter 6 on Policies for promoting responsible business conduct. These include the establishment of the Malaysian Investor Relations Association and other bodies, which are described in more detail above.

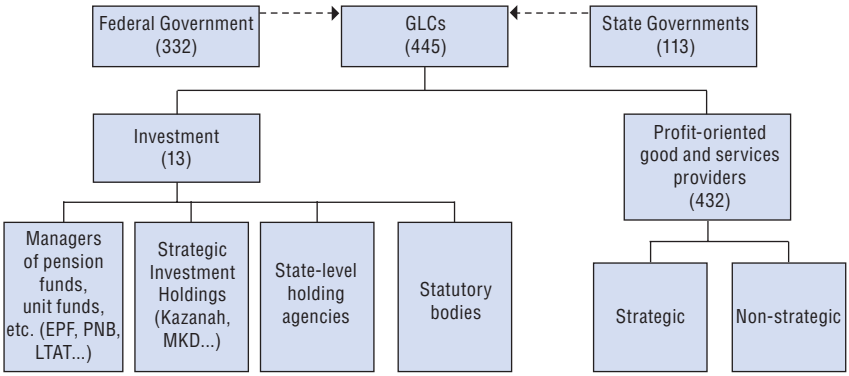
Governance of government-linked companies

In many economies, including in several OECD countries, state-owned or government-linked enterprises still represent a substantial part of GDP, employment and market capitalisation. They are often prevalent in utilities and infrastructure industries, such as energy, transport and telecommunication, whose performance is of great importance to broad segments of the population and to other parts of the business sector. Consequently, the governance of GLCs is critical to ensure their positive contribution to a country's overall economic efficiency and competitiveness. OECD experience has shown that good corporate governance of GLCs is an important prerequisite for economically effective privatisation, since it will make the enterprises more attractive to prospective buyers and enhance their valuation (OECD, 2005).

The scale and scope of GLCs in many Asian economies calls for specific attention to be given to their corporate governance. Even if their economic significance varies greatly from country to country, they still represent a major, if not dominant, part of the economy in some countries (around 30% of GDP in China and 38% in Viet Nam). In Malaysia, GLCs are significant as they represent close to 15% of GDP, 5% of employment and 36% of the total market capitalisation, compared to 20% in Singapore and 25% in Thailand (OECD, 2011 and Putrajaya Committee on GLC High Performance, 2011 based on 2005 data).

The National Economic Advisory Council reveals that there are currently 445 GLCs in Malaysia, the majority owned by the federal government, and the others by state governments (Figure 5.2). The Council highlights difficulties in gathering a complete list of holdings and thus assumes that these figures are higher. As of February 2012, there were 35 listed GLCs in Malaysia.

Figure 5.2. **Government Linked Companies in Malaysia**



Source: Adapted from the National Economic Advisory Council (2010).

In the Malaysian economy, GLCs play a critical role through the provision of backbone services such as transport, energy, telecommunications, and financial services. Khazanah Nasional Bhd, the Employees Provident Fund, and Permodalan Nasional Bhd, a non-financial public enterprise managing unit trusts and property trusts for the *bumiputera* community, are some of the main government-linked investment companies (GLICs – see Box 2.4).

The government holds shares in public listed and unlisted companies through two bodies – the Minister of Finance (Incorporated) [MOF (Inc.)] and Khazanah. MOF (Inc.) was established as a corporation under the *Minister of Finance (Incorporation) Act* 1957, allowing MOF (Inc.) to hold, invest, acquire and dispose assets of every description including shares. Khazanah, a company formed under the *Companies Act* 1965, is wholly owned by MOF (Inc.) except one share held by the Federal Lands Commissioner. Khazanah's official role is

to promote economic growth and to make strategic investments on behalf of the government which would contribute towards nation-building. Some of the key listed companies in Khazanah's investment portfolio include Axiata Group, Telekom Malaysia, Tenaga Nasional, CIMB Group, Malaysia Airlines, Malaysia Airports and UEM Land (see Chapter 8 on Infrastructure development).

Companies held by Khazanah, most of which are listed, are governed by its Memorandum & Articles of Association, the *Companies Act*, and the Listing Requirements of Bursa Malaysia and the *Securities Commission Act*. The GLC Transformation Programme (Box 5.5) spearheaded by the Putrajaya Committee on GLC High Performance, also applies to companies held by Khazanah.

Box 5.5. **The GLC Transformation Programme**

Starting in 2004, Malaysia embarked upon a programme to transform the investee companies of its GLICs into high performing companies. The Transformation Programme for GLCs is part of a broader and long-term modernisation programme of the national economy, based on benchmarking of performance against the experience in other countries. The programme aims to be realistic, performance-focused and highlight governance issues and shareholder value. Implementing this reform programme is managed, tracked and monitored by the "Putrajaya Committee on GLC High Performance" – PCG, chaired by the Finance Minister, including representatives from all key GLCs. Khazanah serves as a secretariat for this committee.

The first phase (2004-2005) introduced key performance indicators (KPIs), performance-linked compensation, as well as changes in board and senior management composition. The work of the PCG culminated in a "Transformation Manual", which includes the overall policy guidelines of the PCG to address some of the core challenges facing GLCs.

In the second "Generate Momentum" phase (2005-2006), ten initiatives were identified for launch and implementation across all GLCs, with the development of in-house guidelines including enhancing board effectiveness, strengthening directors' capabilities, enhancing GLC monitoring, improving the regulatory environment, reviewing and revamping procurement, and intensifying performance management practices. This second stage provided a series of reference books, such as the Green Book on enhancing board effectiveness and revamping board practices and processes, the Silver Book, which clarifies social obligations, the Red Book to review and revamp procurement, the Yellow Book about enhancing operational effectiveness, the Purple Book on optimising capital management practices and the Orange Book on managing and developing human capital.

Box 5.5. **The GLC Transformation Programme** *(cont.)*

The GLC Transformation Programme has yielded positive results: Total shareholder return of the top 20 GLCs (the G20*) outperformed the rest of non-G20 FBMKLCI (FTSE Bursa Malaysia Kuala Lumpur Composite Index) by 0.8% per annum (p.a.) from 14 May 2004 to 18 May 2012, growing at 13.7% p.a. compared with non-G20 FBMKLCI at 12.9% p.a.. Market capitalisation of the G20 has more than doubled from RM 140 billion to RM 319 billion over the same period. G20 net income grew 18.2% p.a. from RM 9 billion in FY2004 to an all-time high of RM 20.1 billion in FY2011.

Source: PCG, 2010, GLC Transformation Programme Progress Review May 2012.

Government-linked corporations in Malaysia are not exempt from the application of general laws and regulations. As companies incorporated under the *Companies Act*, GLCs must comply with its provisions. Likewise, if a GLC is listed on the Exchange, it must comply with the listing requirements and observe all ongoing obligations of a listed company. In this regard GLCs do not benefit from preferential treatment in the Malaysian legislation.

Notwithstanding the encouraging and substantial achievements to date, more could be done to achieve the ultimate aspirations of the programme. Regular initiatives to keep up momentum are critical to avoid any risks of complacency given the long-term nature of the programme. Yet, while GLCs in general still underperform relative to top regional sector peers, some companies with substantial GLC equity interests, such as Axiata, CIMB, and Maybank, have emerged as regional champions in their sectors. The government's efforts to transform the GLCs to create economic and shareholder value have led to the Green Book for GLCs published in 2006 (Box 5.6). One major policy thrust of the Green Book is to upgrade the effectiveness and accountability of GLC boards, and to depoliticise GLCs.

Implementing the Green Book has resulted in significant progress in raising board effectiveness and in enhancing its composition: 83% of the G20 had completed their Board Effectiveness Assessment by 2008 and 67% had developed their Actionable Improvement Programme (OECD, 2011). GLCs have also played an important role in raising the profile of sustainability reporting in Malaysia through the Silver Book launched in 2006 (see Chapter 6 on Policies for promoting responsible business conduct).

As a result, many of the companies that have been ranked highly in terms of good governance practices are actually GLCs. During a survey conducted by the Malaysian Shareholders Watchdog Group for the *Corporate Governance Index* in 2009, 17 out of the 33 listed GLCs were ranked in the top 100 of the *Index* (covering 899 companies). During a survey conducted in 2011, 19 out of

Box 5.6. **Green Book on Enhancing Board Effectiveness in Malaysia**

A review by the Putrajaya Committee on GLC High Performance (PCG) in Malaysia found that the current pool of GLC directors was too small and resulted in some directors holding too many mandates. With the evolving strategic, operational and geographic priorities of GLCs, boards now require new types of expertise in marketing, organisational design and change management. While recognising that not every director will possess all necessary and relevant knowledge and experience, the objective is to ensure that on a collective basis, every board is balanced and reasonably complete in its pool of skills.

PCG recommends that GLICs and GLCs proactively leverage new sources from private sector organisations. GLC CEOs at the early stage of GLC transformation are not encouraged to sit on other boards, apart from the boards of their subsidiaries. Exemptions to this rule are given on a case-by-case basis. Additionally, in order to ensure that directors have the time to be effective board members, PCG recommends that the cap on the number of listed boards on which a director of a GLC can sit be limited to five. The Green Book, which had to be implemented by all GLCs by the end of 2006, aims to help GLC boards to upgrade their effectiveness. It includes the following recommendations where relevant in accordance with the Malaysian Code of Corporate Governance, and reinforced by the Bursa Securities Listing Requirements:

- GLCs have a Nomination Committee – consisting exclusively of non-executive directors, a majority of whom should be independent – to recommend to the board clear and appropriate criteria for directorships.
- At least one-third of the entire board, with preferably no more than 10 members, should be composed of independent directors (up to 2 members may be from management with a maximum of 30% representation).
- There should a clear and distinct separation between the roles of the chairperson and CEO reviewed at least every 2-3 years, to ensure a balance of power and authority, such that no individual has unfettered powers of decision. To reinforce the importance of the chairperson's position, the selection criteria for chairpersons are more stringent than for normal directors.

The Green Book also gives practical suggestions on how to raise board effectiveness. For example, it gives a description of the ideal characteristics of an effective director, in terms of knowledge, skills and mindset. Finally, the Green Book provides guidance on how to conduct an "Effectiveness Assessment" and to develop an "Actionable Development Programme".

Source: OECD (2010), *Policy Brief on State-Owned Enterprises in Asia – Recommendations for Reform.*

the 35 listed GLCs were ranked in the top 100, covering 820 companies listed on the Exchange as of 31 December 2010.

Despite these advances, the government should keep up its efforts reforming GLCs and reducing any crowding-out of private investment (see the Overview). The NEAC in the New Economic Model stresses this point strongly in view of rationalising the government's participation in business. It mentions that GLCs are perceived to have gone beyond their original functions of providing public goods and services and fuelling socioeconomic change through wealth-distribution and are now competing directly with business. A number of GLCs continue to underperform, as manifested through low economic profit figures and low share price developments (NEAC, 2010).

The NEAC has made a series of detailed recommendations to restructure the GLC landscape in Malaysia, including the need for an oversight mechanism for GLCs and for divesting non-strategic GLCs (Table 5.3), while exposing the remaining companies to high governance standards and competition. With regards to the oversight mechanism, the NEAC advises that the government form a GLC Oversight Authority, which could be embedded in the existing Putrajaya Committee (NEAC, 2010).

Table 5.3. **NEAC Proposed divestment strategies for non-strategic GLCs**

Category	High-performing unlisted companies	Unlisted low performers with turnaround potential	Unlisted low performers without turnaround potential
Strategy	Companies with good track records meeting Bursa Malaysia listing criteria to be divested via the capital market. Aggregate government shareholding capped at 10% of issued shares.	Appoint professional managers and provide incentives to revive the companies.	Using objective criteria to determine strike price offer to the private sector for sale, failing which: liquidate entities and establish an asset-management company to dispose of assets in a transparent and market-based manner.

Source: Adapted from National Economic Advisory Council.

The potential impact of GLC reform should not be underestimated. Improving GLCs' corporate governance could potentially lead to significant efficiency gains, improve the quality of public services, decrease the fiscal burden and public debt, and ultimately contribute to overall growth. Expected benefits can also include better valuation of state assets (for potential future privatisation). It will also, in many cases, improve overall public governance, including through greater transparency. Last but not least, it will ensure more effective competition with the private sector.

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Chapter 6

Policies for promoting responsible business conduct

Public policies promoting recognised concepts and principles for responsible business conduct (RBC), such as those recommended in the OECD Guidelines for Multinational Enterprises, *help attract investments that contribute to sustainable development. Such policies include: providing an enabling environment which clearly defines respective roles of government and business; promoting dialogue on norms for business conduct; supporting private initiatives for RBC; and participating in international co-operation in support of responsible business conduct.*

The government of Malaysia's efforts to promote RBC can be seen as part of the overall corporate governance reforms over the past decade. While the RBC culture is relatively new in Malaysia, recent measures, such as high-level endorsement of RBC initiatives, and the emergence of new non-governmental advocates play an important role. This chapter looks at these efforts and recommends ways of driving Malaysia's RBC agenda forward, including by adhering to internationally recognised principles, such as the OECD Guidelines for Multinational Enterprises.

Responsible business conduct (RBC) or corporate social responsibility (CSR) entails above all compliance with laws, such as those on respecting human rights, environmental protection, labour relations and financial accountability. It also involves responding to societal expectations communicated by channels other than the law: within the workplace, by local communities and trade unions, or via the press. Companies are best able to promote RBC when governments fulfil their own distinctive role effectively. To the extent that governments provide an enabling environment for responsible businesses, they are more likely to attract and keep high quality investors who might otherwise be tempted to go elsewhere. At the same time, firms that have adopted high RBC standards are more likely to bring lasting benefits to employees, customers and the societies in which they operate. The roles of government, business and civil society are both complementary and interdependent.

In Malaysia, RBC is considered an extension of efforts to foster a strong corporate governance culture. Both corporate governance and RBC are seen to be about ensuring the sustainability of business through good business practices since both influence corporate strategy and draw on similar elements like accountability and transparency. As in the area of corporate governance, Malaysia has made important steps in strengthening the framework for promoting RBC. The past years have seen a number of policy and institutional advances, in particular in environmental protection and the promotion of green investment (see also Chapter 9 on Green investment), an area where companies still manifest weaknesses. Challenges remain in terms of consultative processes in policy developments and in the area of labour relations, where Malaysia faces some gaps *vis-à-vis* more advanced standards.

Another area that deserves some scrutiny is overall co-ordination of RBC-related initiatives. While this chapter highlights Malaysia's laudable progress in many areas, including high level political endorsement of RBC activities, oversight and co-ordination of RBC policies could be improved, such as by designating a ministry within the government that is mandated with such a function. At the same time, participating in international initiatives would support the government in taking advantage of global experiences on RBC and its implementation. The government should increase its efforts to align itself with the standards and principles upheld in multilaterally backed instruments, including the OECD *Guidelines for Multinational Enterprises*. This

would send an important signal to the global community that Malaysia, also home to significant outward investors, is taking steps to raise RBC standards in its private sector.

Government vs. business roles and responsibilities in promoting RBC

Law making is one of the main forms of communication between governments and business. An effective legal system requires consultation both before laws are drafted and after they are promulgated. These consultation processes cannot work unless citizens' rights to information are respected and grievance mechanisms are in place. The prime tasks of governments are to define and, just as importantly, to implement the laws and regulations that underpin RBC. But going beyond these tasks, governments can and should support RBC initiatives in three main ways:

- Facilitating – setting clear overall policy frameworks.
- Partnering – combining public resources with those of business and other actors to leverage complementary skills and resources.
- Endorsing – showing public political support for particular kinds of RBC practice in the market place or for particular companies.

Carefully considered leadership at the highest level of government is essential for RBC, including statements of support for RBC principles from cabinet ministers and the head of state. From an administrative point of view, governments should decide which branches are to take the lead in co-ordinating policy in this area.

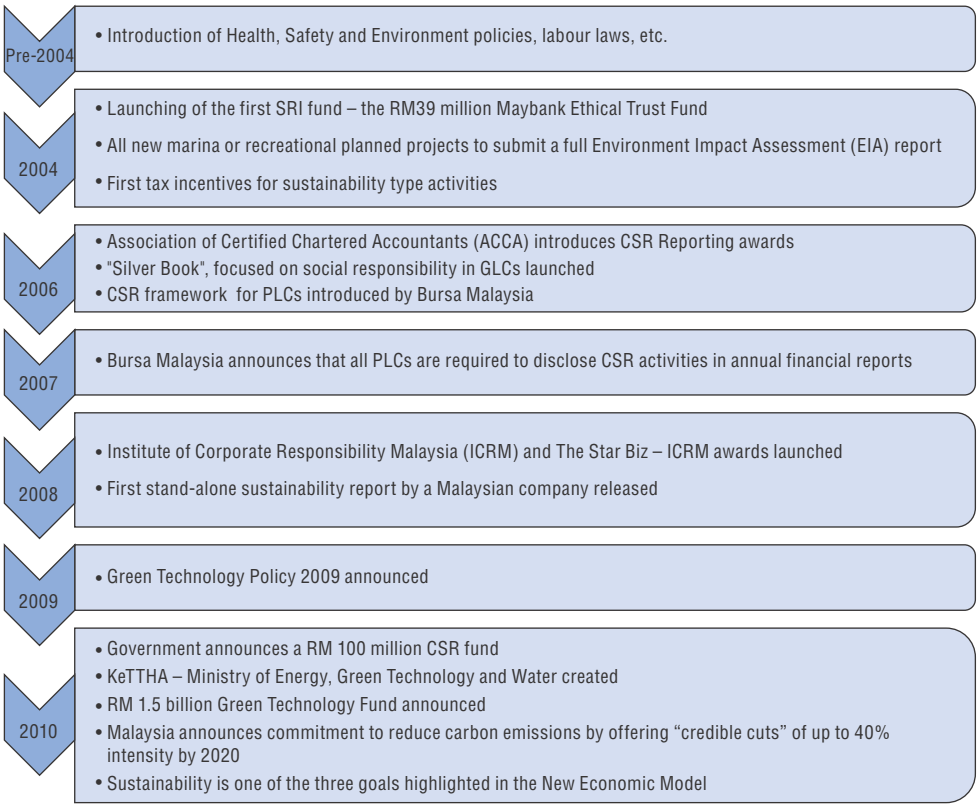
Government's initiatives to promote RBC in Malaysia

The government has demonstrated a strong commitment towards promoting RBC. To help instil a RBC culture in Malaysia, the prime minister announced in his 2007 budget speech that public-listed companies are required to disclose their CSR activities. The "Silver Book", published by the Putrajaya Committee for GLC Transformation (PCG) in September 2006, provides guidelines for GLCs (Royal Embassy of Norway, 2012).

Secondly, Bursa Malaysia, the country's stock exchange, launched a framework to guide the implementation and reporting of RBC activities by listed companies in 2006. It stresses that all listed companies are required to disclose their RBC activities. This is an important step to promote RBC, while Bursa Malaysia clearly mentions that such activities occur on a voluntary basis. The framework looks at four priority areas: the environment, the workplace, the community and the marketplace (Bursa Malaysia, 2012).

Figure 6.1 below highlights some recent public and private initiatives that contribute to the RBC framework in Malaysia.

Figure 6.1. **Main public and private RBC initiatives in Malaysia**



Source: Adapted from Bursa Malaysia (2012).

Other institutions have also undertaken efforts to strengthen the RBC framework and raise awareness on responsible business. The Companies Commission of Malaysia (SSM) published the Corporate Responsibility Agenda ("CR Agenda") in 2009, setting out SSM's strategic framework and approach in relation to corporate responsibility. The CR Agenda also carries the tagline "Driving Business beyond Profitability" reflecting SSM's views that all companies regardless of their type (public or private companies), size of operations, nature of businesses and whether listed or otherwise, can play a prominent part in the social condition, the economy and the environment.

Subsequent to the CR Agenda, SSM has also published a Best Business Practice Circular[1] for companies and businesses to enhance and improve their business practices, as well as their management and operations of companies.

Other initiatives that can act as incentives to actively foster RBC among companies are prestigious awards for RBC activities, including the ASRIA,

MESRA, StarBiz-ICR Malaysia Corporate Responsibility Awards, and the ACCA Malaysia Sustainability Reporting Awards – an international recognition for transparent and efficient reporting. The awards aim to promote full disclosure of sustainability, environmental and social information, as well as to raise awareness of the importance of transparency in reporting. The awards have been generating interest among the business community, manifested through high participation. Recent winners of ACCA awards include UEM Environment Sdn Bhd for Best Sustainable Report (2009), Malaysian Resource Corporation Berhad for best Environmental Performance Report (2009) and Nestlé (Malaysia) Berhad for the best Social Performance Report (2009) (Association of Chartered Certified Accountants, 2010).

Box 6.1. **Prime Minister's CSR Awards**

The Prime Minister's CSR Awards were launched by the Ministry of Women, Family and Community Development in 2007 to recognise companies that have made a difference to the communities in which they are active through their CSR programmes. Those considered for the Awards should therefore demonstrate the company's commitment to, and respect for, communities and the environment.

The Awards are open to all Malaysia-based companies and are given in 10 categories, in addition to an overall best CSR programme:

- Education
- Environment
- Culture and heritage
- Community and social welfare
- Best CSR workplace practices
- Empowerment of women
- Small company CSR
- Special award – best media coverage
- Family friendly workplaces (introduced in 2010)
- Outstanding opportunities for people with disabilities (introduced in 2010)

Source: Anugerah CSR Malaysia (2012) (*www.anugerahcsrmalaysia.org*).

Endorsement by government leaders can provide welcome evidence of official support for partnership initiatives, thus boosting their credibility. The prime minister's CSR Awards are among the most prominent awards in the country and manifest strong political endorsement of the RBC agenda. Particularly notable is the small company CSR category of the Awards (Box 6.1),

which illustrates the sophistication of the RBC agenda driven by the government. Getting smaller companies with fewer resources than large enterprises to dedicate efforts to RBC is a common challenge faced by governments worldwide. There has also been a strong increase in media reporting of RBC related issues (CSR International, 2012) which can have an important reputational effect.

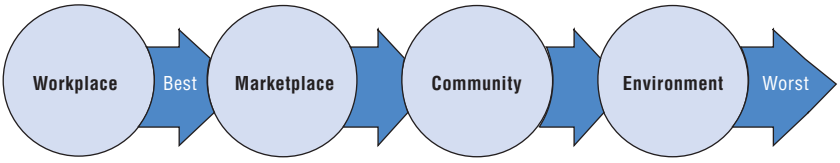
Framework for environmental protection in Malaysia

While enforcement of environmental standards is covered by the *Environmental Quality Act* (1974), sustainable growth is one of the New Economic Model's goals. Malaysia's economic growth inevitably puts a strain on the environment, and the government has taken specific measures to address this challenge. In 2010, the government organised the 6th Silver Book Workshop on "Corporate Sustainability: Moving towards Low Carbon Growth", involving over 50 workshop participants from various GLICs and GLCs (see Chapter 5 on Corporate governance). The objective was to increase the participants' awareness of the benefits of environmental management and reporting beyond compliance. The workshop included a climate change attitude survey which indicated that:

- 38% of organisations were uncertain if they adequately address environmental impacts of their activities;
- 76% of respondents reported that their company is preparing to implement environmental initiatives in the next 12 months (Putrajaya Committee on GLCs, 2011).

Nevertheless, despite the government's efforts, progress with regards to improving environmental standards in companies has reportedly been low. For example, the Bursa Malaysia 2007 Status Report on RBC in Malaysian PLCs highlighted that the surveyed companies received the lowest scores in the environment dimension of the assessment (Figure 6.2). The companies that scored the best on environment issues were those with a high impact on the environment in the manufacturing, industrial and plantation sectors, while the construction companies scored lowest (Bursa Malaysia, 2007). While the assessment covers only a random sample of 200 listed companies, it does provide an indication of the challenges of implementation at company level.

Figure 6.2. **Ranking of dimensions according to RBC performance in Malaysian PLCs (2007)**



Source: Bursa Malaysia (2007).

Labour relations in an RBC context in Malaysia

Another area where Malaysia needs to narrow the gap with international RBC best practices, including is in the area of labour relations. The *Employment Act* of 1955 and the *Industrial Relations Act* of 1967 are the two framing reference texts for labour relations in Malaysia. The government has also ratified five of the ILO core conventions but not the conventions on Freedom of Association and the Right to Organize, Abolition of Forced Labor, and Abolition of Discrimination on the Basis of Occupation.

According to the International Trade Union Confederation (ITUC), a number of restrictions apply to trade unions, despite appropriate policies, which suggests a discrepancy between policies and implementation. For example, while freedom of association is guaranteed in the Constitution, the Director General of Trade Unions (DGTU) within the Ministry of Human Resources has vast powers to decide on union registration and its decisions cannot be appealed in court (ITUC, 2012).

Many restrictions influence the right to organise, the right to collective bargaining and the right to strike, both in legislation and in practice, including heavy procedures prior to strikes. Participation in unlawful strikes is penalised severely. According to the ITUC, the Malaysian Trades Union Congress (MTUC) had complained to the ILO that there were cases in which the DGTU denied organisational and collective bargaining to more than 8 000 workers in the manufacturing sector.

The government has begun to address these concerns, such as amendments to the *Industrial Relations Act* stipulating specific measures to resolve a union's claim for recognition within a period of six months. However, the ITUC warns that inefficiencies in the dispute settlement machinery, as manifested by cases of victimisation and unfair dismissals remaining unresolved for as long as five years, hamper effective enforcement of the Act (ITUC, 2012).

The government has also been urged to act on the abuse of migrant workers. Malaysian firms depend on foreign labourers, with migrants making up more than a fifth of the country's work force. MTUC received more than 400 complaints in 2010 from migrant workers relating to labour rights abuses. At the same time, there appear to be contradicting regulations on the rights of migrant workers with regards to joining a trade union. The Ministry of Human Resources allows migrant workers to join a trade union but work permits, falling within the authority of the Immigration Department, maintain a condition against union membership.

Compliance, both in legislation and implementation, with best practices in labour relations would greatly contribute to dispelling a negative reputation, especially in the area of treatment of migrant workers (NEAC,

2010). Useful guidelines are offered through the International Labour Organization and the International Organization for Migration.

Measures to promote awareness of RBC

Both government regulation and voluntary business standards have merits. Governments should look for ways of facilitating and endorsing business initiatives that extend beyond the minimum legal threshold. For example, governments can use their convening power to bring companies and civil society organisations together and to help develop voluntary initiatives that extend the boundaries of best practice. They may also be able to use government websites and communications networks to publicise information about best practice.

While governments need to consult with representatives from civil society, partnerships and regular interactions with business associations, chambers of commerce and multi-stakeholder groups working on specific RBC issues are likely to be effective bridges for better common private-public understanding. It is thus crucial for such groups to be closely involved and consulted in the drafting and implementation of new laws.

According to the government, companies are made accountable for RBC through existing measures such as annual financial reporting as required under the *Companies Act* 1965 (CA, 1965) which is under the purview of the SSM. In 2007, the SSM established the Companies Commission of Malaysia Training Academy, with one of its main purposes to promote communication on expected RBC to companies by organising awareness programmes in Malaysia. The Academy has introduced various training programmes for local and foreign company directors, as well as senior management from various industries, company secretaries, auditors, lawyers, liquidators, receivers and managers, academics, public officers, co-regulators, business entrepreneurs and SSM employees. Many of the most important RBC initiatives worldwide are industry-led. Governments should look for ways to support these initiatives – for example by providing funds and sources of expertise – but without seeking to control them.

The Business Council for Sustainability & Responsibility Malaysia (BCSRM) is preparing to launch an RBC training programme with Bursa Malaysia. Its main aim is to develop RBC practitioners within the labour force, with a special focus on developing the business case for RBC. This is seen as a crucial current impediment to developing better adherence to high RBC standards among companies in Malaysia, since RBC is still relatively new as a concept and, in general, companies still focus on reporting on profit and not enough on RBC (BCSRM, 2012). Bursa's Listing Requirement also mandates

that directors of a listed company must attend training under the Mandatory Accreditation Programme prescribed by the exchange.

The BCSRM is a national organisation formed in 2011 through a merger of the Business Council of Sustainable Development (established in 1992 with a focus on safety, health and environment issues) and the Institute for Corporate Responsibility Malaysia (formed in 2006). It is a noteworthy initiative as it represents an institutional partnership between an international and a national RBC body. As the regional network partner of the World Business Council for Sustainable Development (WBCSD), which represents 200 international companies from 35 countries and 22 sectors, it aims to infuse knowledge from the WBCSD's RBC experience and competence in to Malaysia's corporate culture. BCSRM currently has some 50 corporate members, most of them larger companies. It undertakes capacity and awareness building, policy advocacy and thought leadership activities for environmental, social and governance related issues. The organisation pays particular attention to energy and climate issues, social development, ecosystem protection and the role of business in driving the sustainability agenda (WBCSD, 2012).

Co-ordination and oversight of RBC activities

Many different parts of the government are taking a pro-active stance towards promoting RBC, and there are genuine efforts to instil an RBC culture among companies in Malaysia. But the variety of organisations involved and approaches poses challenges for effective monitoring and evaluation. There is currently no central agency in Malaysia with a mandate to co-ordinate and oversee RBC activities, including of Malaysian companies abroad. Establishing such a function within an existing public or semi-public body that has sufficient outreach to the private sector would contribute to enhancing the quality, effectiveness and efficiency of RBC policies and activities in Malaysia.

Given the multi-dimensional aspect of RBC, there is no one size fits all approach to institutional arrangements (European Commission, 2007). The experience of jurisdictions with relatively advanced RBC agendas, such as in the European Union and North America, can provide certain leads for finding an appropriate set-up (Box 6.2). One important lesson is that policy developments should be co-ordinated by a lead agency, with inputs from sectoral institutions (World Bank, 2006). In this regard, bringing RBC relevant instruments and initiatives under one umbrella may carry benefits for the government of Malaysia as this would enhance capacity building efforts, policy co-ordination and sharing of best practices, a crucial element in promoting RBC awareness.

Box 6.2. **Selected examples of RBC institutional arrangements**

Italy

The Ministry of Labor and Social Affairs leads the co-ordination of RBC policy development, but environmental policies fall under the authority of the Ministry of Environment. The Ministries of Industry and Trade, Foreign Affairs and Public Administration are also involved.

The United Kingdom

The Department of Trade and Industry covers public RBC activities through its Minister for Corporate Social Responsibility. While there is no one concrete public RBC policy, more than 12 governmental agencies implement various RBC programmes.

Canada

While RBC policy responsibilities are shared between the federal and provincial government, the Department of Industry leads RBC related activities at the federal level. It co-ordinates closely with the Canadian International Investment Agency as well as the following Departments: Health; Foreign Affairs and International Trade; Natural Resources; Environment; and Human Resources and Development.

Belgium

The Federal Government initiated the RBC reference framework co-ordinated by the Interdepartmental Commission for Sustainable Development, with representatives of all federal administrations and policy offices.

Lithuania

As in Belgium, a Permanent Commission on Coordination of Development of RBC was established, with representation from trade unions, employer organisations, state institutions, science, research organisations –including the Ministries of Social Security and Labour, Economy, and Environment, the State Labour Inspectorate, and the Lithuanian SME Agency.

Source: Adapted from the OECD (2009), World Bank (2006), European Commission (2007).

Financial and non-financial disclosure

While investors have traditionally focused solely on companies' financial performance, there is now growing interest in how companies perform on environmental, social and governance issues. Companies' environmental and social policies as well as their performance in this area are increasingly important for all classes of investors and essential for the growing socially responsible investment market for investments in companies that meet

specified social and environmental criteria. As seen in Chapter 5, Malaysia has seen important developments in its regulations for corporate disclosure.

The *Companies Act* (CA 1965) has both financial and non-financial disclosure obligations for directors. Whilst financial disclosure mostly relates to accounts and audits (including directors' and auditors' reports), non-financial disclosure relates to other information on the companies' operations. Section 167 CA 1965 stipulates that companies must prepare accounts in accordance with the applicable approved accounting standards under Section 166A of the CA 1965. Approved accounting standards are issued by the Malaysian Accounting Standards Board (MASB) under the Financial Reporting Act 1997. As of 1 January 2012, Malaysia had fully converged with the International Financial Reporting Standards (IFRS), which is known as Malaysia Financial Reporting Standard (MFRS)

The directors' report must be made in accordance with a resolution of the directors and signed by at least two of the directors and must state the company's affairs as of the end of the financial year. If the company is a holding company, the directors' report must also report on the state of the affairs of the holding company and all its subsidiaries. The contents of a directors' report are extensively provided by section 169(6) of the CA 1965 (see Chapter on Corporate Governance).

Proposed reforms to the CA 1965 would enhance the requirement of Section 169 of the CA 1965 to extend beyond the existing disclosure requirement. Among others, the enhancement would aim to encourage companies to report matters concerning their system of internal controls and their policies relating to business sustainability and corporate responsibility, including employee and stakeholder engagement. As the corporate regulator and the registrar for all companies and businesses in Malaysia, the SSM administers the CA 1965 and Registration of Businesses Act 1956.

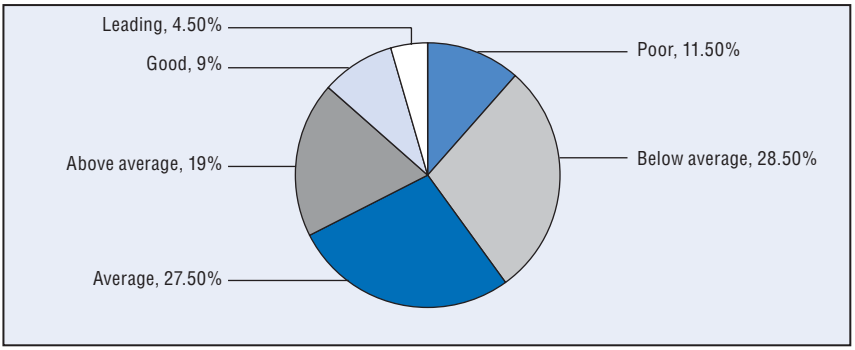
Listed companies' requirement to disclose on corporate responsibility

Governments can promote corporate disclosure through legal reform. Certain Companies Acts, for example, explicitly mandate social and environmental reporting. In this regard, Malaysia undertook an important step through the Bursa requirement[2] to disclose on RBC, though it explicitly stresses that all RBC activity occurs on a voluntary basis. The measure took effect on 31 December 2007 and applies to all public listed companies and their subsidiaries. RBC includes actions that go beyond philanthropy or mere compliance with laws to include activities to safeguard the environment, communities, employees, shareholders and other affected parties' interests (Royal Embassy of Norway, 2012). If there is no RBC report, a statement to that effect is required, thus acting as a form of moral suasion.

This was a result of Bursa's survey of its listed companies on RBC activities mentioned earlier. The exchange selected a random sample of 200 companies including 50 companies from the FTSE Bursa Malaysia 100 list to assess companies' level of disclosure and practice. Figure 6.3 below illustrates the results of the survey, which clearly indicate weak RBC engagement by publically listed Malaysian companies. Particularly notable was their lack of knowledge and awareness of RBC. The best performers were multinational enterprises.

While the Securities Commission reported that companies generally comply with RBC reporting requirements, certain challenges to make it an effective RBC promoting instrument remain. For example, companies do not provide an assessment of their impact on communities, unlike companies in countries such as South Africa, Australia, Norway and Denmark that have begun moving towards integrated reporting (SCM, 2011).

Figure 6.3. **Firm level RBC disclosure and practice (sample of 200 companies, 2007)**



Source: Bursa Malaysia (2007), *Corporate Social Responsibility in Malaysian PLCs, 2007 Status Report*, Kuala Lumpur.

Other additional high profile sources of appraisal of the quality of RBC related reporting, including the National Annual Corporate Report Awards and the MaSRA awards mentioned earlier. The former is one Malaysia's most recognised awards for excellence in annual corporate reporting and is organised by Bursa Malaysia, the Malaysian Institute of Accountants, the Malaysian Institute of Management and the Malaysian Institute of Certified Public Accountants. These awards can serve as a complement to the mandatory RBC reporting in the Bursa listing requirements (World Federation of Exchanges, 2012). The MaSRA awards on the other hand can also offer useful insights for improving corporate reporting in Malaysia. For example, specific observations and recommendations with regards to inclusive stakeholder involvement were made by the MaSRA judges in 2011 (ACCA, 2011). These are mentioned in Box 6.3 below.

Box 6.3. ***Malaysia Sustainability Reporting Awards*: Observations and recommendations**

Materiality and balance:

Sustainability reports tend to focus on positive stories, with little discussion of failures and challenges. This leaves stakeholders with doubt on the credibility of the report.

Completeness and boundaries:

Most companies choose to confine their reporting to limited parts of their activities or geographical operations. This does not reflect the growth and internationalisation of Malaysian companies. For instance, environmental reporting is often limited to headquarter impacts, with no consideration of the impacts from logistics or field operations. Companies also tend to exclude branches or operations abroad, which are a significant factor in carbon footprint measurements. The reports also lack clarity, leaving stakeholders without a clear picture of impacts.

Inclusiveness and stakeholder engagement:

Many reported engagements appear to be testimonials, rather than genuine engagements. More engagement with critical stakeholders is recommended. Stakeholder engagement should demonstrate openness and responsiveness to concerns, going beyond simply reporting meetings with stakeholders. A more structured stakeholder engagement process is needed to demonstrate responsiveness.

Embedding of sustainability:

More disclosure is needed on who is responsible within a company for developing a sustainability strategy and for implementation across the company. More in-depth disclosure on how KPIs and employee rewards are linked to sustainability performance is also recommended

Proactive disclosure:

Most reporting is retroactive. Companies should be more forward looking by:

- Setting long-term targets.
- Benchmarking.
- Investing and involving communities more.

Source: Association of Chartered Certified Accountants and Malaysian Sustainability Reporting Awards (2012).

Bursa Malaysia remains one of the main drivers of an active RBC agenda. This is further illustrated by the launching of an *Environment, Social and Governance Index* which was scheduled for late 2012. This would mark an additional significant step in measuring RBC progress among companies and

could have a motivating effect for them to further develop sustainability strategies and improve disclosure (ACCA, 2011).

Strengthening the business case for RBC

Governments can act to reinforce the business case for RBC by providing information about responsible practices and by lowering the costs of developing and adopting responsible practices, such as through support for industry initiatives. They can also promote internationally accepted concepts and principles.

Currently, the government has strategic partnerships, amongst others, with UNICEF, public and private universities, the Malaysian Institute of Integrity, chambers of commerce, and professional bodies to promote the concept of RBC to the business community and the public at large. Many Malaysian companies, such as Petronas and Tenaga Nasional Bhd., have recognised the business case for RBC and have developed their own RBC and sustainability guidelines. Others actively promote RBC in an international context, such as efforts by the Malaysia Smelting Corp. efforts to improve due diligence in conflict sensitive supply chains of minerals in Africa (Box 6.4).

Box 6.4. **Malaysia Smelting Corp. helps drive responsible and conflict-sensitive supply chains of minerals from Africa's Great Lakes Region**

Malaysia Smelting Corporation Berhad ("MSC") is a publicly-listed Malaysian-based tin producer with mining and smelting operations dating back to 1900. MSC is currently the second largest supplier of tin metals in the world. Since 2009, MSC has taken a proactive role in international and industry-led efforts to promote responsible and conflict sensitive sourcing practices, by contributing to shaping practical solutions to complex challenges for supply chain due diligence within the context of an OECD-hosted multi-stakeholder process that resulted in the adoption of the OECD *Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas* ("OECD Guidance").

The OECD Guidance aims to help companies avoid contributing to conflict and associated abuses of human rights when operating in, or sourcing tin ore from, such challenging environments. As the largest tin smelter and the long-standing traditional commercial partner of Central Africa, MSC's involvement in the development of the OECD Guidance, as well as its commitment to implement it and share experience, is noteworthy.

Box 6.4. **Malaysia Smelting Corp. helps drive responsible and conflict-sensitive supply chains of minerals from Africa's Great Lakes Region** *(cont.)*

It is against this backdrop that MSC has been a founding member and leading implementer for iTSCi, a joint tin and tantalum industry programme of traceability and due diligence covering tin, tantalum and tungsten designed to address concerns over "conflict minerals" from central Africa and to meet the international due diligence expectations outlined in the OECD Guidance through collaborative industry efforts. Currently, MSC is participating in a peer learning due diligence reporting exercise as part of the implementation phase of the OECD Guidance's Supplement on Tin, Tantalum and Tungsten. MSC has also volunteered to be an "OECD Due Diligence champion" in Asia by helping to disseminate the OECD Due Diligence Guidance among Asia-based metals industry, including Malaysian industry bodies.

As the choke point in the global tin supply chain, MSC is also exploring opportunities to build bridges between upstream actors in the Great Lakes region and downstream users to enable market access and create economically viable opportunities for artisanally mined tin, while ensuring that sourcing practices meet responsible sourcing expectations of regulators, customers and consumers.

The government and its specialised agencies should consider fostering more and closer partnerships with companies with proven track records of successful RBC implementation. These companies could be tapped from the various awards mentioned earlier and should involve both international and domestic enterprises.

Malaysia's intergovernmental co-operation to promote international RBC principles

Many of the problems that the RBC agenda seeks to address are also international in scope: climate change and the challenge of reducing carbon emissions; the fight against bribery in cross-border business transactions; and the promotion of responsible labour standards among the suppliers of large international companies. Participating in inter-governmental co-operation allows a government and stakeholders to tap international expertise, sharing experience and contributing to setting global standards.

Intergovernmental bodies such as the OECD, the World Bank and the ILO and other UN agencies play a vital role by providing access to specialist expertise and by serving as forums to develop common standards and promote best practice. Malaysia has had a local UN Global Compact network

since 2008, but the information available from the network seems to suggest that it could be more active in promoting the ten UN Global Compact principles. Also, the government, through the SSM, has signed a memorandum of understanding with UNICEF to enhance the well-being and welfare of children in Malaysia through the practice of corporate responsibility among the corporate and business community.

Malaysia is also member of the ADB/OECD Anti-Corruption Initiative for Asia and the Pacific. The Initiative was established in 1999 to help governments in the Asia-Pacific region meet international anti-corruption standards. The Anti-Corruption Action Plan for Asia and the Pacific sets out the goals and standards for fighting corruption in the region. To date, 28 countries and economies from Asia and the Pacific have endorsed the Plan and agreed on implementation mechanisms to achieve its standards. The Plan encourages effective and transparent public services, strong anti-bribery actions, and integrity in business operations. It supports the objectives of the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and the United Nations Convention against Corruption.

As seen earlier, Malaysian companies are increasingly becoming global players with significant investment abroad (see Chapter 1 and Chapter 5 on Corporate governance). These include investments in socially and environmentally sensitive sectors such as oil and agriculture. While many Malaysian outward investors have their own sustainability and RBC programmes, the government could support this positive trend by subscribing to major international initiatives, such as the OECD *Guidelines for Multinational Enterprises* (the *Guidelines*). Many of the largest outward investors are from countries that have adhered to the *Guidelines* (Table 6.1).

Key recommendations addressed by governments to multinational enterprises in all major areas of business ethics are integral to the *Guidelines* which form part of the OECD *Declaration on International Investment and Multinational Enterprises*. They include steps to obey the law, observe internationally-recognised standards and respond to other societal expectations. First adopted in 1976, the *Guidelines* have since been reviewed several times, most recently in 2011 (Box 6.5).

The government should take more advantage of global experiences on RBC and its implementation and increase its efforts to align itself with the standards and principles upheld in multilaterally backed instruments such as the ILO *Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policies*, and the OECD *Guidelines*. The government could thus consider signing on to the OECD *Declaration on International Investment and Multinational Enterprises* and hence adhering to the *Guidelines*. By doing so, Malaysia would

Table 6.1. **Stock of outward FDI (2011)**

USD billion; *Guidelines* adherents in bold

United States	4 681
United Kingdom	1 731
France	1 581
Germany	1 407
Hong Kong, China	1 046
Switzerland	992
Netherlands	979
Belgium	970
Japan	963
Canada	670
Spain	640
Italy	512
Australia	382
China	366
Russian Federation	362
Sweden	359
Singapore	339
Ireland	314
Denmark	242
Chinese Taipei	213
Brazil	203
Austria	196
Luxembourg	194
Norway (2010)	186
Korea	161
Finland	139
Malaysia	106

Source: OECD FDI Statistics Database and UNCTAD.

Box 6.5. **The 2011 Update of the OECD Guidelines for MNEs**

The OECD *Guidelines for Multinational Enterprises* (the *Guidelines*) are recommendations addressed by governments to multinational enterprises. The *Guidelines* aim to ensure that the operations of these enterprises are in harmony with government policies, to strengthen the basis of mutual confidence between enterprises and the societies in which they operate, to help improve the foreign investment climate and to enhance the contribution to sustainable development made by multinational enterprises.

Box 6.5. **The 2011 Update of the OECD Guidelines for MNEs** *(cont.)*

Following the Update in May 2011, the *Guidelines* include new recommendations notably on human rights and a general principle on the need to exercise due diligence to avoid or mitigate negative impacts with respect to the management of supply chains and other business relationships.

The *Guidelines* include a set of voluntary recommendations in all major areas of corporate responsibility, namely:

- disclosure;
- human rights;
- employment and industrial relations;
- environment;
- combating bribery, bribe solicitation and extortion;
- consumer interests;
- science and technology;
- competition;
- taxation.

The *Guidelines* comprise a distinctive implementation mechanism, National Contact Points, which are government offices charged with advancing the *Guidelines* and handling enquiries in the national context and supporting mediation and conciliation procedures.

* The 44 adherent countries to the *Guidelines* comprise the 34 OECD member countries and 10 non-OECD countries (Argentina, Brazil, Colombia, Egypt, Latvia, Lithuania, Morocco, Peru, Romania, Tunisia). Jordan and Costa Rica are expected to adhere soon.

Source: OECD, www.oecd.org/daf/investment/guidelines.

send a strong signal to the global community of its efforts to raise RBC standards among its companies as they are going global.

Notes

1. SSM has published three BBPCs and one Toolkit (*www.ssm.my/CRAgenda/BBPC_en*) to encourage companies and businesses to adopt responsible business conduct for the interests of their employees and stakeholders. These publications are as follows:
   - *a)* BBPC 1/2010 on establishment of child care centres at the work place (in collaboration with UNICEF);
   - *b)* toolkit on how to set up a child care centre at the work place (in collaboration with UNICEF);
   - *c)* BBPC 2/2011 on nursing mothers programme at the workplace and establishing a conducive working environment for women (in collaboration with UNICEF); and
   - *d)* BBPC 3/2012 on achieving corporate integrity.
2. Part A, Appendix 9C, Chapter 9 of the Bursa Listing Requirements.

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Chapter 7

Financial sector development

Developed financial sectors provide payment services, mobilise savings, and allocate financing to firms wishing to invest. When they work well, they give firms the ability to seize promising investment opportunities, especially small and innovative enterprises and entrepreneurs that need external funding to expand and develop their business ideas. Well-functioning financial markets also impose discipline on firms to perform, boosting efficiency, both directly and by facilitating new entry into product markets. They also enable firms and households to better manage risks.

Malaysia has one of the most developed financial systems among ASEAN countries. Broad-based reforms undertaken following the Asian financial crisis have improved the size, depth and soundness of the financial sector. As a result of reforms Malaysia has become the world's most important Islamic financial centre. Malaysia is moving away from a bank-dominated financial system and towards a more sophisticated and diversified financial sector. This chapter describes the measures implemented to strengthen the banking sector and further develop Malaysia's capital markets, and briefly draws on data and comparisons with other Asian countries to highlight developments or challenges ahead. Malaysia could push for policies that promote further regional and international financial integration and further enlarge the capabilities of its financial sector in order better to address the challenges of making the transition to a high-value added, high-income economy by 2020.

Malaysia has one of the most developed financial systems among ASEAN countries. Broad-based reforms undertaken following the Asian financial crisis have improved the size, depth and soundness of the financial sector, partially evidenced by its resilience during the recent global financial crisis. Total financial assets as measured by banking sector assets, stock market capitalisation and bonds outstanding represented 406% of GDP at the end of 2010 (Figure 7.1a). Within the Asian region, only Hong Kong, China had a higher level of financial assets to GDP.

Driven by two major reform programmes, the Financial Sector Master Plan (FSMP) and Capital Market Master Plan 1 (CMP1), which set out clear and defined outcomes and recommendations to enhance the competitiveness of Malaysia's financial sector, the government has promoted the consolidation of banks, allowed increased foreign participation in the sector, and introduced a strong regulatory framework in line with international standards. Capital market reforms have focused on diversifying the investor base and deepening domestic bond and equity markets, streamlining regulations and improving disclosure standards, besides developing Malaysia as an international hub for Islamic finance.[1]

Malaysia is moving away from a bank-dominated financial system and towards a more sophisticated and diversified financial sector. The banking sector is well capitalised and the quality of assets has improved as evidenced by the lowest level of non-performing loans since the Asian crisis (Figure 7.1b) and a sound level of bank credit to deposits.[2] The domestic public bond market has reached a significant size, with relatively high liquidity levels in the secondary market relative to other ASEAN countries. The equity market is one of the most developed in the region and has seen an initial broadening of the investor base. All this has helped Malaysia's financial sector to rapidly recover from the recent global financial crisis. Total financing provided by the banking system remained strong, growing by 12.6% on an annual basis, as of June 2012.

The financial system has also been enhanced with the gradual liberalisation of the financial sector in the recent decade. Currently, 19 locally incorporated foreign banks and six Islamic foreign banks from 12 countries have a presence in Malaysia. Since 2009, there has been substantial liberalisation of the conventional and Islamic financial sector. However,

remaining restrictions on FDI in the financial sector are still relatively high compared to the OECD average (see Chapter 2). The new Financial Sector Blueprint (Box 7.1) reinforces Malaysia's commitment towards enhancing

Box 7.1. **The Financial Sector Blueprint 2011-2020**

Building on the experience of the FSMP, the Malaysian government has now embarked on a new strategic plan for the financial sector aimed at enabling it to become a catalyst of Malaysia's transition to a high value-added, high-income economy by 2020. The Financial Sector Blueprint 2011-20 seeks to elevate financial sector participation in the economy from 4.3 times to 6 times GDP in 2020, which entails a growth pace at around 8% to 11% per year. Nine focus area outcomes have been postulated and will provide guidance for policymaking towards developing a more competitive, dynamic and integrated financial sector. The Blueprint draws on 69 recommendations and more than 200 initiatives to achieve these outcomes.

The Blueprint incorporates objectives of enhancing the competitiveness of the banking industry to allow more effective and efficient financial intermediation and to improve access to financial services. It seeks to develop the Malaysian financial market into the main regional financial hub through a more open, diversified and integrated financial sector. Under this, foreign banks will be further allowed to invest in Malaysia to enhance the competitiveness of the industry, including the development of a diverse range of financial services (project financing, private pension funds, wealth management, insurance and capital markets). The Blueprint also incorporates the need for improving capacity and skills to support the envisioned transformation and internationalisation of the financial sector. It further recognises the need for enhancing the supervision and regulatory regime under a more internationally-integrated and dynamic business environment. Authorities have reported that co-operation with other regulatory authorities in the region will be undertaken on an on-going basis to strengthen arrangements for cross-border co-operation in supervision, surveillance and crisis management, and to provide a comprehensive framework for the regulation of financial groups, as well as the financial infrastructure for regional payments and settlements.

The plan also seeks to boost the internationalisation of Islamic finance (see Box 7.2), including the issuance of new licences to financial institutions with specialised expertise; enhancing liquidity in Islamic financial markets to facilitate more effective and efficient intermediation of cross-border Islamic financial flows; and promoting active participation in issuance and trading of sukuk, as well as strengthening the Shariah legal, regulatory and supervisory frameworks for Islamic finance.

Source: Bank Negara Malaysia (2011).

trade and investment linkages with other parts of the world. The Blueprint charts the medium-to-longer term initiatives to develop the Malaysian financial sector as a key driver and catalyst of economic growth, and the enactment of the new Financial Services Act 2013 and the Islamic Financial Services Act 2013 are intended to reinforce the already sound, transparent and accountable system for effective regulation and supervision across different financial sectors.

Under the Blueprint, a more flexible foreign investment policy in the financial sector is to be guided by two key criteria: prudential considerations and the best interest of Malaysia. This approach is intended to promote an orderly transition to a more liberalised environment which supports global integration of the Malaysian economy while maintaining a strong and stable financial system. Existing financial institutions in Malaysia will be accorded greater operational flexibility to establish new delivery channels. This expanded outreach will be implemented along with measures to accelerate the development of alternative delivery channels, while maintaining a balanced distribution of branch locations to support the needs of underserved areas and promote financial inclusion. Efforts to boost regional and international integration envisioned in the Financial Sector Blueprint should also contribute to enhance Malaysia's financial sector and raise its capacity to move towards a high-value added, high-income economy by 2020.

This chapter briefly describes the measures implemented to strengthen the banking sector and further develop Malaysia's capital markets following the Asian crisis, drawing on comparisons with other Asian countries to highlight developments or challenges ahead.

Malaysia's gradual opening of its banking sector

Unlike other ASEAN countries that significantly lifted restrictions on FDI in the financial sector after the Asian crisis, Malaysia adopted a managed and sequenced liberalisation approach to avoid destabilising effects on the financial sector. At the onset of the Asian crisis however, the foreign presence in the banking sector was relatively high by regional standards. While in 1996 foreign banks held 14.1% of total banking assets in Philippines, 8.5% in Thailand, 4.1% in Indonesia, they held 22.4% of market share in Malaysia. There were 14 foreign banks and 23 domestic banks operating in the country (Bin, 2003). Commercial banks accounted for roughly 70% of banking assets, 39 finance companies for roughly 22% and 12 merchant banks the remaining (Lindgren et al., 1999). Based on data from the Bankscope Database, over a decade after the Asian crisis, the share of banking assets held by foreign commercial banks operating in Malaysia declined to roughly 20% of total

banking assets. The largest foreign commercial bank in the country is only the 7th largest bank in Malaysia by total assets.

Malaysia's approach towards reforms reflected its view on the importance of having strong domestic banking groups to ensure the orderly growth and development of the financial sector. In this regard, initiatives will continue to be undertaken to ensure that the control of a significant share of domestic banking groups resides with Malaysians in order to promote and secure the best interests of Malaysia through the economic cycles and progressive stages of Malaysia's development. The government clarified that these measures do not protect domestic players from further competition as foreign players have a sizeable market share and are able to participate meaningfully in the Malaysian financial sector.

Foreign banks held over 90% of banking assets before independence in 1957 (Detragiache and Gupta, 2004). As part of the thrust of the New Economic Policy of 1971 that sought to restructure society and correct economic imbalances between different race groups in the country, measures were implemented to enhance the share of *bumiputera* corporate ownership from 2% to 30% by 1990 in all economic sectors. The measures, implemented to a certain extent, affected foreign participation in the financial sector. To address fragmentation in the banking sector, a moratorium on the issuance of new banking licences to both foreign and domestic banks was imposed in the late 1970s and early 1980s, respectively. The authorities wished to prevent over-competition which they felt could have led to unhealthy practices and ultimately have destabilised the financial system. Foreign banks also faced other operational restrictions that limited their ability to compete.[3]

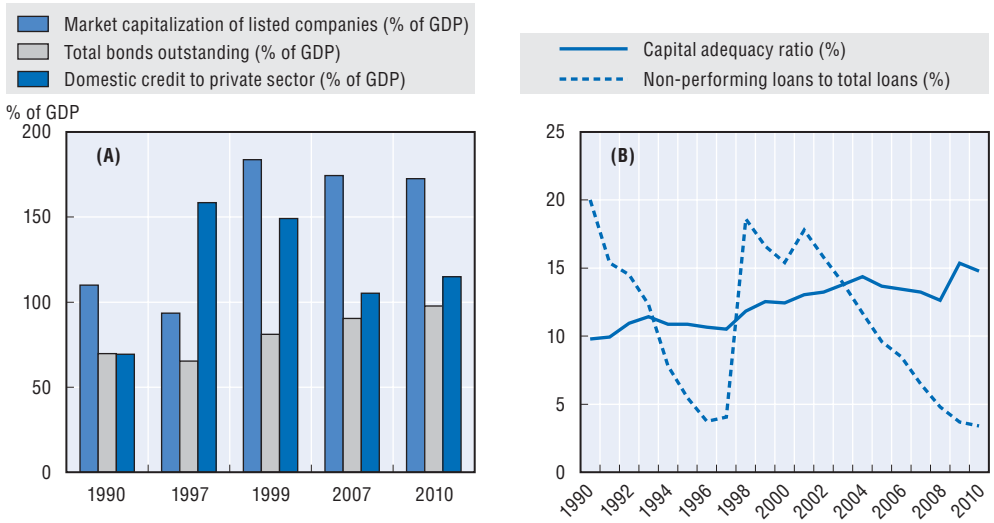
Nevertheless, the Asian crisis highlighted the need for structural reforms to address the weakness of Malaysia's fragmented financial system and increase its competitiveness in a context of increasing cross-border capital flows and international competition from other regional financial centres. As a result, the FSMP was announced in 2001 to chart the direction of the financial sector for the next 10 years that would ensure its effectiveness, competitiveness and resilience against the backdrop of an increasingly global and integrated economic environment and financial markets. The first phase of the FSMP focused on strengthening the capability and capacity of domestic financial institutions through, among others, the restructuring and rationalisation of financial institutions. The levelling of the playing field between domestic and foreign banks, which had been ahead of domestic players in terms of financial performance, comprised the second stage of the Master Plan.[4] The third phase comprised the introduction of new foreign competition in the financial sector.

The Asian crisis highlighted the perils of unbalanced financial intermediation

Malaysia was relatively less affected by the Asian crisis than its regional peers.[5] The earlier banking problems had triggered a series of smaller reforms in the late 1980s and early 1990s that improved regulation and supervision of Malaysia's financial sector and helped to ease the impacts of the Asian crisis in comparison to its neighbours.[6] The *Banking and Financial Institutions Act* 1989 (BAFIA) had strengthened the regulatory and supervisory power of Bank Negara Malaysia (BNM) over banks and other non-banking institutions.[7] In subsequent years, BNM issued new and revised guidelines and circulars on prudential standards, supervision and statistical reporting to enhance the existing regulatory framework.[8] At the time of the Asian crisis, Malaysia complied with 23 of the 25 core principles of the Bank for International Settlements.

After economic recovery in 1987, the government also took further steps to liberalise and consolidate the financial sector.[9] Interest rate controls were eliminated in 1991 as BNM continued with financial liberalisation to increase the competitiveness of Malaysia's financial system. Combined with high economic growth rates, this enabled a rapid expansion of credit to the private sector (Figure 7.1a), in particular to real estate and for securities purchasing.[10]

Figure 7.1. **(A) Composition of domestic financing (% of GDP); (B) Non-performing loans and capital adequacy ratio**



Source: World Bank 2009 Financial Structure Database; Bank Negara Malaysia *Monthly Statistical Bulletin*, March 2012.

However, the over reliance on the banking system, combined with the relative underdevelopment of the bond market, increased risk concentration in the banking sector. In 1997, domestic credit to GDP was above 150%, while the ratio of bank credit to deposits was at 140%. Capital liberalisation also boosted investments in Malaysia's stock exchange, raising stock market capitalisation to above 300% of GDP at the end of 1993. Hence, when contagion affected Malaysia, the stock market and real estate prices plunged, and capital flew out of the country, as with the rest of Asia. As a result, the share of non-performing loans to total loans rose abruptly from 4.1% in 1997 to over 18% in 1998.

The immediate response came through more stringent disclosure requirements and a bank restructuring plan.[11] Three institutions were set up to manage the restructuring of the financial sector. Danaharta, the national asset management company, was created in 1998 to help financial institutions deal with the large volume of non-performing loans and assist with the restructuring of the corporate sector. Danamodal was established in the same year to recapitalise viable banking institutions given the condition of the financial markets. The Corporate Debt Restructuring Committee (CDRC) was established to facilitate out of court debt resolution by distressed corporate borrowers, providing an alternative to companies filing for bankruptcy. All three institutions ceased operations after having successfully completed their agendas,[12] although the CDRC recommenced operations in July 2009 with an expanded mandate, as a pre-emptive measure to facilitate the debt restructuring of corporations in face of the 2008 global financial crisis.

The Financial Sector Master Plan: A comprehensive 10-year plan for the financial sector

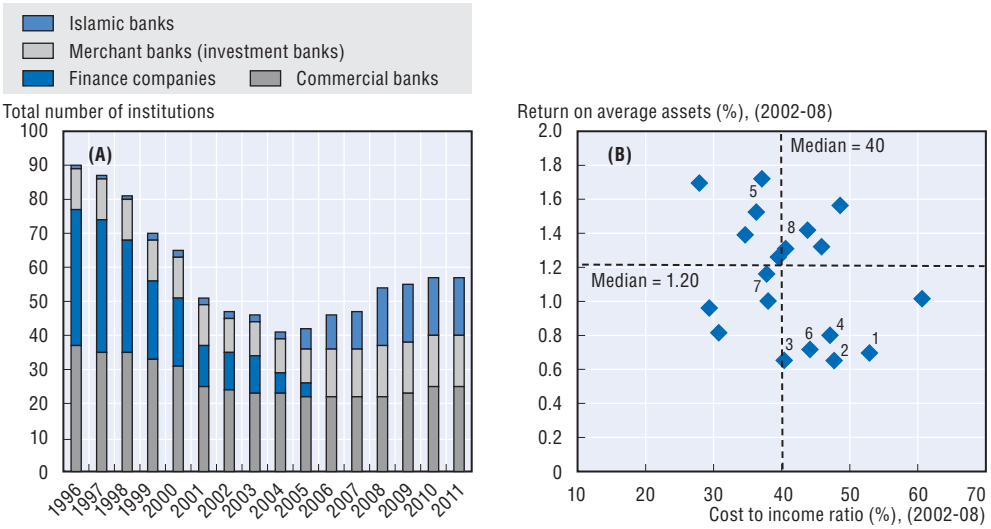
Key structural reforms began in 2001 through the issuance of the Financial Sector Master Plan. The FSMP outlined a three stage reform agenda over ten years aimed at reforming and building an efficient and resilient financial sector to face the challenges of liberalisation and financial globalisation. Reforms under the initial stage sought to build the capacity of domestic institutions and strengthen the regulatory environment.

Initial measures included a comprehensive and guided consolidation of the domestic banking institutions, including the rationalisation of commercial banks and finance companies. A merger programme was designed to consolidate the fragmented financial system into 10 domestic banking groups, in addition to increasing capital requirements. Domestic commercial banks were reduced from 23 institutions in 1997 to 11 by 2001, and to 10 in 2004 (Figure 7.2a). All the existing finance companies at the time were merged into commercial banks. Currently there are no finance companies operating as a single entity in the Malaysian financial sector. This was followed by a

transformation programme of merchant banks, stock-broking companies and discount houses to create investment banks in 2005.

Restructuring has been most evident among domestic players as regulatory restrictions limited the participation of foreign institutions in the process. Malaysia views this strategy to be important for creating a core of strong domestic banking institutions to spearhead financial development and serve as a source of stability. In other Asian countries, foreign financial institutions have played a more significant role in the restructuring of their financial sectors notably after the Asian crisis, which underpinned most of the M&A activity in the sector. Taking into account all financial sector merger and acquisitions (727 transactions) that took place from 1990 to 2002 in Malaysia, only 7.3% were cross-border transactions. In other countries in the region, the percentage of cross-border transactions was around 30% (Reserve Bank of Australia, 2003). As of November 2012, there were 27 commercial banks operating in Malaysia, of which 19 were foreign banks; 16 Islamic banks, of which 6 were foreign banks, and 15 domestic investment banks.

Figure 7.2. **(A) Landscape of financial institutions in Malaysia (1996-2011); (B) Commercial banks return on average assets vs. cost to income ratio**



Source: (A) Bank Negara Malaysia, Financial Stability and Payment Systems Report, several years; (B) Orbis/Bankscope Database. Notes: (b) Data exclude bank holdings, investment banks, Islamic banks, development finance institutions and banks located in the Labuan offshore centre. Data might overestimate results as only those banks for which data were available and that were operating in 2012 were included. Domestic banks underperformance might also to some extent reflect acquisitions/mergers that were accomplished in recent years. Hence, banks that were operating in 2008 and not anymore in 2012 for any reason were not considered. Domestic banks (8 banks) are noted by numbers in red. The remaining are the foreign Banks (12 banks).

Consolidation and capacity building initiatives undertaken under the FSMP have enhanced the resilience and competitiveness of domestic banks and have contributed to narrowing the financial performance gap between domestic banks and locally incorporated foreign banks.[13] Based on a simple accounting-ratio analysis, it seems that foreign commercial banks *a priori* outperformed their domestic counterparts until the recent global economic crisis. From 2002 to 2008, foreign commercial banks were on average more efficient as measured by the cost income ratio and more profitable as measured by the return on average assets and the return on average equity, albeit domestic commercial banks have been catching up during the decade (Figure 7.2b). This perception is shared by a few scholars.[14] The government attributes the relatively better performance of foreign banks to their focus on the more targeted and profitable segments of the market, typically comprising large-value capital activities instead of assets from retail business. For 2009 and 2010, this trend seems to have been reversed, with domestic commercial banks outperforming their foreign counterparts in these indicators, reflecting to certain extent the higher exposure of foreign banks to the global economic slowdown. This analysis does not take into account differences in banks corporate strategies, funding structures and institutional restrictions, but suggests that a further assessment of the effects that an eventual increase in foreign bank participation could have on the banking sector and on the performance of domestic banking institutions could be useful for policy making.

Another important characteristic of Malaysia's banking sector is the presence of the government in the sector (Table 7.1); several government-linked investment companies (GLICs) hold more than 30% stakes. The government holds controlling stakes in four out of the eight domestic banks operating in the country and in one Islamic bank (BIMB Holdings Berhad). The four GLCs in the commercial banking sector were responsible for 50% of total assets of domestic and foreign commercial banks operating in the country in 2011. On an effective interest basis, the government's share of total banking assets amounts to 23%. According to Khazanah, except for CIMB Holdings, in which Khazanah Nasional Berhad has equity interest, GLICs investing in these banks source their investment funds from contributors or unit holders and are therefore accountable to them. Khazanah has clarified that the government avoids interfering in these GLICs investment decisions, as these entities are required to provide an adequate return to their members.

Following the transformation of merchant banks, stock-broking companies and discount houses into investment banks, which included the merger of these institutions, the share of foreign equity limits in investment banks was increased from 30% to 49%, representing Malaysia's commitments to further liberalise the financial sector and further enhance the capacity and capabilities of domestic capital market players. Since then, BNM and the

Table 7.1. **Share of GLCs in the financial sector (USD million, 2011)**

Company name	Total assets (USD million)
Malayan Banking Berhad – Maybank	142 532
CIMB Bank Berhad	73 783
RHB Bank Berhad	45 006
Affin Bank Berhad	15 501
Share of GLCs in total banking assets (%)	50%

Source: Orbis/Bankscope Database and Bank Negara Malaysia.

Securities Commission share regulatory power over the investment banking activity.[15] The foreign equity limit in investment banks was further raised to 70%, following the liberalisation of the financial sector in 2009.

Focus was also given to enhancing diversification of the financial landscape with Development Financial Institutions (DFIs) having the mandate to promote and develop identified strategic economic sectors of the country. The role of DFIs in supporting Malaysia's economic development was strengthened with the enactment of the *Development Financial Institutions Act* 2002 (DFIA).[16] The DFIA was established to regulate the DFIs with due consideration to the unique roles and functions of each individual DFI. The legislation also provides for BNM's regulatory and supervisory authority to maintain the safety and soundness of DFIs. In 2002, all DFIs under the purview of BNM accounted for 6.57% of total banking system assets. As of December 2011, there were six DFIs under the DFIA, which accounted for 8.26% of total assets of the banking system.[17] Moving forward, Bank Negara Malaysia and the Ministry of Finance are also reviewing the laws and regulations governing DFIs to leverage the capability of these institutions to support the transition to a high-value economy by 2020. Amendments to these regulations are expected to be submitted for Parliament approval by end 2013.

The regulatory and supervisory framework was further strengthened beginning in the early 2000s. The *Anti-Money Laundering and Anti-Terrorism Financing Act* was adopted in 2001. A risk-based supervision framework was introduced to complement the compliance-based system in place, and a principles-based approach towards regulation was adopted. Several prudential guidelines and principles were issued to strengthen the capital base and to increase financial disclosure.[18] The *Central Bank Act* 2009 further enhanced BNM's power to undertake surveillance and to act pre-emptively to avert risks that may affect the financial system. Basel II was adopted in 2004, and all major elements of Basel II were in place as of May 2012. BNM has also begun consultations with industry players to further implement the Basel III capital framework and expects to finalise the new standard before the end of 2012. Basel III standards will be implemented in phases, beginning in 2013 until 2019.

A deposit insurance system was introduced with the creation of Perbadanan Insurans Deposit Malaysia in 2005 as part of the effort to enhance consumer protection. In 2008 the deposit insurance system began to follow a risk-based approach, under which less risky banks are entitled to lower premiums. The corporate governance framework was revised in line with OECD *Principles for Corporate Governance* (see Chapter 5) and reforms to the financial reporting standards were implemented in 2010 to prepare for full adoption of the International Financial Reporting Standards (IFRS).[19] As of January 2012, banks and corporations required to report to either the SCM or BNM are requested to issue financial reports in compliance with the IFRS framework (BNM, 2012a). In addition, in an effort to support responsible business conduct, since 2007 all listed companies at Bursa Malaysia are required to report on corporate social responsibility in their annual financial reports (Chapter 6).

The Asian financial crisis also indicated the need to enhance the sharing of credit information in the country. The centralised public credit registry system, established in 2001 by BNM, and other private credit reporting agencies[20] have since facilitated the sharing of consolidated credit information and have contributed to improving access to finance in the country. In 2010, Malaysia introduced the *Credit Reporting Agencies Act* 2010 to govern the activities and operations of private entities that carry out credit reporting business. The aim is to balance between consumers' rights to privacy and protection, and lenders' rights to information for improvements in risk management practices. This development is envisaged to support the prudent expansion of credit to the economy, including to SMEs, and therefore sustaining the quality of loan portfolios of financial institutions.

During the economic crisis in 2008-09, SMEs' access to financing was enhanced with the establishment of the SME Assistance Guarantee Scheme (closed in end-2009) and the Working Capital Guarantee Scheme (extended until end-2013), which provide up to 80% guarantee for financing obtained from financial institutions. In addition, the Small Debt Resolution Scheme, which was established in 2003 to assist financially-distressed but viable SMEs that are constrained with non-performing loans, was expanded to encompass all SMEs facing financial difficulties.

During the second phase of the FSMP, BNM accorded further operational flexibility to locally-incorporated foreign banks by allowing them to establish up to four new branches in 2006. Restrictions on the employment of expatriates were removed to increase competitiveness. BNM also liberalised interest rates in 2004, giving banks the flexibility to set interest according to their funding costs. This has allowed banks to develop new financial products and enhanced competition in the banking sector. With enhanced capacity, domestic banks have also began to expand abroad to penetrate new markets,

broaden their customer base, build a regional franchise and support Malaysian businesses expanding abroad (see Chapter 1). Domestic banks' foreign operations accounted for 19% of total assets in 2012 (BNM, 2012b).

Entering the third stage of the Master Plan, BNM announced in 2009 further steps to open up the financial sector to foreign competitors. These measures included issuing new banking and insurance licences to five foreign commercial banks, two Islamic banks and four family *takaful* operators; the increase in foreign equity limits in insurance companies, *takaful* operators, investment banks and Islamic banks; and introducing operational flexibility in employing expatriates and expanding branches of locally-incorporated foreign banks and insurance companies (see Chapter 2). As a result, four new foreign banks, one new international Islamic bank and two new *takaful* operators entered the market (BNM, 2011 and 2012b). In addition, one new licence was issued to an international Islamic bank. In 2011, foreign banks operating in Malaysia were also allowed to connect to Malaysia's domestic ATM network owned by domestic banks, lifting an important barrier for foreign banks to compete in the retail banking market.

Malaysia has significantly removed restrictions on FDI in the financial sector over time. Remaining restrictions are relatively low compared to other prominent economies in Asia and Pacific, but its financial sector continues to be more restrictive to foreign investment than in most OECD countries (see Chapter 2). Allowing further foreign participation could help to enhance the competitiveness of its financial sector and help to increase the share of loans being allocated to the non-tradable sector since the Asian crisis, which is particularly challenging for SMEs that find it difficult to raise funds in the capital markets, and hence contribute to increasing the investment level (IMF, 2012a). Moreover, commercial bank penetration is low compared to other countries with a similar level of domestic credit to GDP.[21] Moving forward, Malaysia is adopting other innovative channels such as agent and mobile banking to reach the underserved in a more cost effective manner. Since implementing the agent banking initiative in 2012 to further widen access to financial services at the sub-district level, an internal exercise by BNM found that 75% out of 837 sub-districts with a population of more than 2 000 have at least one financial access point, compared to 46% in 2011 (BNM, 2012b).

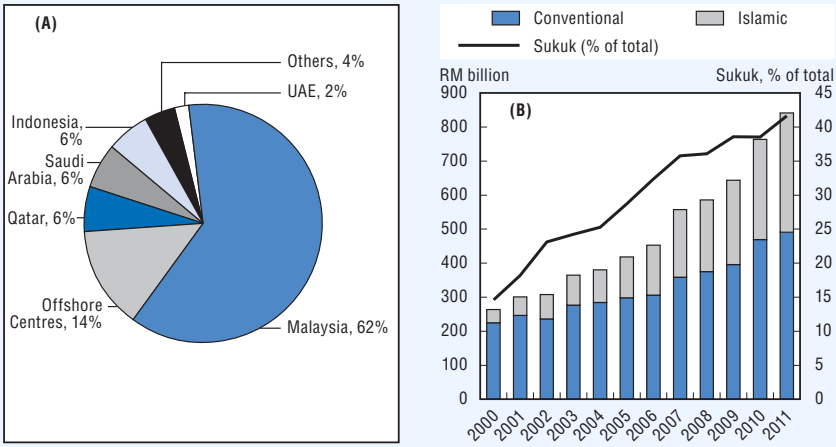
Building on the positive experience with the FSMP, Malaysia has now embarked on a new reform programme for the financial sector aimed at making it a catalyst to a high value-added, high-income economy by 2020. The Financial Sector Blueprint 2011-20 seeks to elevate financial sector participation in the economy from 4.3 times to 6 times GDP in 2020, which entails a growth pace at around 8% to 11% per year.

Box 7.2. **Malaysia's leading position in Islamic finance**

Over the past decade, the global market for Islamic finance has grown impressively at an annual average rate between 20% and 30%. By 2020, the market size is forecast to reach USD 4 trillion. Within this context, Malaysia has taken the lead towards becoming an international hub for the Islamic financial industry. The sector value-added to GDP has substantially increased during the past decade, rising from 0.3% in 2000 to 2.1% in 2009. FDI liberalisation of Islamic banking and takaful activities undertaken in 2009 is expected to boost even more Malaysia's role as an international Islamic financial hub.

The Islamic banking industry has made enormous progress during the last decade, supported by several government-led initiatives. Total assets have grown to account for 22.4% of total banking system assets (including DFIs) at the end of 2011. Deposits within Islamic banking institutions have grown at an average of 17.6% over the last ten years, compared with a growth of 7.1% of conventional deposits, enhancing its role of financial intermediary in the country. As of June 2012, there were 21 Islamic banking institutions operating in the country, of which 5 were international Islamic banks. Global banks such as HSBC, Standard Chartered and Deutsche Bank have established shariah-compliant operations in the country. In 2011, Malaysian Islamic banks accounted for 10% of global Islamic banking assets, behind Iran (40%) and Saudi Arabia (14%). These achievements reflect the government's strong commitment to raise Malaysia to the position of the main international Islamic financial centre.

Figure 7.3. **(A) Share of total global sukuk market[1] (%); (B) Outstanding sukuk and debt securities**



1. July 2011.

Source: (A) Bank Negara Malaysia compilation based on Bloomberg; (B) Bank Negara Malaysia statistics.

Box 7.2. **Malaysia's leading position in Islamic finance** *(cont.)*

Since the enactment of the *Islamic Banking Act* in 1983, the Islamic financial industry has taken a key role in Malaysia's national development plans, and is set to continue this way during the next decade given its prominent role in the Financial Sector Blueprint. The Shariah Advisory Council created in 1996 by the Securities Commission, and the Shariah Advisory Council established by BNM in the subsequent year are the two institutions responsible for laying the foundations for the sector's rapid development. A sound regulatory system that ensures transparency, *shariah* governance and the protection of property rights, supported by tax neutrality measures to promote a level-playing field have provided an attractive environment for both domestic and foreign Islamic financial institutions. The Law Harmonisation Committee was also established in 2010 to review existing laws applicable to Islamic financial transactions towards strengthening legal support for Islamic finance.

This environment has enabled significant innovations in Islamic finance: sovereign and global corporate sukuks structured using both debt and non-debt based contracts, Islamic Real Estate Investment Trusts, Islamic exchangeable bonds, shariah-compliant equity indices, exchange traded funds, warrants, and futures contracts. Malaysia has also been the first to establish a shariah-based commodity trading platform at Bursa Malaysia in 2009.

Malaysia is host of the largest Islamic equity and sukuk market in the world, with 63% share of the global sukuk market (at USD 179 billion) as of July 2011 (Figure 7.3a). Malaysia's Islamic capital market has grown at a 13.6% CAGR from 2000 to 2010, tripling its size from RM 294 billion (USD 98 billion) to RM 1 050 billion (USD 350 billion). As of September 2011, shariah-compliant stocks represented 88% of securities listed on Bursa Malaysia, and accounted for 62% of total market capitalisation of Bursa Malaysia. Malaysia's sukuk market represented 42% of total debt outstanding in 2011, with sukuk issuances accounting for an increasing share of issuances over the years (Figure 7.3b). BNM has issued sukuk notes since 2006 constantly. Malaysia's US dollar-denominated sukuk market is also the second largest in the world, accounting for 15%, behind United Arab Emirates (54%). The depth and liquidity of Malaysia's sukuk market is also an attractive component for global shariah investors to invest in and trade sukuk instruments in the country.

Malaysia's dominant role in the sukuk market is associated with the development of a large investor and issuer base, with demand for sukuk debt arising from takaful operators, the Employees Provident Fund (EPF), Khazanah Nasional Bhd (Malaysia's strategic investment fund), Permodalan Nasional Bhd (Malaysia's national asset management company), among others. The Islamic fund management industry is responsible for 15% of assets under management. Several important global funds have entered

Box 7.2. **Malaysia's leading position in Islamic finance** *(cont.)*

Malaysia's Islamic fund industry, such as BNP Paribas, Aberdeen Asset Management and Amundi. The takaful insurance sector was the second largest in the world in 2009, behind Iran. In 2011, assets of the takaful operators accounted for 8.9% of total assets of the insurance and takaful industry in Malaysia. Following the liberalisation of financial services in 2009, four new takaful operators have entered the market, of which three are foreign-controlled. As of June 2012, there were 12 takaful, one international takaful, and 4 retakaful operators in the country.

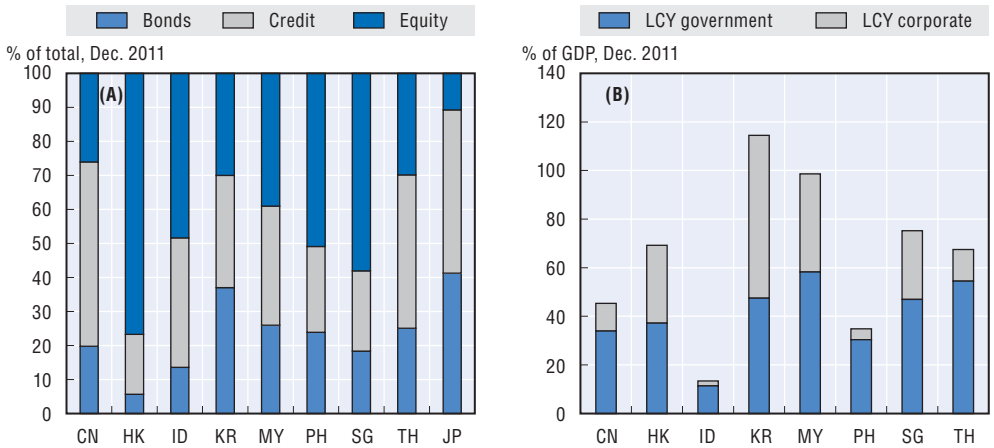
Source: BNM (2011), PriceWaterhouseCoopers (2010), KFH Research (2012), *SCM Annual Report 2011*.

Capital markets in Malaysia

Malaysia has undergone important reforms to upgrade capital markets infrastructure since the Asian crisis. As in other ASEAN countries, Malaysia has focused on developing the domestic debt market to counterbalance the reliance on bank financing and diminish the concentration of credit and maturity risks within the banking sector. Several reforms were implemented throughout the 2000s under the Capital Market Master Plan 1 (CMP1). Regional initiatives, such as the Asian Bond Markets Initiative launched in 2003 by the ASEAN+3 Finance Ministers and the ASEAN Capital Market Forum, have also contributed to deepening Malaysia's capital market.[22] In 2011, the Capital Market Master Plan 2 (CMP2) was announced and showed the policy direction over the next ten years. Reforms will focus on promoting capital formation, facilitating efficient intermediation, deepening liquidity and strengthening governance issues. Particular focus is given to the internationalisation of the investor and issuer base. Delivering on such policies is expected to raise the size of Malaysia's capital market from around RM 2 trillion to RM 4.5 trillion (Securities Commission, 2011).

Malaysia's domestic bond market has grown at 11% CAGR from 2000 to 2011, and continued to increase during the recent global financial crisis. Its share in the composition of domestic financing has increased and is currently one of the most significant in the region (Figure 7.4a). While in December 1997 the share of bonds outstanding in the composition of domestic financing was 21%, it accounted for 26% in December 2011. Malaysia's domestic debt securities market is also one of the most developed in its region (Figure 7.4b). In December 2011, it roughly equalled GDP. The size of both corporate and public bond markets is significant, even in relation to OECD standards. The public bond market has been the main contributor to the deepening of the market in the 2000s, but the corporate bond market is notably important, as it accounted for roughly 41% of the total bond market at the end of December 2011.

Figure 7.4. **(A) Composition of Domestic Financing (% of total); (B) Corporate and Government Bonds Outstanding**



Source: Asian Bonds Online.

The corporate bond market grew on average 8% annually from 2002 to 2011 and accounted for roughly 40% of GDP in 2011 (Bond Info Hub). Most notably, it increased considerably during the recent global financial crisis, indicating that the debt market might have served as an alternative to tougher banking conditions (Felman et al., 2011).

Challenges to increase liquidity in the private bond market remain. Liquidity levels have declined considerably since 2004, though levels have slightly recovered since 2008 and were above the regional median at end of 2011.[23] Further regional integration to establish a strong regional corporate bond market could contribute to further develop the market in Malaysia by enhancing the efficiency of the financial intermediation of Malaysia's surplus savings (Gochoco-Bautista and Remolona, 2012). Enhancing the capacity and liquidity of the private bond market is necessary to meet the level of investments required to make the transition to a developed economy by 2020. Foreign investors are still relatively small in the corporate bond market in Malaysia.

The Securities Commission and Bursa Malaysia have already begun to undertake efforts to boost international integration. For example, in 2009, Bursa Malaysia launched Bursa Suq Al-Sila', an international commodity trading platform, that is multi-currency, allowing more choices, access and flexibility for international financial institutions to participate in this market. Malaysia together with Singapore and Thailand has formed the ASEAN Trading Link that connects Bursa Malaysia, Singapore Exchange and Stock Exchange of Thailand, ASEAN's three largest exchanges. This single entry point is expected to provide greater market access and growth potential for

brokerage firms in each country by reducing the hassle and cost of expansion into another market.

Bond market development boosted by regulatory reforms and regional integration

Malaysian bond market developments in the 2000s are a consequence of significant improvements in the regulatory framework and market infrastructure. Amendments to the *Securities Commission Act* in 2000 ended the previously fragmented institutional environment governing bond markets by centralising regulatory and supervisory power within the Securities Commission.[24] In 2001, the SCM issued the CMP1, setting 24 strategic initiatives and 152 recommendations to be undertaken in the subsequent ten years in order to promote the development of capital markets and strengthen its regulatory regime. The plan was divided into three phases, with the first focusing on facilitating domestic participation in capital markets; the second aimed at gradual liberalisation of market access; the third sought to strengthen market infrastructure and enhance international participation.

Enhancements in market infrastructure and the easing of listing requirements contributed to widening the investor and issuer base.[25, 26] A full disclosure-based approach adopted in 2000 facilitated access to corporate bond markets and the corporate governance framework was improved in line with OECD standards (see Chapter 5). Multilateral developing banks have been allowed to issue local currency bonds in Malaysia since 2004.[27] This was later extended to multinational enterprises in 2006. Investor protection was further enhanced with the *Capital Markets Services Act* 2007 (CMSA).[28] In 2009, the Danajamin Nasional Berhad (Danajamin) was established to provide financial guarantee to facilitate access by private companies to domestic bond markets. In 2012, the government announced its efforts to broaden the supply base of the bond market by introducing retail bonds to the public. In early 2013, Bursa Malaysia launched the Exchange Traded Bond Sukuk to provide retail investors direct access to invest in RM 300 million Sukuk issued by Dana Infra Nasional Berhad.

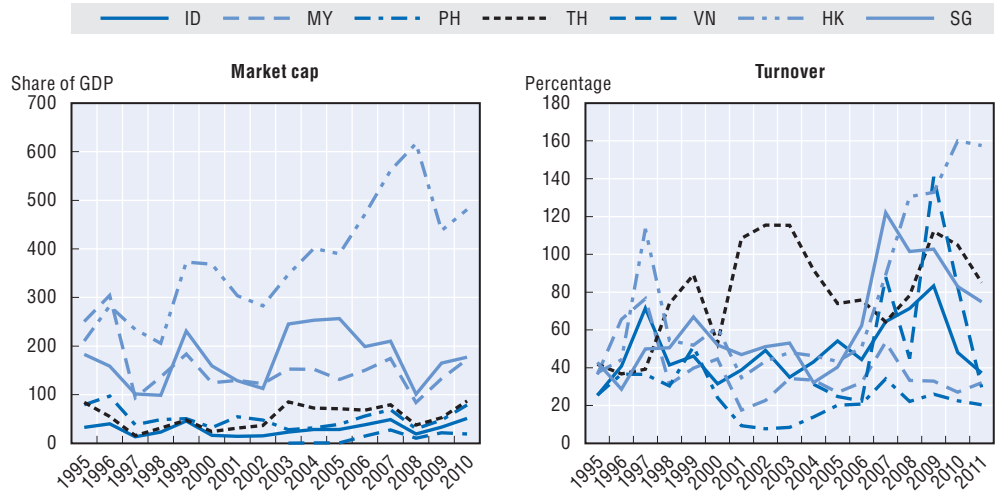
Broadening the investor base and liquidity for further equity market development

Malaysia has a relatively deep equity market by regional and OECD standards. As of end 2010, market capitalisation reached 173% of GDP, behind only Hong Kong (China) and Singapore in the region (Figure 7.5a). The number of listed companies has increased substantially in the past decade. At the end of May 2012, there were 929 companies listed on Bursa Malaysia and stock market capitalisation stood at roughly RM 1.3 billion. Only the Hong Kong Stock Exchange

had more listed companies in the region (1 518 companies). Bursa Malaysia was the 14th largest in the world by market capitalisation as of October 2012.

Despite Malaysia's relatively large capital market, liquidity levels are low in comparison to regional peers (Figure 7.5b). From the Asian crisis to the recent global financial crisis, primary equity issuance has also been modest (Figure 7.6a), which was expected due to the decline in Malaysia's level of investment. This has been partially offset by companies opting for raising funds for their investment needs through debt markets. But equity issues have strongly recovered since the global financial crisis. To a certain extent, the recovery in equity and rights issues since 2009 might reflects the liberalisation measures reducing the *bumiputera* free-float equity condition from 30% to 12.5% (*Financial Times*, 2009). In 2012, Bursa Malaysia became one of the leading stock exchanges as a destination for IPOs by value, ranking fourth globally behind Nasdaq, the New York Stock Exchange, and Tokyo First Section, by proceeds raised. Among other successful IPOs in 2012, the USD 3.3 billion IPO of Felda, a Malaysian palm oil group, was the fourth largest IPO in the world after Facebook, JAL and Santander.

Figure 7.5. **(A) Market capitalisation of listed companies (% of GDP); (B) Stocks traded, turnover ratio (%)**



Source: World Bank Global Finance Indicators.

Under the framework of the CMP1, measures were taken to enhance liquidity, promote the development of market intermediaries and further integrate Malaysia's capital markets into world markets. As an effort to boost liquidity and reduce the costs of domestic listings, the Bursa Malaysia Stock Exchange was created after the merger of the Kuala Lumpur Stock Exchange

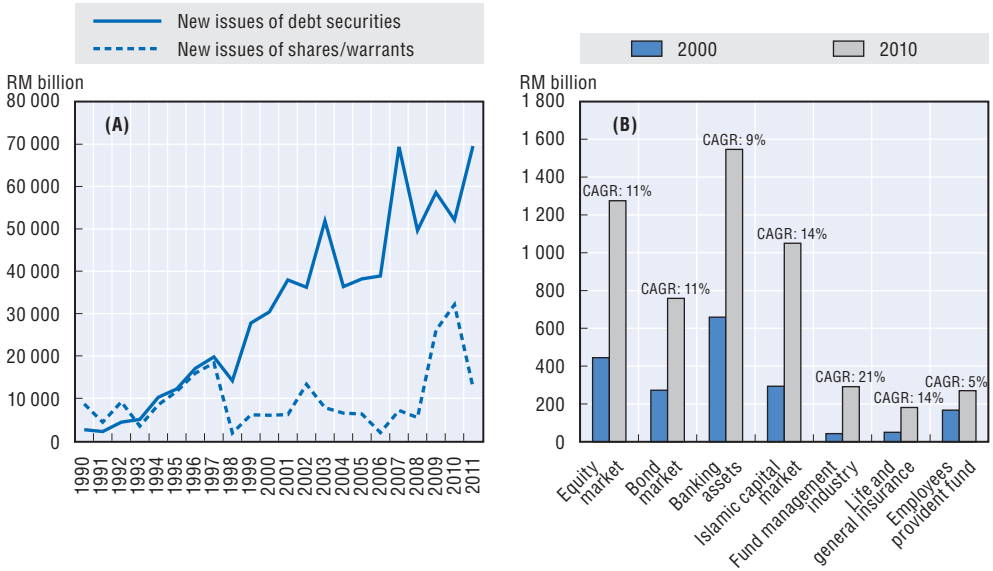
with MESDAQ (OTC market exchange) in 2001. It was later demutualised in 2004 and listed in the stock exchange in 2005. Kuala Lumpur Options and Financial Futures Exchange Berhad and the Commodity and Monetary Exchange of Malaysia were also merged with the stock exchange in 2001. Restrictions on stock broking and fund management activity were lifted, and listing requirements were eased to facilitate market access for smaller enterprises and foreign companies. The affirmative policy requiring that 30% of new equity made available to the public be held by indigenous Malays was reduced to 12.5% in newly-listed companies, although ministries have kept the right to impose different ownership limits and higher restrictions in strategic sectors (see Chapter 2). The corporate governance framework for listed companies was enhanced in line with the OECD *Principles of Corporate Governance* (see Chapter 5).

Liquidity improved prior to the recent financial crisis, but remains low by regional standards. Regional and global capital market integration remains limited and results of recent initiatives have yet to materialise in the equity market. While intra-ASEAN portfolio investment has increased since 2006, the share of intra-ASEAN equity investment in total intra-ASEAN investment has not changed (ADB, 2012). Total foreign shareholdings also remain relatively low by regional standards, despite the previously cited liberalisation measures (ADB, 2011). As of December 2011, foreign investors held 18.5% of securities listed on the Bursa Malaysia (Securities Commission, 2012). A relatively large residual government stake in listed companies as a consequence of the predominant role of government linked companies (GLCs) in several sectors, or large family shareholdings, as indicated by a low free-float capitalisation level, are also a limiting factor. The free-float level is lower than in Hong Kong (China) and Thailand, and close to the free-float levels of the Philippines and Indonesia (World Bank, 2011).[29] Liquidity in the equity market could be enhanced with a reduction in the government's stake in listed GLCs.

The asset management industry

The fund management industry remains relatively nascent compared to banking intermediation, but has grown at a 21% CAGR during the last decade, mostly due to an increase in the unit trust funds industry (Figure 7.6b). As of December 2010, unit trust net asset value was equivalent to 17.8% of Bursa Malaysia market capitalisation, having significantly improved since January 2004, when it was equivalent to 11% of market capitalisation. The number of management companies has changed only slightly, but the number of approved funds has more than doubled. As of December 2011, there were 604 approved funds. Reforms have played a significant role in fostering this development and enabling the development of private sector funds,[30] although industry development has been historically linked to government-

Figure 7.6. **(A) Funds raised by the private sector in the capital market; (B) Financial system assets (2000-10)**



Source: Bank Negara Malaysia, *Monthly Statistical Bulletin*; Securities Commission (2011a).
Notes: Fund management industry refers to Unit Trust & Wholesale funds assets under management. Equity market refers to equity capitalisation at the Bursa Malaysia. Bond market refers to bonds outstanding. Islamic capital market refers to Islamic equity capitalisation and sukuk bonds outstanding. Employees Provident Fund data refers to total accumulated contributions. Life and General Insurance data refers to total assets.

linked funds, which were established to support the objectives of the New Economic Policy of 1971 (FIMM, 2012). The largest fund management company in Malaysia is the government-owned Permodalan Nasional Berhad, which operates a wide range of funds through its subsidiaries. In 2001, government-linked funds were responsible for roughly 50% of total unit trusts net assets value, despite being responsible for only one third of existing funds (Ramasamy and Yeung, 2003). In 2011, government-linked funds accounted for 58% of total unit trusts net assets value.[31]

A significant share of institutional investors in Malaysia tends to invest in liquid and less risky assets, limiting the availability of finance for more risky ventures. Financing for green growth initiatives for instance is limited despite recent policies to develop the industry (see Chapter 9). Government efforts to continue expanding the funds industry are essential to permit financial intermediation to broaden its risk profile and support the development of innovative products and emergence of a broader class of financial assets, and consequently amplifying the availability of finance to more risky ventures. Since 2009, foreign firms have been allowed to establish wholesale fund management companies with 100% foreign shareholding. In the retail sector,

unit trust management companies are allowed to have 70% of foreign shareholding up from 49%. Allowing further participation of foreign firms is expected to raise competition among investment management companies and promote greater product innovation.

The pension system is the second largest in the region as a percentage of GDP. In 2010, it was estimated to account for roughly 60% of GDP. The largest provident pension scheme is the compulsory Employees Provident Fund (EPF), which plays a significant role in financing infrastructure projects in Malaysia (see Chapter 8). The EPF has also been an important player in the domestic equity market supporting the growth of equity issues and equity demand. The EPF faces some constraints given the limited range of investment products and liquidity to trade in large volume locally. There is a need to implement reforms to address the low pension replacement rate, which is among the lowest in the region and much lower than the OECD average, and to raise the rate of return on EPF investments (OECD, 2011).

In October 2010, the government authorised the increase of overseas investments of the EPF to 20% (IMF, 2012b), having already increased the limits on investment in domestic equities in earlier years. In line with its prudent investment policy governed by its Strategic Asset Allocation policy, the EPF maintains a higher weight on fixed income investments for capital preservation, but is gradually increasing exposure in equities, within its stated risk limits, to achieve its targeted real rate of return. Accordingly, the EPF has expanded its global investment portfolio within its risk limits. As of 2011, EPF's global investment exposure stood at 13.4% of the total investment size. EPF has also been gradually increasing its exposure in real assets, including both domestic and global properties as well as infrastructure assets. Efforts to further develop the private pension industry were also made with the introduction of the Private Retirement Scheme and related tax incentives (Securities Commission, 2012).

The venture capital industry has grown at 13% CAGR since 2003 to reach RM 5.46 billion, but has yet to accumulate significant capital. The SCM, as the chair of the Malaysian Venture Capital Development Council, has consulted market players to draft a regulatory framework for the industry. The proposed guidelines remained open to comments from industry players until July 2012. The private equity industry is still nascent as well. A government-linked private equity fund was established in 2009 to support the objectives of promoting *bumiputera* equity participation in Malaysia leading companies under the New Economic Model. The Ekuiti Nasional Bhd has been endowed with RM 500 million in funds to invest in high-growth potential companies. The effects of these policies on the development of the industry and the involvement of the private sector involvement remain to be seen.

Notes

1. Islamic finance comprises a series of banking, capital markets and insurance instruments that are compliant with shariah principles. Islamic finance is based on the following distinguishing principles: the prohibition of interest on financial transactions, the ban on contractual uncertainty and thereby speculation, the promotion of risk-sharing and profit-sharing instruments on financial transactions, the use of tangible assets to back any financial transaction and the prohibition of non-lawful investments under shariah (e.g., business involving alcohol, firearms, tobacco, and adult entertainment, among others), among others. Islamic banking (muamalat) involves several shariah-compliant instruments not explicitly mentioned in this chapter. The term sukuk bonds used in this text refers to Islamic capital market financial certificates that are equivalent to bonds in traditional finance. They are shariah-compliant instruments that can be structured as a partial ownership in a debt, asset or equity. The term takaful insurance used in the text refers to Islamic insurance instruments.
2. In 2009 the ratio of bank credits to deposits was at 78%, and the gross ratio of non-performing loans to total loans was at 3.7%.
3. Foreign banks faced restrictions in providing credit to non-resident controlled companies, as these were conditioned to domestic banks for at least 60% of their credit needs. This was lifted in 2000.
4. The Financial Sector Master Plan recognised that foreign banks out-performed their domestic competitors as reflected by lower cost-to-income ratios, higher product innovation and higher returns on equity and returns on assets (BNM, 2001).
5. Bin (2003) highlights that Malaysia did not face the same pressure to liberalise as problems were mainly concentrated in two banks, Bank Bumiputra and Sime Bank. Response to the crisis focused on restructuring the fragmented banking sector by encouraging local banks to merge into ten banking groups.
6. Lindgren et al. (1999) highlight that non-performing loans fell from 20% of total loans in 1990 to about 3.8% in 1996. Capital adequacy ratios rose to levels above 8% as accorded under Basel I. These improvements, however, partially reflect abnormal asset prices, the rapid growth of credit and collateral-backed lending under a fast growth period, which covered deterioration of underlying asset quality. Nevertheless, exports recovered relatively fast and capital began to flow back to the country by 2000 (Randhawa, 2011).
7. The BAFIA also required foreign banks in Malaysia operating through branches to convert them into locally incorporated companies by 1994 to continue operations in the country.
8. This included imposing limits on securities and property lending, and tightened regulation on disclosure requirements (Lindgren et al., 1999).
9. BNM lifted the administrative controls on the Base Lending Rate (BLR) and a two-tier regulatory system for banking institutions was later introduced in 1994 to strengthen the capital base and promote consolidation in the sector. The two-tier regulatory system was abolished in 1999 as it led banking institutions to undertake excessive capital expansion programmes funded by shareholders' borrowings, which in turn fuel risks of imbalances in the financial system as banking institutions aggressively increased their loan portfolios to meet debt servicing obligations to shareholders. Tier 1 banks were those in compliance with

higher BNM capital standards and were thus allowed to operate in more sophisticated markets.

10. Malaysia's New Economic Policy implemented since 1971 contributed to rapid progress of the financial sector. Private credit to GDP grew from 7% in 1970 to 117% GDP by 1997, particular accentuated since financial liberalisation in the 1990s (Kanitta et al., 2011, in Randhawa, 2011). However, this rapid credit growth was particularly promoted by Tier 2 institutions, reflecting partially their efforts to build the assets base to achieve Tier 1 status (Lindgren et al., 1999).

11. BNM issued regulatory norms to reclassify non-performing assets in the banking system. All financial institutions were required to report and publish key financial indicators on a quarterly basis, which was not the case up until then. BNM also began to publish monthly statistics on financial institutions' capital positions and levels of nonperforming loans and provisions.

12. Danaharta was dismantled in 2005, Danamodal in 2003 and the CDRC in 2002, but the CDRC has recommenced operations in July 2009.

13. This view has been expressed by BNM's Governor, Dr Zeti Akhtar Aziz, before the recent global economic crisis during her speech at the 10th Malaysian Banking, Finance & Insurance Summit: "Liberalisation and Consolidation of Malaysian Banking & Finance Sector: Enhancing Competitiveness & Resilience of Our Economy", Kuala Lumpur, 9 June 2006.

14. Tahir et al., (2010), following a similar approach, also find evidence that foreign banks on average had higher profit ratios and lower interest margins and operational costs. Using a more sophisticated technique, namely stochastic frontier approach, the authors find that foreign banks were more profit-efficient relative to domestic banks, but less cost-efficient. Keng and Wooi (2011), based on a Data Envelopment Analysis, also find evidence that foreign banks were more efficient than domestic ones during the 2003-2008. Randhawa (2011) argues that despite consolidation Malaysia's banking sector remains fragmented, with foreign banks demonstrating superior performance. But the author argues that domestic banks have yet to realize the benefits of the consolidation process.

15. BNM is responsible for prudential regulation in order to maintain stability and soundness of institutions. The SC is responsible for ensuring investor's protection and promoting market integrity. The parameters for regulation and supervision between the two institutions have been clearly defined in the *Guidelines on Investment Banks* and in a *Memorandum of Understanding* that outlines all aspects of co-operation and consultations to ensure smooth and efficient co-ordination of roles and responsibilities over investment banks.

16. Development Financial Institutions are established by the Government with specific mandates to develop and promote key sectors that are considered to be of strategic importance to the overall socio-economic development objectives of the country. These are: Bank Perusahaan Kecil & Sederhana Malaysia Berhad or the SME Bank (provides financing and advisory services to SMEs involved in manufacturing, services and construction sectors); Bank Pembangunan Malaysia Berhad (provides medium to long term credit facilities to finance infrastructure projects, maritime, high technology and capital intensive industries in manufacturing, as well as other identified sectors in line with the national development policy); Bank Kerjasama Rakyat Malaysia Berhad (cooperative bank that mobilises savings and provides financing services to its members and non-members); Export-Import Bank of Malaysia Berhad (provides credit facilities to support exports and imports of goods and services and overseas project financing, as well

as export credit insurance services, guarantee facilities and other facilities offered by export-import and credit insurance financial institutions); Bank Simpanan Nasional (provides retail banking and personal finance, especially for small savers); Bank Pertanian Malaysia Berhad or Agrobank (promotes sound agricultural development and coordinates and supervises the granting of credit facilities for agricultural purposes and mobilises savings, particularly from the agricultural sector and community).

17. Total assets of the banking system for 2002 refer to assets from conventional and Islamic banking institutions, finance companies, investment banks and DFIs prescribed under the DFIA; whereas total assets of the banking system for 2011 refer to assets from conventional and Islamic banking institutions, investment banks and DFIs prescribed under the DFIA.

18. In 2004, financial institutions were required to incorporate market risk into their risk-weighted capital ratios. BNM also issued new regulatory treatment for mortgage-backed securities and Ringgit-denominated bonds.

19. Corporate governance guidelines were revised to ensure that boards of directors and the management of financial institutions are capable and accountable for their responsibilities. These included measures taken to ensure a clear separation between the management and shareholders of financial institutions and to strengthen the independence and responsibility of the board of directors.

20. The public credit registry, Central Credit Reference Information System (CCRIS), which is administered by BNM, collates from and disseminates to financial institutions, factual credit information to facilitate credit-worthiness assessments of borrowers or prospective borrowers. Complementing this, private credit reporting agencies provide value-added products and services based on additional non-bank data, such as trade credit data of companies and utilities information. These products and services include credit scoring, fraud management, credit monitoring services and bankruptcy information.

21. Data from the World Bank Global Development Finance Database for 2009 shows that the number of commercial bank branches per 100 000 adults is low in Malaysia compared to other countries with similar levels of domestic credit to the private sector as a percentage of GDP.

22. Following the Asian financial crisis, it became evident that there was a need to develop domestic debt markets in ASEAN countries to decrease dependence on short-term foreign-currency financing, as maturity and currency mismatches increased these countries vulnerabilities to capital flows. In 2003, ASEAN+3 Finance Ministers agreed to promote the Asian Bond Markets Initiative (ABMI). Under this initiative, countries were encouraged to adopt voluntary measures to facilitate market access in a regional level and enhance market infrastructure to foster bond markets.

23. States benchmarked include China, Hong Kong (China), Indonesia, South Korea, Thailand and Japan. Data was not available for Philippines and Singapore.

24. The Securities Commission has since been the only authority with powers to approve corporate bond issues and formulate policies governing the corporate bond market. The SC also supervises secondary market trading and bond market intermediaries. In 2007, the Securities Commission became an IOSCO principles signatory and the regulatory framework was reported to be highly compliant with IOSCO standards.

25. The minimum investment grade requirement for issuance of bonds was lifted, but the requirement of a rating report was maintained. Rating requirements were lifted for convertible and sukuk bonds. Universal brokers were allowed to participate in fixed income markets.

26. The introduction of the Real Time Electronic Transfer of Funds and Securities System (RENTAS), the central securities depository, has facilitated real time delivery against payment, thereby reducing counterparty risk as parties fulfil their obligations simultaneously. The Fully Automated System for Tendering has enhanced the tendering of private debt securities in primary markets. A bond information and dissemination system was also established to improve access to bond market information and facilitate trading activity in secondary markets (Zamani, 2006). This was later replaced by the Electronic Trading Platform (ETP) launched by the Bursa Malaysia in 2008, which provides post-trading information to the market and contributes to increase market liquidity and transparency. Listed bonds are traded at the ETP managed by the Bursa Malaysia, but the majority is still traded on the OTC market. ETP also records traded of the OTC market.

27. In November 2004, the Asian Development Bank became the first foreign institution to issue a ringgit-denominated bond amounting to RM 400 million in a fixed-rate bonds issue. In the following month, the International Finance Corporation issued RM 500 million 3-year Islamic bonds. Other international organisations have raised funds Malaysian since then.

28. The CMSA consolidated several laws into one piece and gave power to the Securities Commission (SC) to intercede in licensed intermediaries when clients' interests are prejudiced. The SC was also empowered to remove a director of a public company if it assesses that the director is not fit to be on the board of a public company. In 2010, amendments to the act strengthened regulation to prevent wrong-doing. The SC was given the power to "prosecute directors and officers of public companies for causing wrongful loss to the company, and to prosecute anyone who coerces or influences the person responsible for preparing the financial statements of listed corporations causing them to be materially misstated" (IMF, 2012). Amendments to the act in 2011 have extended regulatory functions of the SC and introduced provisions on derivatives and a new framework on the Private Retirement Scheme Industry.

29. Free-float capitalisation differs from market capitalisation in that it excludes from total shares outstanding those shares held by governments or strategic shareholders, such as family or direction shareholdings. Hence, it gives an idea of market capitalisation of shares that would be readily available for trade.

30. For instance: tax incentives, liberalisation measures on foreign ownership in stockbroking and funds management companies, easing of limits that pension and provident funds can invest in equity securities, opening to foreign funds listing and investments, permission to outsourcing the management of insurance companies investment funds, among others.

31. As reported by FIMM, total net asset value of private sector funds as of 31 December 2011 amounted to RM 106 billion or 48% of RM 249 billion, the total net asset value of the unit trust industry.

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Chapter 8

Infrastructure development

Malaysia has good quality infrastructure and its population enjoys good access to basic services such as electricity and water. Infrastructure is a core part of government's development policies and the bedrock of the economy, with the government allocating more funding to infrastructure than to any other sectors in each of its national development plans since 1966. The private sector has also played an active role in developing Malaysia's infrastructure, providing USD 54 billion in investment between 1990 and 2011. Private investment has increased over time, thanks in part to the government's efforts to liberalise the telecommunications, transport and electricity sectors. In the water sector, a major restructuring took place in 2006, leading to a smaller role for the private sector in financing projects. Moving forward, the government needs to find ways to bring the quality of infrastructure in Sabah and Sarawak up to par with that in Peninsular Malaysia. Moreover, the tendering process can be strengthened by reviewing the process of unsolicited bids and direct contract negotiation. The mismanagement of certain projects suggests that better upstream planning and project supervision is needed to improve efficiency. Given the expected increase in the urban population and rising demand for all infrastructure services, a concerted effort is needed to attract additional investment in the infrastructure sub-sectors and propel Malaysia into a modern and developed country.

Overview of Malaysia's infrastructure system

A sound infrastructure system has been a key driver of economic growth in Malaysia. In 2010, the transport and storage sector contributed 3.8% to GDP, communication 4.2%, and utilities (electricity, water and gas) 3% (Ministry of Finance, 2011). Malaysia is ranked 29th out of 144 countries in terms of the quality of its infrastructure, particularly airports, roads, railways and ports, which all help to make Malaysia a competitive destination for investment (Table 8.1) (WEF, 2012). In addition, each of the 200 industrial estates and 14 free industrial zones hosts projects, making infrastructure the backbone of economic development in Malaysia. Access rates are relatively high even in rural areas, with 99% of the rural population having access to improved water sources and mobile phone subscriptions over 100% (WB WDI, 2012).

Having made significant progress in tackling capital development and access issues, the government aims to transform the country into a world-class provider of infrastructure services and a thriving logistics and transport hub. It also considers infrastructure development to be a driver of economic diversification and a key means of spurring Malaysia into a dynamic, globalised economy. The New Economic Model (NEAC, 2010) identifies the logistics industry as a potential "economic sweet spot" and considers roads, ports and ICT infrastructure as key levers to develop the industry. All the same, there are important variations in the quantity and quality of infrastructure stocks, with infrastructure more developed in peninsular Malaysia than in Sabah and Sarawak.

Table 8.1. **Malaysia's infrastructure competitiveness**

Indicator	Rank out of 144 countries
Quality of overall infrastructure	29
Quality of roads	27
Quality of railroads	17
Quality of ports	21
Quality of airports	24
Quality of electricity supply	35
Mobile telephone subscriptions/100 pop.	33
Individuals using Internet, %	41

Source: Adapted from World Economic Forum, *Global Competitiveness Report 2012-2013*.

Assessing investment needs

After independence in 1957, the government played a key role in funding infrastructure development but turned to privatisation in the 1980s. A Privatisation Master Plan was introduced in 1991 that led to 204 privatised projects through divestment, leasing, sales of equity, and various concession models such as build-own-transfer (BOT) and build-own-operate (BOO) (EPU, 2001). Several infrastructure companies were privatised through equity sales on the Malaysia stock market, including Malaysia Airline System Bhd (listing date 1985); Malaysia International Shipping Corporation Bhd (1987); Telekom Malaysia Bhd (1990); and Tenaga Nasional Bhd (1992). In many cases, the government provided tax incentives, soft loans and other inducements to facilitate private investment in projects with a high social value, such as the Light Rail Transit System, and low traffic density roads (EPU, 2001). The government's financial support helped ensure the affordability of privatised projects for end-users.

In line with general government policies, the government is promoting citizens' participation in infrastructure sectors. Concretely, the government's general procurement guidelines state that one of the objectives of procurement is to encourage alternative and multiple sourcing through supplier/vendor development. In the tendering process, international tenders are invited for supplies and services if there are no locally produced supplies or services available. The guidelines add that for specific works, if local contractors do not have the expertise and capability, tenders may be called on a joint venture basis between local and foreign contractors to encourage the transfer of technology. International tenders for works may only be called when local contractors do not have the expertise and capability, and a joint venture is not possible.[1] In practice, the Indah Water Konsortium, Telekom Malaysia Bhd and Tenaga Nasional BhD all used small and medium-scale vendors as input suppliers, network operators and joint-venture partners. The vendor development scheme and procurement system are also a way to promote *bumiputera* participation in the economy.

Malaysia's experience with private sector participation in infrastructure

Under the 2006-10 Ninth Malaysia Plan (9MP), the private finance initiative was adopted, whereby private contractors were made directly responsible for financing capital expenditure and managing operations through 25-30 year concession contracts. The concessionaires were paid directly by the government based on their performance on a number of output specifications while penalties were imposed for failing to meet goals. In this way, the initiative encouraged the private sector to provide quality service throughout the lifecycle of their contracted projects.

Between 1990 and 2011, 98 projects with private sector participation (PSP) reached financial closure in Malaysia. Compared to its neighbours, Malaysia has quite advanced levels of PSP, as measured by the number of PSP projects and the volume of investment from the private sector (Table 8.2).

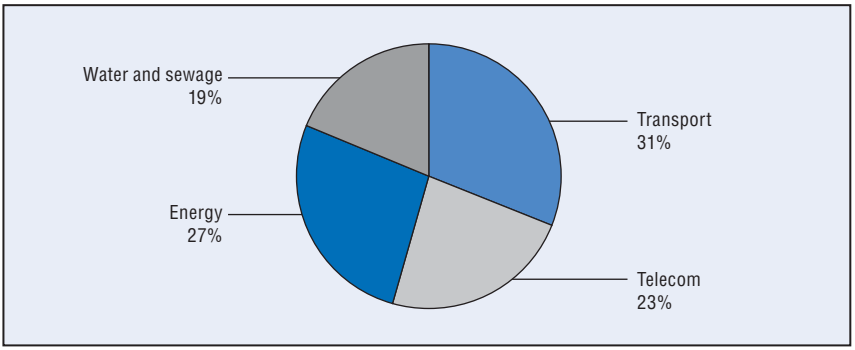
Table 8.2. **PSP in Malaysia and the Region**

	Malaysia	Indonesia	Philippines	Thailand	Viet Nam
Number of PSP projects, 1990-2011	98	91	111	112	69
Total investment in projects, 1990-2011, USD billion	54.1	50. 8	54.3	43.4	8.7

Source: World Bank PPI Database.

Concession and greenfield projects predominate in Malaysia, representing 29% and 60% of total PSP projects respectively (WB PPI, 2012b). The bulk of investment has been in the transport sector (Figure 8.1). A quarter of Malaysia's privately financed projects since 1990 were either cancelled or distressed, suggesting that the experience of private sector participation in infrastructure has not been entirely smooth. In part, the problems encountered were a consequence of the Asian financial crisis in 1997-98 which upset the balance sheets of several privatised companies and led to government bail-outs of distressed companies and projects. The government had to regain control of several companies, including: Star Rail and Putra Light Rail where it restructured the concessionaires' debts; the construction conglomerate United Engineers Malaysia, which was running a profitable toll division as of October 2012; the Port Klang Free Trade Zone project; the Malaysia Airline System Berhad (MAS); and, the Indah Water Konsortium, the national sewerage company. By 2007, however, the government announced that it would no longer guarantee bail-outs of PSP projects that fail or become distressed.

Figure 8.1. **Private investment in Malaysia's infrastructure sectors, 1990-2011**



Source: Based on data in the World Bank's PPI Database, accessed 11 September 2012.

Investor appetite in Malaysia's infrastructure sectors improved during the 2000s. Under the 9MP, 22 projects worth approximately RM 12 billion were undertaken through privatisation and public-private partnership (PPP). The government intends to increase the number of projects with private sector participation under the 10MP (2011-15) and is considering 52 projects with an estimated value of RM 62.7 billion (EPU, 2010). The government's interests are skewed towards major transport projects, such as highways and toll roads, with few projects in the energy and water sectors. A rebalancing in this area might be judicious, as the sections that follow will show.

A framework for private investment

Attracting private financing in infrastructure

Despite relatively strong private sector participation in infrastructure, a weak procurement process has tarnished the overall quality of PSP in Malaysia. Some contracts have been privately negotiated by tender boards set up in the Ministry of Finance rather than publicly and transparently tendered (Beh, 2010). During the 9MP, 38% of projects were directly negotiated – the equivalent of RM 63 million – while the rest were openly tendered (Beh, 2010). More recently, under the 10MP, a procurement system has been proposed based on the principles of value for money through risk sharing; whole life costing, output based specifications, performance-based payment mechanisms and competition (EPU, 2010). Moreover, the participation of *bumiputera*, such as through vendor schemes and the provision of better access to capital, is an important government strategy (EPU, 2001). The Ministry of Finance has developed Procurement Guidelines and procuring agencies are required to advertise tenders on their websites and to inform foreign embassies. The strengthened tendering system should make it easier for both GLCs and private companies to compete on equal footing.

Despite government initiatives to promote transparency in procurement systems, the high-profile mismanagement of the Port Klang free trade zone suggests that more effort is needed to stamp out corrupt practices in construction projects. The Port Klang zone was intended to be the site of an international logistics and cargo hub in Malaysia, in the mould of Dubai port. An independent audit and the Parliamentary Public Accounts' Committee found that several public officials had mismanaged developments in the zone leading to massive cost overruns. More attention to project design and more oversight in implementation are required if Malaysia is to continue promoting similarly ambitious projects in the future.

Public Financing for the Infrastructure Sectors

The government has allocated more funding to infrastructure than to any other sector in each of its national development plans since 1966 (Kumar, Nagesh, 2008). Between 1990 and 2005, government spending in infrastructure was RM 98.8 billion (about USD 32.2 billion), which was equivalent to an average of 2% of GDP. In some years, such as during the Seventh Malaysia Plan, public investment reached 9.4% of GDP (Kumar, Nagesh, 2008). During the same period, private financing for Malaysia's infrastructure was RM 150 billion (about USD 49 billion) with 72% of this amount derived from domestic bonds and the rest from equity and loans (JBIC, 2007).

Since the adoption of the private finance initiative during the 9MP, the government is emphasising private funding of infrastructure projects in partnership with the public sector. To facilitate this, the government has put in place institutional and financial structures to make the most of public and private resources. A PPP Unit/3PU, was established in 2009 and is housed in the Prime Minister's Department, with a staff of 130 in 11 divisions (Borneo Post, 2010). It monitors project implementation in the country's five economic corridors and administers the Facilitation Fund, which the government established under the 10MP to attract private finance to strategic, high-impact infrastructure projects (Box 8.1). This approach follows the example of countries such as India, which established a Viability Gap Fund to subsidise the capital costs of projects through government grants. Such funds can be a useful way of making capital intensive projects more commercially viable.

GLCs play a significant role in the infrastructure sector in Malaysia

As well as providing direct funding for infrastructure initiatives, the government plays a prominent role in the sector through government-linked corporations (GLCs), where the government is the ultimate owner or controlling shareholder, either directly or through its funds. In 2004, a number of GLCs were placed under the management of Khazanah Nasional Bhd, the government's strategic investment fund that is tasked with making strategic investments domestically and abroad. Khazanah Nasional's portfolio includes the following infrastructure companies:

- UEM (and its expressway arm PLUS);
- Malaysia Airports Holdings, which operates and manages Malaysia's 39 airports;
- Malaysian Airline System Bhd, the country's national airline;
- TNB, a power company;
- Axiata Group, a telecommunications company; and
- Telekom Malaysia, another telecommunications company.

Box 8.1. **Facilitation Fund to make infrastructure projects more commercially viable**

The government has created a RM 20 billion Facilitation Fund (USD 6 billion) to bridge the viability gap that often impedes private investment in large-scale, greenfield infrastructure projects. The fund will be used to provide grants worth up to 10% of the total financing invested by private companies. The value of the project has to be at least RM 100 million to be eligible. Overall, a quarter of the Fund is to be allocated for acquiring land for the projects while RM 2 billion has been allocated for projects involving *bumiputera* entrepreneurs. In 2012 alone, the government plans to disburse RM 2.5 billion from the Fund, including RM 300 million for projects led by *bumiputera* developers. To be eligible for assistance, projects must have a minimum capital cost of RM 100 million; align with the government's strategic priorities; and committed private funds must be in hand before the company can receive government funds. The Johor Raw Water Supply project is one of the first projects to be identified for government funding from the Facilitation Fund.

The Fund could help to make projects bankable but the government makes it clear that it will not assume a significant share of the project risks and will disqualify projects that require too much government support. In reality, some amount of risk sharing is needed for any PPP project and the government should shoulder the risks that it can best manage, such as regulatory risks or delays in securing permits. While infrastructure projects will likely be the main beneficiaries of the Facilitation Fund, other projects – such as shopping centres and high tech parks – are also eligible, thereby reducing the amount of capital available for greenfield infrastructure projects. Moreover, the Fund bars projects at incubator or R&D stage from receiving Facilitation Fund grants but these projects face a lot of hurdles in attracting private finance because of the high risks involved. As of July 2012, RM 5.1 billion had been disbursed, reflecting about a quarter of the funds, suggesting that the Fund will meet its disbursement mark by 2015, when the 10MP ends.

Source: Analysis based on the 2012 Budget Speech; Tenth Malaysia Plan; Facilitation Fund Guidelines; and a press interview with Minister Yackop of the Economic Planning Unit (MYSInche, 2012).

GLCs are usually the main sponsors or off-takers of projects, as is the case with the electricity generating company, TNB and several independent power producers. Table 8.3 has more details on the structure of these GLCs.

There is a concern that GLCs may be crowding out private investment and making it harder for new firms to enter the infrastructure market. To illustrate, GLCs[2] have a 44% share of market value in information and telecommunications; 72% in transport and storage; and 98% in utilities, including electricity (Menon, 2012). Moreover, the government retained

Table 8.3. **Overview of GLCs in the infrastructure sector in Malaysia**

Company name	Industry	Market capitalisation	Total assets	Net income
SIME Darby Bhd	Agriculture and infrastructure	19 314	14 192	1 213
Petronas Chemicals Group Bhd	Transport and warehousing	16 739	8 951	825
Axiata Group Bhd	Information communication	15 056	12 764	738
Tenaga Nasional Bhd	Utilities	11 649	25 035	168
Petronas Gas Bhd	Utilities	11 266	3 383	340
Telekom Malaysia Bhd	Information communication	6 359	6 727	375
MISC Berhad	Transport and warehousing	5 665	12 663	618
Malaysian Airline System Bhd	Transport and warehousing	1 260	4 031	76
NCB Holdings Bhd	Transport and warehousing	662	610	50

Source: Adapted from Menon, 2012.

"special shares" in some infrastructure companies that were privatised in the late 1990s, including Malaysia Airlines and Telekom Malaysia. The shares allowed the government, through the Minister of Finance, to ensure that certain major decisions affecting the operations of the companies as GLCs were consistent with the government's policy. The government is attempting gradually to eliminate rights attached to golden shares that impede value creation. The authorities suggest that supervisory and monitoring roles for national interest, which were previously granted by GLC golden share-holders, have been taken over by regulators to ensure that value creation is facilitated in these GLCs while also protecting national interests.

The dominance of the GLCs, and the influence potentially and actually wielded by the government over them, has been described by some as being highly unusual for an open, modern market economy (Menon, 2012). Several measures were introduced to transform GLCs into corporatised entities, such as enhancing board effectiveness, strengthening directors' capabilities, and using performance-based compensation (see Chapter 5 on Corporate governance). Moreover, the government has put in place measures to limit regulatory agencies' participation in project implementation to avoid possible conflicts of interest. Some challenges remain, notably the overlap between federal and state government responsibilities over project oversight, and heavy bureaucratic procedures that delay project implementation. These challenges require a government response beyond corporate governance reform alone.

Pension fund investment in infrastructure financing

Institutional investors have been an important source of funding for infrastructure projects. Malaysia's sovereign pension fund, the Employees Provident Fund (EPF), is the sixth largest sovereign pension fund in the world

and the fourth largest in Asia after Japan, South Korea and Singapore in terms of asset size, with its total investment assets at RM 469 billion at book value in 2011. Over a third of its investment portfolio comprises loans and bonds, which are used in part to finance infrastructure projects. Of the top 30 companies in which EPF has invested equity, five are in infrastructure related projects: three in telecommunications – Digi.Com Bhd, Telekom (M) Bhd and Axiata Group (Bhd) – and two in electricity – Tenaga Nasional Bhd and Sime Darby Bhd (EPF, 2011). EPF's equity investment in these companies is about 15% on average and never more than 20%. In 2011, EPF acquired the toll roads business of PLUS Expressway Bhd via a joint venture with UEM Group Bhd. The deal contributed RM 962 million or about 7% of EPF's total equity income that year, suggesting that investing in infrastructure may be a lucrative option for other pension funds as well.

Bonds have been used for financing infrastructure

Bonds, known locally as private debt securities, have been a significant source of private debt financing in Malaysia. The first infrastructure-related bonds were issued in the mid-1990s but issuance declined during the Asian finance crisis in 1997 and 1998. Since then, the bond market has recovered. In 2003, the proportion of infrastructure bonds in the total bond market was a record 59%, and they continue to generate demand. About 60% of the bond issues were split evenly between the transport and energy sectors, with a 23% share for water and sewerage projects and 17% for telecommunications. The bonds are used mainly for capital investment and, in some cases, for refinancing existing debt and acquiring infrastructure companies. However, few ringgit bonds have tenures of ten years or more so they are not always well-suited to long-term projects. Moreover, most buyers are institutional investors (unit trusts, pension funds, and insurance companies) who are obligated by the law to buy only high-quality bonds (at least A grade) regardless of the viability of the project. Broader financial sector reforms can help make bonds even more relevant for infrastructure projects (see Chapter 7 for more analysis on the financial sector).

Malaysian companies are a source of foreign direct investment abroad

A number of GLCs are involved in infrastructure development in other countries. For instance UEM, through its international highways business subsidiary, PLUS Expressway Bhd, has been building and operating highways in Indonesia and India. In 2011, Malaysia Airport Holdings Bhd (MAHB) successfully bid for the concession to build, operate and modernise the Ibrahim Nasir International Airport in the Maldives. MAHB has also formed strategic foreign ventures through operations and management contracts for Indira Gandhi International Airport and Rajiv Gandhi International Airport,

both in India, and Sabiha Gokcen International Airport in Turkey. Also, Malaysia Airports Consultancy Services Sdn Bhd (MACS), the consultancy arm of MAHB, entered into a joint venture agreement with Nagamas Enterprise (HK) Limited to provide consultancy services for the development of Yongzhou Lingling Airport and other airports in China. In October 2012, a joint venture company was set up between MACS and a Qatari investor to undertake facilities maintenance at airports, including the new Doha International Airport. MACS is also pursuing other business consulting opportunities in Iran, the Philippines and Qatar (MAHB, 2011).

Malaysian telecommunication companies are another important source of outward direct investment in the ASEAN region and beyond. Axiata, for instance, has interests in Cambodia, Indonesia, Bangladesh, India and Sri Lanka. The government has encouraged telecom companies to locate in domestic corridors as well, as part of the NEM's goal of developing a logistics hub in Malaysia. The section below elaborates.

Telecommunications

The telecommunications industry is becoming increasingly liberalised

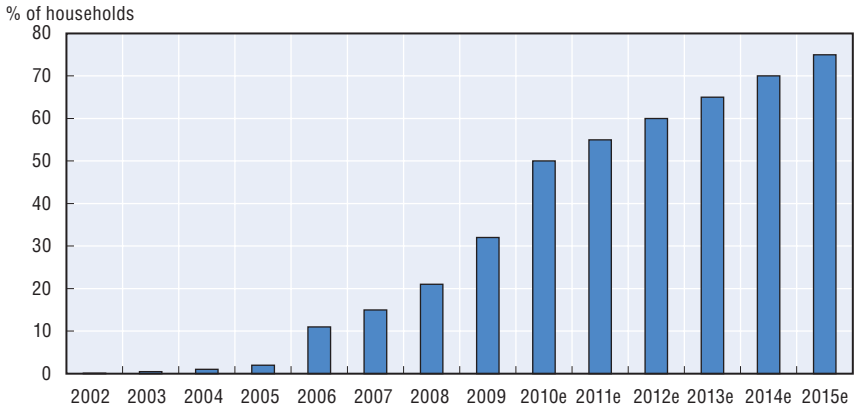
As part of the government's privatisation programme at the time, the telecommunications sector was liberalised in 1983, initially by allowing private companies to supply telecommunications equipment to the Malaysian Telecommunications Department (Namibiar, 2009). In 1987, Telekom Malaysia was corporatised and the mobile phone market was opened to the private sector. Further reforms followed in the 1990s, when the limit on foreign equity in telecommunications was raised from 30% to 49% and foreign equity in mobile telephony was allowed to reach 61% on a case-by-case basis (see Table 2.1, Chapter 2). To date, there are four mobile phone operators in Malaysia: Celcom, Maxis, DiGi, and UMobile. The fixed line market has also been liberalised, with six fixed line operators: TM, TdC, Maxis, Digi, P1 and Celcom. In 2011, the government made further revisions to foreign equity restrictions for a number of service sub-sectors, including telecommunications. Foreign equity can now reach 70% in network facilities and service provision and 100% for application service providers (see Chapter 2). Overseeing the licensing process is the Malaysian Communications and Multimedia Commission (MCMC), the telecommunications regulator, although the sector minister has ultimate approval power. MCMC is required by law to hold public consultation sessions before taking any decisions, which is an important way of ensuring consumer interest is taken into account.

Internet broadband infrastructure needs to be better developed

While mobile telecommunications access rates are quite high, access to Internet services, at 64%, is not as high as access rates in other sectors. The

government sees high-speed broadband as a means of facilitating network-based production processes and moving up the value chain. To advance this agenda, the 10MP sets a goal of increasing the proportion of households with access to Internet broadband to 75% by 2015 (Figure 8.2). Under the Economic Transformation Programme, the government wants to make access to broadband an essential utility service in the same vein as water and electricity and following the lead of industrialised nations such as Finland and the UK. To achieve this goal, the government amended the Uniform Building By-Laws (1984) to make it mandatory for building developers to install broadband infrastructure in new housing developments (EPU, 2011). Local governments are in the process of implementing the legal amendment, and mayors are encouraging businesses, malls, universities and so on to set up wireless Internet hot spots.

Figure 8.2. **Trends in Malaysia's household broadband penetration**



Source: Economic Planning Unit (2010), 10MP Chapter 3.

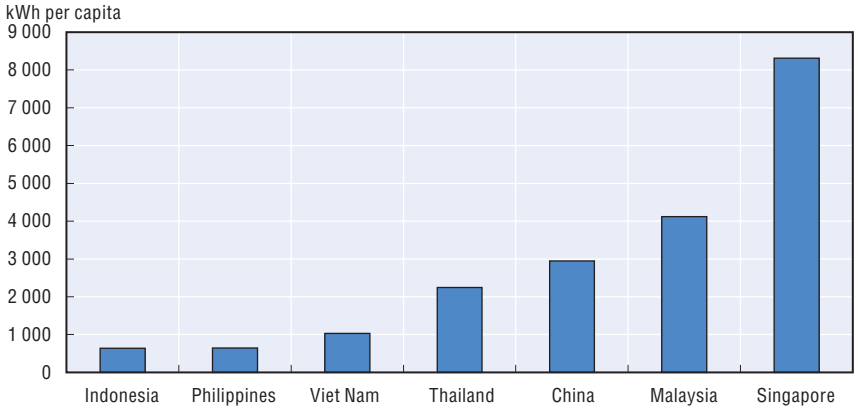
The government is also partnering with the private sector to expand Internet broadband coverage in rural areas and small towns. For instance, network operators are encouraged to offer a variety of Internet packages to meet the needs of different user income groups. A High Speed Broadband project worth RM 11.3 billion (USD 3.6 billion) was introduced as a public-private partnership with Telekom Malaysia in 2008. Under the terms of the agreement, Telekom Malaysia was to ensure that 1.3 million premises were to be equipped with high-speed broadband access by 2012, with the government contributing a fifth of the project cost and Telekom Malaysia the rest.[3] Telekom Malaysia was able to complete the project on time and the government reports that it has already had significant uptake (EPU, 2011). Moreover, the increased demand for data services and applications requires high levels of bandwidth, presenting a significant business opportunity for potential investors.

Electricity

The power sector has been an important part of Malaysia's economic growth

The electricity sector is the bedrock of many other economic sectors in Malaysia and facilitates the development and usage of transport, water and ICT services. Research indicates that between 1971 and 2009, electricity consumption stimulated economic growth in Malaysia and led to an increase in foreign direct investment as well (Bekhet and Othaman, 2011). Malaysia has one of the highest rates of electricity consumption per capita in the ASEAN region and China (Figure 8.3) and consumption is expected to increase as Malaysia becomes more developed. The largest utility company in Malaysia, Tenaga Nasional Berhad (TNB), projects that demand for electricity in Malaysia will grow by 3.5% to 4.6% a year between 2013 and 2017 (TNB, 2012). Virtually the whole population (99.4%) has access to electricity and, with economic growth and higher urbanisation, demand is expected to grow at a rate of 3-5% annually from 2010 to 2020.[4] Industry and commerce are fuelling most of the demand, with households accounting for 20% of the growth in demand (Ministry of Finance, 2011). However, power supply has struggled for years to meet demand and TNB projects that supply challenges will persist in the future (Star Online, 2012).[5]

Figure 8.3. **Electric power consumption in ASEAN and China, 2011**

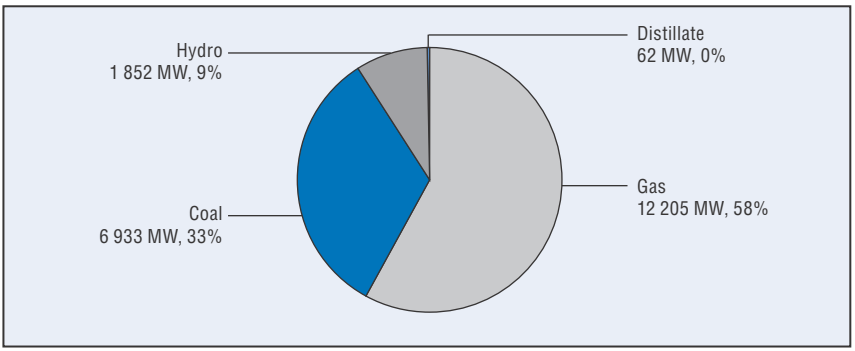


Source: World Bank, *World Development Indicators: http://data.worldbank.org/indicator/EG.USE. ELEC.KH.PC.*

Malaysia's dependence on fossil fuels for electricity generation is not sustainable

It is becoming increasingly clear that Malaysia's reliance on fossil fuels is not sustainable over the long term. Most of the electricity is generated from natural gas, coal and hydropower (Figure 8.4) with very little from renewable

Figure 8.4. **Composition of peninsular Malaysia's electricity generation capacity**



Source: Tenaga Nasional Berhad: *www.tnb.com.my/nuclear/current-capacity-status.html.*

energy. Originally, the government focused on developing a diversified mix comprised of oil, gas, coal and hydro under the Four Fuels Policy and it added a fifth fuel, renewable energy, during the Eighth Malaysia Plan. More recently, there has been an increasing focus on nuclear energy as a potential sixth fuel. While a National Nuclear Policy was developed in 2010, public outcry against nuclear power may impede its development (FMT News, 2012). The government aims to increase generation capacity by 6 000 MW between 2015 and 2020 to add to the 21 052 MW of current capacity (TNB Website). To achieve this, coal is expected to increase significantly from 6% of the power generation mix in 2002 to 45% by 2020 and 50% by 2030 (Gas Malaysia website). Two coal-fired power plants, in Janamanjung and Tanjung Bin, are planned and will add 2 000 MW of new capacity once operational. The share of oil, gas and hydro will decline during this period although gas will still make up a significant share, approximately 45% of the generation mix, by 2030.

The government's attempt to increase the country's generation capacity is commendable but its focus on coal and natural gas conflicts with its commitment to reduce the country's carbon intensity. As Chapter 9 argues, Malaysia should exploit its renewable energy resources and redouble its efforts to promote energy efficiency which together would have a lower impact on the environment than coal and gas. Moreover, TNB and independent power producers import all of their coal from Indonesia and Australia for power generation, thereby exposing them to supply risks. Also, Malaysia's reserves of coal and natural gas are finite and from an energy security perspective, it may be worthwhile to concentrate on developing renewable energy sources with coal and gas as back-up supplies.

Power sector policies

Malaysia has developed a sound policy framework for energy since the adoption of the 1979 National Energy Policy, which focused on supply, utilisation and the environment. Under the 10MP, the government introduced a New Energy Policy 2011-15, which focuses on five areas:

- *Securing and managing reliable energy supply*: Developing alternative fuels; importing LNG and coal by 2015; developing new coal-fired plants in peninsular Malaysia; feasibility studies and a public awareness campaign to consider nuclear electricity.
- *Encouraging energy efficiency*: Set minimum energy efficiency standards for appliances and technologies; promote production of energy efficient equipment.
- *Adoption of market-based energy pricing*: Achieve market-based energy pricing by 2015, in part by eliminating energy subsidies; revise gas prices every six months; itemise subsidy value in consumer bills; provide social assistance to low-income energy consumers.
- *Stronger governance*: Liberalise the gas supply industry; instil market discipline in the electricity sector e.g. through separate accounts for generation, transmission and distribution; competitive bidding for new power plants; and renegotiating power purchase agreements.
- *Managing change*: An integrated approach to manage the structural changes in the sector, including pricing, supply- and demand-side management, and new oversight mechanisms.

In the 1980s, the government launched a successful Rural Electrification Programme to increase electrification in rural and isolated parts of the country (World Bank, 1990). The government allocated funding from the central budget and also used the national utility, NEB (present day TNB) to cover 50% of the capital costs. As a result, NEB extended its transmission network to Eastern Malaysia, which had the lowest household electrification rates. The government has also put in place a number of policies and mechanisms to boost renewable energy and energy efficiency (see Chapter 9).

Independent Power Producers (IPPs) are the main sources of electricity generation

The Energy Commission serves as the regulator for the electricity sector. There are three main electricity utilities in Malaysia. Tenaga Nasional Berhad (TNB) is the biggest utility and supplies peninsular Malaysia while Sarawak Electricity Supply Company and Sabah Electricity Limited (80% owned by TNB) supply Sarawak and Sabah respectively. The electricity sector has been open to independent power producers (IPPs) since 1994. IPPs negotiate power

purchasing agreements (PPAs) with TNB, which owns and controls the national grid. The Energy Commission regulates retail tariffs while wholesale prices between TNB and IPPs are negotiated through bilateral agreements. Private sector participation is more restricted in electricity distribution although foreign equity participation of up to 30% in all segments of the electricity network, including distribution, is allowed by law.

Foreign entities account for 12.6% of TNB's shareholding as of August 2012. Khazanah Nasional is the largest shareholder, with 35.4% of the shares, while other corporations and government agencies account for 45.7% of shares. The Malaysian public holds the remaining 6.3% of the shares (TNB, 2012). The first IPPs involved a power purchasing agreement between TNB and YTL Power Generation in 1993. YTL was licensed to construct two power plants at Paka and Pasir Gudang. The project was financed through a combination of bond issues, equity shares and operational cash flows. In recent years, the concept of performance payment has been adopted. GB3 Sdn Bhd, for instance, negotiated a power purchasing agreement with TNB, its sole off-taker, based on specific terms and conditions that GB3 had to meet to be fully compensated by TNB. GB3 is paid through energy payments by selling electricity to TNB and capacity payments, whereby GB3 ensures the availability of power at a certain capacity level. The government was criticised for negotiating the first round of IPPs directly instead of through open, competitive bidding, leading to higher-than-normal tariffs, especially compared to similar projects in neighbouring Thailand (Woodhouse, 2005).

Today, IPPs produce 60% of the electricity generated in peninsular Malaysia compared to 40% by TNB. Virtually all the IPPs in Malaysia are local companies and most of the financing and inputs are derived locally. State pension funds and state banks played a huge role in financing the IPPs. Because of lower capital and operating costs, and the relatively short project gestation period, natural gas power plants are the projects of choice for many IPPs. The preference for gas has, however, fuelled Malaysia's gas dependency (Jalal and Bodger, 2009). In addition, IPPs receive gas at subsidised prices from Petronas, the state-owned oil and gas company (Malaysian Insider, 2011). Removing these subsidies may make it possible for other energy sources, particularly renewable sources such as wind and solar, to compete on an equal footing with natural gas.

In line with initiatives towards market liberalisation, the government has issued two concessions for coal-fired plants to independent power producers. The first was awarded to Malakoff Corporation Bhd for the construction of the Tanjun Bin power plant, which became fully operational in August 2007. The second concession was awarded to TNB Janamanjung Sdn for a 1 000 MW coal-fired power plant which is expected to be commissioned in March 2015 (MEIH, 2010). This additional capacity will at best strengthen the national

reserve margin but will not make a significant contribution towards meeting the growing demand for electricity. Moreover, coal has adverse impacts on the environment and the costs of pollution and health problems need to be taken into account to reflect the full economic and social implications of developing this fuel source.

Transport

The transport sector is a key element of Malaysia's economic competitiveness

Malaysia has an extensive system of roads, highways and railways connecting towns and cities throughout the country. This transport network has proved to be a key part of the country's business competitiveness (Figure 8.1). The transport sector has historically received the most public funding of all the infrastructure sectors (Kumar and Nagesh, 2008). It contributes about 3.8% to GDP every year, making it a driver of economic growth together with other infrastructure sectors (Ministry of Finance, 2011). Improving public transport is one of the seven national key result areas identified under the Government Transformation Programme. A number of light rail projects, such as expanding the Kuala Lumpur Light Rail Transit, have been identified to help create liveable, inclusive cities that can make Malaysia more competitive. Moreover, seven toll highways are planned, as well as the privatisation of Penang Port and the development of an integrated transport terminal in Gombak.

The *Road Transport Act* (1987) has provided the legislative framework for the transport sector, especially for regulating toll road charges. In addition, the *Land Public Transport Act* (2010) and the *Land Public Transport Commission Act* (2010) were passed to rationalise the 15 public agencies that were previously involved in setting policy on public transport in Malaysia. The latter act created a Public Land Transport Commission, whose mandate is to set policy in consultation with other agencies and to regulate and enforce public and freight transport by land in peninsular Malaysia. As for air transport, the Civil Aviation Department, within the Ministry of Transport, regulates the airline industry. Major federal ports have been privatised and are regulated by their respective port authorities that are statutory bodies under the Ministry of Transport.

Private sector participation is extensive and has led to positive gains

There has been significant private sector participation through build-operate-transfer concessions in roads and railways, starting with the North-South Expressway, the KL Interchange, the North Kalang Straits Bypass, and the Kuching/Kepong Interchange in the 1980s. In the 1990s, various highways, expressway links, bridges and roads were constructed with

private involvement, as well as the Light Railway Transit System I and II. Since then, the transport sector has had the highest share (32%) of total investment in the infrastructure sectors, with USD 16.8 billion invested between 1990 and 2011 (WB PPI, 2012b). In some cases, PSP in the transport sector has had a positive impact. For instance, the Port of Tanjung Pelepas in Johor was completed six months ahead of schedule while the Damansara-Puchong Highway in Selangor was similarly finished ahead of time (EPU, 2001).

A comparison of various indicators before privatisation and afterwards reveals that annual profits, employee efficiency, container capacity and number of containers handled per hour also improved significantly after privatisation (EPU, 2001). Malaysia's ports are rated the 21st best in the world (WEF, 2013). Based on a global ranking of individual ports, Port Klang ranked 13th and the Port of Tanjung Pelepas 17th in 2011.[6] The private sector has played a key role in achieving this success. PSP's role in the ports sub-sector in Malaysia is especially important because they serve as the conduits for more than 90% of the country's trade. PSP can also help Malaysia to reach its goal of becoming a regional transport and logistics hub. The government's decision in 2009 to eliminate all foreign equity restrictions in 27 service sub-sectors, including the transport sector (see Table 2.1 Chapter 2) can further fuel PSP in the sector by making it easier for foreign firms to invest.

Demand for light rail services has been growing, as has traffic on tolled highways. Rising urbanisation and rapid economic development may help explain the increase in demand for public transport. In response, the government has launched a number of rail projects, including the MY Rapid Transit (MRT), a system of railway lines in the Greater Kuala Lumpur area. The MRT project will be the government's single largest infrastructure investment and is expected to generate RM 3-4 billion (about USD 1-1.3 billion) in revenues between 2011 and 2020 (Ministry of Finance, 2011). Moreover, railway lines in Sabah will be refurbished and modernised and thus help to integrate the local population with the rest of the country. Under the 10MP, investment in railways is expected to lead to an increase in the volume of freight from 1.3% in 2011 to 10% in 2015. The increase in demand for transport services, coupled with the government's emphasis on the sector, present an opportunity for the private sector to participate in developing projects.

Better tendering processes are needed to avoid problems in project implementation

Some projects have been publicly criticised because of the way they were developed, with some not tendered openly. Project preparation also needs some improvement, as evidenced by the STAR and PUTRA urban rail projects, which had overly optimistic traffic projections. The heart of the problem was

that the private operators were expected to shoulder the demand risk and when they could not mitigate the risk or deal with it when it materialised, the government nationalised the assets (PPIAF, 2010). Moreover, the government influenced the setting of fare rates, which made it politically difficult for the operator to raise fares to meet costs (PPIAF, 2010). The ELITE toll road also experienced toll receipts below expected revenue, leading to a government bail-out. Another private road project, the Middle Ring Road 2, was the subject of public outcry after concrete started falling off in August 2008 following similar incidents earlier. The incidents raised concern about insufficient project supervision and maintenance work (Beh, 2010). These examples of faulty projects suggest that more scrutiny is needed when awarding concessions to private companies to ensure the financial viability of proposed projects. Greater upstream project preparation, in the form of detailed due diligence, feasibility studies and transport demand modelling, could help to improve project implementation in the future.

Better prospects for foreign investment in airports

In the airports sub-sector, Malaysia enjoys a world-class global airport hub in Kuala Lumpur International Airport (KLIA). Within two years after its opening, KLIA was ranked the best airport for business passenger satisfaction by an International Air Transport Association (IATA) survey. As of June 2012, KLIA was ranked third for the 25-40 million passengers per annum category and seventh worldwide for the Airport Service Quality Survey Ranking. Malaysia Airports Holdings Bhd expects work on the KLIA 2 in Sepang to be completed in time for the planned June 2013 opening.

Khazanah divested a total of 28.7% of its shares in the Malaysia Airports Holdings Bhd as of end-2011. Moreover, in June 2009, the government shifted authority for setting foreign equity guidelines from the Foreign Investment Committee to the Department of Civil Aviation, the sector regulator. The 30% fixed equity restriction on foreign investment in airlines was lifted and the regulator can decide on equity limits at its discretion.

Under the Government Transformation Programme, the government has set ambitious targets to increase public transport. In the Greater Kuala Lumpur area, the share of public transport is expected to increase from 12% in 2009 to 25% by 2015. To date, the Programme has achieved some significant achievements, as outlined in Box 8.2.

Box 8.2. **Transport sector achievements under the Government Transformation Programme**

- The Integrated Transport Terminal Bandar Tasik Seletan (or Bersepadu) diverts more than 700 express buses away from the central business district daily;
- transforming Pudu Sentral (formerly Puduraya) Terminal which underwent its first major revamp since it was opened in 1976. Since April 2011, it has offered modern world-class facilities;
- introducing 8 Bus Expressway Transit services to reduce bus journey time for prime bus routes;
- adding 35 trains into the Kelana Jaya Light Rail Transit line. The line at present carries more than 200 000 passengers daily;
- adding 38 trains into the KTM Komuter line (also known as a MyKomuter) in 2012. The line at present carries more than 100 000 passengers daily;
- introducing 470 RapidKL buses to increase the frequency of buses across the Klang Valley. By the end of 2011, up to 4.04 million more passengers used the Rapid KL bus service than in 2010;
- refurbishing 1 100 bus stops throughout Klang Valley; and
- introducing the new RapidKL Automatic Fare Collection. The new system allows single fare-seamless travel on the Rapid KL public transport system including LRT Kelana Jaya, Ampang lines and KL Monorail.

Water and sanitation

Malaysia has ample water resources but needs to work on sector planning

Malaysia is well-endowed with water resources, with per capita renewable water resources at 20 752 m^3 compared to a global average of 6 000 m^3. However, Malaysia has had a number of water crises, such as in 1990, when the Tunggal Dam in the state of Melaka dried up. In 1998, water supply was disrupted in Selangor, affecting 1.8 million people. In 2005, there was a water shortage in Negeri Sembilan (Seremban area) and Johor (Kluang areas) leading to rationing. These crises are in part the result of poor sector planning and institutional inefficiency in service provision. Distribution losses can reach up to 60% in some states. There is also variation in water resources, with some states having significant water wealth (e.g. Pahang, Terengganu, Kelantan, Perak and Sarawak) and others having few water resources (Penang, Melaka, Selangor and Negeri Sembilan). This calls for a co-ordinated approach to water sharing and resource management.

The government restructured the water and waste sector in the 2000s…

Until the mid-2000s, the water and sanitation sector was mainly under the control of state governments. However, by the early 2000s, state governments (with the exception of Penang) faced financial distress after borrowing heavily from the central government and failing to raise additional capital or collect adequate tariff revenue to service their debts (JBIC, 2007). As a result, the government restructured the water sector in the mid-2000s. The *Water Services Industry Act* was passed in 2006, centralising the treatment and distribution of potable water and regulating the activities of water service operators, but water resource management remained under the jurisdiction of state governments. Policy objectives for the sector were also articulated at that time (Box 8.3). The *SPAN Act* (2006) was also passed and the National Water Services Commission (SPAN) was created to serve as the sector regulator for peninsular Malaysia. The act applies only to peninsular Malaysia and the island of Labuan.

Box 8.3. **Ten national policy objectives for the water sector**

- To establish a transparent and integrated structure for water supply services and sewerage services that delivers effective and efficient services to customers.
- To ensure long-term availability and sustainability of water supply including the conservation of water.
- To contribute to the sustainability of the watercourses and the water catchment areas.
- To facilitate the development of competition to promote economy and efficiency in the water supply services and sewerage services industry.
- To establish a regulatory environment that facilitates financial self sustainability amongst the operators in the water services and sewerage services industry in the long term.
- To regulate for the long-term benefit of the consumers.
- To regulate tariffs and to ensure the provision of affordable services on an equitable basis.
- To improve the quality of life and environment through the effective and efficient management of water supply services and sewerage services.
- To establish an effective system of accountability and governance between operators in the water services and sewerage services industry.
- To regulate the safety and security of the water supply system and sewerage system.

Source: Explanatory note on the enforcement of the *Water Services Industry Act* 2006.

Regulations were introduced in 2007 regarding licensing of owners and operators of private and public water supply and sewerage systems. State governments continue to oversee operations and maintenance while the central government is responsible for capital development through a newly created Water Asset Management Company (PAAB) which owns the water assets and has assumed the liabilities of the water utilities. It plans to raise sovereign bonds in order to fund capital development.

... but restructuring was not universally well-received

While the restructuring of the water sector was a concrete response to the challenge of poor performance of state-run utilities, it faced opposition from a number of state governments, particularly in Terengganu and Kelantan, which are run by the opposition party. Moreover, the *Water Services Industry Act* does not apply to Sabah and Sarawak, leading to a disjointed legal framework for the sector and potentially creating extra requirements for operators with interests in both the peninsula and Sabah and Sarawak. As of March 2011, five years into the reforms, only 4 out of 11 states had transferred their assets to PAAB, even though the *Water Services Industry Act* stipulated that the assets had to be transferred by the end of 2009. The transferral process was hampered by disagreements between state governments, concessionaires and PAAB about the valuation of assets. Moreover, there was a misunderstanding about the restructuring exercise, because it involves a transfer of assets to PAAB for 30 to 45 years, rather than a permanent transfer.

Restructuring reduced the role of the private sector in financing projects

The 2006 water reforms also had an impact on private sector participation in the sector. Since the 1980s, PSP in water and sanitation has been strong, starting with management contracts and developing into concessions. The first build-operate-transfer concessions were negotiated in 1989, for the Larut Matang Water Supply and the Ipoh Water Supply projects. In some states, such as Penang and Selangor, water utilities were privatised and private contractors negotiated terms directly with state governments. Despite the toll of the Asian financial crisis, Malaysia was one of the few countries to attract large concessions in the early 2000s, notably for Johor and Syabas. The concessions involved local companies and tapped local capital markets for funding (PPIAF, 2006). Overall, between 1990 and 2011, Malaysia ranked 9th worldwide in terms of private investment in water and sanitation. During this time, Malaysia attracted USD 54 billion in private investment (WB PPI, 2012*c*). That said, the government invested more than the private sector in the sector between 1991 and 2009 (Tan, 2012). With the creation of PAAB, the government will continue to take the lead in financing the capital

expenditure needs of the water sector and the private sector's role will be limited to providing water supply services, management expertise, technological know-how and financing by subscribing to the bonds issued by PAAB.

Malaysian water companies are globally dominant

As with other infrastructure sectors, Malaysian water companies have been important sources of outward investment abroad. Salcon Bhd, for instance, is one of the top 20 private water companies in the world, with eight projects implemented between 2001 and 2011 (Perard, 2012). This trend is likely to continue.

Notes

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Chapter 9

Investment framework in support of green growth

Malaysia has placed increasing emphasis on pursuing a sustainable growth path, acknowledging that a "growth first, environment later" approach is no longer feasible. It leads the ASEAN region on environmental performance measures and the government has resolved to become a leader in the global green revolution. An array of policies and legislation has been put in place, including a National Policy on Climate Change, a Green Technology Policy and a Renewable Energy Policy and Action Plan. The government has also created dedicated funds to catalyse private investment in renewable energy, green buildings and low-carbon transport. In addition, the government offers financial incentives for investment in green sectors, such as import duty exemptions for solar PV equipment. In 2011, a feed-in tariff was introduced for various sources of renewable energy, complemented by power-purchase agreements, which led to strong interest from power producers and an increase in installed renewable energy capacity. Some challenges remain and must be addressed if Malaysia is to surge ahead with its environmental initiatives and attract additional private investment for its green sectors. Malaysia remains dependent on fossil fuels and fossil fuel subsidies are still in place, despite previous efforts to eliminate them. There is significant potential for renewable energy generation from biomass, solar power and hydro power but investor interest has been disproportionately skewed towards solar, at the expense of other energy sources. Also, more efforts are needed to attract the support of local financial institutions for funding green projects. Addressing these gaps can help make Malaysia a more attractive destination for green investment.

The OECD defines green growth as "fostering economic growth and development while ensuring that the natural assets continue to provide the resources and environmental services on which our well-being relies. To do this it must catalyse investment and innovation which will underpin sustained growth and give rise to new economic opportunities" (OECD, 2011). Investment for green growth includes, *inter alia,* investment in infrastructure such as renewable energy, energy efficiency, water sanitation and distribution systems, waste management, transport and housing, and in sustainably managing natural resources. UNESCAP has focussed on green growth in Asia and the Pacific and emphasises the need to move away from a "*grow first, clean up later*" approach towards a more responsible long-term attitude. Governments can promote this by encouraging economic growth with an emphasis on environmental and social concerns.

A conducive environment for investment in support of green growth, comprises not only a sound investment framework but also a strong government commitment to support green growth and to foster private investment in support of these objectives. Key elements of a green investment framework are: policies and regulations that guide investors towards more environmentally-sound investments, including the design and implementation of incentives and financial mechanisms for green investment; the country's capacity to design, implement and monitor green investment policies, including institutional capacity and the development of a capable workforce to respond to the demands of "green" investors; policies to encourage more environmentally responsible behaviour by companies and to promote cleaner production; and strategies to support increased demand for environmentally preferable goods and services. Lastly, as the bulk of investment in support of a green economy is likely to be directed to infrastructure, it is also important that governments provide adequate policy incentives to support private sector involvement in green infrastructure projects.

Green growth in Malaysia: Challenges and opportunities

Malaysia's natural resource endowment provides it with numerous opportunities to build the basis for a green economy. At the same time, it also faces some important challenges, similar to those of other countries in the region, which require strong policy commitments to overcome market failures and drive investment towards a green development path.

In terms of natural resources, Malaysia exports crude and refined petroleum (10% of its total exports), palm oil (9%), liquefied natural gas (6%) and rubber products (2.5%) as of 2010 (MATrade, 2010). The mining and quarrying sector accounted for 9.8% of GDP in 2010 (8.8% in 2011).[1] Traditionally, Malaysia's forests were bedrocks of the economy, contributing as much as 15% to GDP before the financial crisis of 1985 (Hezri, Hasan, 2006). While timber and rubber have declined in importance over time, palm oil remains a significant export. Together with Indonesia, Malaysia is one of the world's largest producers and exporters of crude palm oil, producing about 15 million metric tonnes per year (Shafie et al., 2011) (Box 9.1). Malaysia's water basins and rivers, especially in Borneo, are another important resource in support of agriculture and hydropower.

Box 9.1. **Palm oil: The challenge of going green**

Palm oil and its related products have been the mainstay of the Malaysian economy for years, representing the second biggest export from the country. Not only is crude palm oil production increasing – reaching a record of 18.9 million tonnes in 2011 – but exports and export revenues have been increasing in recent years, reaching RM 60 billion (approximately USD 19.5 billion) in 2011 alone. Currently, 5 million hectares of land are under cultivation and the government has expressed its intention of expanding the amount of land under palm oil plantations by a million hectares. This decision raises concerns about the potential increase in carbon emissions from oil palm production and the reduction in carbon sinks from the clearing of forest land. Moreover, expanding the area covered by oil palm plantations is a major reason for rainforest destruction in Southeast Asia and could disrupt forest ecosystems. All the same, palm oil plantations represent an opportunity to increase the amount of biomass generated from empty fruit brunches and other plantation wastes. This can help meet the government target of increasing biomass' contribution to power generation capacity to 800 MW by 2020. However, there is a possibility that the increase in carbon emissions from palm oil plantations could offset the potential emissions reductions from biomass produced from palm oil wastes.

Source: Sulaiman et al. (2011) and Malaysian Palm Oil Board (2011).

Malaysia is near the equator, which makes it ideally positioned to exploit solar energy for electricity generation. The country receives an average daily solar radiation of 4 500 kWh/m^2 and about 12 hours of average daily sunshine (Shafie et al., 2011). There is only one geothermal project (at Sabah) but the government is undertaking studies on geothermal and wind potential in the country. Tidal energy has not yet been explored as a potential energy source,

and more research is needed before it can be considered technically or economically viable.

The government has identified green industries as "economic sweet spots" that can help transform Malaysia into a high-income, competitive nation by 2020 (NEAC, 2010). The New Economic Model (NEM), which includes the Economic Transformation Programme and the 10th Malaysia Plan (2011-2015), identifies green technology and high-value green services as potential areas for investment. Complementary measures, such as making it easier for non-Malaysian green financing specialists to secure work permits, have also been put in place and the government has prepared a number of incentives to attract investors (see sections below). Looking forward, the renewable energy sectors, particularly solar, biomass and small-scale hydropower projects, provide attractive investment opportunities while promising to create jobs and strengthen the economy.

There are a number of challenges to greening Malaysia's economy, but the challenges also provide opportunities for investment and sustainable development. For instance, the transport sector is the second biggest contributor to greenhouse gas emissions in Malaysia (MNRE, 2011). To reduce emissions from the sector and respond to growing demand for urban transport services, the government has prioritised the development of low-carbon public transport such as light rail, making it a potential target for investment. Demographic changes also make the sector propitious for investors. As Malaysia becomes increasingly urbanised, there will be a growing market for public transport. A pioneer project, the Mass Rapid Transit in the Klang Valley in Greater Kuala Lumpur, was implemented in 2011, with an estimated capital contribution of RM 40 billion (about USD 13 billion) from private investors. According to the 2011 Budget Speech, it is expected to be completed by 2020. The project sends a signal to investors that low-carbon, mass transit projects are feasible and in demand in Malaysia. Moreover, the light rail system will have important knock-on effects on the economy by reducing travelling time in the Klang Valley and integrating the region with other transport nodes, thereby facilitating commercial and social activities.

Another challenge is the effect of climate change on water resources, particularly an expected increase in flooding. To adapt, the government realises that there will be greater need for flood mitigation technologies and relevant infrastructure (MNRE, 2011). Water management techniques to lower consumption, particularly in the agriculture sector, are also needed. Agriculture is the biggest consumer of water resources in Malaysia, accounting for 54% of water demand in peninsular Malaysia alone (MNRE, 2011). Precision irrigation, drainage and other measures can help to control the unsustainable use of water and the private sector can lead the way in finding innovative solutions.

Malaysia's commitment to green growth

The government has ranked green growth high on its economic development agenda. In the 2010 NEM, "ensuring the sustainability of growth" is one of the Strategic Reform Initiatives. The NEM acknowledges that to achieve environmental sustainability, the approach taken in the past, focusing on "delivering growth first and dealing with the environment later," is no longer feasible. Instead, the NEM states that equal emphasis must be placed on both protection of the environment and economic growth (NEAC, 2010).

The NEM includes a range of policy proposals to achieve sustainable growth, including: preserving natural resources (e.g. by using appropriate pricing, regulatory and strategic policies to manage non-renewable resources sustainably, and encouraging all sectors to embrace green technology in production and processes); meeting Malaysia's international commitments (e.g. by reducing its carbon footprint), and facilitating bank lending and financing for green investment. To achieve the latter, possible policy measures include increasing banks' capacity to assess credit approvals for green investment using non-collateral based criteria, liberalising entry of foreign experts in financial analysis of the viability of green technology projects, and supporting green technology investment through venture capital funds (NEAC, 2010). The NEM also acknowledges that building on Malaysia's natural resources and biodiversity is central to strengthening the country's comparative advantage and states that Malaysia should "lead the global green revolution" (NEAC, 2010)

Malaysia is well-positioned to meet its ambition of becoming a global leader on low-carbon development. It is ranked 25th out of 132 countries in the 2012 *Environmental Performance Index* (EPI),[2] outperforming all other ASEAN countries and placing 3rd in the Asia Pacific region after New Zealand and Japan.[3] Malaysia performs particularly well in terms of the ecosystem vitality of agriculture, water use and biodiversity and habitat protection. The EPI nevertheless reveals some challenging areas that the government needs to address, notably forest loss and reduced forest cover, high carbon emissions and low levels of renewable energy.

Malaysia's first significant piece of environmental legislation was the *Environmental Quality Act*, adopted in 1974 and amended several times since. Other legislation covers waste management, energy efficiency and biodiversity conservation. Malaysia is also part of the key multilateral environmental agreements, including the United Nations Framework Convention on Climate Change (UNFCCC) and the Kyoto Protocol.[4] At the 15th UNFCCC Conference of the Parties (COP) meeting in Copenhagen in December 2009 (COP 15), the government pledged to reduce carbon emission intensity by 40% of GDP by 2020 compared to 2005 levels, subject to financial

and technological help from developed countries.[5] Since COP 15, Malaysia has taken a range of initiatives to promote a green economy (Table 9.1 summarises the most relevant laws and policies).

Table 9.1. **Summary of environmental legislation and policies for green growth**

Name of Policy/Legislation	Main features
Environmental Quality Act (1974 + several amendments, latest 2001)	Sets environmental compliance standards on discharge of hazardous substances, pollution and waste and on environmental impacts.
Electricity Supply Act 1990 (amended 2001)	Establishes the Electricity Commission as regulator; new installations must meet energy efficiency standards.
Five Fuels Policy (2001)	Adds renewable energies (RE) to the other four fuels (oil, gas, hydro and coal); sets non-mandatory target of 350MW grid-connected electricity by 2010.
National Policy on the Environment (2002)	Based on 8 related principles, one of which includes increasing the role of the private sector in environmental protection and management.
National Waste Minimisation Master Plan and Action Plan (2006)	Sets target of 22% recycled waste by 2020; awareness raising activities under a National Recycling Programme; establishes an information management system.
National Biofuels Policy (2006)	All government vehicles are mandated to use at least 5% palm oil and diesel by 2010.
Solid Waste Management Act (2007)	Requires households to separate waste – penalties imposed after a 2 year grace period; Empowers the federal government to enter into agreements with private parties for solid waste management.
Efficient Management of Electrical Energy Regulation (2008)	A regulation under the Electricity Supply Act obliges enterprises to appoint an energy manager, make energy/usage audits, and put in place EE mechanisms.
National Green Technology Policy (2009)	Seeks to attain energy independence and promote efficient utilisation, conserve and minimise the impact on the environment, enhance national economic development through the use of technology and improve the quality of life for all. It has short-, medium- and long-term objectives see Box 9.2 for more details
National Policy on Climate Change (2009)	Integrates climate change into new and ongoing programmes; 43 action areas based on 10 strategic poles.
Economic Transformation Programme (2010)	Has 10 key pillars, inc. oil, gas and energy; solar, nuclear and hydro are singled out as niches to be developed; sets target to increase solar to 65 MW by 2015.
National Renewable Energy Policy and Action Plan, (2010)	Sets target to increase RE from 1% to 5% of national mix by 2015; introduces a feed-in tariff; obliges distributors to interconnect and purchase RE or face a penalty. Includes 5 goals: 5 goals: increase the share of RE in national generation mix; grow the RE industry; ensure reasonable RE costs; conserve the environment, enhance awareness of role and importance of RE.
Tenth Malaysia Plan (2011-2015)	Sets target to derive 5% of energy production from RE; sets up a Facilitation Fund for investment in early-stage PPP projects.

A key pillar of Malaysia's efforts towards developing a green economy is the National Green Technology Policy, adopted in October 2009, with the goal of "providing direction and motivation for Malaysians to continuously enjoy good quality living and a healthy environment" (Box 9.2).[6] One of its main

Box 9.2. **Malaysia's National Green Technology Policy 2009**

The National Green Technology Policy seeks to attain energy independence and promote efficient utilisation, conserve and minimise the impact on the environment, enhance national economic development through the use of technology and improve the quality of life for all. It has short-, medium- and long-term objectives, to be achieved under the 10th, 11th and 12th Malaysian Plans.

Short term goals (10th Malaysia Plan 2011-15):

- increased public awareness and commitment for adopting and applying green technology (through advocacy programmes);
- widespread availability and recognition of green technology in terms of products, appliances, equipment and systems in the local market (through standards, rating and labelling programmes);
- increased foreign and domestic direct investments in green technology manufacturing and services;
- expansion of local research institutes and institutions of higher learning to expand research, development and innovation activities on green technology towards commercialisation.

Medium term goals (11th Malaysia Plan 2016-2020):

- green technology becomes the preferred choice in procurement of products and services;
- green technology reaches a larger local market share against other technologies
- increased local production of green technology products;
- increased research, development and innovation of green technology by local universities and research institutions and commercialisation in collaboration with the local industry and MNEs;
- expansion of local small and medium enterprises (SMEs) and small and medium institutions (SMIs) on green technology into the global markets; and
- expansion of green technology applications to most economic sectors.

Long term goals (12th Malaysia Plan 2020-2024 and beyond):

- inculcation of green technology in Malaysian culture;
- widespread adoption of green technology reduces overall resource consumption while sustaining national economic growth;
- significant reduction in national energy consumption;
- improvement of Malaysia's ranking in environmental ratings;
- Malaysia becomes a major producer of green technology in the global market; and
- expansion of international collaboration between local universities and research institutions with green technology industries.

Source: : KeTTHA (Ministry of Energy, Green Technology and Water), Perbadanan Putrajaya (Federal Terriroty of Putraja) and Ismail (2010).

objectives is to provide a favourable environment for the development of green technology. This includes introducing and implementing innovative economic instruments and establishing effective fiscal and financial mechanisms to support the growth of green industries. The Policy also gives priority to environmentally friendly goods and services in government procurement. In launching the Policy, the government also mentioned the importance of promoting foreign and domestic investment in green technology and fostering the participation of local industry.[7]

Typically, countries reflect their interest in green growth in economic co-operation agreements, such as investment and free trade treaties. A small but growing number of countries are making reference to environmental protection in bilateral investment agreements (Gordon and Pohl, 2011). Malaysia is not among them: there are no provisions relating to the environment or the promotion of green investment in any of the bilateral investment treaties that Malaysia has signed. On the other hand, Malaysia does include provisions dealing with environmental issues in a range of recent free trade and economic partnership agreements (Gallagher and Serret, 2010). The content of the provisions vary, ranging from standard WTO-inspired language in the agreement with India, to co-operation arrangements on environmental issues, such as in the FTAs with New Zealand and Australia (Box 9.3). As Chapter 3 notes, Malaysia is using investment chapters in its FTAs to promote investment protection and investment liberalisation. Investment in green sectors is no exception.

As Chapter 3 pointed out, Malaysia has ratified several treaties on intellectual property (IP) protection and introduced IP laws in line with international standards. A specialised agency, MyIPO, and IP courts were also established to ensure enforcement of the law. These measures can help to support IP protection, which is vital for innovation in clean technology and the diffusion of green technologies across borders. Evidence suggests that few developing countries file patents in clean technologies and that industrialised countries account for the bulk of existing patents (ICTSD, 2012). Therefore, if Malaysia wants to realise its goal of leading the global green revolution, it should pave the way for innovation in environmental issues. Chapter 3 mentioned that IP agencies need greater capacity and suggested steps to address the dearth of skills and knowledge, including measures to take into account the IP needs of green sectors. A licensing framework for green technologies could help in this regard. Malaysia could also follow the example of Brazil, Korea, Australia, the United Kingdom and Japan, which have all set up fast-track schemes to accelerate the processing of "green" patent applications.

Box 9.3. **Environmental protection in Malaysia's trade and economic partnership agreements**

The Malaysia-**India** Comprehensive Economic Cooperation Agreement, signed in September 2010 and in force since 1 July 2011, provides that "all measures to facilitate trade shall be without prejudice to the fulfilment of legitimate statutory and policy objectives, including revenue and the protection of national security, health and the environment.[1]

In the Economic Partnership Agreement between **Japan** and Malaysia, the Parties agree not to encourage investments by investors of the other country by relaxing environmental measures.[2]

In the Free Trade Agreement with **New Zealand**, environmental protection plays a more prominent role. In the Preamble, Parties declare that they are "aware that economic development, social development and environmental protection are components of sustainable development and that free trade agreements can play an important role in promoting sustainable development", and recognise their "desire to enhance communication and co-operation on labour and environment through bilateral co-operative agreements between them".[3] Furthermore, Malaysia and New Zealand have signed a separate agreement on Environmental Cooperation, where they express their intention to co-operate in environmental areas of common interest, such as waste management, wetlands management, eco-tourism, water resources/watershed management, environmental remediation, climate change-related technologies, extended producer responsibility, biodiversity conservation, national park/reserve management, sustainable forest management, marine and coastal resources management, public participation in environmental management and education.[4]

Under the Malaysia-**Australia** Free Trade Agreement, signed on 30 March 2012 and entering into force on 1 January 2013, the Parties have agreed on several areas of co-operation.[5] One of them is in the area of Clean Coal Technology, where Australia will assist Malaysia in developing a carbon capture and storage technology project for the purpose of reducing carbon dioxide emissions from thermal power plants.

1. Official Portal of the Ministry of International Trade and Industry, *www.miti.gov.my/cms/content.jsp?id=com.tms.cms.section.Section_54ce4f96 -c0a8156f-2af82af8-6735df31*.
2. Agreement between the Government of Japan and the Government of Malaysia for an Economic Partnership (signed 2005) Article 90, *www.mofa.go.jp/region/asia-paci/malaysia/epa/index.html*.
3. New-Zealand-Malaysia FTA. *www.mfat.govt.nz/Trade-and-Economic-Relations/2-Trade- Relationships-and-Agreements/Malaysia/index.php#text*.
4. Malaysia-New Zealand Agreement on Environmental Co-operation: *www.mfat.govt.nz/ downloads/trade-agreement/malaysia/mnzfta-environment-agreement.pdf*.
5. Malaysia-Australia Free Trade Agreement: *www.miti.gov.my/cms/content.jsp?id= com. tms.cms.section. Section_55b684ea-c0a8156f-2af82af8-5b2b191e*.

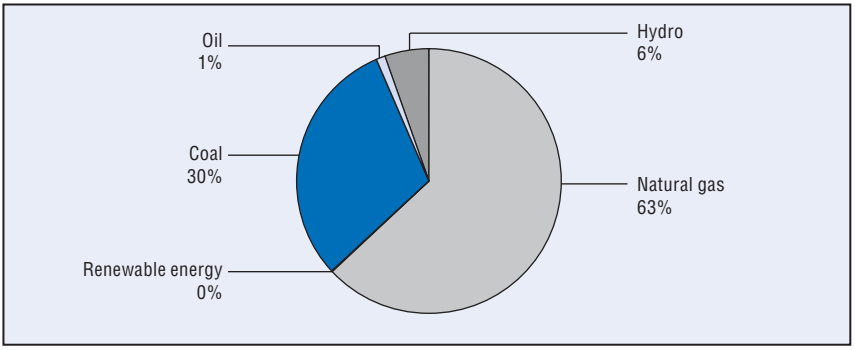
Regulatory and policy framework for investment in priority areas for green growth

At present, Malaysia's efforts to promote green technology development focus on four sectors: energy (supply and consumption), waste and water management, and the building and the transport sectors. To different degrees, all of them offer potential for private investment. This section focuses on measures to promote investment in the renewable energy and building sectors.

Renewable energy

Renewable energy has a very small share of Malaysia's energy mix (Figure 9.1). Malaysia has used renewable energies since the 1980s, although initially, projects were private sector-led and not backed by a specific government policy. Since 2001, the government has introduced a number of renewable energy policies, starting with the creation of the Small Renewable Energy Power Programme (SREPP), under which small-scale renewable energy producers can sell up to 10 MW of electricity to utilities through the distribution grid system.[8] Under SREPP, private operators source their own funds and have to negotiate power purchase agreements with utilities directly in return for 21-year operating licences. The renewable energy sources that have been identified under this programme are biomass, biogas, solar, mini-hydro and solid waste. A number of successful projects were developed under SREPP, for example the Jana landfill-to-biogas project, the first grid-connected renewable energy project in Malaysia. By March 2010, 43 projects with a total capacity of 286 MW had been approved or licensed. Biomass made up about half of the projects by number and 71% by capacity.[9]

Figure 9.1. **Malaysia's energy portfolio (2009)**



Source: Shafie et al., *Current Energy Usage And Sustainable Energy In Malaysia: A Review* (2011).

The SREPP programme ended when the *Renewable Energy Act* and *Sustainable Energy Development Authority* (SEDA) were passed in April 2011. A few lessons can be drawn from the SREP Programme and help shed light on how to strengthen future renewable energy project frameworks. Firstly, project developers were obliged to enter into contracts with a single buyer under "take and pay" arrangements. Therefore, if the off-taker refused to take or pay for the electricity, the operators were left without a revenue source (Haris and Ding, 2009). The obligation for private companies to secure their own

Box 9.4. **Malaysia's energy portfolio**

Malaysia is well endowed with conventional energy resources such as oil, gas and coal, as well as renewable energy sources such as hydro, biomass and solar energy. Energy generation in Malaysia is dominated by fossil fuels (petroleum, natural gas, coal and diesel). Thermal sources are expected to decrease to 75.9% of the installed capacity by 2030 as the government implements its renewable energy programme (APM, 2012).

Petroleum's share of energy consumption has declined from 87% in 1980 to 54.5% in 2008 and coal has also been decreasing in importance too. Hydropower has had a modest increase, from 5.8% of the total electricity mix in 1980 to 6.4% in 2008 (Ong, 2011) although a number of projects, such as the 2 400 MW Bakun hydropower project, are expected to become operational in the next few years and this could increase the total share of hydropower in the electricity generation mix (Ong et al., 2011). In 2011, electricity sold from the Bakun plant amounted to 830GWh. According to one projection, hydropower's contribution to the national energy mix could grow from 8.2% in 2010 to 15% by 2020 (APM, 2012). There is concern, however, that Bakun will be used mainly for industrial purposes, in particular to power two aluminium smelters in Sarawak, and will barely benefit the local population (Sovacool and Valentine, 2011). Moreover, the environmental and social challenges typical of hydropower projects, such as disrupting downstream habitats and forcibly relocating communities to make way for the dam site, must be addressed in the Bakun plant and future projects to maximise the benefits of increased hydropower generation.

Other renewable energy sources, while a minor part of the total energy mix, have significant potential especially in biomass and solar power. The government has also been considering nuclear power and is currently assessing the feasibility of a nuclear programme. If approved, the first nuclear plant could be built in the early 2020s. There is some cogeneration through agricultural crop residue from paddy (e.g. rice husks), rubber and sugar but this is a negligible part of electricity generation in Malaysia.

financing could have been an obstacle for interested project developers, and foreign companies were limited to 30% equity contributions, thereby precluding significant funding from abroad. Moreover, the government body tasked with evaluating projects, the Special Committee on Renewable Energy, met only twice a year forcing prospective operators to wait for up to six months to present their project applications. These shortcomings constrained investment and project development to some extent and perhaps undermined SREPP's potential impact.

In April 2010, the Cabinet approved the National Renewable Energy Policy and Action Plan, as the cornerstone of a more aggressive deployment of renewable energies in Malaysia. Malaysia is currently also finalising a National Energy Efficiency Master Plan which aims to anchor the country's energy efficiency measures in a broader strategy addressing issues such as energy security and climate change. In 2011, the government introduced a feed-in tariff and other incentives (see section below on incentives) to promote the uptake of renewable energies. Measures were taken to promote human resource development in the field of renewable energies and other green technologies (see section below on capacity building).

To increase the amount of generation capacity and meet growing demand, the government has spearheaded some mega-projects, such as the Bakun hydropower project in Sarawak. However, smaller-scale projects should also be encouraged, especially in rural areas where electrification rates are below urban areas.

Building sector

The Association of Consulting Engineers Malaysia and the Malaysian Institute of Architects created the Green Building Index (GBI), an initiative to make buildings more environmentally sustainable. It defines the parameters for green buildings; sets standards for measuring and refurbishing buildings to make them greener; and nurtures environmental leadership among developers, architects, planners and contractors. The GBI can be used in the design process of green buildings, for instance, in retrofitting factories to make them less polluting. Buildings are awarded a GBI rating based on six criteria: energy efficiency; indoor environmental quality; sustainable site planning and management; the use of environmentally-friendly material; water efficiency; and innovation.[10] Building owners that obtain the rating certification are eligible to receive tax exemptions on additional investments made to green their buildings and exemptions of stamp duty for transferring ownership of GBI certified green building (see section on incentives).

The government has introduced incentives for buildings awarded with GBI in the 2010 National Budget announcement. Building owners obtaining GBI certificates from 24 October 2009 until 31 December 2014 are entitled to

income tax exemptions equivalent to the additional capital expenditure in obtaining such certificates. Buyers purchasing buildings with GBI certificates from developers will be given stamp duty exemption on instruments of transfer of ownership. The exemption amount is equivalent to the additional cost incurred in obtaining the GBI certificates.

While GBI is a private initiative, there is also a public performance rating system for buildings. The Construction Industry Development Board, a statutory body under the Ministry of Works, is in the final process of developing the Green Performance Assessment System (GreenPASS), a low carbon building system to facilitate and rate the implementation of low carbon in building development in Malaysia. An earlier initiative was the Malaysian Building Integrated Photovoltaic, set up by the government in collaboration with the GEF and UNDP and implemented under the 9th Malaysia Plan to promote widespread and sustainable use of PV in buildings. The project was launched in July 2005 for five years.

Another instrument, the Low Carbon Cities Framework, set up in 2010, aims to promote the planning, design, construction and maintenance of sustainable townships. The tool includes criteria in six core categories including: climate, energy and water; ecology and environment; community planning and design; transport and connectivity, building and resources; and business and innovation. Two locations (Putrajaya and Cyberjaya) have been designated to become models of green townships in the country. Towards this end, government offices in Putrajaya have targeted to reduce their energy and water consumption by 10% by end of 2012, and to achieve a CO_2 emission reduction of 60% by 2025.

Incentives for green investment

The government has provided a number of incentives, such as tax breaks and loans, to attract investment in renewable energy generation.[11] It has simplified regulations, thereby reducing administrative obstacles to doing business, and introduced a feed-in-tariff (FiT) in 2011. It introduced a 15-year tax holiday on solar manufacturing companies' profits, which allowed it to attract major companies such as First Solar, further signalling the attractiveness of the solar energy market to other investors. A range of other financing options is also in place. For example, the government provides low-interest loans for companies looking to expand their activities related to clean production or other environmentally-friendly processes and outputs. A summary of the different mechanisms is provided in Table 9.2.

Most mechanisms are available to established companies in Malaysia, regardless of their ownership, but a few are granted only to companies under Malaysian majority control (e.g. the feed-in tariff and the Green Technology Financing Scheme see below).

Table 9.2. **Green investment incentives in Malaysia**

Name	Purpose of the incentive	Type of benefit	Beneficiary sectors/activities
Promotion of Investments Act 1986	Promote energy conservation	Pioneer status and tax allowance for 100% of statutory income for 10 years; projects must be implemented within a year of receiving incentive	Energy service companies implementing energy conservation projects
2009 Budget	Promote renewable energy (RE)	"Pioneer status" tax exemption of 100% of statutory income for 10 years (until end-2015)	Generation of electricity from biomass, hydropower (< 10 MW) and solar power
2009 Budget	Promote renewable energy (RE)	100% investment tax allowance on capital expenditure within first 5 years (until end- 2015)	RE generation for companies' own consumption
2010 Budget	Promote green buildings	Tax exemption on 100% of additional capital expenditure for greening buildings	For building or upgrading buildings to Green Building Index certificate standards
2010 Budget	Promote green buildings	Stamp duty exemption	Transfer of ownership of a GBI certified building
	Increase use of environmental protection technology	Capital allowance on capital expenditure (40% initial and 20% annual thereafter)	Equipment for waste treatment and waste recycling
2009 Budget	Facilitate development of solar power	Import duty and sales tax exemptions on solar PV and solar heating equipment (until end-2012)	Solar PV system equipment
2009 Budget	Promote energy efficient (EE) products	Sales tax exemption on energy efficiency products (e.g. electronic products, manufacturing inputs)	Imported materials and equipment can receive some import duty and sales tax exemption. Locally manufactured energy efficient goods such as refrigerators, lights and tvs can receive full exemption on sales tax.
2011 Budget	Complement Clean Development Mechanism (CDM) – expired 12/2010	Exemptions on income tax from sales of Certified Emissions Reductions (CERs) until end 2012	CDM projects
2011 Budget; 2012 Budget	Reduce emissions from vehicles (extended until end-2013)	Full import duty exemption and 50% excise duty exemption	For hybrid and electric cars and motorbikes

Sources: Malaysia Investment Development Authority (Incentives for Environmental Management), PriceWaterhouseCoopers (Green Tax Incentives for a Sustainable Malaysia), 2011 Budget Speech.

Tax incentives

The government also provides incentives which may be seen to conflict with its green growth objectives. For example, it continues subsidising fossil fuels although it has pledged to remove them by 2015. Table 9.3 describes the current state of fossil fuel subsidies.

Table 9.3. **Subsidy by type of fossil fuel in Malaysia (USD billion)**

Fuel	2008	2009	2010
Oil	4.61	1.58	3.89
Gas	2.97	1.68	0.97
Coal	0	0	0
Electricity	2.2	0.59	081

Source: World Energy Outlook 2011; IEA Subsidy Database: *www.iea.org/subsidy/index.html*; accessed 13 June 2012.

The Malaysian government provides significant energy subsidies, defined by the IEA as government actions directed primarily at the energy sector that lower the cost of energy production, raise the price received by energy producers or lower the price paid by energy consumers.[12] As of 2010, subsidies represented 2.4% of GDP, which is equivalent to a subsidisation rate of USD 200 per person or 20% of the true cost of the fuels.[13]

The government successfully reduced subsidies for gasoline, diesel and LPG in July 2010, following a previous failed attempt due to public protests in 2006. However, an increase in international oil prices in 2011 led to a doubling of the fossil subsidy bill and the government decided to keep fossil fuel subsidies in place.[14] Many countries have faced significant challenges in removing their fossil fuel subsidies.

Malaysia's Feed-in Tariff

The *Renewable Energy Act* passed in 2011 introduced a feed in tariff (FiT) mechanism to catalyse the generation of RE in Malaysia. It allows electricity produced from indigenous RE resources to be sold to power utilities at a fixed premium price for a specific duration. Eligible RE technologies include biogas (as well as landfill gas), biomass, small hydropower, and solar photovoltaic for up to 30 MW of electricity generated. Capacity limits, or quotas, are imposed on the RE sources. Moreover, several categories differentiate the source of energy and the corresponding tariff. While mini-hydro and solar PV can receive FiTs for up to 21 years, biomass and biogas are only eligible for 16 years each. Moreover, the FiT is lowered as the installed capacity level of the RE source increases because economies of scale make generation less costly. The

FiT decreases annually from 2013, except for small hydropower, because it is anticipated that the costs of technology will drop as the technology matures.[15, 16]

Foreign investors can be eligible for the FiT provided that the foreign equity shareholding in the applicant company is 49% or less.[17] According to the government, the cap is to ensure that local companies benefit the most, so that a local renewable energy industry develops. The FiT became operational in December 2011. The Sustainable Energy Development Authority (SEDA) Malaysia was set up to implement national RE policies, including the FiT; advise government agencies on sustainable energy matters; and promote private investment in sustainable energy.

The FiT scheme is financed through a 1% surcharge on top of consumer's electricity bill. Funds are managed by the *Renewable Energy Fund*, established under the *Renewable Energy Act* of 2011 The RE Fund is capitalised by an initial grant from the government. Heavier consumers will have to pay more into the RE Fund, while domestic customers who consume less than 300kWH or RM 77 a month are exempted. In effect, this means that only 44% of consumers are paying into the RE Fund.[18] By one estimate, only 25% of consumers are paying into the RE Fund. SEDA Malaysia manages the finances of the Fund, which can only be used to cover payments to distribution licencees and any administrative costs associated with the FiT programme.

As of 31 January 2013, 437 MW of renewable energy capacity had been approved through the FiT programme.[19] Solar PV was especially popular, accounting for 438 out of 474 applications for its category of feed-in tariff.[20] The Cypark renewable energy park, comprising several subsidiary companies generating electricity from solar, biogas and landfill waste, has received a 21-year power purchasing agreement with TNB based on the FiT.[21] Cypark is now planning to expand to four other states and to install an additional 25 MW of solar power capacity. Malaysia's policies in support of a green economy have led to increased investment in a range of areas. For example, according to the government, by mid-2012, Malaysia had attracted almost RM 12 billion in investments from the solar PV industry through investment.[22]

The administrative process for registering solar PV projects is less onerous than for other RE sources. For example, up to thirty approvals may be required before beginning work on small hydro plants, and the construction time itself can take up to 36 months for small hydro and biomass plants.[23] Administrative simplification is therefore a reform priority if renewable energy is to flourish. SEDA Malaysia has indicated that it will review the solar PV tariff but it does not expect that the rates for other sources will change much.[24]

Other sources of finance in support of green investment

A number of other mechanisms are in place to support investment in renewable energies and other green initiatives. These include various investment funds, private financing, the Clean Development Mechanisms and development assistance.

Investment funds

The Green Technology Financing Scheme was established under the 2010 budget in order to increase the development and use of green technology. The Scheme is based on RM 1.5 billion (about USD 500 million) in incentives and soft loans for green technology in the energy, transport, water and waste management and building sectors. Participating financial institutions, namely commercial and Islamic banks and development finance institutions, are meant to provide the financing. Eligible beneficiaries include manufacturers and users of green technology: the former can receive up to RM 50 million and the latter up to RM 10 million. The tenor of loans varies, as manufacturers' loans mature at 15 years while those of users at 10 years. Restrictions on foreign ownership have been imposed. For producers, only legally registered Malaysian companies with local ownership of at least 51% are eligible for financing. For users, legally registered Malaysian companies with at least 70% ownership are eligible. In all cases, the government provides a 2% annual interest rate subsidy and guarantees of 60% of the financing amount.[25]

Table 9.4. **Total project cost and green technology (GT) total cost for Green Technology-certified applications (as of April 2012)**

Sector	Number of certified applications	Total project cost (RM million)	Total green technology recommended cost (RM million)
Energy	113	4 630	2 190
Water and waste	50	1 214	907
Building	8	321	94
Transport	7	1 729	181
TOTAL	**178**	**7 895**	**3 372**
of which : Producer	**151**		
: User	**27**		
Total GHG emission reduction (tCO_2e/yr) **8 870 523**			

Source: KeTTHA, Ministry of Energy, Green Technology and Water (2012).

After almost three years of implementation, 251 applications have been processed and 219 companies have received the Green Certification. Out of this number, 76 projects have been approved for a loan from related financial

institutions with a total funding of RM 1.02 billion. The CEO of Malaysian Green Technology Corporation, the agency tasked with implementing the Scheme, explained that banks have been reluctant because of a lack of understanding of green projects and doubts about the ability of loan holders to service their loans. Moreover, there is not enough expertise within banks to evaluate the creditworthiness of green projects or green technologies.[26]

Recognising these challenges, various measures were undertaken by Bank Negara Malaysia in collaboration with other ministries and agencies such as Malaysia Green Technology Corporation, SEDA, the Association of Banks Malaysia, and the Institute of Bankers Malaysia. These measures include establishing a Joint Action Committee to resolve implementation issues, launching an education and awareness programme for bankers as well as technical training on credit assessment of green technology projects. As a result, the performance of the Scheme has improved, with an approval rate of 78% in terms of the number of accounts, as compared to 62% at end-2010. As of August 2012, 65 applications amounting to RM 806 million (approximately USD 274 million) were approved by financial institutions.

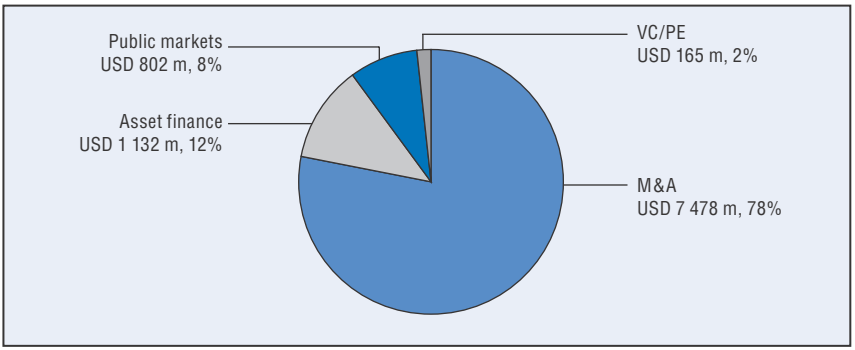
To encourage further development in green technology, the government recently announced a new allocation of RM 2 billion (about USD 680 million) and an extension of the Scheme until 2015.

Khazanah, the government's strategic investment fund, had in 2008, via the formation of KCS Green Energy, committed to invest up to USD 150 million in a number of municipal waste-to-energy projects in China. To date, three waste-to-energy plants have been completed and are operational. In September 2010, it acquired a 23.6% stake in Camco International Ltd, a global developer of clean energy projects and solutions to reduce greenhouse gas emission, listed on the Alternative Investment Market of the London Stock Exchange. Khazanah and Camco also entered into a joint venture to set up a regional player based in Malaysia. This joint-venture company, Camco South East Asia, capitalised at USD 30 million, was officially launched in December 2010, and is currently focusing on developing a pipeline of emission-to-energy projects (such as biogas) and energy efficiency projects in Malaysia and the rest of Southeast Asia. The joint venture is also expected to contribute towards Malaysia's conditional voluntary targets to reduce the emission intensity of real Malaysian GDP by 2020 (Khazanah Nasional, 2010).

Private financing for clean energy projects

Malaysia has received USD 9.5 billion in cumulative investment flows for clean energy projects from a combination of asset finance (funding from companies' balance sheets); mergers and acquisitions; private equity, venture capital and public market stock issues (Figure 9.2). To put that amount in

Figure 9.2. **Financing for renewable energy in Malaysia**



Source: OECD analysis based on data extracted from the Bloomberg New Energy Finance Database; 19 June 2012.

context, total global investment in renewable energy was worth USD 211 billion in 2010 alone and regional (and global) leader China attracted USD 49 billion that same year. (REN 21, 2011) The sections below explain the funding sources for Malaysia's green sectors.

Mergers and acquisitions (M&A)

M&A represents the bulk of investment in the renewable energy sector, with about USD 7.5 billion invested cumulatively (Figure 9.2).[27] There have been 10 M&As to date, seven in the biofuels sector and three others in geothermal, small hydro and solar energy projects. The biggest deal was in 2007, when Sime Darby Bhd acquired a 100% stake in Golden Hope Plantations Bhd, a Malaysian plantation management company involved in biodiesel production. The deal was worth RM 8.2 billion (USD 2.44 billion). International M&A has had diverse origins: Germany, Indonesia, Singapore, UAE, South Korea and Australia have had at least one or two companies taking stakes in Malaysian companies. Measured by value, Malaysian companies account for the biggest M&A activity – USD 7.2 billion or 96% of the total investment. In recent years, the country has seen an overall decline of 72% in outward M&A activity and many countries in Asia and beyond have seen similar declines.[28] M&A in Malaysia's clean energy sector has not been spared, with a significant lull in new activity since 2010.

Asset finance

Asset finance is the second biggest contributor to renewable energy financing in Malaysia. The disclosed total value of the 65 projects funded through asset-finance is USD 1.13 billion, which is derived almost entirely from companies' balance sheets, although a couple of projects were funded

from convertible term loans and one project partly from project finance. Most of the projects are in biofuels (33), followed by biomass (13), solar (and wastewater treatment) (7 each), small hydro (3) and digital energy (1) and carbon capture and storage (1).

A number of public agencies have financed projects off their balance sheets. These include:

- the Ministry of Energy Green Technology & Water, which provided RM 478 m (USD 142.2 m) for the development of the Jelutong Sewage Treatment Plan; the Kuching Water Board, which financed the expansion of the Batu Kitang Treatment Plant; Indah Water Konsortium Sdn Bhd, a national sewerage company, wholly-owned by the Minister of Finance Incorporated, which financed several sewage treatment plants;
- Tenaga Nasional Bhd and Felda Palm Industries Sdn jointly financed the RM 120 million (USD 39.3 million) development of the Jengka Biomass Plant.

Some of these projects were co-financed with other public and private companies. For example, the Puchong plant and the Kapupaten Solok project were co-financed by the Japan International Co-operation Agency and an Indonesian public company. Moreover, some Malaysian firms have invested abroad, such as Carotech Bhd, Rubiatec Sdn Bhd and Mission Biotechnologies Sdn Bhd.

Public markets

Secondary share placements, initial public offerings (IPOs) and convertible issues have raised a total of USD 802 million on domestic and foreign stock markets to date. This amount represents eight deals: five in biofuels, two in solar and one in energy storage. Malaysian and Australian stock exchanges were the most popular markets, but sales also took place in the Hong Kong (China), London, Chinese Taipei and Tokyo stock exchanges.

Venture capital and private equity

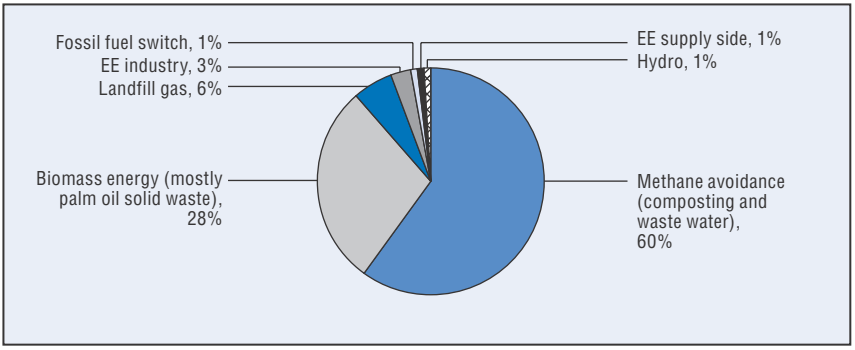
Venture capital (VC) and private equity (PE) have contributed USD 164.7 million to Malaysia's renewable energy sector to date. Most VC is in biofuels, biomass and fuel cells. VC/PE has proved to be a valuable source of funding for green projects in emerging economies because these types of investors seek out companies or technologies at an early stage of development and in some cases, have mitigated the associated risks through a combination of industry experience, policy awareness and specific mitigation instruments (UNEP/Bloomberg, 2012). Malaysian VC/PE has recently received a boost with the creation of the Asia Clean Tech Fund, which will be managed by SBI Investment, a Japanese VC firm, and RHB Equity, a Malaysian VC firm. The

Fund will invest in Malaysia's neighbouring countries and requires a minimum commitment of USD 50 million from institutional investors.

The Clean Development Mechanism (CDM)

Malaysia is a participant of the Clean Development Mechanism (CDM), set up under the UNFCCC to allow developed countries to invest in projects in developing countries that can reduce GHG emissions in return for Certified Emission Reduction (CER) credits. These credits can be sold on the market and used to meet developed countries' emissions reduction commitments under the Kyoto Protocol. To date, Malaysia has registered 169 CDM projects, which compares to 260 projects in Viet Nam (the Southeast Asia regional leader for CDM projects), 187 in Thailand, 172 in Indonesia and 89 in the Philippines.[29] Of the 169 CDM Projects, 61 were at the validation stage, 2 were requesting registration and 106 were registered projects as of June 2012. Most of the projects are in methane avoidance, with a substantial number in biomass as well (Figure 9.3).

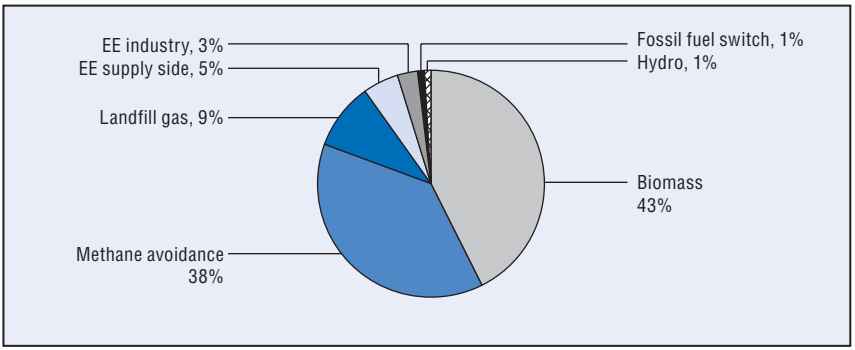
Figure 9.3. **Number of registered CDM projects in Malaysia by sector**



Source: United Nations Environment Programme, Risøe, "CDM Project Pipeline"; *www.cdmpipeline.org/cdm-projects-region.htm#2*; accessed 18 June, 2012.

Malaysia has a well-developed institutional architecture for developing CDM projects. An umbrella body, the National Steering Committee on Climate Change, sets general policy on climate change and co-ordinates the national implementation plan on climate change. The Ministry of Natural Resources and Environment serves as the designated national authority (DNA) and its main responsibility is to develop guidelines and eligibility criteria for CDM projects.[30] Since the implementation of the CDM is cross-sectoral, the Ministry of Natural Resources and Environment has established a National Committee on CDM, comprised of various ministries and NGOs, and two Technical Committees on energy and forestry with their respective

Figure 9.4. **Malaysia's total 2012 CERs by sector**



Source: United Nations Environment Programme, Risøe; "CDM Project Pipeline"; *www.cdmpipeline.org/cdm-projects-region.htm#2*; accessed 18 June, 2012.

secretariats. The technical committees evaluate CDM proposals in their respective areas. The Malaysia Green Technology Corporation provides research and capacity building services on CDM issues.

While Malaysia has laid a good foundation for using the CDM to mitigate climate change, there are a few issues that need to be addressed if the mechanism is to have greater uptake from project developers and investors. The primary challenge, at both national and global levels, is the high cost of CDM undertakings, relative to the market price of Certified Emission Reductions. These costs include a minimum capital requirement (USD 32 500) and transaction costs, which can be as much as the minimal project cost.[31] Addressing these financial constraints can help bolster interest in CDM potential in Malaysia.

Development assistance

Official development assistance (ODA) contributes USD 15 million to energy financing in Malaysia.[32] Most of the funding, USD 14.7 million, is for nuclear power plants, while solar energy (USD 119 000), biomass (USD 438 000) and power generation from renewable sources (USD 54 000) account for the rest. There is no ODA directed at geothermal energy, hydroelectric plants, wind power or ocean power.[33] The United States, Japan, Korea and Australia are major bilateral donors to green sectors in Malaysia and the European Commission and Global Environment Facility have also provided funding in the past.

Capacity to design and implement green investment policies

The Malaysian government has taken steps to increase both the country's institutional capacity to implement its green growth policies, such as the Renewable Energy Policy and the National Policy on Climate Change, including to design and implement related investment policies – and to develop human resources to respond to the increasing demand for specialised skills in green technologies, manufacturing and services.

One of the strategic thrusts of the National Green Technology Policy is to strengthen the institutional framework for green investment. Among the recently created institutions are the Ministry of Energy, Green Technology and Water (KeTTHA), established in April 2009, and the Sustainable Energy Development Authority (SEDA), established in 2011. According to commentators, a lack of cohesion among different agencies has been an obstacle to the success of green initiatives in the past. The National Green Technology and Climate Change Council, headed by the Prime Minister, with KeTTHA and MNRE as co-secretariats, was established to help overcome these problems.[34] It is intended to be a high-level platform to co-ordinate ministries, agencies, the private sector and key stakeholders to implement green technology policies.[35]

In order to promote human resource development, the National Green Technology Policy makes provisions for financial packages to help with the commercialisation of new technologies and sets out incentives for students embarking on green technology-related subjects. The government also encourages local research institutes and institutions of higher learning to strengthen research, development and innovation activities in green technology.

Policies to promote environmentally responsible business conduct and to raise awareness

Responsible business conduct

Policies to limit the adverse impact of business activities on the environment and, more generally, to promote more responsible behaviour and improve the environmental performance of firms are an integral part of a green economy. Better environmental performance can yield competitive advantage for firms, given the growing demand for "green" products and services, the attention that investors and consumers now pay to the image of firms, and the environmental risks they face, in particular those relating to climate change (OECD, 2010) (Box 9.5). The OECD *Guidelines for Multinational Enterprises* (see Chapter 6), and their environment chapter in particular, provide indications of internationally recognised standards of responsible corporate behaviour (OECD, 2005, 2010).

Box 9.5. **What constitutes responsible business practice in addressing climate change?**

The three key areas of action taken by leading companies to address climate change include measuring and disclosing GHG emissions; reducing emissions, and engaging actors beyond the company's border in emission reduction efforts.

Measuring and disclosing GHG emissions helps companies to assess their impacts on the climate and the associated costs of mitigation and risks, and to design emissions reduction plans.

For companies, **reducing GHG emissions** generally often starts with energy conservation measures, with both environmental and economic benefits. Other emission-reduction measures, such as reducing waste generation, adopting low-carbon technologies, optimising logistics and shifting to renewable energies, may be more costly and have a longer return on investment. To implement those, the vast majority of companies require stronger government incentives and signals – such as global emissions trading markets, carbon taxes, regulations and standards.

For many companies, the bulk of GHG emissions is produced **beyond the company's borders**, through the supply chain and the use and disposal of products. Managing emissions in the supply chain and throughout the life-cycle of products is a recent area of public and corporate action. Public-private partnerships to promote good practices and provide training and capacity building could support companies' efforts to engage their suppliers. Greater consumer mobilisation is also crucial and will depend on the combined capacity of governments and companies to provide clear signals and guidance.

Source: OECD (2010), *Transition to a Low-Carbon Economy: Public Goals and Corporate Practices*, OECD Publishing. *http://dx.doi.org/10.1787/9789264090231-en.*

The agency in charge of environmental management in Malaysia is the Department of Environment (DOE), created in 1975 and located within the Ministry of Natural Resources and Environment. The Department's main role is to prevent, control and abate pollution through the enforcement of the *Environmental Quality Act* of 1974 (which was subsequently amended several times) and other environmental legislation.[36]

Under the *Environmental Quality Act 1974*, new projects (or, in terms of the Act, "prescribed activities"), as defined by the Minister of Natural Resources and Environment, are subject to environmental impact assessment (EIA).[37] The project proponent of a prescribed activity must submit the EIA to the Director General of Environmental Quality before the proposed activity is approved by the relevant approving authority. The EIA report must be in accordance with the guidelines issued by the DOE, contain an assessment of

the impact of the activity on the environment, and detail the proposed measures to be implemented in order to prevent, reduce or control adverse impacts on the environment. A "detailed EIA" is required for projects with a significant impact on the environment, or situated in environmentally sensitive areas. The portal of the Malaysian Investment Development Authority (MIDA) provides an overview of relevant environmental legislation, including EIA-related information, of interest to investors. [38]

Under the Malaysian *Environmental Quality Act* 1974 and associated regulatory standards companies are required to report on their environmental performance, but these do not include key environmental issues such as climate change, biodiversity loss and water scarcity. Some business-led initiatives have nevertheless started to emerge. For example, two Malaysian companies (Digi and Malayan Banking) responded to the Carbon Disclosure Project's questionnaire on greenhouse gas emissions in 2010 and 2011 (CDP, 2012).

The DoE has developed a range of online tools, such as the Malaysia Green Industry Database, an inventory of emissions from various enterprises and their sources, and a Cleaner Production Implementation Tool to help small and medium enterprises assess their options for switching to cleaner production methods and to conduct audits that identify opportunities for waste reduction.[39] The DoE also has a Green Industry Virtual Centre with manuals and case studies of companies that have saved money through investing in energy efficiency and waste reduction. Publications on Cleaner Production Tips and Cleaner Production: Do-It-Yourself were prepared for small and medium industries.[40]

The government also plans to encourage private initiatives to establish environmental management systems. Other measures include relocating polluting companies to industrial parks with treatment facilities and applying clean production technologies. Though the government has called on all actors in Malaysia to contribute to the governments' goal of reducing the country's carbon intensity by 40% in 2020, there are few initiatives (beyond the promotion of renewable energy) to strengthen companies' action to reduce their carbon footprint.

Overall, progress with regards to improving environmental standards in companies has reportedly been low. At present, efforts to improve responsible business conduct seem to come mainly from multinational enterprises operating in the country. For example, a 2010 publication on sustainable development initiatives in Malaysia cites mainly foreign MNEs, including Panasonic, General Electric, and Toyota (MPC, 2010).[41] Among the Malaysian companies which stand out in their efforts to improve their environmental performance is Digi, a telecommunications company, which focuses on reducing its impact on climate change through its "DeepGreen" programme.[42]

The government has established a programme, MyHijau, that aims to strengthen eco-labelling and green procurement by targeting small and medium enterprises (SMEs). The programme consists of:

- *MyHijau Directory*: A listing of certified green products by companies that has been operational since January 2011 (*www.greendirectory.my*). It is a purchasing guide for government departments who want to make purchasing decisions based on the environmental aspects of goods and services.
- *MyHijau Labelling*: A national green endorsement and labelling programme that aims to co-ordinate existing green labels from various sectors – such as agriculture, timber and forestry, and energy efficiency under one common framework. GreenTech Malaysia acts as the central authority for producers and service providers seeking to certify or endorse their products and services.
- *MyHijau SMEs*: A programme to build the capacity of SMEs to manufacture eco-labelled products
- *MyHijau Procurement*: This programme is still under development, but it is expected that the government will give priority to environmentally-friendly products and services that comply with green technology standards.

Green jobs

In recognition of the importance of green jobs and the need to meet the global demand for green jobs, the Skills Development Department under the Ministry of Human Resources (MoHR) with the co-operation of the Ministry of Energy, Green Technology and Water (KeTTHA) developed in 2010 the National Occupational Skills Standards, National Competency Standards and Occupational Analysis for Green Technology jobs. The objective is to develop human capital in green technology through various training programmes.

KeTTHA and MoHR, with the ILO, are currently conducting a Green Jobs mapping study for Malaysia which covers the area of jobs demand and supply as well as skills requirement. The study started in August 2012 and is expected to end in July 2013. The MoHR is also working towards looking at manpower requirements in the area of green technology for business services.

Notes

1. Department of Statistics Malaysia; Annual National Accounts, Gross Domestic Product (GDP), 2005-2011.
2. The Environmental Performance Index was developed by Yale and Columbia Universities in collaboration with the European Commission and the WEF. It

measures and ranks countries on 22 performance indicators spanning ten policy categories in environmental, public health and ecosystem vitality.

3. 2011 Environmental Protection Index; Yale University; *http://epi.yale.edu/epi2012/casestudies/reports/environmental-quality-indicators-malaysia*.
4. Malaysia is also party to more than 30 international environmental agreements in such areas as protection of the marine environment, protection of the ozone layer, and combating desertification (see the list of these agreements in Annex D). During the 2011 Conference of Parties in Durban (COP 17) Malaysia supported renewal of the Kyoto Protocol.
5. The commitment was announced in a statement by Prime Minister Najib (*http://cdm.greentechmalaysia.my/resources/doe/doe-list.aspx*). However, Malaysia did not submit an official communication under Annex II of the Copenhagen Accord.
6. KeTTHA (Ministry of Energy, Green Technology and Water): *www.kettha. gov.my/en/content/national-green-technology-policy-goals*.
7. Malaysia launches National Green Technology Policy, 9 October 2009, *www.renewableenergyfocus.com/view/4421/malaysia-launches-national-green-technology-policy*.
8. Small Renewable Energy Power Programme, 8 December 2009, *www.kettha.gov.my / en/content/small-renewable-energy-power-programme-srep*.
9. Malaysia Energy Commission, *http://www.st.gov.my/v4/index.php?Itemid=4228& id=5245 &lang=en&option=com_content&view=article*.
10. Green Building Index, February 2012 brochure, *www.greenbuildingindex.org*.
11. Green World Investor; 26 October 2010; *www.greenworldinvestor.com/2010/10/26/reasons-behind-malaysias-surprising-success-in-solar-industry-beating-larger-rivals-usa-and-japan/*.
12. *World Energy Outlook 2010*; Chapter 19: Analysing Fossil-Fuel Subsidies; p. 570; International Energy Agency/OECD, 2010.
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16. Please see Sustainable Energy Development Authority of Malaysia (SEDA) *website: Home/ Feed-in-Tariffs/ Feed-in-Tariff Rates. www.seda.gov.my*.
17. Sustainable Energy Development Authority (SEDA) website, Frequently Asked Questions: *www.seda.gov.my*.
18. *http://thestar.com.my/news/story.asp?file= /2011/11/23/nation/9960533&sec=nation*.
19. *Solar Magazine*, 23 May 2012, *www.solarserver.com/solar-magazine/solar-news/current/2012/kw21/malaysia-considers-changes-to-feed-in-tariff-due-to-over-subscription-of-pv.html*.
20. Ibid.
21. Cypark-TNB Renewable Energy Power Purchase Pact, Cypark Press Release, 30 March 2012, *www.crbenv.com/press_releases.html*.
22. Solar energy shines bright: *www.standardsusers.org/standardsusers/index.php? option=com_content&view=article&id=1160:solar-energy-shines-bright& catid=36:features &Itemid=70*.

23. *Ibid*.
24. SEDA website: *www.seda.gov.my*.
25. Green Technology Financing Scheme website: *www.gtfs.my/faq*.
26. See interview with the CEO at *www.mdv.com.my/v2/archives/news-post/loans-for-green-tech-projects-hard-to-come-by*.
27. Bloomberg New Energy Finance (BNEF) Database, extracted 19 June 2012. Unless otherwise stated, figures in this paragraph are derived from the BNEF database.
28. OECD Investment News, May 2012, *www.oecd.org/daf/investment/news*.
29. UNEP-Risoe Database, CDM Pipeline Projects, *www.cdmpipeline.org/*; accessed 18 June 2012.
30. Criteria include: 1) the project should contribute to sustainable development in social, economic and environmental dimensions; 2) the project should lead to concrete and measurable climate change mitigation and emissions reductions that are additional to any reductions from a non-certified project 3) the project must involve an Annex 1 party, who is authorised to buy credits from the project under the Kyoto Protocol; 4) the project must result in technology transfer benefits for Malaysia and 5) the project developer must be locally incorporated and must demonstrate evidence of sufficient funds (at least RM 100 000 or about USD 32 500).
31. Green Tech Malaysia provides an estimate of the transaction costs: *http://cdm.greentechmalaysia.my/faq/faq12.aspx*.
32. According to data extracted from the OECD DAC Creditor Reporting System, accessed 14 June 2012. These categories do not include forestry or biodiversity.
33. *Ibid*.
34. Renewable Energy Focus Blog, *www.renewableenergyfocus.com/view/4421/malaysia-launches-national-green-technology-policy*.
35. KeTTHA, National Green Technology and Climate Change Council, (MTHPI), 24 October 2011, *www.kettha.gov.my/en/content/national-green-technology-and-climate-change-council-mthpi*.
36. Department of Energy Legislation, Acts, Regulation and Order, *www.doe.gov.my/portal/legislation-actsregulation-order*.
37. Activities subject to EIA are prescribed under the Environmental Quality Order of 1987. EIA studies have to be conducted by competent individuals who must be registered with the Department of Environment under the EIA Consultant Registration Scheme.
38. Malaysian Investment Development Authority, Environmental Requirements, *www.mida.gov.my/env3/index.php?page=environmental-requirements*.
39. Green Industry Virtual Center: *http://cp.doe.gov.my/givc/*.
40. For text, please see: *https://docs.google.com/viewer?url=http://cp.doe.gov.my/givc/wp-content/uploads/2012/05/Cleaner-Production-Tips-for-SMI.pdf&hl= en_US&embedded =true*.
41. The report also cites Malaysia Green Technology Corporation, a non-profit organisation for energy research under the Ministry of Energy, Green Technology and Water.

42. Digi Deep Green Programme, *www.digi.com.my/deepgreen/ambitions_goals.jsp*.

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