FEM 3204
FINANCIAL PLANNING IN
THE GLOBAL MARKET

UNIT 1-10/10

By:

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MODUL PEMBELAJARAN : FEM 3204 FINANCIAL PLANNING IN THE GLOBAL MARKET disediakan dalam bentuk bahan pengajaran dan pembelajaran kondisi di bawah program Pendidikan Jarak Jauh, Universiti Putra Malaysia. Sebarang pertanyaan dan cadangan untuk memperbaiki gaya penyampaian dan isi kandungan modul ini bolehlah dikemukakan kepada penulis dengan menggunakan alamat Pusat Pendidikan Luar.

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FIN 3204: FINANCIAL PLANNING IN THE GLOBAL MARKET

INTRODUCTION

1. The Course Information

1.1 Department : Resource Management and Consumer Studies, Faculty of Human Ecology, University Putra Malaysia.
1.2 Course Title : Financial Planning in Global Markets
1.3 Course Code : FEM 3204
1.4 Credit Hours : 3 (2+1)
1.5 Course Synopsis : The course consists of 2 hours of lecture and 1 hour practical work (1 hour of practical work equivalent to 3 hour lecture in a week. To fulfill the requirement, the students need to attend 2 practical sessions in a semester and have to submit 1 (one) comprehensive group assignment. In every practical session, the students have to finish at least 2 topics of assignment. During the semester, the practice and assignment requires at least 30 hours of student times.

2. The Author Profiles

2.1 Name : Haji Mohd Amim Haji Othman, CFP
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2.3 Telephone No. : 603-8946-7119/7094
2.4 Faks No. : 603-8946-6157
2.5 E-mail Address : Mohdamin@putra.upm.edu.my
2.6 Expertise : Personal finance

3. Objective Of The Course

The course is one of the require subjects in the Human Development Bachelor of Science Program. The main objective is to deliver the knowledge to the student about the financial planning and to explain:

3.1 The importance of financial planning and its relationship towards building the stability of the consumer financial well-being,
3.2 The financial planning processes in the global financial services,
3.3 The impact of global market on financial behaviour and their well-being and:
3.4 The issues and challenges of global market on values and cultures of the local community

4. The Course Synopsis

The importance of financial planning and the relationship of financial planning and social security. Understanding of financial planning processes in the global services. Discussion will also be focused on the impact of global market on financial behaviour and its impact on consumer well-being.

5. The Course contents

Overall, the course requires maximum 28 credit hours (2 x 14 weeks) of lectures and 30 hours (3 x 10 weeks) of practical assignment. The course module will be divided into 10 unit comprises of several important topics. To help the student learn and understand the course topics, the course synopsis will be provided to the student in the appendix.

* please refer appendix 1 and 2

5. Practical and group assignment

To fulfill the 30 hours requirement on practical session, 4 (four) practical assignments and 1 (one) group assignment will be given to the student. The instructor has a liberty to change the topic accordingly to suit the current need of the subject matters. Generally, the practical and group assignment will be as follows:

1. Practial assignment (20%)
   i. Financial Sources, Life Cycle and the Value of Money
   ii. Financial Goals
   iii. Financial Institution Services
   iv. Saving and Investment

   Please refer appendix 3.

2. Group assignment (15%)

A topic of financial planning subject will be given during the interface session with the students.
7. **Course evaluation**

The course evaluation process will be divided into two (2) sections: the coursework and final examination. The coursework consist of practical assignment, group assignment and mid-term test. The summary of the course evaluation are as below:

<table>
<thead>
<tr>
<th></th>
<th>Practical assignment</th>
<th>20%</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.1</td>
<td>Group assignment</td>
<td>15%</td>
</tr>
<tr>
<td>7.2</td>
<td>Mid-term test</td>
<td>25%</td>
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<tr>
<td>7.3</td>
<td>Final examination</td>
<td>40%</td>
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<tr>
<td>7.4</td>
<td><strong>Full marks</strong></td>
<td>100%</td>
</tr>
</tbody>
</table>

Test 1 will be based on unit 1-5 and final - unit 6-10.

8. **Test**

For the whole semester, only one (1) test or mid-term examination will be conducted to measure the level of knowledge of student. The question asked will be based on the course module. The method of question is mixed objective and subjective. For the examination question will cover from unit 1 until unit 5 of the course module. However, it is at the liberty of the course instructor to prepare the question. In addition, the latest news on the test structure will be announced through electronic medium (e-mail) or by the tutor at the education provider. The total mark of the test is 25%.

9. **The Main References**


10. The Additional References


11. Appendixes

APPENDIX 1
The topic and proposed credit hours

<table>
<thead>
<tr>
<th>Unit</th>
<th>Topic</th>
<th>Week</th>
<th>Hour</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Introduction to Financial Planning and Global Markets</td>
<td></td>
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</tr>
<tr>
<td>2</td>
<td>Financial Planning and Social Security: Issues and Relations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Financial Planning Process</td>
<td></td>
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<tr>
<td>4</td>
<td>Search for Financial Information and the Evaluation of Conventional And Online Services: The Cyber User</td>
<td></td>
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</tr>
<tr>
<td>5</td>
<td>Cost and benefit of non-cash transaction</td>
<td></td>
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<tr>
<td>6</td>
<td>Investment Choices and Risk Management</td>
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<tr>
<td>7</td>
<td>Financial Rules and Regulations and Its Impact on Individuals and Organizations</td>
<td></td>
<td></td>
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<tr>
<td>8</td>
<td>Development of Financial Services and It impacts on individual and organisation</td>
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<td></td>
</tr>
<tr>
<td>9</td>
<td>Analysis, Approaches and Strategies to Global Marketability and Its Impact to Individual Financial Attitudes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Issues and challenges of financial planning in the context of global markets</td>
<td></td>
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</tr>
</tbody>
</table>
APPENDIX 2
THE COURSE CONTENTS
FINANCIAL PLANNING IN GLOBAL MARKETS

1.0 INTRODUCTION TO FINANCIAL PLANNING AND GLOBAL MARKET

1.1 Roles of Money in Daily Life
   1.1.1 The Meaning of Money
   1.1.2 Functions of Money
   1.1.3 The Psychology of Money

1.2 Benefits of Financial Planning
   1.2.1 The Development of Financial Planning
   1.2.2 Financial Planning and Its Benefits

1.3 Challenges in Global Market
   1.3.1 Changing Needs Over The Life Cycle
   1.3.2 Values and Attitudes
   1.3.3 Life Situation
   1.3.4 General Economic Conditions

2.0 FINANCIAL PLANNING AND SOCIAL SECURITY: ISSUES AND RELATIONS

2.1 The current consumption and future consumption
   2.1.1 Introduction
   2.1.2 Current vs. future consumption
   2.1.3 Advantages and disadvantages

2.2 Retirement planning
   2.2.1 Type of retirement
   2.2.2 The Types of Retirement needs
   2.2.3 Source of Income
   2.2.4 Methods of Estimating the Retirement Income needs
   2.2.5 The preparation for fulfilling basic retirement need
   2.2.6 Issues and challenges for preparing retirement needs

2.3 Social Security and Financial Planning
   2.3.1 Understanding the concept
   2.3.2 Provider of social security in Malaysia
   2.3.3 Financial planning and managing social security needs.

3.0 THE FINANCIAL PLANNING PROCESS

3.1 Financial Planning Model
   3.1.1 Types of Financial Planning Model
   3.1.2 The 6 Steps in Financial Planning Process

3.2 System Approach in Financial Planning
   3.2.1 The Life Cycle of Financial Plan
   3.2.2 The Traditional Personal Financial Planning Life Cycle
3.3 Financial Status and Financial Goals
  3.3.1 Type of Financial Goals
  3.3.2 Plans To Achieve Financial Goals
  3.3.3 Financial Record Keeping
  3.3.4 Time Value of Money

3.4 Income Statement, Balance Sheet and Budgeting
  3.4.1 The Cash-Flow Statement
  3.4.2 The Balance Sheet
  3.4.3 Financial Ratio
  3.4.4 Budgeting

4.0 SEARCH FOR FINANCIAL INFORMATION AND THE EVALUATION OF CONVENTIONAL AND ONLINE SERVICES: THE CYBER USER

4.1 Conventional Financial Services
4.2 Islamic Financial Services
  4.2.1 Islamic schemes for deposits and consumer loans (1-22)
4.3 Searching for Financial Information from Various Sources Including Internet
  4.3.1 Internet banking
  4.3.2 Telephone banking: Interaction and SMS

5.0 COST AND BENEFITS TRANSACTION USING CREDIT

5.1 Cash vs. Credit
5.2 Advantages and Disadvantages of Consumer Credit
5.3 The Cost of Credit
  5.3.1 Finance Charge and Annual Percentage Rate (APR)
  5.3.2 Calculating The Cost of Credit
5.4 General Rules of Credit Capacity (Debt Limits)
  5.4.1 Debt Payments to Income Ratio
  5.4.2 Debt To Equity Ratio
5.5 Determining of Credit limit and credit comparisons
5.6 Credit Choices in Market
  5.6.1 Types of Consumer Credit
  5.6.2 Types of Consumer Loans

6.0 INVESTMENT CHOICES AND RISK MANAGEMENT

6.1 Investment principles and strategies
  6.1.1 Introduction
  6.1.2 Performing a Financial Checkup
  6.1.3 Factors Affecting the Choice of Investments
  6.1.4 Concept and advantage of portfolio investment
6.2 Risk management
  6.2.1 Risk and return
6.2.2 Types of risk
6.2.3 Portfolio Management Risk
6.3 Investment choices in the global market
6.3.1 Primary investment
6.3.2 Working Asset Allocation

7.0 FINANCIAL RULES AND REGULATIONS AND IT IMPACTS ON INDIVIDUAL AND ORGANIZATION

7.1 The financial rules and regulations
7.1.1 Companies Act 1965
7.1.2 BAFIA Act 1989
7.1.3 Islamic Banking Act 1983
7.1.4 Insurance Act 1996
7.1.5 Takaful Act 1984
7.1.6 SIA Act 1983 and SC Act 1993
7.1.7 Unit Trust Scheme: Section 2, SC Act 1993
7.1.8 Bursa Malaysia
7.1.9 MESDAQ
7.1.10 KLOFE and Future Industry Act 1993
7.1.9 FPAM

7.2 International Rules and Regulations
7.2.1 We must follow the domestic rules and regulations while dealing with the securities: case studies USA.

7.3 Issues and Problems in Financial Regulations:
7.3.1 Advantages and disadvantages
7.3.2 Breaking the laws and its punishment
7.3.3 The creation of BAFIA after the collapse of banking system

8.0 DEVELOPMENT OF FINANCIAL SERVICES AND IMPACTS TOWARDS INDIVIDUAL AND ORGANIZATION

8.1 Introduction
8.1.1 Types of Financial Services
8.1.2 Financial Services and Economic Condition
8.2 Electronic Banking
8.2.1 History and Development
8.2.2 Types of Products and Services
8.3 Market and Effects to Financial Planning

9.0 ANALYSIS, APPROACHES AND STRATEGIES TO GLOBAL MARKETABILITY AND IT IMPACTS TO INDIVIDUAL FINANCIAL ATTITUDES.

9.1 Analysis on the strategies of the global market
9.2 Global market and its local cultures and values
9.3 The influences on local values and cultures from the global markets
10.0 ISSUES AND CHALLENGES OF FINANCIAL PLANNING IN GLOBAL MARKET CONTEXT ISU

10.1 Poverty and Consumption Gaps
10.2 Resources Availability and Needs Fulfillment
10.3 Cost of Living and Quality of Life
   10.3.1 Concept
   10.3.2 The Relationship between Cost of Living and Quality of Life with Financial Planning
APPENDIX 3
PRACTICAL ASSIGNMENTS

PRACTICE 1
FINANCIAL SOURCES, LIFE CYCLE AND THE VALUE OF MONEY

Objective
1. To understand the process of family life cycle
2. To identify the relation between life cycle with financial resources
3. To determine the changes of value of money and its relation with the cost of living

Activity
1. To identify life cycle of each family with making one table involving all in the family. For the first column, put level of age. Then, write activities following the level of age. All activities must put in the table. You also must predict activity that will carry by each of family.

<table>
<thead>
<tr>
<th>Age</th>
<th>Farid</th>
<th>Fazilah</th>
<th>Farithah</th>
<th>Fatimah</th>
<th>Fadhill</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-6 years</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7-17 years</td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>18-24 years</td>
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<tr>
<td>25-45 years</td>
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<tr>
<td>46-55 years</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>56 years</td>
<td></td>
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</tr>
</tbody>
</table>

2. Describes the effect of raising in goods price towards value of money and cost of living? Get suitable example from this case.

3. How the changes of value of money in each year related with the changes of consumer price index for the country below?

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>CPI</td>
<td>100.0</td>
<td>110.9</td>
<td>115.5</td>
<td>125.8</td>
<td>131.3</td>
<td>135.2</td>
</tr>
</tbody>
</table>

Task
1. Table of member of family’s life cycle
2. The effect of raising in goods price
3. Determination of value of money

Report Format
1. Report must be in 5 pages
2. Double spacing and 12 sizes and Century Gothic or Arial font
Family case in year 2000:

Farid and Fazilah has been married since 1983 at the age of 25, a year and working at the early working. Farid use a motorcycle to his office which near his house whereas Fazilah go by bus which her office is about 10 km from her house. They have three children, Fatihah, Fatihah and Fadhil. The first child was born in 1984, the second in 1986 and the younger in 1988. They bought a car when they got the second daughter, which Fazilah use it to work. They send their children to the nearby nursery. After six years, Farid that working in the bank has been promoted and the pay was RM3,200 per month. The bonus that he gets at the end of the year is 2 month pay and also get holiday package around RM800 per year. Farid has to pay back his MARA loan, is RM 250 for 5 years and 4 months which he got the loan for RM 4,000 per year in 4 years, whereas Fazilah not need to pay back her Ministry of Education loan but she has to work in the government for 7 years.

Fazilah still in the same school and they bought a semi-detached house in the same place where they stayed before 1985. Although they have their own house, they decide to buy a land and build a bungalow. They can rent the old house and expect can get around RM1,000. Fazilah’s pay at the time is RM2,600 and she hope that get more pay if they continue studying to the higher level. She decide to do master next year and working in the universities so that the income will be more than RM3,000 per month. The first daughter, Fatihah now studying in boarding school and the ambition is to be an accountant. Whereelse, Fatimah wants to be a teacher. Fadhil since childhood interest in doing the technical work such as repairing the electrical thing so he hope to continue studying in electrical engineering.

Their parents hope that everyone of them can further their study in local universities and try to save money for their fees. In trying to save enough money for their children, Farid take serious about the changes in cost of living. Farid feel that a big changes has done because at that time a pair of school shoes is only RM10/- but now its RM25/-, so he expect that their children need them had took life insurance. After 5 years working and they have to pay RM260 per month within 20 years. The matured duration is in 2007. The insurance value at the matured duration is RM 2,000. Medical treatment for the family will support from Farid’s employee.
Objective

1. To separate the goals following the categories
2. To analyze whether family's goals can be achieved and how to achieve the goals
3. To identify whether the goals can be an asset and become a financial resources or not

Activity

1. Write the goals of all members in family
2. Compile the goals following the importance
3. To predict the cost or total that necessary need, monthly saving and frequent of purchasing or usage of money
4. To classified the goals following the short terms category to long terms, continuously frequency to once in life, purchasing of goods that can use or long lasting and the needs can be counted or not. All particulars must put in the table.
5. Make a table of financial goals achievement. For example:

<table>
<thead>
<tr>
<th>Goals</th>
<th>2000</th>
<th>2001</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Housing</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Emergency</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vehicles</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

6. State the increasing of financial goals that need you add or deliberate you add to complete the financial goals for the whole family
7. On retirement
   i. Describe from property side that belongs to this family
   ii. How about the financial resources of this family

Report Format

1. Table of financial goals following categories
2. Table of financial goals achievement
3. Property and financial resources on retirement

Family case in year 2000:

Farid and Fazilah has been married since 1983 at the age of 25, a year and working at the early working. Farid use a motorcycle to his office which near his...
house whereas Fazilah go by bus which her office is about 10 km from her house. They have three children, Fathiah, Farithah and Fadhil. The first child was born in 1984, the second in 1986 and the younger in 1988. They bought a car when they got the second daughter, which Fazilah use it to work. They send their children to the nearby nursery. After six years, Farid that working in the bank has been promoted and the pay was RM3,200 per month. The bonus that he gets at the end of the year is 2 month pay and also get holiday package around RM800 per year. Farid has to pay back his MARA loan, is RM 250 for 5 years and 4 months which he got the loan for RM 4,000 per year in 4 years, whereas Fazilah not need to pay back her Ministry of Education loan but she has to work in the government for 7 years.

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Their parents hope that everyone of them can further their study in local universities and try to save money for their fees, in trying to save enough money for their children, Farid take serious about the changes in cost of living. Farid feel that it's big changes has occur because at that time a pair of school shoes is only RM 1.00/- but now its RM 25.00/-, so he expect that their children need them had take life insurance. After 5 years working and they have to pay RM260 per month within 20 years. The matured duration is in 2007. The insurance value at the matured education is RM 72,000. Medical treatment for the family will support from Farid's employee.
PRACTICE 3
FINANCIAL INSTITUTION SERVICES

Objectives:

1. To understand or recognize financial bodies in Malaysia that give service to individual in household.
2. To recognize services that give by financial bodies to individual in household.

Task:

1. Find information about services that give by financial body from brochures or magazines by bank or financial company.
2. Made report about services that give by financial body using format below.

Report Format:

1. Financial body background
   a) History
   b) Objective, vision and mission
   c) Duration of operation
   d) Branches
   e) Ownership

2. Types of services
   a) Types of account
   b) House loan
   c) Vehicle loan
   d) Education loan
   e) Personal loan
   f) Personal shares
   g) Insurance

   Each of services that provided should be given with related terms.

3. Attach with brochures and magazines.
2. How much the interest you should pay if you take loan RM670.00 for 8 months with 12% interest.

3. What is the future value for RM800 with 8% interest after 6 years?

4. How much the saving if you save RM200 in a bank with 6% interest within 8 years and compounded twist a year.

5. How much the future value for the yearly saving of RM230 with get 6% interest within 15 years.

6. How much the present value Ali's retirement account if he has deposited RM375 a year for 25 years with profit 12% a year.

7. How much the present value of RM2,200 with profited 15% for 8 years.

3. To accumulate RM6000 for children education within 10 years, how much you have the parent should save in the saving account if the account can give the profit 12% with it compounded fourth time a year.

7. What is the present value for the RM200 with is windrower at the end of the year for 14 years from the account with receive 11% profit?

0. How much you should deposited today in order to get RM650 at the end of each year for 20 years from the account with profited 11%.
PRACTICE 4
SAVING AND INVESTMENT

Objective:

1. Make calculation the value of saving in the future.
2. To determine present value for getting the future value.
3. To identify the time effect and profit rate to the amount that we want in the future.

Activity 1:

1. Students have to analyze a family case and answer the question.

Case:

At the moment Mogana family has RM 5000 in bank saving account. The primary financial goals are to further study for 2 years in master with cost RM 10,000 in the next 5 years, to change a new car with cost RM 20,000 in the next 6 years, to save house deposit valued RM 12,000 in 10 years.

Besides the above budget, Mogana start saving RM 200 every month in the account. The saving accounts give 8% interest compounded annually. Only 60% from this saving is allocated for those financial planning and the balance will be provided for emergency plan.

a) In your opinion why Mogana’s family make investment in that saving account compare to other means.

b) Explain with calculation whether Mogana’s family has made the wise investment to achieve those financial plans. If not, what your suggestion to Mogana family?

c) What are the factors should be consider ensuring the value of the saving in the future can achieve the wanted value.

Activity 2:

Solve the problems below by using the calculation formula with you have learned. You can use the lecture note and revision book to solve the problems.

1. How much interest you will receive if you are deposited RM300.00 with 6% interest for 27 months.
GROUP ASSIGNMENT

1. Students will be given the list of topics for group assignment during the first
   session of the semester.

2. Each group must not exceed more than 5 persons.

3. Each group must choose only one topic and the assignment should be in
   academic style of writing.

4. The length of the assignment must not exceed 15 pages excluding front
   page, references and appendix.

5. The instructor has the liberty to decide the title of the assignment accordingly.

6. Generally, the title of the assignment will be based on the issue related to the
   financial planning in the global markets.

ATTENTION

The students need to attend the special arranged classes for practical session at
the Faculty of Human Ecology 2 (two) times during the semester. The first (1) and
second (2) practice session will be conducted after first session of mass lectures
commenced at the faculty. The third (3) and fourth (4) practice session will be
conducted after the second mass lectures. For students from Sabah and Sarawak,
they need to prepare four (4) short assignment based on the practice notes given
to them and 1 group assignment and post it to the faculty administration office.

For group assignment, the students have to choose one topic from the list given at
the beginning of the first mass lectures. The length of of practice report is not more
than 3 pages and the group assignment not more than 15 pages. The report and
assignment should follow these requirements:

1. Line spacing : 1.5 spacing
2. Paper size : A4
3. The official font : Century Gothic (size 12)
UNIT 1

INTRODUCTION TO FINANCIAL PLANNING
AND GLOBAL MARKET

Unit objectives: At the end of this lesson, students will be able to:
1. Understand the roles of money in daily life
2. Knowing the importance of financial planning
3. Understand the Challenges in Global Market

Content:
Topic 1: Roles of Money in Daily Life
Topic 2: Importance of Financial Planning
Topic 3: Challenges in Global Market
CHAPTER 1 - INTRODUCTION TO FINANCIAL PLANNING AND GLOBAL MARKETS

TOPIC 1
THE ROLES OF MONEY IN DAILY LIFE

1.1 THE MEANING OF MONEY
Money defined as anything that is generally accepted in payment for goods and services and the repayment of debt. Money is one of the types of assets in which wealth can be held. Historically many things have served as money, however the ones that have stood the test of time are gold and silver. Now we use pieces of paper and token coins and are rapidly moving in the direction of electronic money that consists of sums of money in a computer account. Historic necessary conditions for something to function as money:

- Must be readily acceptable by the majority of traders
- Must be standardized so that all units have easily ascertainable value.
- Must be easily divisible to make change
- Must be easily transportable (have high value to weight ratio)
- Must be durable and not deteriorate or spoil

1.2 THE TYPE OF MONEY
- Commodity money – money that has its value on its own or in other words it has intrinsic value. Example of the commodity money are gold, silver, barley, wheat, salt and dates. During the world war, the prisoners of war used cigarettes as money.
- Private bank notes – notes that bank issued with promise to redeem for gold. This is widely used in 1800 in US. The major problem with private bank notes was bank insolvency due to issuance of notes more than the gold reserve.
- Gold standard – this gold standard is actually government issues paper currency backed by gold. Each note could be redeemed for a specified quantity of gold and the system is more likely work as the commodity money except that it reduces the cost of carrying physical gold.
- Fiat money – this type of money is actually a piece of worthless paper but accepted for exchange of goods. This system depends heavily on the trust of the people to believe that is has value and being accepted by others. We have been using the fiat money since the abandonment of the Bretton Wood System and currently not a single commodity such as gold backing up the fiat money.
1.3 THE HISTORY OF MONEY

- **In the Beginning: Barter**
  Barter is the exchange of resources or services for mutual advantage, and may date back to the beginning of humankind. Some would even argue that it’s not purely a human activity; plants and animals have been bartering - in symbiotic relationships - for millions of years. In any case, barter among humans certainly pre-dates the use of money. Today individuals, organizations, and governments still use, and often prefer, barter as a form of exchange of goods and services.

- **9,000 - 6,000 BC: Cattle**
  Cattle, which include anything from cows, to sheep, to camels, are the first and oldest form of money. With the advent of agriculture came the use of grain and other vegetable or plant products as a standard form of barter in many cultures.

- **1,200 BC: Cowrie Shells**
  The first use of cowries, the shell of a mollusc that was widely available in the shallow waters of the Pacific and Indian Oceans, was in China. Historically, many societies have used cowries as money, and even as recently as the middle of this century, cowries have been used in some parts of Africa. The cowrie is the most widely and longest used currency in history.

- **1,000 BC: First Metal Money and Coins**
  Bronze and Copper cowrie imitations were manufactured by China at the end of the Stone Age and could be considered some of the earliest forms of metal coins. Metal tool money, such as knife and spade monies, was also first used in China. These early metal monies developed into primitive versions of round coins. Chinese coins were made out of base metals, often containing holes so they could be put together like a chain.

- **500 BC: Modern Coinage**
  Outside of China, the first coins developed out of lumps of silver. They soon took the familiar round form of today, and were stamped with various gods and emperors to mark their authenticity. These early coins first appeared in Lydia, which is part of present-day Turkey, but the techniques were quickly copied and further refined by the Greek, Persian, Macedonian, and later the Roman empires. Unlike Chinese coins which depended on base metals, these new coins were made from precious metals such as silver, bronze, and gold, which had more inherent value.

- **118 BC: Leather Money**
  Leather money was used in China in the form of one-foot-square pieces of white deerskin with colorful borders. This could be considered the first documented type of banknote.
800 - 900 AD: The Nose
The phrase "To pay through the nose" comes from Danes in Ireland, who slit the noses of those who were remiss in paying the Danish poll tax.

806 AD: Paper Currency
The first paper banknotes appeared in China. In all, China experienced over 500 years of early paper money, spanning from the ninth through the fourteenth century. Over this period, paper notes grew in production to the point that their value rapidly depreciated and inflation soared. Then beginning in 1455, the use of paper money in China disappeared for several hundred years. This was still many years before paper currency would reappear in Europe, and three centuries before it was considered common.

1500s: Polliwag
"Polliwag" comes from Chinook Indian custom that existed in many North American Indian cultures. It is a ceremony where not only were gifts exchanged, but dances, feasts, and other public rituals were performed. In some instances polliwag was a form of initiation into secret tribal societies. Because the exchange of gifts was so important in establishing a leader's social rank, polliwag often spiraled out of control as the gifts became progressively more lavish and tribes put on larger and grander feasts and celebrations in an attempt to outdo each other.

1535: Wampum
The earliest known use of wampum, which are strings of beads made from clam shells, was by North American Indians in 1535. Most likely, this monetary medium existed well before this date. The Indian word "wampum" means white, which was the color of the beads.

1816: The Gold Standard
Gold was officially made the standard of value in England in 1816. At this time, guidelines were made to allow for a non-inflationary production of standard banknotes which represented a certain amount of gold. Banknotes had been used in England and Europe for several hundred years before this time, but their worth had never been tied directly to gold. In the United States, the Gold Standard Act was officially enacted in 1900, which helped lead to the establishment of a central bank.

1930: End of the Gold Standard
The massive Depression of the 1930's, felt worldwide, marked the beginning of the end of the gold standard. In the United States, the gold standard was revised and the price of gold was devalued. This was the first step in ending the relationship altogether. The British and international gold standards soon ended as well, and the complexities of international monetary regulation began.
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- **The Present:**
  Today, currency continues to change and develop, as evidenced by the new $100 US Ben Franklin bill.

- **The Future: Electronic Money**
  Digital cash in the form of bits and bytes will most likely become an important new currency of the future.

### 1.4 MALAYSIAN CURRENCY

On June 12, 1967 the Malaysian dollar replaced the Malaya and British Borneo dollar at par. The Malaysian dollar was issued by the new central bank, Bank Negara Malaysia. Until 1973, the Malaysian dollar was exchangeable at par with the Singapore dollar and Brunei dollar. The Monetary Authority of Singapore and the Brunei Currency and Monetary Board still maintain the exchangeability of their two currencies.

The Malay names ringgit and sen were officially adopted as the sole official names in August 1975. Previously they had been known officially as dollars and cents in English and ringgit and sen in Malay, and in some parts of the country this usage continues. For example, in Penang one ringgit is “one dollar” in English; in North Malaya, denominations of ten sen are called kupang, in Malay, e.g. 50 sen is 5 kupang. The use of the dollar sign “$” (or “M$”) was not replaced by “RM” (Ringgit Malaysia) until the 1990s, though internationally “MYR” (MY being the country code for Malaysia) is more widely used.

**Bank Negara Malaysia Coins**

Currently [as on year 2006], Malaysia coins are minted in 5 denominations:

- 1 sen [RM 0.01]
- 5 sen [RM 0.05]
- 10 sen [RM 0.10]
- 20 sen [RM 0.20]
- 50 sen [RM 0.50]

On December 7, 2005, the RM1 coin was demonetised and withdrawn from circulation. This was partly due to problems with standardization [two different versions of the coin were minted] and forgery. Three denominations of gold bullion coins, the “Kijang Emas” [The kijang [a species of deer] is the official logo of Bank Negara Malaysia] are also issued, at the face value of RM 50, RM 100 and RM 200. It was launched on July 17, 2001 by Bank Negara Malaysia and minted by Royal Mint of Malaysia Sdn Bhd. The purchase and reselling price of Kijang Emas is determined by the prevailing international gold market price.
Bank Negara Malaysia Banknotes

Bank Negara Malaysia first issued Malaysian dollar banknotes in June 1967 in $1, $5, $10, $50 and $100 denominations. The $1000 denomination was first issued in 1968. Malaysian banknotes have always carried the image of the first Yang di-Pertuan Agong of Malaya. The second series was issued with Malaysian traditional ornamental designs in 1982-1984, in $1, $5, $10, $20, $50, $100, $500, and $1000 denominations. The $20 was generally relatively uncommon. The second series notes are still occasionally encountered.

In 1993, $1 notes were discontinued and replaced by the $1 coin. The current and third series was issued with designs in the spirit of Wawasan 2020 in 1996-1999 in denominations of RM2, RM5, RM10, RM50 and RM100. The larger denomination RM50 and RM100 notes had an additional hologram strip to deter counterfeitters. To commemorate the 1998 Commonwealth Games in Kuala Lumpur, a commemorative RM50 polymer banknote was issued, marking Malaysia's first usage of polymer banknotes. This note is hardly ever seen in normal usage, its use being a collector's commemorative.

In 1999 the RM500 and RM1000 notes were discontinued and ceased to be legal tender. This was due because of the Asian monetary crisis of 1997 when huge amounts of ringgit were taken out of the country to be traded in these notes. In effect the notes were withdrawn out of circulation and the amount of ringgit taken out of the country in banknotes was limited to RM1000. In 2000 the RM1 note was reintroduced, replacing the RM2 note which remains legal tender.

In 2004, Bank Negara issued a new RM10 note with additional security features including the holographic strip previously only seen on the RM50 and RM100 notes. A new RM50 polymer banknote with a distinctive transparent window was also issued. Both new banknotes are almost identical to their original third series designs. According to Bank Negara, all paper notes will eventually be phased out and replaced by polymer notes.

Malaysian banknotes have long followed a colour code originating from colonial times. In the lower denominations this pattern is followed by Singapore and Brunei, and when Bank Negara first introduced the RM2 note it copied the lilac of the Singapore $2 note.

- RM1 - blue / RM2 - lilac / RM5 - green / RM10 - red
- RM20 - brown/white / RM50 - blue/grey / RM100 - violet
- RM500 - orange / RM1000 - blue/green
1.5 FUNCTIONS OF MONEY

- **Medium Of Exchange**
  Replaces barter where goods or services are traded directly for other goods or services. Money eliminates the need for a double coincidence of wants: A coat maker that wants to trade for a pair of shoes must find a shoe maker that wants to trade for a coat. Money greatly improves the efficiency of transactions by reducing transactions (search) costs. Instead of needing to find a shoemaker that wants a coat (high search costs), the coat maker only needs to find anyone who wants the coat and is able to pay for it with money. The coat maker then only needs to find any shoemaker that is willing to accept money in payment.

- **Unit of Account**
  Money is a means of measuring and recording value. For example: Meat is measured in ringgit, distance is measured in kilometers and value is measured in units of money. In barter, the value or price of every good and service must be measured in terms of the value of every other good and service.

- **A Store of Value**
  Since money, as a medium of exchange, represents purchasing power, it can be stored and used in the future. (This is why it can't rot). Money is a store of value but it is not usually a good store of value during inflation money loses value and money in a cigar box or in a current account does not earn interest. Money is a highly liquid asset and form of wealth.

1.6 THE PSYCHOLOGY OF MONEY

Money is probably the single most important non-human resource in this world today simply because sufficient amount of money empower its possessors with 'choice'. Money enables people to choose their preferred lifestyles in most
societies. Money brings security to people by fulfilling their basic subsistence needs to survive. Except for terminal illness, physical disabilities and issues of an emotional or spiritual nature, in particular, money is the elusive key to fulfilling one's ambitions, dreams and aspirations. If one were to exclude emotional and spiritual fulfillment, much of human problems stem from material deprivation which impacts people's emotional states.

Do not underestimate the power of money in achieving human fulfillment. If one excludes emotional and spiritual fulfillment which are subjective and differ from one individual to another, money is a powerful tool to achieve happiness. In areas of life within human control, money can: buy all kinds of health-enhancing and beauty-enhancing products; buy the rarest and most expensive food; buy one's dream house; buy one's dream car, plane, ship and other gadgets; buy the woman one fantasizes; buy fame and power; buy the resources and create the background to give one's children a headstart in life etc. If one still cannot feel happy after attaining all of the above, when one refers to rich people who are still unhappy, the latter only have themselves to blame for not knowing how to use their wealth astutely to achieve happiness.

- Money brings freedom
- Money brings security
- Money is what matters
- Money is power
- Money makes you successful
- Money gives you option
- Money brings happiness
- Money is your possession
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TOPIC 2
THE IMPORTANCE OF FINANCIAL PLANNING

2.1 THE DEVELOPMENT OF FINANCIAL PLANNING

Financial planning as an encompassing, centralized program is still a relatively new concept. Most individuals have engaged in some form of financial planning. They may have a budget, setting aside an amount from each pay to save for a short-term expenditure such as a trip or deposit on a longer term ‘asset’ such as a car or a home. They may have purchased home and contents insurance, taken a life insurance policy or made a will. All of these form part of a financial plan, but most people lack the skills, knowledge or interest to put all of their financial actions into a formal plan. Until fairly recently, there was little need to do so.

In the past, savings were deposited with a bank or building society. Investments were made in government bonds and property. A small number of people invested in the share market. Aside from war and depressions, there was an overall stability. Interest rates were steady. Families could borrow to build a home and the interest rates would hardly move over the life of the mortgage. Significant social and economic changes began in the late 1960s. These changes removed the expectation of stability and changed the financial planning environment for all. The uncertainty and rapid pace of change gave rise to the need for a financial planning industry. The major forces that gave rise to the growth of the industry were:

- Inflation
- The growth of credit
- Government need for increased revenue (higher taxes)
- Regulation and deregulation
- Demographic shifts
- Privatisation of government-owned businesses (e.g. Telekom, TNB)

2.2 DEVELOPMENT OF FINANCIAL PLANNING IN MALAYSIA AND WORLDWIDE OVERSEAS

The professional financial planning industry has operated overseas since the 1980s. A major step in advancing international recognition of the CFP certification process was taken when the International CFP Council was established in 1990.

The International CFP council is a forum for financial planning organization from around the world that seek to advance the proffesional of personal financial planning. The Council works to establish ethical, competency and practice
standards for financial planners, and increase public awareness of the benefits of financial planning. Each Council member has endorsed the Certified Financial Planner certification process as the means of testing for, and demonstrating, financial planner competency and ethical behavior. Members of the Council work to promote the CFP certification mark shown below as the globally recognized standard of the excellence for financial planners.

The Council’s 13 member organisations (from Australia, Canada, France, Germany, Japan, Korea, Malaysia, New Zealand, Singapore, South Africa, Switzerland, the U.K and the U.S) meet twice a year to share information, ideas and research in an effort to develop financial planning as an international profession.

2.3 USERS OF FINANCIAL PLANNING SERVICES

While some people do invest in the sharemarket, the take-up rate of both direct shares and unit trusts is nonetheless lower than in the United States, for example, where a significant number of people invest in mutual funds. However, this is changing.

The take-up of unit trusts and financial planning go hand in hand. The professional bodies of both fund managers and financial planners are seeking ways to attract more people to the investment markets through collective (or pooled) products. With the rapid increase in the number of people who will need financial planning and the initiatives of fund managers and the Financial Planning Association of Malaysia, plus the efforts of individual financial planners, there should be an increasing flow of funds to savings.

While EPF is seen as a savings mechanism, most people make only these personal contributions as their savings strategy. They then feel that they are saving for their retirement and do not see a need to save outside EPF. In fact, there are few simple savings product which provide a return significantly over the rate of inflation. When taxation is taken into consideration, they may actually offer a negative real rate of return.

While financial planning can be useful to most people throughout their lives, the main categories of current users are:

- professionals
- retirees
- retrenched workers
- executives
- small business owners.

Obviously, each of the different groups, has a different set of needs and characteristics. It is essential to understand the different needs and objectives of
the different groups and the particular client, before drawing on the range of
products to develop plans appropriate to an individual investor.

You may find that you want to specialize in one of these groups. You will have to
understand their needs and attitudes. If you have the appropriate skills,
experience, financial resources and commitment, the availability of affordable
technology means that regulatory and dealer limitations are the major
constraints on what you can do in a financial planning practice.

2.4 PROVIDERS OF FINANCIAL PLANNING SERVICES

In the past, people have naturally turned to their bank managers for financial
advice. With the best intent, bank managers were not, and are not, trained to
offer advice on a wide range of options. Accountants, where people had one,
also provided advice. People would also have approached professionals in their
work environment. They would also discuss ideas with family and friends. Recent
surveys show that while financial planners are beginning to be recognized as
sources of financial advice, many people still seek investment and financial
advice from other sources.

There are now many sources for financial advice, including planners. Most of the
larger financial institutions have a financial planning arm, whether they are
dealer groups, banks, life companies, building societies or credit unions. Solicitors,
accountants, life agents and life brokers may also provide some level of financial
planning advice.

As more people seek investment advice and the number of products available
has increased, the number of advisers offering financial planning also
increased. The independence of advisors is a major issue. With a large proportion
of authorized financial planners working in the big financial groups, there is both
regulatory and investor concern that recommendations are provided with
regard to the dealer’s product line, not the investor’s needs.

The manners in which financial planners have been paid (i.e. commissions from
the product providers) has lent itself to criticism that product recommendations
were based on the size of the commission, rather than suitability to the client.

As you would expect, the quality of advice varies considerably, as does the level
of client service, research and the range of products available. Good financial
planners know that ‘high return’ do not equal high levels of security; they know
that high returns are associated with higher risks. There are many organizations
that will provide some levels of financial planning, as shown in Figure 1.

- Life Insurance Companies
  Life companies are natural investment managers. They collect and invest
  premium dollars to meet claims and to make a profit. It is a very short step
to managing money as an investment manager. In the process known as
"bundling", many products offered by life offices have combined life insurance with an investment component, such as a whole-of-life insurance policy. The current trend is away from bundled products to separate investment and insurance products, such as superannuation funds, unit trusts, and annuities, as well as unit trusts.

A large number of the life companies have their own distribution channels—their agency sales networks. Many of the life companies have set up, bought or converted their agency networks into financial planning arms.

**Figure 1.1: Providers of Financial Planning**

- **Banks, Building Societies and Credit Unions**
  Bank managers have been traditional sources of financial advice. All of the retail banks have fund management and financial planning arms, offering their own line of products and sometimes other fund managers' product as well. They have a natural client base from walk-through bank trade and referrals from branch managers and loan officers. Most also have a life insurance license.

- **Stockbrokers**
  Stockbrokers were initially regarded by many people as catering for the wealthy and offering a limited range of services revolving around securities listed on the stock exchange. Many stockbrokers have now broadened their activities into financial planning, retirement planning, fund management, and financing and advising on unlisted securities. Stockbrokers are regulated under the Securities Industry Act 1983. Stockbrokers have the advantage of access to all financial markets, as well as unlisted products.
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- Corporate Trustee Companies
  As well as performing their duties as trustees, some corporate trustee companies are also active in the funds management area. They provide some level of advice on their private trustee clients.

- Independent Financial Planners
  While as a financial planner you are likely to work for a large dealer groups at some time in your career, many financial planners have also set up their own practice or work within a small dealer group. If you did this, you would be under the same professional and regulatory requirements as any other dealer. You may find that you enjoy providing a personal level of service to your clients and running your own business. Independent financial planners can obtain research and technical information from external sources and software from many different providers. They may also work in conjunction with other professionals, accountants, tax agents and solicitors to form a full service group.

- Fund or Asset Managers
  Initially, fund or asset managers developed and offered products which were sold through financial planners. As the banks and life companies stretched themselves to be asset managers, product providers and distribution networks, fund managers needed a way to promote their products. While many still market their products to the independent financial planners and to dealer groups, most have joined forces with the dealer groups to provide wholesale-priced asset management to dealer group master trusts. Some fund managers are investigating methods of selling directly to investors, such as through the Internet. Others have established or purchased their own financial planning arms.

- Accountant, Solicitors and Real Estate Agents
  These people already have specialist skills and clients who turn to them for a certain level of financial advice. Accountants especially have opportunities to provide a wide range of advice, as they are intimately involved with people’s finances. Many accountants now run a ‘mixed business’, working under a proper authority with a dealer group. While these categories of professionals are all able to provide some financial planning advice if it is ‘incidental’ to their normal activities, there is concern that some be providing a range of advice beyond their skills and training and well above their licensing.

2.5 FINANCIAL PLANNING AND ITS BENEFITS

Personal financial planning is the process of managing your money to achieve personal economic satisfaction. This planning process allows you to control your financial situation. Every person, family or household has a unique financial position and any financial activity therefore must also be carefully planned to meet specific needs and goals. A comprehensive financial plan can enhance
the quality of your life and increase your satisfaction by reducing uncertainty about your future needs and resources. The specific advantages of personal financial planning include:

- Increased effectiveness in obtaining, using and protecting your financial resources throughout your lifetime.

- Increased control of your financial affairs by avoiding excessive debt, bankruptcy and dependence on others for economic security.

- Improved personal relationships resulting from well-planned and effectively communicated financial decisions.

- A sense of freedom from financial worries

- Worries obtained by looking to the future, anticipating expenses and achieving your personal economic goals

We all make hundreds of decisions each day. Most of these decisions are quite simple and have a few consequences. Some are complex and have long-term effects on your personal and financial situations.

**Figure 1.2: Overview of Effective Personal Financial Planning**
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TOPIC 3
CHALLENGES IN GLOBAL MARKET

As you build your financial plan, you'll need to consider many factors that influence spending and saving behavior. Some are unique to you, such as where you are in your life cycle, family makeup, values and attitudes. Others such as inflation and interest rates, affect everyone to some extent. Both types of factors can be expected to change over time, so plan will need to continually adapt to new circumstances.

3.1 CHANGING NEEDS OVER THE LIFE CYCLE

In general, your income level through your early 20s will be lower than it will be later and your wealth may even be negative - that is, you may have more debts than assets at this point in your life. That's because you're currently making investments in education that have not yet paid off.

Marriage, career development, the purchase of a home and investments in your children's education will likely occur from your late 20s through your 40s. During this time, your household will focus on setting goals, establishing savings and protecting the family from unexpected negative events, such as premature death or job loss due to illness or disability. This is also the beginning of the wealth accumulation phase, which continues through your 50s to early 60s. As retirement approaches, most people in their 50s and 60s closer attention to meeting retirement income and health needs and preserving wealth for their heirs. During retirement period, on average beginning at age 65, you will decumulate or spend, your accumulation wealth.

3.2 VALUES AND ATTITUDES

People have different money styles - different values and attitudes regarding money and its use. Your money style generally is the result of both learned behaviors and inherent tendencies. Individuals who are impulsive by nature often have difficulty controlling their spending, just as those with a tendency to orderliness are more likely to have finances in order as well. Thus both "nature and nurture" help to form your values and attitudes toward money. Values are fundamental beliefs about what is important in life. What do you think is most important: family, friends, education, religious faith, financial success, fame, health, self sufficiency? The weight you place on each will influence the goals that you set and the strategies that you develop to achieve your goals. Attitudes are opinions and psychological differences between people that affect their decisions.
3.3 LIFE SITUATION

Family makeup and demographic characteristics such as age, marital status, income and wealth significantly affect financial planning. Households with children for example tend to have higher expenses and therefore less ability to save during their child-rearing years. Double-income couples, particularly those with no children, tend to be better off financially than singles. Those without children are also to focus on career goals and therefore can more quickly move up the employment ladder. Demographic factors such as gender, age, income and education have often been linked to risk attitudes.

3.4 GENERAL ECONOMIC CONDITIONS

A fundamental truth about the economy is that it is very unpredictable. Even the experts cannot say with certainty what the future may hold. Some factors in the economy have a known influence on personal finances and it’s important for you to recognize these factors and incorporate them in your financial planning decisions. Some factors that are highly likely to affect your future are inflation, interest rates, employment conditions, political unrest and global issues.

- **Inflation**
  Generally inflation refers to an increase in prices. As prices of goods and services go up, the spending power if your money goes down – a ringgit will not purchase as much as it previously did. Inflation affects nearly every aspect of your finances. Your grocery bills are probably higher this year than they were last year. Your monthly rent will probably go up next year, too. As prices of goods get higher over time, you can only maintain your standard of living if your income after taxes also rises by the same amount. To your standard of living to improve, your income must rise at a rate faster than the inflation rate. Inflation affects your investments as well. If the costs of goods rise at a rate of 4 percent, but your savings account is only paying you 3 percent, then you are actually losing spending power. Inflation is measured by the change in the consumer price index (CPI) – a measure of the price of a representative basket of household goods and services in the Malaysian market.

- **Interest Rates**
  An interest rate is a cost of money. Interest is usually expressed as a percentage of the amount lent or borrowed. When you borrow money, the interest rate is a cost to you. When you invest money, it is a measure of your earnings or return on that investment. Interest rates can also be thought of as a cost of consumption. How much additional money will you need to get in the future to be willing to not spend a certain amount today on consumption. Like the prices of goods and services, interest rates are driven by supply and demand. When there is a lot of demand for borrowing, but not a lot of money available to borrow, interest rates go up. In recessions, when businesses do not need or want to invest in growth, the demand for borrowing is lower and rates may go down.
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- **The Economic Cycle and Employment Conditions**
  
  Your personal finances will also be affected by cyclical business and employment conditions. Historically, the Malaysian economy has experienced a pattern of ups and downs, commonly referred to as the economic cycle, or business cycle. A low point in the cycle is called a recession (or in the extreme, a depression) and is characterized by reduced business investment and high unemployment rates. Economic expansion periods are characterized by increased business investment and employment opportunities. In times of growth and low unemployment, salaries tend to rise more quickly and there are better opportunities for advancement.

- **Political Unrest and Global Issues**
  
  It should be obvious that political and global factors can affect personal finances. For some time following September 11, 2001, the looming threat of terrorism had a negative impact on global economy. The stock market, which had already seen substantial declines from its high of the previous year, continued to plummet, losing more than 20 percent of its value from September 2001 to September 2002; unemployment increased rapidly and governmental spending increased.

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ACTIVITIES
1. What are the roles of money in our daily lives?
2. From your perspective, what is money?
3. Explain the major forces that gave rise to the growth of the financial planning industry in Malaysia?
4. Name three benefits that you're likely to gain by having a better understanding of financial planning?
5. Give an example what are the consumer’s challenges in global market?
UNIT 2

FINANCIAL PLANNING AND SOCIAL SECURITY:
ISSUES AND RELATIONS

Unit objectives: At the end of this lesson, students will be able to:

1. Understand the current consumption and future consumption.
2. Define retirement planning, issues and challenges.
3. Explain the social security and the importance of financial planning in preparing social security needs during retirement years.

Content:

Topic 1: The Current Consumption and Future Consumption
Topic 2: Retirement Planning
Topic 3: Social Security and Financial Planning
TOPIC 1
THE CURRENT CONSUMPTION AND FUTURE CONSUMPTION

1.1 INTRODUCTION

People need money as an exchange for products and services. The decision on determining for the current consumption and future consumption is based on the value of money. Money can be thought of as having different values at different points of time. In other words, an amount of money received today is worth more than the same amount if it were received some year from now. One of the primary reasons that a Ringgit today is worth more than a Ringgit to be received in the future is that the current Ringgit can be invested to earn a rate of return.

The unit of Ringgit will be value more in the future. The rational human being will choose to receive the amount of money immediately, as the value is more than received it later. Economists have advanced the following rationale:

- Personal consumption preference
  It is generally assumed that most people would prefer to consume things now rather than later. If that was not the case, why would anyone bother to consume anything? If people would prefer to consume things now, rather than later, should they be rewarded by a greater sum in the future because they have deferred the gratification from their resources at the current time?

- Inflation
  Inflation may be defined as a fall in the purchasing power of money, reflected in a persistent increase in the general level of prices as measured by the consumer price index (CPI).

  If people can buy less in the future with the unit of money that they can buy now with the same unit of money, then the money’s role as a stable store of purchasing power can be doubted. Thus, if inflation persists, more money will be needed at each future point of time to purchase the same goods and services. This leads to a given quantity of money having different values at different points of time.

- Risk
  It is assumed that if money may be used at the current time, the holder is certain of its existence and utility. However, receipt of money is postponed to a
subsequent date, because of it has been entrusted to someone else, it may not be received or it may not have the same utility when received.

The economic environment offers different investments that may be made, each offering different degrees risk. If people are less certain of the units of money they may receive in the future than they are of the units of money they hold today, they has to be sufficient inducement for them to part with the money they hold. The inducement, often termed as risk premium, has to be greater the greater the uncertainty surrounding a financial transaction. The further we look into the future the greater the doubt surrounding our views about it; thus leading to greater risk premiums and as consequences different values for money.

1.2 CURRENT VS. FUTURE CONSUMPTION

The choices of consumption over time between current (consuming) and future (saving) are known as intertemporal choices. Usually, the consumer is willing to substitute some amount of consumption today for consumption tomorrow, and how much he is willing to substitute depends on the particular pattern of consumption that he has.

Given a consumer's budget constraint and his preferences for consumption, the consumer would react to a change in the interest rate. Thus if a person is a lender and the interest rate increases, he will remain a lender. If a person is a borrower and the interest rate decreases, he will remain a borrower. On the other hand, if a person is a lender and the interest rate decreases, he may well decide to switch to being a borrower; similarly, an increase in interest rate may induce a borrower to become a lender.

The concept of present value determines the patterns of current and future consumption of consumer. The concept of present value gives us another way express the budget for a two-period consumption problem: a consumption plan is affordable if the present value of consumption equals the present value of income.

The consumer has to decide whether to consume today or save for tomorrow consumption. His decision is influenced by the aspect of inflation, interest rate and personal preferences.

1.3 ADVANTAGES AND DISADVANTAGES

The influences of inflation and interest rate on investment will determine the advantages and disadvantages of consumption. The current price of goods will not be the same as compared to the future price. With the same unit of RM, the inflation will increase the amount of money you have to pay for the goods. The real rate of interest measures the extra consumption that you can get in the
future by giving up some consumption today. The current and future consumption influences planning for retirement and social security benefits, you need to consider the important of putting certain amount for money today for saving than spending it all.
CHAPTER 2 – FINANCIAL PLANNING AND SOCIAL SECURITY: ISSUES AND RELATIONS

TOPIC 2
RETIREMENT PLANNING

2.1 INTRODUCTION

Every person is expected to retire from work someday and there will be those who continue to work even after retire due to certain reason. The retired people can no longer utilize their ability to generate an income for basic sustenance of oneself. The only way they can live is to draw on past savings, earning from asset, assistance from relatives or children's income or on to rely on social welfare.

According to Mun, F.W and Kee, K.S (2001), people usually make three common mistakes in planning for retirement such as putting off planning until it is too late, saving too little during the working years and investing too conservatively or too aggressively. And this people who retire today, can expect to live for another 15 to 20 years or more depend on their way of life. With increased awareness of health concept, improvement to health care system and practicing the healthy life style, people generally living longer than those of the past generations. The life expectancy of a Malaysian male is about 70 while women are estimated to live slightly longer. With increased longevity arises the problem of retirement income.

The ground rules for retirement planning are changing rapidly. There are several important issues to be addressed before developing your retirement planning programs.

- The expected expenses
- How long your money can support your retirement expenses
- Do you have any social security program to support and pay for your basic living expenses
- The expected investment rate to keep pace with inflation
- Health and medical insurance to cover medical expenses
- The time to retirement
- The amount of saving available.

It is vital to engage in basic retirement planning activities throughout your working years and to update retirement plans periodically. It is never too late to begin with and tries to avoid many unnecessary difficulties by starting retirement early. In addition, saving now for future requires tackling the trade-offs between spending and saving or differentiating the important of current consumption and future consumption.
2.2 TYPE OF RETIREMENT

Retirement does happen when you need to leave the working environment due to several occasions. There are four types of retirement; firstly, you are forced to retire because of the unexpected event such as death or accident. The force to retire is the most unwanted events when you may leave behind you unsettled businesses dealing with money and the future of your loved one.

Secondly, you are forced to retire because of reaching your retirement ages 55 and, most of these people facing mixed feelings of living in the world of freedom and thinking of financial burden awaiting them during retirement age. Thirdly, you retire because your source of incomes, i.e., your employer went bankrupt and you were asked you to retire or leave you with VSS programs. Finally, retirees early due the financial independence. During the stage, people income coming from the asset and their assets working for them.

2.3 THE TYPES OF RETIREMENT NEEDS

The preparation for retirement must be based upon the future need of individual physical and emotional needs. There are expected and unexpected events that may occur and affects the financial well-being of the retiree. Firstly, as an old man, you are expected to face gradually changes in the quality of health. You need to be financially stable to support the mounting medical fees. The money need to buy medicine, medical consultation and hospital bills.

Secondly, you need to finance your daily expenses. Since no more are expected income coming in to support your financial responsibilities, your largest sources of income may come from your asset. Thirdly, you need someone to assist you in keeping with your daily activities especially when you are no more able to do it yourself. The time will come where you need to purchase the services. With the increasing number of unmarried individual and married couple with no children, the era of professional assistance will create an industry.

2.4 THE BASIC OF RETIREMENT PLANNING

There are several basic steps for planning your retirement. The first step is to analyse your current assets and liabilities. Secondly, estimate your spending needs and adjust them for inflation. Thirdly, evaluate your planned retirement income and finally, increase your income by working part-time, if necessary.

- **Analyse current financial status**
  It is good to have plan for retirement as you need to expect what would be the future for you. The future financial health is a result of what you have planned today. By analyzing what you have and what you owed, you will be able to measure your true wealth. It also tells you what is your future financial situation will be, the financial behaviour, spending patterns and spending needs.
CHAPTER 2 – FINANCIAL PLANNING AND SOCIAL SECURITY: ISSUES AND RELATIONS

Estimate spending needs and adjust for inflation
The retirement income will be half of what you have getting today. The exact spending needs is come only after your retirement. However, it can be determine based on current consumption, inflation rate and discounted it after considering several spending needs that cease after you retire.

Evaluate planned retirement income

Evaluation for planned retirement income should consider the following factors:
1. the current assets and liabilities
2. the risk management practices
3. the investment portfolio
4. the economic condition

* Increase Income – cover the different

2.5 SOURCE OF INCOME

In essence, there are three broad sources of income for fulfilling the retirement need of an individual. In Malaysia, there is no social security system like those found in many developed countries. The lack of social security net thus leaves for the following approaches to fund for retirement: the government pension scheme, the EPF, private retirement schemes or through personal accumulations or combination of these.

2.6 METHODS OF ESTIMATING THE RETIREMENT INCOME NEEDS

There are two types of estimating your retirement income: the replacement method and the expense method.

- The replacement method
This method of retirement planning assumes that the standard of living enjoyed during the years just prior to retirement will be the determining factor for the standard of living during retirement. Essentially, this method assumes that changes in the cost of living will be reflected by changes in the individual’s income, and the post-retirement income needs can be estimated from the individual’s pre-retirement income. It is assumes that the retiree should maintain most of the current purchasing power. In general, a 70-90 per cent replacement ratio of the retiree final average salary is typically used for individual retirement planning purposes.

- The expense method
This method is to construct a budget for post-retirement living. This involves estimating costs that will be need to be met for housing, clothing, food and other necessities, medical expenses etc. However, it is easier to determine the amount needed if the retiree is closer to retirement age.
In the United States, the Social Security Act was passed as part of President Franklin Delano Roosevelt’s New Deal program. The act established two social insurance programs: a federal-state program of unemployment compensation and a federal program of old-age retirement insurance. It also provided for federal grants to assist the states with programs for the disabled, the aged, child welfare services, public health services, and vocational rehabilitation.

Definition of Social Security

A system of federally funded services and payments to help support the needy, the aged and neglected children, rehabilitation for the disabled and host of other social services. The system was established as part of the New Deal and is funded by payroll taxes paid by workers and employers.

It has two meanings; the noun meaning explains the social welfare program that was including old-age and survivors insurance and some unemployment insurance and old-age assistance. It gives two distinct meanings to American life. Specifically it refers to the old-age insurance system established by the Social Security Act 1935. It also describes a much broader goal such as protection for all citizens against a wide range of suffering, including poverty, homelessness, disability and ill health. The considerable difference between the two meanings says much about America’s approach to social aspiration. The broader meaning of Social Security in America also stems in part from the Social Security Act, which introduced other programs.

Two have become especially important. One is unemployment insurance, which financed by taxes on employer payrolls. The other is means-tested public assistance, originally to categories of needy people such as the blind, the handicapped, the elderly poor and dependent children in single-parent families.

However, the Social Security mainly refers to a field of social welfare concerned with social protection, esp. protection against socially recognized needs, including poverty, old-age, disability, unemployment, families with children and others.

In Malaysia, the concept of social security is not well known as Malaysian has their own type of social security program. Although the terms used to explain the retirement benefit is different form what has Malaysian government adopted for so many years, the spirit is the same as to deliver the security for facing retirement.

Social security is identified in the Universal declaration of Human Right (1948) which is everyone as a member of society, has the right to social security and is entitled to realization, through national effort and international co-operation and in accordance with the organization and the resources of each State, of the economic, social and cultural rights indispensable for his dignity and the free development of his personality.

The Social Security system works like this: when you work, you pay taxes into Social Security. The tax money is used to pay benefits to:

- People who already have retired;
People who are disabled;
- Survivors of workers who have died; and
- Dependents of beneficiaries.

The money you pay in taxes is not held in a personal account for you to use when you get benefits. Your taxes are being used right now to pay people who now are getting benefits. Any unused money goes to the Social Security trust funds, not a personal account with your name on it.

Social Security is more than retirement

Many people think of Social Security as just a retirement program. Although it is true that most of the people receiving Social Security receive retirement benefits, many others get Social Security because they are:

- Disabled; or
- A spouse or child of someone who gets Social Security; or
- A spouse or child of a worker who died; or
- A dependent parent of a worker who died.

Depending on your circumstances, you may be eligible for Social Security at any age. In fact, Social Security pays more benefits to children than any other government program. Today, more than 48 million people, about one out of every six Americans, collect some kind of Social Security benefit.

Social Security Taxes

The Social Security taxes you and other workers pay into the system are used to pay for Social Security benefits. You pay Social Security taxes on your earnings up to a certain amount. That amount increases each year to keep pace with wages. In 2006, that amount is $94,200.

Medicare Taxes

You pay Medicare taxes on all of your wages or net earnings from self-employment. These taxes are used for Medicare coverage.

<table>
<thead>
<tr>
<th>If you work for someone else</th>
<th>Social Security tax</th>
<th>Medicare tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>You pay</td>
<td>6.2%</td>
<td>1.45%</td>
</tr>
<tr>
<td>Your employer pays</td>
<td>6.2%</td>
<td>1.45%</td>
</tr>
<tr>
<td>If you are self-employed</td>
<td></td>
<td></td>
</tr>
<tr>
<td>You pay</td>
<td>12.4%</td>
<td>2.9%</td>
</tr>
</tbody>
</table>
Where your Social Security tax dollars go

When you work, 85 cents of every Social Security tax dollar you pay goes to a trust fund that pays monthly benefits to current retirees and their families and to surviving spouses and children of workers who have died. The other 15 cents goes to a trust fund that pays benefits to people with disabilities and their families. From these trust funds, Social Security also pays the costs of managing the Social Security programs. The Social Security Administration is one of the most efficient agencies in the federal government, and we are working to make it better every day. Of each Social Security tax dollar you pay, we spend less than one penny to manage the program. The entire amount of taxes you pay for Medicare goes to a trust fund that pays for some of the costs of hospital and related care of all Medicare beneficiaries. Medicare is managed by the Centers for Medicare & Medicaid Services, not Social Security.

Retirement benefits

Choosing when to retire is one of the most important decisions you will make in your lifetime. If you choose to retire when you reach full retirement age, you will receive your full retirement benefits. But if you retire before reaching full retirement age, you will receive reduced benefits for the rest of your life.

Full Retirement Age

If you were born before 1938, you were eligible for your full Social Security benefit on your 65th birthday. In 2003, the age at which full benefits are payable began to increase gradually. The following chart will guide you in determining your full retirement age:

<table>
<thead>
<tr>
<th>Year of birth</th>
<th>Full retirement age</th>
</tr>
</thead>
<tbody>
<tr>
<td>1937 or earlier</td>
<td>65</td>
</tr>
<tr>
<td>1938</td>
<td>65 and 2 months</td>
</tr>
<tr>
<td>1939</td>
<td>65 and 4 months</td>
</tr>
<tr>
<td>1940</td>
<td>65 and 6 months</td>
</tr>
<tr>
<td>1941</td>
<td>65 and 8 months</td>
</tr>
<tr>
<td>1942</td>
<td>65 and 10 months</td>
</tr>
<tr>
<td>1943-1954</td>
<td>66</td>
</tr>
<tr>
<td>1955</td>
<td>66 and 2 months</td>
</tr>
<tr>
<td>1956</td>
<td>66 and 4 months</td>
</tr>
<tr>
<td>1957</td>
<td>66 and 6 months</td>
</tr>
<tr>
<td>1958</td>
<td>66 and 8 months</td>
</tr>
<tr>
<td>1959</td>
<td>66 and 10 months</td>
</tr>
<tr>
<td>1960 or later</td>
<td>67</td>
</tr>
</tbody>
</table>
NOTE: Although the full retirement age is rising, you should still apply for Medicare benefits within three months of your 65th birthday. If you wait longer, your Medicare medical insurance (Part B) may cost you more money.

Delayed retirement

If you choose to delay receiving benefits beyond your full retirement age, your benefit will be increased by a certain percentage, depending on the year you were born. The increase will be added in automatically from the time you reach full retirement age until you start taking benefits or reach age 70, whichever comes first. If, for example, you were born in 1940, your benefit would increase 7 percent for each year between your full retirement age and age 70, that you do not get retirement benefits.

Early retirement

You may start receiving benefits as early as age 62. However, if you start your benefits early, your benefits are reduced permanently. Your benefit is reduced about one-half of one percent for each month you start your Social Security before your full retirement age. For example, if your full retirement age is 65 and 8 months and you sign up for Social Security when you are 62, you would only get 76.7 percent of your full benefit.

NOTE: The reduction will be greater in future years as the full retirement age increases.

If you work and get benefits

You can continue to work and still receive retirement benefits. Your earnings in (or after) the month you reach full retirement age will not reduce your Social Security benefits. However, your benefits will be reduced if your earnings exceed certain limits for the months before you reach your full retirement age.

If you work but start receiving benefits before full retirement age, $1 in benefits will be deducted for each $2 in earnings you have above the annual. In 2006, the limit is $12,480.

In the year you reach your full retirement age, your benefits will be reduced $1 for every $3 you earn over a different annual limit ($33,240 in 2006) until the month you reach full retirement age.

Once you reach full retirement age, you can keep working, and your Social Security benefit will not be reduced no matter how much you earn.

Issues and Challenges of Social Security

In United States, there is an important national discussion going on concerning the future of Social Security. Nowadays, the fear of Social Security having financial problems are the main concern for the people. People in US are living longer, the first
baby boomers are nearing retirement, and the birth rate is low. The result is that the worker-to-beneficiary ratio has fallen from 16.5-to-1 in 1950 to 3.3-to-1 today. Within 40 years it will be 2-to-1. At this ratio there will not be enough workers to pay scheduled benefits at current tax rates.

According to the Trustee Report 2006, if the current system of Social Security is not changed, payroll taxes will have to be increased, the benefits of today’s younger workers will have to be cut, or massive transfers from general revenues will be required. Social Security’s Trustees state, “If no action were taken until the combined trust funds become exhausted in 2040, much larger changes would be required. For example, payroll taxes could be raised to finance scheduled benefits fully in every year starting in 2040. In this case, the payroll tax would be increased to 16.65 percent at the point of trust fund exhaustion in 2040 and continue rising to 17.78 percent in 2080. Similarly, benefits could be reduced to the level that is payable with scheduled tax rates in every year beginning in 2040. Under this scenario, benefits would be reduced 26 percent at the point of trust fund exhaustion in 2040, with reductions reaching 30 percent in 2080.

Social Security is not sustainable over the long term at present benefit and tax rates without large infusions of additional revenue. There will be a massive and growing shortfall over the 75-year period.

Social Security’s Chief Actuary projects that in present-value dollars the financial shortfall (or unfunded obligation) for the 75-year period is $4.6 trillion. This unfunded obligation indicates that if an additional $4.6 trillion had been added to the trust fund at the beginning of 2006, the program would have had adequate financing to meet the projected cost of benefits scheduled in current law over the next 75 years.

This challenge also faced by most countries in Europe as well as Japan. These countries have more serious challenges than the U.S. Europe some developing countries are starting to face up to the aging of their populations such as Malaysia (government retirement pension scheme). Many of these countries have begun to profound their social security plans. More than 30 countries, including Britain, Australia and Sweden, have established versions of personal accounts.

The Alternatives for Modernization and Reform

The four basic alternatives that are being discussed — singly or in combination with each other — are (1) increasing payroll taxes, (2) decreasing benefits, (3) using general revenues or (4) prefunding future benefits through either personal savings accounts or direct investments of the trust funds. The independent, bipartisan Social Security Advisory Board examined many options that addressed Social Security’s long-range solvency problem.
CHAPTER 2 - FINANCIAL PLANNING AND SOCIAL SECURITY: ISSUES AND RELATIONS

3.2 PROVIDER OF SOCIAL SECURITY IN MALAYSIA

There is no entity similar to social security in the United States. However, workers in Malaysia get a similar system under the law where they can apply for having such a retirement plan. In Malaysia, workers and employers are obliged and compulsory to join such a system.

The Employees Provident Fund (EPF) is a scheme which provides retirement benefits for members through management of their savings in an efficient and reliable manner. The EPF also provides a convenient framework for employees to meet their statutory and moral obligations to their employees.

The main role of the EPF is to provide financial security to its members, especially after retirement, through a compulsory savings scheme. Contributors can withdraw their EPF savings at age 55 to enjoy a comfortable life without worrying about having a regular income upon retirement. As supplementary benefits, members are allowed to utilize part of their savings for house ownership, children's education and healthcare.

3.3 FINANCIAL PLANNING AND MANAGING SOCIAL SECURITY NEEDS.

Financial planning helps the individual to manage the social security needs of the future. Once you have determined your future expenses, the social security plan will help you evaluate the sources and amount of your retirement income.


**ACTIVITIES**

1. What is the importance of retirement planning?
2. What are the basic steps in retirement planning?
3. What are the sources of income?
4. What are the types of retirement?
UNIT 3

THE FINANCIAL PLANNING PROCESS

Unit objectives: At the end of this lesson, students will be able to:

1. Understand the financial planning model
2. Describe the six steps in financial planning process
3. Understand the life cycle of financial plans
4. Understand and apply the basic principles of the time value of money
5. Identify financial goals
6. Describe the income statement, balance sheet and budgeting
7. Use financial ratio to evaluate current financial position

Content:

Topic 1: Financial Planning Model
Topic 2: System Approach in Financial Planning
Topic 3: Financial Status and Financial Goals
Topic 4: Income Statement, Balance Sheet and Budgeting
CHAPTER 3 - THE FINANCIAL PLANNING PROCESS

TOPIC 1
FINANCIAL PLANNING MODEL

1.1 THE FINANCIAL PLANNING ENVIRONMENT

Financial planning is not carried out in isolation, but in an economic environment created by the actions of business, government and consumers. Your purchase, saving, investment and retirement plans and decisions are influenced by both the present and future state of economy. Understanding the economic environment will allow you to make better financial plans and decision.

For example, a strong economy can lead to big profits in the stock market, which can positively affect your investment and retirement programs. The economy can also affect the interest rates you pay on your mortgage and credit cards and those earn on savings accounts and bonds. Two important aspects of the planning environment: the major financial planning players and the economy.

- The Players

The financial planning environment contains various interrelated groups of players, each attempting to fulfill certain goals. Although their objectives are not necessarily incompatible, they do impose some constraints on one another. There are three vital groups: government, business and consumers. Exhibit 3.1. depicts the relationship among these groups.

I. Government

The federal, state and local governments provide us with many essential public goods and services such as police and fire protection, national defense, public education and public health. The federal government also plays a major role in regulating the level of economic activity. Government is also a customer of business and an employer of consumers. As a result, it is a source of revenue for business and wages for consumers.

II. Business

Business provides consumers with goods and services and in return receives payment in the form of money. To produce these goods and services, firms must hire labor and use land and capital (what economists refer to as factors of production). In return, firms pay out wages, rents, interest and profits to the various factors of production. Thus business are an important part of the circular flow of income that sustains our free enterprise system.
II. Consumers

The consumer is the central player in the financial planning environment. Consumer choices ultimately determine the kinds of goods and services business will provide. In addition, the consumer’s choice of whether to spend or save has a direct impact on the present and future circular flows of income. Consumers are often thought to have free choices in the marketplace, but they must operate within an environment that interacts with government and business.

○ The Economy

Our economy is the result of interaction among government, business and consumers as well as economic conditions in other nations. The government’s goal is to regulate the economy and provide economic stability and high levels of employment through specific policy decisions. These government decisions have a major impact on the economic and financial planning environment. For example, increases in the money supply tend to lower interest rates. This typically leads to a higher level of consumer and business borrowing and spending that increases overall economic activity. The reverse is also true. Reducing the money supply raises interest rates, reducing consumer and business borrowing and spending and slowing economic activity.

The government’s other principal tool for managing the economy is fiscal policy, its program of spending and taxation. Increased spending for social services, education, defense and other program stimulates the economy, while decreased spending slows economic activity. Increasing taxes, on the other hand, gives business and individuals less to spend and as a result, negatively affects economic activity. Conversely, decreasing taxes stimulates the economy.

Exhibit 3.1: The Financial Planning Environment
1.2 FUNDAMENTALS OF FINANCIAL PLANNING

Financial planning is the process whereby an individual moves towards meeting personal and financial goals through development and implementation of a comprehensive financial plan. It typically involves six activities starting from identifying goals and objectives to analyzing financial situations and ending with recommendations and regular monitoring.

- **Financial Planning Components**
  
  I. **Obtaining**
  
  You obtain financial resources from employment, investments, or ownership of a business. Obtaining financial resources is the foundation of financial planning, i.e., these resources are used for all financial activities.

  II. **Planning**
  
  Planned spending through budgeting is the key to achieving goal- and future financial security. Efforts to anticipate expenses and financial decisions can also help reduce taxes. The ability to pay your fair share of taxes is vital to increasing your financial resources.

  III. **Saving**
  
  Long-term financial security starts with a regular savings plan for emergencies, unexpected bills, replacement of major items, and the purchase of special goods and services. Once you have established a basic savings plan, you may use additional money for investments that offer greater financial growth. An amount of savings must be available to meet current household needs.

  IV. **Borrowing**
  
  Maintaining control over your credit-buying habits will contribute to your financial goals. The abuse and misuse of credit may cause a situation in which a person's debts far exceed the resources available to pay those debts. Bankruptcy is a set of federal laws that allow you to either restructure your debts or remove certain debts.

  V. **Spending**
  
  Financial planning is designed not to prevent your enjoyment of life but to help you obtain the things you want. Too often, however, people make purchases, without considering the financial consequences. Some people shop compulsively, creating financial difficulties. You should detail your living expenses and your other financial obligations in a spending plan.

  VI. **Managing Risk**
  
  Adequate insurance coverage is another component of personal financial planning. Certain types of insurance are commonly overlooked in financial plans. For example, the number of people who suffer disabling injuries or
diseases at age 50 is greater than the number who die at that age, so people may need disability insurance more than they need life insurance.

vii. Investing
While many types of investment vehicles are available, people invest for two primary reasons. Those interested in current income select investments that pay regular dividends or interest. In contrast, investors who desire long-term growth choose stocks, mutual funds, real estate and other investments with potential for increased value in the future.

viii. Retirement and estate planning
Most people desire financial security upon completion of full-time employment. But retirement planning also involves thinking about your housing situation, your recreational activities and possible part-time or volunteer work. Transfers of money or property to others should be timed, if possible, to minimize the tax burden and maximize the benefits for those receiving the financial resources.
2.1 THE LIFE CYCLE OF FINANCIAL PLANS

Financial planning is a dynamic process. As you move through different stages of your life, your needs and goals will change. Certain financial goals are important regardless of age. Having extra resources to fall back on in an economic downturn period of unemployment should be a priority whether you are 25, 45 or 65. Some changes—new job, marriage, children, moving to new area, may be part of your original plan.

However, more often than not, you will face unexpected “financial shocks” during your life: loss of a job, a car accident, divorce or death of a spouse, a long illness, or the need to support adult children or aging parents. With careful planning you can get through tough times and prosper in good times. To cope with life’s financial shocks, you need to plan ahead and take steps for example setting up an emergency fund or reducing monthly expenses. That will protect you and your family financially if a setback occurs.

As we move from childhood to retirement age, we traditionally go through different life stages. Exhibit 3.2 illustrates the various components of a typical financial planning life cycle as it compares with these different life stages. As we pass from one state maturation to the next, our patterns of income change simultaneously. From early childhood, when we relied on our parents for support, to early adulthood, when we started our families and, very likely, held our first “real jobs”, we can see a noticeable change in income pattern.

Exhibit 3.2: The Traditional Personal Financial Planning Life Cycle
2.2 THE SIX STEPS IN FINANCIAL PLANNING PROCESS

Step 1 Determine current financial situation
In the first step, you will determine your current financial situation regarding income, savings, living expenses and debts. Preparing a list of current asset and debt balances and amounts spent for various items gives you a foundation for financial planning activities. The personal financial statements will provide the information needed to match your goals with your current income and potential earning power.

Step 2 Develop financial goals
You should periodically analyze your financial values and goals. This activity involves identifying how you feel about money and why you feel that way. The purpose of this analysis is to differentiate your needs from your wants. Specific financial goals are vital to financial planning. Your financial goals can range from spending all of your current income to developing an extensive savings and investment program for your future financial security.

Step 3 Identify alternative courses of action
Developing alternatives is crucial when making decisions. Although many factors will influence the available alternatives, possible courses of action usually fall into these categories:

- Continue the same course of action. For example, you may determine that the amount you have saved each month is still appropriate.
- Expand the current situation. You may choose to save a larger amount each month.
- Change the current situation. You may decide to use money market account instead of a regular savings.
- Take a new course of action. You may decide to use your monthly saving budget to pay off credit card debts

Step 4 Evaluate alternatives
You need to evaluate possible courses of action, taking into consideration your life situation, personal values and current economic conditions. Every decision closes off alternatives. For example, a decision to invest in stock at Bursa Saham Kuala Lumpur may mean you cannot take a vacation. Opportunity cost is what you give up by making a choice. This cost, commonly referred as the trade-off a decision, cannot always be measured in ringgit.

Step 5 Create and implement financial action plan
This step of financial planning process involves developing an action plan that identifies ways to achieve your goals. For example, you can increase your savings by reducing your spending or by increasing your income through extra time on the job. To implement your financial action plan, you may need assistance from others. For example, use the services of an
insurance agent to purchase property insurance or the services of an investment broker to purchase stocks, bonds or mutual funds.

Step 6  Review and revise plan
Financial planning is a dynamic process that does not end when you like a particular action. You need to regularly assess your financial decisions. You should do a complete review of your finances at least one a year. Changing personal, social and economic factors may require more frequent assessments. When life events affect your financial needs, this financial planning process will provide a vehicle for adapting to those changes.

Exhibit 3.3: The Financial Planning Process
3.1 FINANCIAL GOALS

Financial goals cover a wide range of financial desires from controlling living expenses to meeting retirement needs, from setting up a savings and investment program to minimizing the amount of taxes you pay. Some of the most-often cited financial goals include having enough money to live as well as possible now, being financially independent, sending children to universities and providing for retirement.

You should define your financial goals as specifically as possible and focus them on the results you want to attain. Simply saying that you want to save money next year is not a specific goal. How much do you want to save and for what purpose? Goal setting is a process that should involve your immediate family. Having each family member effectively "buy into" these goals eliminates potential future conflicts and improve the family's chances of achieving them. Once you define and approve your goals, you can prepare appropriate cash budgets. Finally, you should assign priorities and a definite time frame to financial goals.

- Short and Intermediate-term goals

Short-term financial goals are set each year and cover a 12 month period. Intermediate-term goals bridge the gap between short and long term goals (about 2 to 5 years). Both should be consistent with established long-term goals. Short-term goals become the key input for the cash budget, a tool used to plan for short-term income and expenses. Short-term planning should also include establishing an emergency fund with 3 to 6 months's worth of income.

- Long-term goals

Long-term financial goals should indicate the individual's or family's wants and desires for a time period covering about 6 years out to the next 30 or 40 years. Although it's difficult to pinpoint exactly what you will want 30 years from now, you should establish some tentative long-term financial goals. Recognize, though, that many long-term goals will change over time and you'll need to revise them accordingly.
How Financial Goals Change During A Person's Life Cycle

<table>
<thead>
<tr>
<th>Personal Situation</th>
<th>Short-term goals (1 year)</th>
<th>Intermediate goals (2-5 years)</th>
<th>Long-term goals (6+ years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Final year undergraduate</td>
<td>* Find a job</td>
<td>* Repay study loans</td>
<td>* Begin an investment program</td>
</tr>
<tr>
<td></td>
<td>* Rent an apartment</td>
<td>* Trade in car and upgrade nicer model</td>
<td>* Buy a condominium</td>
</tr>
<tr>
<td>Single, mid-20s</td>
<td>* Get a bank credit card</td>
<td>* Begin regular savings program</td>
<td>* Build in investment portfolio</td>
</tr>
<tr>
<td></td>
<td>* Prepare a budget</td>
<td>* Buy life insurance</td>
<td>* Save enough for down payment on</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>a home</td>
</tr>
<tr>
<td>Married, couple with children, late 30s</td>
<td>* Build an emergency fund</td>
<td>* Increase college/university fund</td>
<td>* Diversity investment portfolio</td>
</tr>
<tr>
<td></td>
<td>* Reduce expenses 10%</td>
<td>* Increase second income</td>
<td>* Buy a larger home</td>
</tr>
<tr>
<td>Married couple with grown, mid 50s</td>
<td>* Review skills for possible career change</td>
<td>* Shift investment portfolio into income-producing securities</td>
<td>* Decide whether to relocate when retired</td>
</tr>
</tbody>
</table>

3.2 TIME VALUE OF MONEY

Personal financial planning is all about making choices. How will you spend your money? Where will you invest your savings? How will you finance major purchase? For every financial choice you must make, there is inevitably a tradeoff. For example, if you want to send your children to university, you'll have to spend less on other things so that you can save for this important goal.

In evaluating and comparing various alternatives for achieving financial goals, we will often make use of an important personal financial planning tool called the "Time Value of Money." The basic idea is simple: Money received today is worth more than money to be received in the future because you can invest it to earn compound interest. Compounding occurs when you earn interest on your investment balance and then leave the interest in the account so that you earn future interest on the original balance plus the accumulated interest earnings. The time value of money is also the reason you shouldn’t keep your savings in piggy bank or under mattress at home. Aside from the risk of fire or theft, money that is not invested in interest-earning or growth assets will actually lose purchasing power over time because of the eroding effects of inflation.
CHAPTER 3 – THE FINANCIAL PLANNING PROCESS

To illustrate the concept of compounding, suppose you’re offered an investment opportunity on which you will earn 10 percent interest per year, payable at the end of the year. If you keep RM10,000 in the account for one year, you will receive 10 percent of RM10,000, or RM1,000 in interest at the end of the year. Now suppose you leave both the original amount at the earned interest, totaling RM11,000 in the account. At the end of the next year, you will receive interest on the full RM11,000. Thus, your interest earnings at the end of year 2 will be 10 percent of RM11,000, or RM1,100; at the end of year 3, you will earn RM1,210 (10 percent of RM12,100); and so on. The longer you leave your money in the account, the greater the dollar interest earnings each year will be. As illustrated in Exhibit 3.3, your money will also grow faster if you can earn higher rate of interest on the invested amounts.

Exhibit 3.4: The Power of Compounding

- **Future Value of Lump Sum**

  The future value (FV) of a lump sum is its value at a particular time in the future if invested today at a given rate of interest. For example, suppose that you have RM1,000 invested in an account that earns 5 percent interest per year, compounded annually. Annually compounding means that the interest on the balance is calculated once per year. How much will you have at the end of one year?
The future value (FV) of a lump sum is the present value (PV), or the amount invested today, plus the compound interest earned on the present value for the period. In this case, we're looking for the value in one year and in two year. The present value is RM1,000 and the interest rate is 5 percent. After one year, we'll have the original RM1,000 plus RM50 in interest (RM1,000 x 0.05 = RM50), for a total of RM1,050. Notice that this is the same as multiplying the original RM1,000 times 1 plus the interest rate, since RM1,000 x 1.05 = RM1,050.

Now suppose you leave the RM1,050 in your account for another year. At the end of the second year, you'll have the RM1,050 from one year plus RM52.50 in interest for the second year (RM1,050 x 0.05 = RM52.50), for a total RM1,102.50. This is the same as multiplying the original RM1,000 times 1.05^2 since RM1,000 x 1.05 x 1.05 = RM1,102.50. The equation for the future value as follows:

\[ FV = PV \times (1 + i)^n \]

Where:
- \( FV \) = future value
- \( PV \) = present value, or the amount invested today
- \( i \) = interest rate for one period
- \( n \) = number of periods

To solve the two-year problem above, substitute the appropriate values and solve for the future value (FV):

\[ FV = PV \times (1 + i)^n \]
\[ = RM1,000 \times (1+0.05)^2 \]
\[ = RM1,102.50 \]

* **Present Value of a Lump Sum**

In personal financial planning, we often set goals for the future and the attempt to take steps to achieve those goals. A common type of problem is one in which we need to determine how much to invest today in present value (PV) in order to have a desired amount in the future. Another use of present value is to determine how much an amount to be received in the future is worth to you today. Present value will always be less than its future value, we often use the word discounting to describe the process of calculating present value.
CHAPTER 3 - THE FINANCIAL PLANNING PROCES

For example, you want to buy a RM10,000 used car four years from now. You would like to set aside enough money so that, if you earn 5 percent interest over the four years, you'll have exactly RM10,000 to buy the car at the end of the fourth year. Your timeline for this problem should look like this:

![Timeline Diagram]

\[
\text{PV} = ? \\
1 = 5\% \\
FV = 10,000
\]

\[
\text{PV} = \text{FV} \times \left( \frac{1}{1 + i} \right)^n
\]

Where:
- \(FV\) = future value
- \(PV\) = present value, or the amount invested today
- \(i\) = interest rate for one period
- \(n\) = number of periods

We can enter the values from our example to find the solution:

\[
\begin{align*}
\text{PV} &= \text{RM10,000} \times \left( \frac{1}{1 + 0.05} \right)^4 \\
&= \text{RM10,000} \times (0.9524)^4 \\
&= \text{RM10,000} \times 0.8227 \\
&= \text{RM8,227}
\end{align*}
\]

Future Value of Annuity

The amount to which a regular series of payments will grow, with compounding, if invested at a given rate of interest for a particular period of time. An annuity is a series of payment of equal ringgit amounts made at regular intervals for a period of time. Example of annuity include fixed mortgages and car payments. An ordinary annuity is one in which each payment occurs at the end of the period, such as weekly paycheck. An annuity due is one in which each payment occurs at the beginning of the period, such as rent payment.

Calculating the future value of an annuity is the equivalent of calculating the future value for each of the payments as lump sums and then adding them together. For example, Encik Ahmad plan to make two payments of RM100, one invested one year from now and one invested two years from now, and he expect his investment to earn 5 percent per year, compounded annually. Because each payment is made at the end of the year, this is an ordinary annuity. If Encik Ahmad reinvest all his interest earnings, how much will the total be worth at the end of two years? The timeline for the problem as below:
At the end of the two-year period, the first RM100 payment (PMT1), will have been in the account for only one year so it will have grown to 100 \times (1.05) = RM105. The second RM100 payment (PMT2), will be invested at the end of year two and therefore will not have earned any interest yet. So it’s still worth only RM100 at the end second year. Altogether, Encik Ahmad will have RM205. Now, what if he paid RM100 at the end of each year for three years? At the end of the third year, he’d have:

\[
\frac{[100 \times (1.05)^2] + [100 \times (1.05)] + 100}{1} = RM315.25
\]

Where:

- FVA = Future value of an ordinary annuity
- PMT = Payment per period
- i = Interest rate for one period
- n = Number of periods

Use the equation to solve the three-period problem presented earlier

\[
FVA = RM100 \times (1.05)^3 - 1
\]

\[
= RM100 \times 1.157625
\]

\[
= RM100 \times 3.1525
\]

\[
= RM315.25
\]

- Present Value of Annuity

Present value of annuity (PVA) is the amount you would have to set aside today to be able to withdraw a particular amount of money each period for a given number of periods. The original amount will be less than the total of the payments because the account will continue to earn interest each period on the gradually declining balance. If you want to take RM10,000 per year from an account for 10 years, you don’t need to deposit RM100,000 today. You need to deposit a smaller amount that, together with compound interest, will be sufficient to allow you to withdraw the RM10,000 per year, leaving you with a zero balance by the end of the tenth year. To calculate the amount you would
need to deposit, we use the present value of an annuity calculation presented in this section.

Annuities are a way of providing a stable cash flow for a period of time. For this reason, financial investments that provide annuity payments are popular with retirees. We also commonly pay back loans by making a series of equal payments to the lender, often on a monthly basis, as in the case of a typical 30-year-payment mortgage or a 5-year-payment car loan. For example, Mr. Muthu considering the purchase of an annuity contract in which his bank promises to pay him RM2,000 at the end of every year for the next three years. Note that this is an ordinary annuity since the payments are made at the end of each year. The timeline for this annuity is presented below:

Timeline:

\[
\begin{array}{c|c|c|c}
0 & 1 & 2 & 3 \\
\hline
PV = ? & PMT1 = 2,000 & PMT2 = 2,000 & PMT3 = 2,000
\end{array}
\]

Assume that the interest rate is 10 percent. Since an annuity is just a series of lump sum payments, we can calculate the present value of each one separately and add them up. Recall that the formula for the present value of a lump sum is \( PV = FV \times \left[ \frac{1}{(1+i)^n} \right] \). Since the amounts to be received in the future are the three payments PMT1, PMT2 and PMT3, these can be substituted in that equation with the appropriate number of periods to find the present value of each individual payment. The present value of the series of payments, rounded to nearest ringgit, will therefore be

\[
PVA = \left[ \frac{PMT \times (1)}{1+i} \right] + \left[ \frac{PMT \times (1)}{1+i} \right] + \left[ \frac{PMT \times (1)}{1+i} \right]
\]

\[
= \frac{RM2,000 \times (1)}{1.1} + \frac{RM2,000 \times (1)}{1.1} + \frac{RM2,000 \times (1)}{1.1}
\]

\[
= \frac{RM2,000 \times 0.7513}{1.1} + \frac{RM2,000 \times 0.8625}{1.1} + \frac{RM2,000 \times 0.9091}{1.1}
\]

\[
= RM1,503 + RM1,653 + RM1,818
\]

\[
= RM4,974
\]

This means that if Mr. Muthu's bank takes the RM4,974 and invests it to earn 10 percent interest per year, it can pay Mr. Muthu at the end of each year and have enough to get to the end. To see that this is so, consider the bank's account balance over the three-year period:

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning Balance (RM)</th>
<th>Interest (RM)</th>
<th>Payment (RM)</th>
<th>Ending Balance (RM)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>4,974.00</td>
<td>+497.40</td>
<td>-2,000.00</td>
<td>3,471.40</td>
</tr>
</tbody>
</table>
The mathematical formula for the present value of an annuity is a bit complicated

\[
PVA = \frac{PMT \times (1 - (1+i)^{-n})}{i}
\]

Where:
- PVA = Present value of ordinary annuity
- PMT = Payment per period
- i = Interest rate for one period
- n = Number of periods

We solve for the present value of the three RM2,000 payments as follows:

\[
PVA = \frac{RM2,000 \times (1 - (1+0.1)^{-3})}{0.1} \\
= \frac{RM2,000 \times (1 - 0.7513)}{0.1} \\
= RM2,000 \times 2.4869 \\
= RM4,973.70
\]

- The Rule of 72

Suppose you don’t have access to a time value of money tables or a financial calculator, but want to know how long it takes for your money to double. There is an easy way to approximate this using the rule of 72. Simply divide the number 72 by the percentage rate you are earning on your investment:

\[
\text{Number of years to double money} = \frac{72}{\text{Annual compound interest}}
\]

For example, assume that you recently opened a savings account with RM1,000 that earns an annual compound rate of interest of 4.5 percent. Your money will double in 16 years (72 / 4.5 = 16). If you can find a RM1,000 investment that earns 6.25 percent, you will have RM2,000 in about 11.5 years (72 / 6.25 = 11.5 years). The rule of 72 also applies to debts. Your debts can double very quickly with high interest rates, such as those charged on most credit card accounts. So keep the rule of 72 in mind whether you invest or borrow.
Chapter 3 - The Financial Planning Process

Exhibit 3.5: The Rule of 72

<table>
<thead>
<tr>
<th>Interest Rate (%)</th>
<th>Years to Double</th>
</tr>
</thead>
<tbody>
<tr>
<td>12%</td>
<td>6 years</td>
</tr>
<tr>
<td>10%</td>
<td>7.2 years</td>
</tr>
<tr>
<td>8%</td>
<td>9 years</td>
</tr>
<tr>
<td>6%</td>
<td>12 years</td>
</tr>
<tr>
<td>4%</td>
<td>18 years</td>
</tr>
</tbody>
</table>
4.1 FINANCIAL STATEMENTS

Financial statements are compilations of personal financial data designed to communicate information on money matters. They are used often along with other financial data to indicate the financial condition of an individual or family. The two most useful statements are the cash-flow statement and the balance sheet.

A cash-flow (or income and expenses) statement lists and summarizes income and expense transactions that have taken place over a specific period of time, such as a month or a year. It tells you where your money came from and where it went. A balance sheet (or net worth statement) describes an individual's or family's financial condition on a specified date by showing assets, liabilities and net worth. It provides a current status report and indicates information on what you own, owe and what the net result would be if you paid off all of your debts.

- The Cash-Flow Statement
The cash-flow statement is very different from a balance sheet. Whereas the balance sheet shows your financial condition at a single point in time, the cash-flow statement summarizes the total amounts that have been received and spent over a period of time, usually one month or one year. The cash-flow shows whether you were able to live within your income during that time period. A cash-flow statement includes three sections: income (total income received), expenses (total expenditure made) and surplus (or net gain or net income), where total income exceeds total expenses, or deficit (or net loss), where expenses exceed income.

Income: You may think of income simply what is earned from salaries or wages. In fact, many other types of income exist that you should also include on a cash-flow statement. Some examples:

- Child support and alimony
- Bonuses and commissions
- Public assistance
- Social security benefits
- Pension and profit-sharing income
- Scholarship and grants
- Interest and dividends received
- Income from: the sales of assets
CHAPTER 3 – THE FINANCIAL PLANNING PROCESS

Expenses: All expenditures made during the period covered by the cash-flow statement should be included in the expenses section. The number and type of expenses shown will vary for each individual and family. Two types of expenses: (1) fixed expenses are usually paid in the same amount during each time period, they are often contractual, (2) variable expenses are expenditures over which an individual has considerable control.

<table>
<thead>
<tr>
<th>Fixed Expenses</th>
<th>Variable Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Saving and investments</td>
<td>• Meals (at home and away)</td>
</tr>
<tr>
<td>• Housing (rent, mortgage, loan payment)</td>
<td>• Utilities (electricity, water, gas)</td>
</tr>
<tr>
<td>• Automobile (installment payment)</td>
<td>• Medical expenses</td>
</tr>
<tr>
<td>• Insurance (life, health, liability)</td>
<td>• Transportation</td>
</tr>
</tbody>
</table>

Surplus (Deficit): The surplus (deficit) shows the amount remaining after you have itemized income subtracted expenditures from income, as illustrated by the following calculations of the surplus/deficit formula.

\[
\text{Surplus (deficit)} = \text{total income} - \text{total expenses}
\]

RM1,000 surplus = RM3,000 – RM2,000
RM300 deficit = RM500 – RM800

Table 3.1: Cash-Flow Statement of Family with Two Children – Mr. Wong and Mrs. Suzy

<table>
<thead>
<tr>
<th></th>
<th>$ (RM)</th>
<th>$ (RM)</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wong’s gross salary</td>
<td>43,180</td>
<td>65.42</td>
<td></td>
</tr>
<tr>
<td>Suzy’s salary (part-time)</td>
<td>12,500</td>
<td>18.94</td>
<td></td>
</tr>
<tr>
<td>Interest and dividends</td>
<td>1,800</td>
<td>2.73</td>
<td></td>
</tr>
<tr>
<td>Bonus</td>
<td>600</td>
<td>0.91</td>
<td></td>
</tr>
<tr>
<td>Tax refunds</td>
<td>200</td>
<td>0.30</td>
<td></td>
</tr>
<tr>
<td>Net rental income</td>
<td>7,220</td>
<td>11.70</td>
<td></td>
</tr>
<tr>
<td><strong>Total Income</strong></td>
<td>64,000</td>
<td>100.00</td>
<td></td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed Expenses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgage loan payments</td>
<td>12,000</td>
<td>18.18</td>
<td></td>
</tr>
<tr>
<td>Real estate taxes</td>
<td>2,400</td>
<td>3.64</td>
<td></td>
</tr>
<tr>
<td>Homeowner’s insurance</td>
<td>760</td>
<td>1.15</td>
<td></td>
</tr>
<tr>
<td>Automobile loan payment</td>
<td>4,400</td>
<td>6.67</td>
<td></td>
</tr>
<tr>
<td>Automobile insurance and registration</td>
<td>1,191</td>
<td>1.80</td>
<td></td>
</tr>
<tr>
<td>Life insurance premiums</td>
<td>1,200</td>
<td>1.82</td>
<td></td>
</tr>
<tr>
<td>Medical insurance</td>
<td>2,980</td>
<td>4.52</td>
<td></td>
</tr>
</tbody>
</table>

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CENTRE FOR EXTERNAL EDUCATION

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### Variable Expenses

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food</td>
<td>4,900</td>
</tr>
<tr>
<td>Utilities</td>
<td>2,100</td>
</tr>
<tr>
<td>Gasoline, oil, maintenance</td>
<td>3,100</td>
</tr>
<tr>
<td>Medical</td>
<td>1,245</td>
</tr>
<tr>
<td>Medicines</td>
<td>750</td>
</tr>
<tr>
<td>Clothing and upkeep</td>
<td>1,950</td>
</tr>
<tr>
<td>Donation</td>
<td>1,200</td>
</tr>
<tr>
<td>Gifts</td>
<td>900</td>
</tr>
<tr>
<td>Personal allowances</td>
<td>1,160</td>
</tr>
<tr>
<td>Children’s allowances</td>
<td>960</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>500</td>
</tr>
<tr>
<td><strong>Total variable expenses</strong></td>
<td>18,765</td>
</tr>
<tr>
<td><strong>Total Expenses</strong></td>
<td>64,786</td>
</tr>
<tr>
<td><strong>Surplus (deficit)</strong></td>
<td>1,214</td>
</tr>
</tbody>
</table>

**The Balance Sheet**

The first step to a better financial ought to be an assessment of where you are on the wealth-building scale that is your net worth. A balance consists of three parts: assets, liabilities and net worth. **Assets** include everything you own that has monetary value. **Liabilities** are your debts, what you owe to others. Your net worth is the ringgit amount left when what is owed is subtracted from the ringgit value of what is owned that is when liabilities are subtracted from assets.

**Assets**

I. **Monetary assets** (also known as liquid assets) include cash and near-cash items that can be readily converted to cash. They are primarily used for maintenance of living expenses, emergencies, savings and payment of bills.

II. **Tangible** (or use) assets are physical items that have fairly long lifespan and could be sold to raise cash, but whose primary purpose is to provide maintenance of one’s lifestyle for example a car. Tangible assets generally depreciate in value over time.

III. **Investment assets** (also known as capital assets) include tangible and intangible items acquired for the monetary benefits they provide, such as generating additional income and increasing in value. Successful financial planning generally requires diversification of investment assets by putting money into a variety of investments such as stocks, real estate, bonds and mutual funds.
The total assets on a balance sheet must equal the total liabilities plus the net worth. Both sides must be in balance. Accuracy and sufficiency are the key considerations.

Following are some examples of items to include in the liabilities section:

- Net worth: $10,000 - liabilities:
  - $5,000 mortgage
  - $2,000 credit card
  - $1,000 car loan
  - $1,000 personal loan
  - $2,000 other
  - Total liabilities: $10,000
  - Net worth: $0

Short-Term Liabilities
- Credit card balance
- Money owed by others
- Taxes unpaid

Long-Term Liabilities
- Personal loans
- Mortgages
- Credit card balances
- Education loan balances

Tangible Assets
- Automobiles
- Furniture
- Home equity balance

Investment Assets
- Stocks, bonds, mutual funds
- Life insurance
- Personal property

Monetary Assets
- Savings and checking accounts
- Money owed by others
- Tax refunds due
- Personal property

Summarizes debts owed, including both personal and business-related debts. The debt could be either a short-term (current) liability or a long-term liability. On obligation to be paid off in a time period longer than one year.
Table 3.2: Balance Sheet For A Couple With Two Children – Mr. Wong and Mrs. Suzy

January 1, 2006

<table>
<thead>
<tr>
<th>Assets</th>
<th>$ (RM)</th>
<th>$ (RM)</th>
<th>$ (RM)</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monetary Assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash on hand</td>
<td>260</td>
<td></td>
<td>0.01</td>
<td></td>
</tr>
<tr>
<td>Savings account</td>
<td>1,500</td>
<td></td>
<td>0.43</td>
<td></td>
</tr>
<tr>
<td>Wong’s current account</td>
<td>600</td>
<td></td>
<td>0.17</td>
<td></td>
</tr>
<tr>
<td>Suzy’s current account</td>
<td>700</td>
<td></td>
<td>0.21</td>
<td></td>
</tr>
<tr>
<td>Tax refund due</td>
<td>700</td>
<td></td>
<td>0.21</td>
<td></td>
</tr>
<tr>
<td>Rent receivable</td>
<td>660</td>
<td></td>
<td>0.21</td>
<td></td>
</tr>
<tr>
<td>Total monetary assets</td>
<td>4,480</td>
<td></td>
<td>1.41</td>
<td></td>
</tr>
<tr>
<td>Tangible Assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Home</td>
<td>176,600</td>
<td></td>
<td>56.79</td>
<td></td>
</tr>
<tr>
<td>Personal property</td>
<td>9,000</td>
<td></td>
<td>2.91</td>
<td></td>
</tr>
<tr>
<td>Automobiles</td>
<td>11,500</td>
<td></td>
<td>3.7</td>
<td></td>
</tr>
<tr>
<td>Total tangible assets</td>
<td>196,500</td>
<td></td>
<td>63.40</td>
<td></td>
</tr>
<tr>
<td>Investment assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SBB mutual fund</td>
<td>4,500</td>
<td></td>
<td>1.44</td>
<td></td>
</tr>
<tr>
<td>Prudential mutual fund</td>
<td>5,000</td>
<td></td>
<td>1.6</td>
<td></td>
</tr>
<tr>
<td>Kenanga stock</td>
<td>2,800</td>
<td></td>
<td>0.91</td>
<td></td>
</tr>
<tr>
<td>Malaysia bond</td>
<td>1,000</td>
<td></td>
<td>0.33</td>
<td></td>
</tr>
<tr>
<td>Life insurance cash value</td>
<td>5,400</td>
<td></td>
<td>1.77</td>
<td></td>
</tr>
<tr>
<td>ASB</td>
<td>6,300</td>
<td></td>
<td>2.00</td>
<td></td>
</tr>
<tr>
<td>Real estate investment</td>
<td>84,000</td>
<td></td>
<td>27.11</td>
<td></td>
</tr>
<tr>
<td>Total investment assets</td>
<td>109,030</td>
<td></td>
<td>35.17</td>
<td></td>
</tr>
<tr>
<td>Total assets</td>
<td>309,920</td>
<td></td>
<td>100.00</td>
<td></td>
</tr>
</tbody>
</table>

Liabilities

| Short-term Liabilities          |        |        |        |         |
| Dentist bill                    | 120    |        | 0.04   |         |
| Credit card debt                | 1,545  |        | 0.50   |         |
| Total short-term liabilities    | 1,665  |        | 0.54   |         |
| Long-term Liabilities           |        |        |        |         |
| Automobile                      | 7,700  |        | 2.46   |         |
| Savings and loans – Real estate | 92,000 | 99,710 | 29.69  |         |
| Total long-term liabilities     | 101,365| 32.71  | 99.71  |         |
| Total liabilities               |        |        |        |         |
| Net worth                       | 203,555| 67.29  | 100.00 |         |
| Total liabilities and net worth | 309,920| 100.00 |        |         |
4.2 FINANCIAL RATIOS

Financial ratios are numerical calculations designed to simplify the process of assessing your financial ratio condition. Ratios can serve as yardsticks to help manage financial resources more effectively and to develop spending and credit-use patterns consistent with your goals.

- **Basic Liquidity Ratio**

Liquidity is the speed and ease with which an asset can be converted to cash. You can use the basic liquidity ratio to determine the number of months that you could continue to meet your expenses using only your monetary assets should all income cease. For example, compare the monetary assets on the balance sheet for Mr. Wong and Mrs. Suzy in Table 3.2 (RM4,420) with their monthly expenses in Table 3.1 (RM64,786+12= RM5,399) using equation:

\[
\text{Basic liquidity ratio} = \frac{\text{monetary (liquid) assets}}{\text{monthly expenses}} = \frac{\text{RM4,420}}{\text{RM5,398}} = 0.82
\]

This financial ratio suggests that the family may have insufficient monetary assets, unable to support them for even one month (0.82) if they faced a loss of income. Experts recommend that people should have monetary assets equal to three month's expenses in emergency cash reserves.

- **Assets-to-Debt-Ratio**

The asset-to-debt ratio compares total assets with total liabilities. It provides you with a broad measure of your financial liquidity. This ratio measures solvency and ability to pay debts. Calculation based on the figures in the Mr. Wong's balance sheet show that the couple has ample assets compared with their debts because they own items worth more than three times what they owe.

\[
\text{Asset-to-debt ratio} = \frac{\text{total assets}}{\text{total debt}} = \frac{\text{RM95,220}}{\text{RM101,365}} = 3.057
\]

If you owe more than you own, then you're technically insolvent. While your current income may be sufficient to pay your current bills, you still do not have enough assets to cover all of your debts.
• **Debt Service-to-Income Ratio**

The debt service-to-income ratio provides a view of your total debt burden by comparing the ringgit spent on gross annual debt repayments with gross annual income. Using data in Table 2.5, Equation shows that the Mr. Wong's RM16,400 in annual loan repayments (RM12,000 for the mortgage loan and RM4,400 for the automobile loan) amount to 24.85 percent of their RM66,000 annual income. A ratio of 0.36 or less indicates that gross income is adequate to make debt repayments, including housing costs and implies that you usually have some flexibility in budgeting for other expenses. This ratio should decrease as you grow older.

\[
\text{Debt service-to-income ratio} = \frac{\text{annual debt repayments}}{\text{gross income}}
\]

\[
= \frac{\text{RM16,400}}{\text{RM66,000}}
\]

\[
= 24.85\%
\]

• **Debt Payments-to-Disposable Income Ratio**

The debt payments-to-disposable income ratio divides monthly disposable personal income (not gross income) into monthly debt repayments (excluding mortgage debt). Disposable personal income is the amount of your income remaining after taxes and withholding for such purposes as insurance and unincurred. A debt payments-to-disposable income ratio of 16 percent or more is considered to be problematic because the person is overindebted and would be in serious financial trouble if a disruption in income occurred.

In the Mr. Wong's case, their monthly disposable income from Table 2.4 is RM3,932.50 (RM66,000 - RM2,980 - RM6,800 - RM3,100 - RM720 - RM4,260 - RM950) / 12. Their monthly debt repayments from Table 2.4 are RM366.67 (RM4,400 / 12). The result using equation is a debt payments-to-disposable income ratio of 9.32 percent.

\[
\text{Debt payments-to-disposable income ratio} = \frac{\text{monthly non-mortgage debt repayments}}{\text{disposable income}}
\]

\[
= \frac{\text{RM366.67}}{\text{RM3,932.50}}
\]

\[
= 9.32\%
\]

• **Investment Assets-to-Total Assets Ratio**

The investment assets-to-total assets ratio compares the value of your investment assets with your net worth. This ratio reveals how well an individual or family is advancing toward their financial goals for capital accumulation, especially as related to retirement. Inserting the data from their balance sheet in Table 2.5 into equation shows that the Mr. Wong have a ratio 0.352 or 35.2 percent. As you can...
money is actually received. If you get paid once a month, planning is easy since you will work with a single amount. But if you get paid weekly or twice a month, you will need to plan how much of each paycheck will go for various expenses.

Step 3  Budgeting An Emergency Fund and Savings
Financial advisers suggest that an emergency fund representing three to six months of living expenses be established for use in periods of unexpected financial difficulty. This amount will vary based on person’s life situation and employment stability. A very common budgeting mistake is to spend the amount you have left at the end of the month. When you do that, you often have nothing left for savings. Since savings are vital to long-term financial security, advisers suggest that an amount be budgeted as a fixed expense.

Step 4  Budgeting Fixed Expenses
Definite obligations make up this portion of a budget. Assigning amounts to spending categories requires careful consideration. The amount you budget for various items will depend on your current needs and plans for the future.

Step 5  Budgeting Variables Expenses
Planning for variable expenses is not as easy as budgeting for savings or fixed expenses. Variable expenses will fluctuate by household situation, time of year, health, economic conditions and a variety of other factors.

Step 6  Recording Spending Amounts
After you’ve established your spending plan, you will need to keep records of your actual income and expenses similar to those you keep in preparing an income statement. The family’s actual spending was not always the same as planned. A budget variance is the difference between the amount budgeted and the actual amount received or spent. Variances for income should be viewed as the opposite of variances for expenses. Less income than expected would be a deficit, while more income than expected would be a surplus.

Step 7  Reviewing Spending and Saving Patterns
The results of your budget may be obvious: having extra cash in checking, falling behind in your bill payments and so on. Occasionally, you will have to sit down (with other household members, if appropriate) and review areas where spending has been more or less than expected. You can prepare an annual summary to compare actual spending with budgeted amounts. This type of summary may also be prepared every three or six months.
see, a little more than one-third of their total assets is made up of investment assets, a typical proportion for this stage in their lives. Experts recommend a ratio that is 50 percent or higher.

\[
\text{Investment assets-to-total assets ratio} = \frac{\text{investment assets}}{\text{total assets}}
\]

\[
= \frac{\text{RM109,000}}{\text{RM309,520}}
\]

\[
= 0.352
\]

\subsection*{Savings Ratio}

The savings ratio compares your ringgit saved to your after-tax income. For the Mr. Wong family, their savings from (Table 2.4) add up to RM6,474 (RM1,260 + RM4,000 + RM1214) and the after-tax income totals RM50,170 (RM66,000 - RM6,800 - RM3100 - RM720 + RM4260 - RM950). Thus, their saving ratio is 12.5 percent, an acceptable rate.

\[
\text{Savings ratio} = \frac{\text{annual savings}}{\text{after-tax income}}
\]

\[
= \frac{\text{RM6,474}}{\text{RM50,170}}
\]

\[
= 0.129
\]

\section*{4.3 Budgeting}

A budget, or spending plan, is necessary for successful financial planning. The common financial problems of overspending, lack of regular savings program and failing to ensure future financial security can be minimized through budgeting. The main purposes of a budget are to help you:

\begin{enumerate}
\item Live within your income
\item Spend your money wisely
\item Reach your financial goals
\item Prepare for financial emergencies
\item Develop wise financial management habits
\end{enumerate}

\subsection*{Step 1 Setting Financial Goals}

Future plans are an important dimension of your financial direction. Financial goals are plans for future activities that require you to plan spending, saving and investing. Financial goals should be realistic, have a definite time frame and imply the type of action to be taken.

\subsection*{Step 2 Estimating Income}

A common budgeting period is a month, since many payments such as rent or mortgage, utilities and credit cards are due each month. In determining available income, include only money that you are sure you will receive. Bonus, gifts or unexpected income should not be considered until they...


**ACTIVITIES**

1. What do you understand with the financial planning environment?
2. Describe the financial planning components and give an example?
3. What is net worth and how is it calculated? Give an example?
4. Differentiate between fixed and variable expenses?
5. How is the liquidity ratio calculated and what does it measure?
6. What are the process involves in budgeting?
UNIT 4

SEARCH FOR FINANCIAL INFORMATION AND THE EVALUATION OF CONVENTIONAL AND ONLINE SERVICES: THE CYBER USER

Unit objectives: At the end of this lesson, students will be able to:
1. Understand the conventional and Islamic financial services.
2. Searching for financial information from various sources including internet.

Content:
Topic 1: Conventional and Islamic Financial Services
Topic 2: Searching for financial informations
1. CONSUMER FINANCIAL SERVICES

a. Housing and Mortgage

Buying a house is a major step, so it deserves careful thought and planning. If you are buying a property under construction, you should check the background of the developer. You should ensure that the developer:

- Has a valid licence issued by the Ministry of Housing and Local Government which is still in force (not expired)
- Has a valid advertising and selling permit issued by respective local authority which is still in force

You have the right to enquire from the developer, information on licence and permit. You can also refer to the Ministry of Housing and Local Government for further clarification. A developer with a good track record reduces the risk of the project being abandoned.

1.1. Packages offered by financial institutions

- Term loan
  - A facility with regular predetermined monthly instalments.
  - Instalment is fixed for period of time, say 30 years
  - Instalment payment consists of the loan amount plus the interest

- Overdraft facility
  - A facility with credit line granted based on predetermined limit
  - No fixed monthly instalments as the interest is calculated based on daily outstanding balance
  - Allows flexibility to repay the loan anytime and freedom to re-use the money
  - Interest charged is generally higher than the term loan

- Term Loan and Overdraft combined
  - A facility that combines Term Loan and Overdraft. For example, 70% as term loan and 30% as Overdraft
  - Regular loan instalment on the term loan portion is required
  - Flexibility on the repayment of overdraft portion
CHAPTER 4 - SEARCH FOR FINANCIAL INFORMATION AND THE EVALUATION OF CONVENTIONAL AND CYBER SERVICES: THE CYBER USER

1.1 Margin of Financing
The amount of financing provided by a financial institution depends on the market value (for completed properties only) or purchase price of the house, whichever is lower. The margin of financing could go as high as 95% of the value of the house. It is assessed on factors such as:

- Type of property
- Location of property
- Age of the borrower
- Income of the borrower

1.2 Loan Tenure
The length of a loan can range anytime up to 30 years or until the borrower reaches age 65 (or any other age as determined by the financial institution), whichever is earlier.

1.4 Loan Features
Each financial institution packages its housing loans differently. You should examine all the features of a loan package and not just base your decision on any single feature. Pricing is just one consideration; other features like flexible repayment terms could balance the scale or even translate into greater loan savings. Financial institutions generally offer housing loan packages either in the form of a term loan, overdraft, or a combination of a term loan and overdraft.

1.5 Daily Rests Vs Monthly Rests
Financial institutions may charge you interest either on daily rests or monthly rests depending upon the product offered. In the case of daily rests, the loan interest is calculated on a daily basis, while in the case of monthly rests, interest is calculated once a month based on the previous month's balance. Under both types of loan, the principal sum immediately reduces every time a loan instalment is made.

1.6 Loan Disbursement
The financial institution disburses (pays out) the loan once it has received advice from its lawyer that the legal process has been completed and the loan documents are in order. At this time you will be informed of the date and amount of the first instalment you have to make.

1.7 Partial Prepayment of the Outstanding Loan
Many borrowers find it useful to shorten the loan tenure by making partial prepayments with surplus savings or annual bonus. Partial prepayment can be in any amount. However, some financial institutions may impose restrictions on the amount to be pre-paid while others may impose a penalty. It is extremely effective in reducing the interest charges you would have to pay if prepayments are made during the early years.
b. Automobile

1. Introduction

Buying a car under hire purchase is one of the most common ways to own a car. Before entering a hire purchase agreement for a car for private use, you need to understand what is involved. Understanding the steps in financing via hire purchase will help you save time and avoid uncertainty and cisfety. The information in the following pages will guide you through the basics, explain the technical terms and give you invaluable tips on hire purchase financing.

2. What is hire purchase (HP)?

Hire purchase is the hiring of goods with the option to purchase. You are the hirer and the company financing the goods (financier) is the owner. Ownership is transferred to the hirer after all the instalments have been paid. Meanwhile, you have possession and use of the goods.

3. Where to Get Financing?

You can apply for a HP facility from a finance company.

4. Goods under HP?

Various goods can be financed via HP, including the following:
- All consumer goods which are purchased for personal, family or household purposes
- Motor vehicles including invalid carriages, motorcycles, motor cars (including taxis and hire cars), goods vehicles and buses

However, this consumer guide specifically covers HP for motor vehicles for private use.

5. Governing Legislation - the Hire Purchase Act 1967

All HP transactions are governed by the Hire Purchase Act 1967 (HP Act). The forms and contents of HP agreements, the legal rights, duties, obligations of hirers and financiers are set out in the HP Act. The HP Act is under the purview of the Ministry of Domestic Trade and Consumer Affairs.

6. How Much Can I Afford?

Before you commit yourself to the purchase of a motor vehicle through HP, work out a budget to help you determine how much you can afford to pay in monthly instalments. As a guide, your monthly commitment to pay instalments on your house and motor vehicle should not exceed 33% of your monthly household income. You should also budget for additional payments for
insurance and road tax. It is also important to check out your duties and obligations including penalties before signing a HP agreement.

7. **Taking HP From A Finance Company:**

A HP agreement can be made directly with the finance company or through a motor vehicle dealer who can submit your application for a HP facility to a finance company.

- If you deal directly with a finance company, you will be given a written financial statement known as Second Schedule Part I. The statement will inform you of your financial obligations under the proposed HP Agreement.
- If you go through a motor vehicle dealer, you will receive Second Schedule Part I and an additional statement known as Second Schedule Part II which states the consent of the finance company to be a party to the agreement. This part is to be signed by the dealer and finance company after you have received Part I of the Second Schedule.
- You cannot be compelled to enter into any HP agreement or be made to pay for the cost of preparing and obtaining the Second Schedule, if you decide not to sign the HP agreement.
- The Second Schedule statement (Part I and II) is not binding on you if you have not entered into the HP agreement.
- If you agree to hire the motor vehicle upon receipt of the Second Schedule statement (Part I and II), there must be a HP agreement made between you and the finance company.

8. **The HP Agreement**

- A HP agreement must contain the following important information:
  - Description of motor vehicle
  - Computation of the total sum payable
  - Minimum Deposit
  - Term charges and Annual Percentage Rate for term charges
  - Late payment charges
  - Date on which hiring commences
  - Number of instalment repayments
  - Amount of each instalment repayment
  - Person to whom repayments are to be made, time and place of repayments
  - Address where the motor vehicle is to be kept
- You should ensure that the particulars in the agreement do not differ from the Second Schedule statement.
- The agreement will be stamped at a nominal rate, which will be borne by you.
- You do not need a lawyer to enter into a HP agreement.
9. **Minimum Deposit**
   The minimum deposit is 10% of the cash price of the motor vehicle. The finance company can request for a higher deposit.

10. **Term Charges (Interest Rate)**
    The maximum term charges that a finance company can charge is 10% flat per annum. This is a fixed percentage charge over the entire HP tenure. If you are charged 10% flat over the period of 5 years for a hire-purchase financing of RM50,000, the annual percentage rate (APR) that you pay is 17.3%.

11. **Late Payment Charges**
    The maximum late payment charges that a finance company can charge is 8% per annum calculated on a daily basis on overdue instalments.

12. **Guarantor**
    The finance company will conduct a credit assessment on the applicant of the HP facility. Based on the result of the credit assessment, the finance company may require a guarantor for the HP facility as additional security for the HP facility. The guarantor will be required to sign a letter of guarantee. The guarantor will receive a copy of the HP agreement and is liable for the HP facility. In the event the hirer defaults on payments, the guarantor is responsible for the unpaid portion of the HP facility and the interest due.

13. **Calculation of Term Charges**
    Term charges, or interest is calculated as follows:

    For example, if you have taken a financing of RM50,000 at 10% per annum for five years, interest on HP facility is calculated on the initial amount financed and not on the outstanding balance as in a normal loan.

14. **Calculation of HP Instalments**
    Using the earlier example,

    Monthly Installment
    
    \[
    \text{Amount financed} \times \text{Total interest on amount financed} \\
    \text{Repayment period (months)}
    \]
    
    \[
    \text{RM50,000} \times \text{RM25,000} \\
    60
    \]
    
    \[
    \text{RM5,000} \\
    60
    \]
    
    \[
    \text{RM1,250}
    \]
15. Insurance

- The finance company has the duty to insure the motor vehicle in your name for the first year only. In subsequent years, it is your responsibility, as the hirer, to renew the insurance policy.
- If you fail to renew or effect a new policy, the finance company can insure the motor vehicle and charge any costs incurred to you.
- You will be given a copy of the insurance receipt.
- In practice, the finance company normally requires a comprehensive insurance policy to be taken on the motor vehicle.

16. Early Settlement

You can repay in advance the balance due under the HP agreement. If you do so, you will be entitled to a rebate on the interest for early settlement. Using the earlier example, if your HP tenure is 5 years (60 months) and you have already paid installments for 4 years (48 months) and would like to settle the loan, you will be entitled to an interest rebate for the remaining repayment period of 12 months (i.e. 60 months - 48 months = 12 months). The calculation of rebate on the interest using the above example is as follows:

Total interest on the amount financed is RM25,000.

Calculation of rebate on interest:
Rebate on interest = \( \frac{RM25,000 \times (1 + \frac{2}{1 + \frac{3}{2 + \frac{4}{3 + \frac{5}{4 + \cdots}}}})}{1 + \frac{2}{1 + \frac{3}{2 + \frac{4}{3 + \frac{5}{4 + \cdots}}}}} \)

where:
- \( n \) = remaining repayment period (in months) i.e. 12 months
- \( k \) = original repayment period (in months) i.e. 60 months

Rebate on interest = \( \frac{RM25,000 \times (1 + \frac{2}{1 + \frac{3}{2 + \frac{4}{3 + \frac{5}{4 + \cdots}}}})}{1 + \frac{2}{1 + \frac{3}{2 + \frac{4}{3 + \frac{5}{4 + \cdots}}}}} \) - RM25,000 x \( \frac{2}{1 + \frac{3}{2 + \frac{4}{3 + \frac{5}{4 + \cdots}}}} \)

= RM1,046

C. Credit and Debit Card

1. What Is A Credit Card And How It Works?

A credit card is a payment instrument that enables you to make purchases of goods and payment for services instead of using cash. You can use the credit card at any merchant, locally or internationally, which displays the same credit card brand as that on your credit card.
CHAPTER 4 - SEARCH FOR FINANCIAL INFORMATION AND THE EVALUATION OF CONVENTIONAL AND ONLINE BANKING SERVICES: THE CREDIT CARD

When you use your credit card, the credit card issuer will pay the merchant on your behalf first and bill you later. Once you get your monthly statement, you are required to settle at least the minimum repayment amount by the due date. An interest-free period (usually 20 days) is granted by the credit card issuer where you do not have to pay any interest on the outstanding amount. The credit card issuer will impose finance charges (interest) on the outstanding amount if it is not paid by the due date. A credit card can also be used for cash advances at Automated Teller Machines (ATMs) and at respective credit card issuer counters. However, a cash advance fee may be charged for each cash advance transaction on top of the finance charge. There is also no interest-free period for cash advance. The finance charge is calculated from the cash advance date.

The credit card issuer will send you a monthly credit card statement with details of your purchases including cash advances (if any), the total outstanding balance, the minimum payment amount and the payment due date.

2. Applying For a Credit Card

You can apply for a credit card from institutions issuing credit cards, as long as you are 21 years old or above, earn an income of at least a minimum of RM18,000 per year and comply with any other requirements set by the credit card issuer. To support your application, you may be required to submit the following:

- A photocopy of your Identity Card (IC)
- Job appointment letter
- Latest income tax statement (Form J)
- Bank statements
- Previous months' pay slips

If you are self-employed, you may be required to submit your business registration details and other documentary proof of income, and be subject to other requirements such as placement of a fixed deposit.

3. Understanding the Charges Applicable for Credit Card

It is important for you to understand the various charges involved in the usage of credit cards. As long as you use your credit card wisely and settle payments on time, you can minimise unnecessary charges imposed on you. The following are the common charges that you may incur:

- Joining fee
  Credit card issuers sometimes impose a one-time joining fee for credit cards. The fee may vary depending on the credit card issuer.
CHAPTER 4  •  SEARCH FOR FINANCIAL INFORMATION AND THE EVALUATION OF CONVENTIONAL AND ONLINE SERVICES: THE CYBER USER

- **Annual fee**
  This is a flat fee which is payable annually once you accept the credit card. You will have to pay the fee even though you do not use the credit card. Annual fees may range from RM60 to RM90 for a classic card and RM130 to RM195 for a gold card.

- **Finance charges (Interest charges)**
  These are charges imposed on you by the credit card issuer on the outstanding balance which you have not settled with them after the payment due date. It is usually calculated on a daily rest basis. You are advised to ask your credit card issuer to explain the method used in calculating the finance charges, as this amount can be large if you do not make payments on time.

- **Cash advance fee**
  This is a fee charged for each cash advance transaction. This fee, which normally ranges from 3% to 5% of the total cash advanced, is in addition to the finance charges imposed on the amount of the advance given to you. The finance charge is calculated from the transaction date or when the amount is posted to your credit card account. There may be a limit on the amount of cash advance allowed for each customer.

- **Late payment charge**
  This is a charge imposed when you fail to pay at least the minimum monthly payment by the due date. If payment is made after the interest free period, you will be charged both the finance charges (the interest on your outstanding balance) and late payment charges for the minimum monthly repayment amount due.

4. **Tips On Shopping For Credit Cards**

With so many credit cards being offered, it is important for you to get the credit card that best suits your needs. Here are some tips for shopping for a credit card or evaluating the credit cards you already have:

- **Promotional gifts**
  The credit card issuers may offer you promotional gifts such as handphones, leather wallets, etc. to promote their credit cards. However, before you apply, it is important for you to understand the T&C related to the offer. Pay attention to the conditions set for the promotional gifts and the penalties for not complying with such conditions.

- **Teaser rates**
  In order to attract you, credit card issuers may temporarily offer lower fees and finance charges, or even waive them for a certain period. The promotional materials may highlight an attractive and low introductory interest rate in a large, easy-to-read font size, sometimes without expiration date. The interest rate in effect after the promotion period is
CHAPTER 4 - SEARCH FOR FINANCIAL INFORMATION AND THE EVALUATION OF CONVENTIONAL AND ONLINE SERVICES: THE CYBER USER

disclosed much less prominently, i.e. in a smaller font size and may only appear on the reverse side of the application or on the last page of a multi-page promotional material. You should understand the T&C for the promotion and be aware of when the promotion period expires as you may be charged the regular or substantially higher fees and charges after the promotion period ends.

Finance charges, fees and interest free period

Credit card business generates profits mainly from finance charges. You will be imposed finance charges if you do not settle your outstanding balance in full after the interest free period. However, for cash advance and balance transfer, you may be charged a fee as well as finance charges starting from the transaction date. Pay attention to the fees for cash advance and balance transfer transactions, the finance charge, and the interest free period offered by the credit card issuers.

a. Interest free period

Credit card issuers offer an interest free period, usually 20 days, from the posting or statement date up to the due date, except for cash advance and balance transfer. Therefore, shop for credit cards that offer longer interest free periods to settle your balances in full without incurring finance charges.

b. Fees on cash advance/balance transfer

Most credit card issuers impose a cash advance fee on top of finance charges when you use your credit card for cash advance or balance transfer transactions. The cash advance fee may vary between 3% to 5% of the amount. Thus, always consider applying for credit cards which have lower cash advance/balance transfer fees.

What is a Charge Card?

1. Introduction

A charge card is a payment card with a preset limit that can be used to make payments for goods and services at participating merchants either locally or internationally. It is a convenient payment instrument for shopping, dining, travelling, paying bills, etc. The usage of the charge card is similar to other payment cards such as credit and debit cards, i.e. you can use the charge card to make payments at merchants displaying the same charge card brand name as that on your charge card.

In Malaysia, charge cards are issued based on conventional or Islamic principles. Examples of charge cards are American Express Card, Diners Club International Card and HSBC Amanah MasterCard.
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2. How It Works

When making purchases, the merchant must swipe or insert your charge card into a terminal, in order to get an authorisation from the charge card issuer. Most merchants would require you to sign on the payment slip as a proof of your purchase, which would be compared against the specimen signature at the back of your charge card. You may not be required to sign on the payment slip when making transactions at unattended point-of-sales terminals such as the self-service terminals at petrol pumps. For every purchase made, the charge card issuer will pay the merchant on your behalf and bill you later. The charge card issuer would send you a monthly statement giving you information on your charge card transactions such as details of your purchases, payment due date and penalty charges, if any.

3. Comparison between Charge Cards and Credit Cards

While both the charge card and credit card allow you to conduct payment transactions, there are differences between the two types of payment cards. The main difference between the charge cards and credit cards is on the amount that must be settled by the payment due date.

For a charge card, you must settle the outstanding balance in full by the payment due date and there will be no interest charged. However, you will be charged a late payment charge if you fail to settle your balance in full by the payment due date. The late payment charge is usually between 3.0% to 3.5% per month (or 36% to 42% per annum) of the outstanding balance.

For Islamic charge cards, instead of the conventional late payment charge between 3.0% to 3.5% per month, you will be charged with a compensation charge up to a certain maximum amount allowed, normally RM70 per month. Charge card issuers will usually cancel your charge card if you have defaulted on such repayments for a few months (period varies depending on the issuer’s internal policy).

As for credit cards, you may settle your outstanding balance in full by the due date, or pay the minimum monthly repayment, which is usually 5% of the total outstanding balance. Therefore, you may continue to pay the minimum repayment amount each month. While credit cards offer you a flexible way of paying your credit card debt, it can be a costly affair. Credit card issuers usually imposes a finance charge of about 18% per annum for the balances that are unpaid and a late payment charge is imposed if you fail to pay at least the minimum monthly repayment by the due date.
There are some payment cards, which have the combination of credit card and charge card facilities. The charge card facility will be activated once the transaction value exceeds the credit limit provided for the credit card facility. Such amount that is over the credit limit will be required to be settled in full as per the terms and conditions of the charge card facility.

4. Summary of Comparison between Credit and Charge Cards
Some of the major features of credit and charge cards are shown below:

**Credit Card**
- **Credit Limit:** Maximum limit provided to cardholder
- **Minimum Payment:** Minimum payment of 5% on monthly outstanding balance
- **Joining Fee:** One time payment. Fee varies between card issuers or waived
- **Finance Charges:** Maximum 18% per annum on outstanding balance
- **Annual Fee:** Normally between RM60 to RM90 for classic card
- **Late Payment Charge:** Maximum 1% per month on outstanding balance or RM5, whichever is higher
- **Cash Advance Fee:** Normally 3% to 5% of total cash advance, in addition to finance charges

**Charge Card**
- **Credit Limit:** Usually, the spending limit set by the card issuer is not made known to the cardholder, unless requested by the cardholder. However, a transaction value that exceeds the limit may be allowed depending on certain conditions set by the charge card issuer
- **Minimum Payment:** Outstanding balance must be settled in full by due date
- **Joining Fee:** One time payment. Fee varies between card issuers or waived
- **Finance Charges:** Not applicable as outstanding balance must be settled in full
- **Annual Fee:** Normally between RM80 to RM160 for classic card
- **Late Payment Charge:** Normally 3.0% to 3.5% per month (or 36% to 42% per annum) on outstanding balance or fixed minimum amount whichever is higher. Normally, Islamic charge cards have a fixed maximum amount of RM70 per month
- **Cash Advance Fee:** Normally 3% to 4% depending on the card issuer. Some card issuers do not provide cash advance facility. For Islamic charge cards, a fixed fee is normally charged up to RM1.5
2.1 ISLAMIC BANKING

The earliest form of Islamic banking activity may be traced back to September 1963 when Perbadanan Wang Simpanan Bakal-Bakal Haji (PWSBH) was set up. PWSBH was set up as an institution for Muslims to save for their Hajj (pilgrimage to Mecca) expenses. In 1969, PWSBH merged with Pejabat Urusan Haji to form Lembaga Urusan dan Tabung Haji (now known as Lembaga Tabung Haji).

The first Islamic bank was established in 1983. In 1993, commercial banks, merchant banks and finance companies were allowed to offer Islamic banking products and services under the Islamic Banking Scheme (IBS). These institutions however, are required to separate the funds and activities of Islamic banking transactions from that of the conventional banking business to ensure that there would not be any co-mingling of funds.

Islamic banking is a banking activity that is based on Syariah principles. It does not allow the paying and receiving of interest and promotes profit sharing in the conduct of banking business.

a. Syariah Principles in Islamic Banking

Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of Syariah, known as Fiqh al-Muamalat (Islamic rules on transactions). The basic principle of Islamic banking is the sharing of profit and loss and the prohibition of riba' (interest). Amongst the common Islamic concepts used in Islamic banking are profit sharing (Mudharabah), safekeeping (Wadiah), joint venture (Musyarakah), cost plus (Murabahah) and leasing (Ijarah).

b. Syariah Advisory Council/Consultant

Islamic banks and banking institutions that offer Islamic banking products and services (IBS banks) are required to establish Syariah advisory committees/consultants to advise them and to ensure that the operations and activities of the
bank comply with Syariah principles. In addition, the National Syariah Advisory Council set up at Bank Negara Malaysia (BNM) advises BNM on the Syariah aspects of the operations of these institutions, as well as on their products and services.

c. Syariah Concepts in Islamic Banking

Wadiah (Safekeeping)
In Wadiah, a bank is deemed as a keeper and trustee of funds. A person deposits funds in the bank and the bank guarantees refund of the whole amount of the deposit, or any part of the outstanding amount, when the depositor demands for it. The depositor, at the bank’s discretion, may be rewarded with ‘hibah’ (gift) as a form of appreciation for the use of funds by the bank.

Mudharabah (Profit Sharing)
Mudharabah is an arrangement or agreement between a capital provider and an entrepreneur, whereby the entrepreneur can mobilise funds for its business activity. Any profits made will be shared between the capital provider and the entrepreneur according to an agreed ratio while losses are borne solely by the capital provider.

Musyarakah (Joint Venture)
This concept is normally applied for business partnerships or joint ventures. The profits made are shared on an agreed ratio while losses incurred, will be divided based on the equity participation ratio.

Murabahah (Cost Plus)
The selling of goods at a price, which includes a profit margin agreed by both parties. The purchase and selling price, other costs and the profit margin must be clearly stated at the time of the sales agreement.

Ba‘il Bithaman Ajil (Deferred Payment Sale)
The selling of goods on a deferred payment basis at a price, which includes a profit margin agreed by both parties.

Wakalah (Agency)
When a person appoints a representative to undertake transactions on his/her behalf.

Qarzul Hassan (Benevolent Loan)
A loan extended on a goodwill basis and the borrower is only required to repay the amount borrowed. However, the borrower may, at his discretion, pay extra (without promising it) as a token of appreciation.

Ijarah Thumma Al Ba‘il (Hire Purchase)
There are two contracts involved in this concept. The first contract, ijarah contract (leasing/renting) and the second contract, Ba‘il contract (purchase) are undertaken one after the other. For example, in a car financing facility, a customer enters into the first contract and leases the car from the owner (bank) at an agreed rental
over a specific period. When the leasing period expires, the second contract comes into effect, which enables the customer to purchase the car at an agreed price.

_Bai’ al-Inah (Sell and Buy Back Agreement)_
The financier sells an asset to the customer on a deferred payment and then the asset is immediately repurchased by the financier for cash at a discount.

_Hibah (Gift)_
A token given voluntarily in return for loan given or benefit obtained.

2.2. Islamic Schemes for Deposits and Consumer Loans

The main function of the bank is to provide loan dan making profits. Like any other bank, an Islamic bank will acquire funds through deposits from the public and use them to make profit. However, banks involve in Islamic banking practices need to separate the funds received under the interest-free banking system from the funds received under the national scheme.

a. Deposit schemes

i. _Al-wadiah_
In this type of scheme, the bank gives assurance to return to the depositors their investments via a guarantee called Yad Dhammanah when they require the money back. The scheme allowed the bank to apply the money deposited for its transactions but the sharing of profits with the depositors is at the discretion of the bank.

ii. _Al-Mudharabah_
The Al-Mudharabah is basically an investment account with carrying period of investment. In this arrangement, the depositors or investor is called the Rabbu’ or and the bank or entrepreneur the Mudharib. The investor would allow the entrepreneur to use the money deposited with it and in return the entrepreneur would agree to share a pre-determined portion of the profits earned with the investor. The investors, not the bank, would absorb any loss.

b. Loan schemes for businesses and individuals

i. _Al-Bai Bilarmon Aqil or Deferred Instalment Sale_
In this arrangement, the bank would acquire the customer-desired assets (capital assets) from the supplier or the manufacturer and then sell them to the interested business. In lieu of charging interest of the amount used in acquiring the assets, the bank makes a profit by marking up the sale price and selling the assets to the individual. The individual then could settle the debt by instalments over an agreed period of time. The mechanics of this scheme is similar to the commercial hire purchase scheme, and capital allowance
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would be allowed if the money used in the acquisition of assets falls as qualifying capital expenditure.

ii. Al-Murabahah or Deferred Lump Sum
This type of scheme is used for trade financing (trading stocks) is normally of a shorter duration of less than 3 months. Basically, the bank would purchase the trading stocks, mark-up the price for an appropriate amount and then sell them to the interested business. The repayment is made in the lump sum on the agreed payment date. The cost incurred by the business is reflected in the income statement as the cost of goods, which is deducted from the revenue to derive the gross profits.

iii. Al-Musyarakah or Partnership
This scheme is similar to the partnership arrangement. Essentially, the bank and the participating business or individual would team-up and contribute the capital to the venture in agreed proportion of their capital contribution. Although both parties have the rights in the management of the venture, either party may waive the right. For the tax purposes in the tax code on partnership would apply.

iv. Al-Ijara or Lease Contract
The Al-Ijara is basically a lease contract arrangement following the Shariah. Islamic laws demands that the lease rental to be in proportion to the enjoyment or application of the assets. Furthermore, the lease arrangement should not have any condition attached to it. The deduction rules under Sec. 33 and 39 of the tax code would apply to any Al-Ijara transaction.
3.1 Internet Banking

Internet Banking allows the individual to manage your finances from home, work or from just about anywhere in the world. Currently, only banking institutions licensed under the Banking and Financial Institutions Act 1989 and the Islamic Banking Act 1983 are allowed to offer Internet Banking services in Malaysia. A list of banking institutions that were granted approval by Bank Negara Malaysia are eligible to offer the Internet banking services.

Internet Banking provides you with a fast and convenient way to undertake various banking transactions from the comfort of your home, office or wherever you may be, during and after banking hours. Most banking institutions offer the service 24 hours a day, 7 days a week. You avoid travelling time and the need to wait in queues to access banking services or to pay bills.

Internet Banking does not require special software or access to a private network, but is conducted through the Internet. If you have a computer with Internet access, a modem and telephone line, an Internet browser and have registered for an Internet Banking service with your banking institution, then you can conduct Internet Banking from virtually anywhere in the world. It is also recommended that you install a personal firewall and regularly update your virus protection software.

You can apply for Internet Banking facilities if you have an account with a banking institution that offers Internet Banking services. Details on the application procedures are available on the banking institutions' websites.

With Internet Banking facilities, you will be able to perform a variety of banking transactions online. Depending on the banking institution, the main services offered through Internet Banking allows you to:

- Check your balances and statements online
- Submit applications for new accounts, credit cards or loans online
- Place fixed deposits
- Transfer funds between accounts (own and third party)
- Pay bills, credit cards, loans and insurance premiums
- Create, change and cancel standing orders
- Request for cheque books and statements
- Check the status of your cheques
- Request for stop cheque payments
- Apply for Bank Drafts and Telegraphic Transfers
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Some additional services offered include interest rates calculator as well as foreign currency converters. Please check with your banking institution to obtain the full list of services offered and the additional features and channels that are available.

Prior to signing up for the service, you are advised to read and understand the terms and conditions of the service. The terms and conditions should provide:

- Information on the duties of the banking institution and customers
- Information on who will be liable for unauthorised or fraudulent transactions
- Mode by which you will be notified of changes in terms and conditions
- Information relating to how you can lodge a complaint, and how a complaint may be investigated and resolved

You should also discuss with your banking institution the risks involved in using Internet Banking services and to understand fully your rights and responsibilities.

Is Internet Banking Safe?

As in any other system, there is a risk involved in Internet Banking. However, any potential risk could be minimised with banking institutions’ continuous check on the security of the system and the care taken by you when using Internet Banking services.

a. Actions taken by Banking Institutions to ensure security

Before starting out on Internet Banking, banking institutions have spent a lot of time and effort to ensure that their Internet Banking set up is safe for consumers. In addition, banking institutions offering Internet Banking are also required to comply with the minimum guidelines issued by Bank Negara Malaysia. Amongst the safety measures taken by the banking institutions are:

- Regular tests of the system to ensure its reliability
- Provision of Internet security arrangements to ensure a secure infrastructure
- Usage of a number of security technologies such as encryption, firewalls, automatic log-off and monitoring tools
- Installation of a system to detect and disable attacks from hackers
- Undertake a periodic review every 6 months to assess possible risks and detect possible weaknesses in the banking institution’s risk management system. You can find information about the banking institution’s security practices on its website.

b. Actions you should take to ensure security

You too have a role in ensuring the safety of Internet Banking transactions. Some of the recommended actions that you, as a bank customer, should practise are:
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1. Do not reveal your Login ID and Password or PIN
   - Keep your Login ID and password or PIN confidential
   - Memorise it and do not write it down anywhere
   - Change your password or PIN regularly and avoid using easy-to-guess passwords such as names or birthdays. Ideally, your password should be a combination of characters (uppercase and lowercase) and numbers
   - Check your transaction history details and statements regularly to make sure that there are no unauthorised transactions on your accounts or additions to the list of registered payees
   - If you suspect any unauthorised use of your accounts or that someone else may know your password or PIN, you should change your password or PIN immediately and notify your banking institution
   - Do not store your Login ID and Password or PIN on the computer

2. Check for the right and secure website
   - Before doing any online transactions or sending personal information, make sure that you are in the correct website
   - You should also ensure that you are in a “secure” website by checking the Universal Resource Locators (URLs) to ensure that it begins with “https” and look for a display of a closed padlock symbol on the status bar of your browser
   - Always enter the URL of the website directly into the web browser. You should avoid being redirected to the website, or hyperlink to it from a website that may not be as secure

3. Protect your personal computer from hackers, viruses and malicious programs
   - Install a personal firewall and a reputable anti-virus program to protect your personal computer from virus attacks or malicious programs such as “Trojan Horse”
   - You should also ensure that the anti-virus program is up-to-date and runs at all times
   - Always keep your operating system and web browser up-to-date with the latest security patches, in order to protect against weaknesses or vulnerabilities

4. Be careful when downloading software
   - When you receive a program or an attachment, you should always check it with an updated anti-virus program to ensure that it does not contain any virus that could attack your personal computer
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- Never download any file or software from sites or sources, which you are not familiar with or click on hyperlinks sent to you by strangers. Opening such a file could expose your system to a computer virus that could hijack your personal information, including your password or PIN

5. Do not leave your computer unattended when logged in

- You should log off from the Internet Banking site when you leave your computer unattended, even if it is for a short while

6. Always remember to log-off

- It is important that you log-off when you have completed your banking transactions
- You should clear the memory cache and transaction history after logging out from the website to remove your account information. This would avoid incidents of the stored information being retrieved by unwanted parties

7. Other measures

- You should not send any personal information particularly your password or PIN via ordinary e-mail
- Do not have other browser windows open while you are banking online
- You should avoid using shared or public personal computers to conduct your Internet Banking transactions
- You are also advised to disable the “file and printer sharing” feature on your operating system
- If you have a security concern about your online accounts, contact your banking institution to discuss the issue and remedies

Privacy of Your Personal Information

Both banking institutions and you have a role in ensuring privacy. Protection of your personal and financial information is an extremely important matter when banking via the Internet. Bank Negara Malaysia considers the privacy of consumer personal information to be an important element of public trust and confidence in the Malaysian Banking System.

3. Responsibilities of banking institutions in ensuring privacy

All banking institutions offering Internet Banking services have to adopt responsible privacy policies and information practices. Therefore, banking institutions are required to prompt you with a message to inform you that you will be leaving the banking institutions’ websites and hence you will not be protected by the privacy policies and security measures of the banking institutions when you hyperlink to third parties from their websites.
b. Your responsibilities in ensuring privacy

You are advised to read the privacy policy statement of the banking institutions posted at their websites prior to providing your personal information. By reviewing this policy, you will know the type of information banking institutions collect and maintain about you. Banking institutions may want to share information about you with a related entity to market specific products that meet your needs and interests. If you do not want your banking institution to share your personal information with others without your permission.

3.2 Telephone banking: Interaction and SMS

Telephone banking is the high technology banking systems that connect you with your bank. You can enjoy the convenience of telephone banking anywhere, anytime. You need to register before being allowed to use the system. With the system, you can:

- Obtain your account balance(s) and account transaction history;
- Transfer funds between accounts;
- Report lost or stolen ATM cards;
- Obtain interest rates on products;
- Obtain foreign exchange rates;
- Obtain joint account history;
- Transfer funds to and from joint accounts;
- Access e-Payment Services to pay your bills; and
- Access MasterCard® and Qtrade Investor.

Using Telephone Banking, the customer needs to follow these 5 easy steps:

1. Call the bank, say “Telephone Banking” or dial extension number given by the automatic teller machine system or follow the recorded instructions.

2. Select your language of choice.

3. Enter your portfolio number.
   (The portfolio number used to be called “Member Number” or “Account Number”).

4. Enter your Personal Identification Number (PIN).
   The first time you call, you will be asked to choose a personalized PIN between 4 and 12 digits long. You can obtain your temporary PIN by calling the Service Centre or visiting your branch.

5. Listen and follow the prompts.

* Note: Telephone banking requires a touch-tone telephone.

Gilman, L. J., and Joehnk, M.D (2002). Personal Financial Planning:


www.bankinginfo.com.my
www.maybank2u.com.my

ACTIVITIES

1. What are financial products offered by financial institutions?
2. What are the Syariah principles in Islamic banking?
3. Explain the tips and suggestion on shopping for credit cards?
UNIT 5

COST AND BENEFITS TRANSACTION USING CREDIT

Unit objectives: At the end of this lesson, students will be able to:
1. Define consumer credit and analyze its advantages and disadvantages
2. Evaluate credit cards alternatives, including terms and costs
3. Assess credit capacity and build credit rating
4. Understand the various types of consumer credit in market

Content:
Topic 1: Cash vs. Credit
Topic 2: The Cost of Credit
Topic 3: General Rules of Credit Capacity (Debt Limits)
Topic 4: Credit Choices in Market
CHAPTER 3 - COST AND BENEFITS: TRANSACTION USING CREDIT

TOPIC 1
CASH VS. CREDIT

1.1 Introduction

Credit is an arrangement to receive goods or services now and pay for them in the future. Consumer credit refers to the use of credit for personal needs (except a home mortgage) by individuals and families, in contrast to credit used for business purposes. Most consumers have three alternatives in financing current purchases: They can draw on their savings, use their present earnings or borrow against their expected future income. Each of these alternatives has trade-offs. If you continually deplete your savings, little will be left for emergencies or retirement income. If you spend your current income on luxuries instead of necessities, you will be suffering. And if you pledge your future income to make credit purchases, you will have little or no spendable income in the future. Consumer credit is based on a trust in people's ability and willingness to pay bills when due. It works because people by and large are honest and responsible.

1.2 Cash or Credit

Any time you receive cash, goods or services now and arrange to pay for them later, you are buying on credit. If you use credit for personal needs other than home purchases, you’re using consumer credit. You can borrow from a friend or family member, a firm with which you do business or a financial institution (bank, credit union or insurance company). The most common types of consumer credit are credit card accounts, automobile loans, home equity loans and student loans. In each case, the lender is letting you have the use of the money now and is expecting you to repay it with interest, often over a specified time period.

Before you decide to borrow funds to make a purchase, whether through a credit card or a consumer loan, be careful to evaluate the short-term and long-term effects on your monthly cash flow. The future payments, including the original purchase price and interest charges, will reduce your net monthly cash flow and thus your ability to make contributions to savings. Interest charges will increase the total cost of the product you are purchasing. Therefore, in deciding whether to pay cash, take money from savings, or borrow the funds to make a purchase, be sure to consider the tradeoffs between the cost of borrowing and the lost earnings on savings.
Many types of consumer credit, most credit cards for example require that you pay interest rates that are much higher than what you earn on your savings. If you have to pay 18 percent interest on your credit card and you're only earning 5 percent on savings account, you'll be better off taking the money from savings rather than borrowing the funds for the purchase. Sometimes, though, consumer loan rates are lower than rate you're earning on your invested ringgit, making it preferable to borrow.

For example, suppose you plan to purchase a car for RM10,000. You have sufficient savings to make this purchase and are earning 5 percent per year interest on your savings account. If the car dealer is offering 3 percent interest on a car loan, you may be better taking out the loan, making payments from the saving accounts and earning the 2 percent difference.

1.3 The Advantages and Disadvantages of Credit

Some of the reasons why people use credit are summarized in the following list:

1. **Convenience** - Using credit and credit cards in particular simplifies the process of making many purchases. It provides a record of purchases and it can be used as leverage if disputes arise over purchases.

2. **Emergencies** - Consumers may use credit to pay for such unexpected expenses as emergency medical services or automobile repairs.

3. **Identification** - For many activities such as reserving a hotel room or renting an automobile, consumers may need to show a bank credit card to verify identities.

4. **To make reservation** - Most hotels and car rental agencies require some form of deposit to hold a reservation.

5. **To consume expensive products sooner** - Buying “big tickets” items such as a computer or automobile on credit allows the consumer to enjoy immediate use of the product.

6. **To enjoy good life** - An increasing number of people are using credit as a way to raise their current lifestyle in anticipation of higher incomes in the future. As a result, they can enjoy a rate of consumption today that is higher than their current income seemingly would permit.

7. **To take advantage of free credit** - Merchants sometimes offer “free” credit for a period of time as an inducement to buy. Known as “same as cash” plans, these programs allow the buyer to pay later without incurring finance charges. Typically the free credit lasts for a defined time period such as 90 days or six months.
CHAPTER 5 - COST AND BENEFITS TRANSACTION USING CREDIT

8. To consolidate debt - Many consumers who have difficulty making credit repayments resort to a debt-consolidation loan, through which the debtor exchanges several smaller debts with varying due dates and interest rates for a single large loan. Even when the debt-consolidation loan has a higher interest rate, the new payment is usually smaller than the combined payments for the other debts because the term of the new loan is longer than the terms of the old ones.

9. For protection against rip-offs and frauds - Mail-order and telephone purchases made on a credit card can be contested with the credit card issuer under the guidelines of the Fair Credit Billing Act.

10. To obtain an education - The rising cost of higher education has forced many students to borrow to pay their tuition. This application may be one of the better uses of credit, as the borrower is investing in himself or herself to raise the quality of life and or income in the future.

1.4 The Downside of Credit Usage

1. Financial statement impact

   The more you borrow, relative to your total wealth, the worse your liquidity and debts ratios will look. This means that you may limit your financial flexibility if you take on too much credit. You may also expose your household to too much risk, since you're committing your family to greater fixed expenses; if you or your spouse were laid off, you might not be able to meet these expenses.

2. Increased costs

   When you use consumer credit as a means of spreading the cost of a purchase over time, you nearly always pay more for your purchase in the long run because of the financing costs of the loan. Credit is never free. Lenders charge interest for the use of their funds and commonly also charge additional fees and penalties.

3. Risk of Overspending

   The availability of the consumer credit increases the risk that you will overspend. Without credit cards, if you don't have enough cash in your pocket or your current account, you can't make the purchase. If you have a credit card, though, not only can you make the purchase but you also can more easily find a good reason to do so. Instead of buying one sweater at the great sale price, why not buy one in each of the three colors?
4. Higher Insurance Premiums

For the last several years, insurance companies have been using consumer credit history as a factor in pricing individual auto and homeowner's insurance policies. Thus, if you have a lot of outstanding debt or a history of making late credit card payments, you may be paying a higher insurance premium than others with better credit.
CHAPTER 5 – COST AND BENEFITS TRANSACTION USING CREDIT

TOPIC 2
THE COST OF CREDIT

2.1 Finance Charge And Annual Percentage Rate (APR)

Credit costs vary. If you know the finance charge and the annual percentage rate (APR), you can compare credit prices from different sources. Under the Truth in Lending Law, the creditor must inform you, in writing before you sign any agreement, of the finance charge and the APR. The finance charge is the total ringgit amount you pay to use credit. It includes interest costs and sometimes other costs such as service charges, credit-related insurance premium; or appraisal fees. For example, borrowing RM100 for a year might cost you RM 0 in interest. If there is also a service charge of RM1, the finance charge will be RM111.

The annual percentage rate (APR) is the percentage cost (or relative cost) of credit on yearly basis. The APR is your key to comparing costs, regardless of the amount of credit or how much time you have to repay it. Suppose you borrow RM100 for one year and pay a finance charge of RM10. If you can keep the entire RM100 for the whole year and then pay it all back at once, you are paying an APR of 10 percent.

<table>
<thead>
<tr>
<th>Amount Borrowed</th>
<th>Month Number</th>
<th>Payment Made</th>
<th>Loan Balance</th>
</tr>
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<tbody>
<tr>
<td>RM100</td>
<td>1</td>
<td>RM100</td>
<td>RM100</td>
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<tr>
<td></td>
<td>2</td>
<td>0</td>
<td>100</td>
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<td>12</td>
<td>100</td>
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<td></td>
<td>(plus RM10 Interest)</td>
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<td></td>
</tr>
</tbody>
</table>

On average, you had full use of RM100 throughout the year. To calculate the average use, add the loan balance during the first and last month, then divide by 2.

\[
\text{Average balance} = \frac{\text{RM100} + \text{RM100}}{2} = \text{RM100}
\]
But if you repay the RM100 and the finance charge (a total of RM110) in 12 equal monthly payments, you don’t get use of the RM100 for the whole year. In fact, as shown next, you get use of less and less of that RM100 each month. In this case, the RM10 charge for credit amounts to an APR of 18.5 percent.

<table>
<thead>
<tr>
<th>Amount Borrowed</th>
<th>Month Number</th>
<th>Payment Made</th>
<th>Loan Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>RM100</td>
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<td>RM0</td>
<td>RM100</td>
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<tr>
<td></td>
<td>2</td>
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<td>5</td>
<td>0.33</td>
<td>66.68</td>
</tr>
<tr>
<td></td>
<td>6</td>
<td>0.33</td>
<td>58.35</td>
</tr>
<tr>
<td></td>
<td>7</td>
<td>0.33</td>
<td>50.02</td>
</tr>
<tr>
<td></td>
<td>8</td>
<td>0.33</td>
<td>41.69</td>
</tr>
<tr>
<td></td>
<td>9</td>
<td>0.33</td>
<td>33.36</td>
</tr>
<tr>
<td></td>
<td>10</td>
<td>0.33</td>
<td>25.03</td>
</tr>
<tr>
<td></td>
<td>11</td>
<td>0.33</td>
<td>16.70</td>
</tr>
<tr>
<td></td>
<td>12</td>
<td>0.33</td>
<td>8.37</td>
</tr>
</tbody>
</table>

There are two ways to calculate the APR: using an APR formula and using the APR tables. The APR tables are more precise than the formula. The formula, given below, only approximates the APR:

$$r = \frac{2 \times n \times l}{P (N + 1)}$$

Where:
- $r$ = approximate APR
- $n$ = number of payment periods in one year (12= payments monthly, $52=$ weekly)
- $l$ = total dollar cost of credit
- $P$ = principal or net amount of loan
- $N$ = total number of payments scheduled to pay off the loan

Let us compare the APR when the RM100 loan is paid off in one lump sum at the end of the end year and when the same loan is paid off in 12 equal monthly payments. Using the formula, the APR for the lump-sum loan is

$$r = \frac{2 \times 1 \times RM10}{RM100 \times (1+1)} = \frac{RM20}{RM100 \times (2)} = \frac{RM20}{RM200} = 0.10 \text{ or } 10 \text{ percent}$$

Using the formula, the APR for the monthly payment loan is

$$r = \frac{2 \times 12 \times RM10}{RM100 \times (12+1)} = \frac{RM240}{RM100 \times (13)} = \frac{RM240}{RM1300} = 0.1846 \text{ or } 18.46 \text{ percent}$$
2.2 Calculating the Cost Of Credit

The two most common methods of calculating interest are compound and simple interest formulas. Perhaps the most basic method is the simple interest calculation. Simple interest on declining balance, add-on interest, bank discount and compound interest are variations of simple interest.

1. Simple Interest

Simple interest is the interest computed on principal only and without compounding; it is the ringgit cost of borrowing money. This cost is based on three elements: the amount borrowed (principal), the rate of interest and the amount of time for which the principal is borrowed.

\[ \text{Interest} = \text{Principal} \times \text{Rate of interest and Time} \quad \text{or} \quad I = P \times r \times T \]

Example 1: Suppose you've persuaded a relative to lend you RM1,030 to purchase a desktop computer. Your relative agrees to charge only 5 percent interest, and you agreed to repay the loan at the end of one year. Using the simple interest formula, the interest will be 5 percent of RM1,000 for one year or RM50.

\[ I = \text{RM}1,000 \times 0.05 \times 1 \]

\[ \frac{2 \times \text{RM}1 \times \text{RM}50}{\text{RM}1,000 (1 + 1)} = 0.05 \times 5 \text{ percent} \]

2. Simple Interest on the Declining Balance

When more than one payment is made on a simple interest loan, the method of computing interest is known as the declining balance method. Since you pay interest only on the amount of the original principal that you have not yet repaid, the more frequent the payments, the lower the interest you will pay. Most credit unions use this method for their loans.

Example 2: Using simple interest on the declining balance to compute interest charges, the interest on a 5 percent, RM1,000 loan repaid in two payments, one at the end of the first half-year and another at the end of the second half-year, would be RM37.50, as follows:

**First payment:**
\[ I = P \times r \times T \]
\[ = \text{RM}1,000 \times 0.05 \times \frac{1}{2} \]
\[ = \text{RM}25 \text{ interest plus RM500, or RM525} \]
CHAPTER 5 - COST AND BENEFITS TRANSACTION USING CREDIT

Second payment:
I = P \times r \times T
= RM500 \times 0.05 \times \frac{1}{2}
= RM12.50 interest plus the remaining balance of RM500, or RM512.50

Total payment on the loan = RM525 \times RM512.50 = RM1,037.50

Using APR formula:
\[
\frac{2 \times n \times I}{P(n + 1)} = \frac{2 \times 2 \times RM37.50}{RM1,000(2+1)} = RM150 \approx 0.05 \text{ or } 5\text{ percent}
\]

Note that using simple interest under the declining balance method, the stated rate, 5 percent, is also the annual percentage rate.

3. **Add-On Interest**

Interest is calculated on the full amount of the original principal. The interest amount is immediately added to the original principal and payments are determined by dividing principal plus interest by the number of payments to be made. When only one payment is required, this method produces the same APR as the simple interest method. However, when two or more payments are to be made, the add-on method results in an effective rate of interest that is higher than the stated rate.

**Example 3**: Consider again the two-payments loan in example 2. Using the add-on method, interest of RM50 (5 percent of RM1,000 for one year) is added to the RM1,000 borrowed, giving RM1,050 to be repaid – half (or RM525) at the end of the first half-year and the other half at the end of the second half – year. Even though your relative’s stated interest rate is 5 percent, the real interest rate is:

\[
\frac{2 \times n \times I}{P(n + 1)} = \frac{2 \times 2 \times RM50}{RM1,000(2+1)} = RM200 \approx 0.006 \text{ or } 0.6\text{ percent}
\]

Note that using the add-on interest method means that no matter how many payments you are to make, the interest will always be RM50. As the number of payment increases, you have use of less and less credit over the year.

4. **Adjusted Balance Method**

The assessment of finance charges after payments made during the billing period have been subtracted.

5. **Previous Balance Method**

A method of computing finance charges that gives no credit for payments made during the billing period.
6. **Average Daily Balance Method**

A method of computing finance charges that uses a weighted average of the account balance throughout the current billing period.

Here is how some different methods of calculating finance charges affect the cost of credit:

<table>
<thead>
<tr>
<th></th>
<th>Average Daily Balance (Including new purchases)</th>
<th>Average Daily Balance (excluding new purchases)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly rate</td>
<td>1.5%</td>
<td>1.5%</td>
</tr>
<tr>
<td>APR</td>
<td>18%</td>
<td>18%</td>
</tr>
<tr>
<td>Previous balance</td>
<td>RM400</td>
<td>RM400</td>
</tr>
<tr>
<td>New purchases</td>
<td>RM500 on the 18th day</td>
<td>RM500 on the 18th day</td>
</tr>
<tr>
<td>Payments</td>
<td>RM300 on the 15th day (new balance=RM100)</td>
<td>RM300 on the 15th day (new balance=RM100)</td>
</tr>
<tr>
<td>Average daily balance</td>
<td>RM270*</td>
<td>RM250**</td>
</tr>
<tr>
<td>Finance charge</td>
<td>RM4.05 (1.5% x RM270)</td>
<td>RM3.75 (1.5% x RM270)</td>
</tr>
</tbody>
</table>

* Average daily balance (including new purchases)
  \[
  (RM400 \times 15 \text{ days}) + (RM100 \times 3 \text{ days}) + (RM150 \times 12 \text{ days}) + 30 \text{ days} = \\
  (RM6,000 + RM300 + RM1800) + 30 = RM8,100 + 30 \text{ days} = RM270
  \]

** Average daily balance (excluding new purchases)
  \[
  (RM400 \times 15 \text{ days}) + (RM100 \times 15 \text{ days}) + 30 \text{ days} = \\
  (RM6,000 + RM1500) + 30 = RM7,500 + 30 \text{ days} = RM250
  \]

<table>
<thead>
<tr>
<th></th>
<th>Adjusted Balance</th>
<th>Previous Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly rate</td>
<td>1.5%</td>
<td>1.5%</td>
</tr>
<tr>
<td>APR</td>
<td>18%</td>
<td>18%</td>
</tr>
<tr>
<td>Previous balance</td>
<td>RM400</td>
<td>RM400</td>
</tr>
<tr>
<td>Payments</td>
<td>RM300</td>
<td>RM300</td>
</tr>
<tr>
<td>Average daily balance</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Finance charge</td>
<td>RM1.50 (1.5% x RM100)</td>
<td>RM6.00 (1.5% x RM400)</td>
</tr>
</tbody>
</table>

7. **The Rule of 78s**

A mathematical formula to determine how much interest has been paid at any point in a loan term. This formula dictates that you pay more interest at the beginning of a loan, when you have the use of more of the money, and pay less and interest as the debt is reduced. Because all of the payments are the same in size, the part going to pay back the amount borrowed increases as the part representing interest decreases.
CHAPTER 5 - COST AND BENEFITS TRANSACTION USING CREDIT

TOPIC 3
GENERAL RULES OF CREDIT CAPACITY

3.1 Introduction

Credit card issuers set a credit limit for each of their card holders. You should set your own debt limit which is the overall maximum you believe you should owe based on your ability to meet the repayment obligations. When considering a new loan, many people simply look at the monthly payment required. This view is very short-sighted, however as it is easy to get a low monthly payment simply by lengthening the time period over which the loan will be repaid. There are three useful ways to determine your debt limits.

1. Debt Payments-to-Disposable Income Method

Disposable income is the amount of your income remaining after taxes and withholding for such purposes as insurance and union dues. Table 5.1 shows some monthly debt-payment limits expressed as a percentage of disposable personal income. As the table indicates, with monthly payments representing 16 to 20 percent of monthly disposable personal income, a borrower is seriously over-indebted and fully extended, taking on additional debt would be unwise. This means that someone in with an average income and an expensive car loan might not be able to afford to carry any credit card balances that revolve from month to month.

Once you have decided the percentage that is appropriate for you, you can compare it to your debt payments-to-disposable income ratio as discussed in Unit 3. In that unit we calculated a debt payments-to-disposable income ratio for Mr. Wong of 9.32 percent. As indicated by Table 5.1, Mr. Wong could take on new debt but only cautiously.

2. Ratio of Debt-to-Equity Method

Another method of determining your debt limit involves calculating the ratio of your consumer debt to your assets. In Unit 3, we performed such an analysis for the Mr. Wong’s family when we calculated their asset-to-debt ratio. The ratio of debt-to-equity is similar except that it uses the equity in a person’s assets (the amount by which the value of those assets exceeds debts), excluding the value of a primary residence and the first mortgage on that home. This ratio recognizes that mortgage debt does not get people into trouble.
CHAPTER 5 – COST AND BENEFITS TRANSACTION USING CREDIT

From Table in Unit 3, we see that the Mr. Wong family has assets of RM133,920 (RM4,420-monetary assets; RM20,500-tangible assets less the value of their home; and RM109,000-investment assets). Their debts (excluding their home mortgage) total RM9,365 (RM120+RM1,545+RM7,700). With RM9,365 in debts and RM133,920 in assets, the Mr. Wong have equity of RM124,555 (RM133,920-RM9,365) or a debt-to-equity ratio of 0.08 (RM9,365+RM124,555).

The ratio of debt-to-equity method provides a quick idea of one’s financial solvency. The larger ratio, the riskier the likelihood of repayment. A ratio in excess of 0.33 is considered high.

2. Continuous-Debt-Method

Another approach for determining when debts are too large is the continuous-debt-method. If you are unable to get completely out of debt every four years (except for a mortgage loan), you probably lean on debt too heavily. You could be developing a credit lifestyles, in which you will never eliminate debt and continuously pay out substantial amounts of income for finance charges likely RM1,000 or more per year.

Table 5.1: Debt-Payment Limits as a Percentage of Disposable Personal Income*

<table>
<thead>
<tr>
<th>Percent</th>
<th>Current Debt Situation</th>
<th>Take on Additional Debt?</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>No debt at all</td>
<td>Taking on some consumer debt is fine</td>
</tr>
<tr>
<td>10 or less</td>
<td>Little debt</td>
<td>More debt could be undertaken cautiously</td>
</tr>
<tr>
<td>11 to 15</td>
<td>Sale debt limit but fully extended financially</td>
<td>Should not acquire more debt, and a debt consolidation loan from a credit union may be a good option</td>
</tr>
<tr>
<td>16 to 20</td>
<td>Seriously over-indebted</td>
<td>Absolutely positively should not take on more debt</td>
</tr>
<tr>
<td>21 to 25</td>
<td>Precariously over-indebted</td>
<td>Contact a non-profit credit counseling company</td>
</tr>
<tr>
<td>26 to 30</td>
<td>Excessively over-indebted</td>
<td>Contact a bankruptcy attorney</td>
</tr>
<tr>
<td>31 +</td>
<td>Dangerously over-indebted</td>
<td>Contact a bankruptcy attorney</td>
</tr>
</tbody>
</table>

* Excluding home mortgage loan repayments and convenience credit card purchases to be repaid in full when the bill arrives.
CHAPTER 5 - COST AND BENEFITS TRANSACTION USING CREDIT

TOPIC 4
CREDIT CHOICES IN MARKET

4.1 Types of Credit

Two basic types of consumer credit exist: closed-end credit and open-end credit. With closed-end credit, you pay back one-time loans in a specified period of time and in payments of equal amounts. With open-end credit, loans are made on a continuous basis and you are billed periodically for at least partial payment.

a) Close-End Credit

Close-end credit used for a specific purpose and involves a specified amount. Mortgage loans, automobile loans, and installment loans for purchasing furniture or appliances are examples of close-end credit. An agreement or contract, lists the repayment term: the number of payments, the payment amount and how much the credit will cost. Closed-end payment plans usually involve a written agreement for each credit purchase. A down payment on trade in may be required, with the balance to be repaid in equal weekly or monthly payments over a period of time. Generally, the seller holds title to the merchandise until the payments have been completed.

The three most common types of close-end credit are installment sales credit, installment cash credit, and single lump-sum credit.

i) Installment sales credit - loan that allows you to receive merchandise, usually high-priced items such as large appliances or furniture. You make a down payment and usually sign a contract to repay the balance, plus interest and service charges in equal installments over a specified period.

ii) Installment cash credit - is a direct loan of money for personal purposes, home improvements or vacation expenses. You make no down payment and make payments in specified amounts over a set period.

iii) Single-lump-sum credit - is a loan that must be repaid in total on a specified day, usually within 30 to 90 days. Lump-sum credit is generally, but not always, used to purchase a single item.

b) Open-End Credit

Using a credit card issued by a department store, using a bank credit card (Visa, Master) to make purchase at different stores, charging a meal at a restaurant and using overdraft protection are examples of open-end credit. You do not
apply for open-end credit to make a single purchase, as you do with closed-end credit. Rather, you can use open-end credit to make any purchases you wish if you do not exceed your line of credit, the maximum amount of credit the lender has made available for you. You may have to pay interest, a periodic charge for the use of credit, or other finance charges. Some creditors allow you a grace period of 20 to 25 days to pay a bill in full before you incur any interest charges.

4.2 Consumer Loans

Consumer loans are an alternative to credit card borrowing. Most financial institutions offer several types of consumer loans and many of these loans are available at lower rates of interest than credit cards. In deciding what type of consumer credit is best for you, you should consider the costs and benefits associated with each of your sources of borrowing. Typically, any contract terms that reduce the risk of your defaulting on the loan will result in a lower interest rate charged by the lender.

Types of Consumer Loans

a) Home Equity Loans – A home is the most valuable asset most household possess. As your property value increases and your mortgage is repaid over time, you will gradually build up home equity, defined as difference between the market value of your home and the remaining balance on your mortgage loan. A home equity loan allows you to borrowing against this valuable asset. Like your primary mortgage loan, the home equity loan is secured by your home.

The lender’s right to the home is secondary to that of the primary mortgage lender, however, so these loans are also referred to as second mortgages. In the event of default, the first mortgage must be repaid from the proceeds of the sale of the home before the second mortgage lender get anything. Home equity loans are usually installment loans payable over 5 to 15 years in equal monthly payments.

b) Car Loans – A car loan is a secured loan made specifically for the purpose of buying a car. Lenders typically limit the amount of the loan some percentage of the current market value of the car being purchased and they require that the borrower pledge the car as security for the loan. Both new car prices and rates on car loans have been unusually low in the last few years due to competition among auto dealers and generally low market interest.

c) Student Loans – A student loan is a loan made for the purpose of paying educational expenses. Understandably, as the costs of both public and private education continue to rise at a faster rate than inflation, student loan debt is also on the increase. Such loans can be used to finance either
undergraduate or graduate studies, and there are special government-subsidized loan programs available to students and parents.

d) **Personal Loans** — These loans are typically used for nondurable expenditures, such as an expensive vacation or to cover temporary cash shortfalls. Many personal loans are made on an unsecured basis — that is, there is no collateral with the loan other than the borrower’s good name.

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**References**


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**ACTIVITIES**

1. Explain the advantages and disadvantages of consumer credit for individuals?
2. How is open-end credit different from closed-end credit? Give an example of each?
3. What is Annual Percentage Rate?.
4. Explain the common method in calculating interest rate?
5. Give three types of consumer loan and describe?
CHAPTER 6 – INVESTMENT CHOICES AND RISK MANAGEMENT

TOPIC 1
INVESTMENT PRINCIPLES AND STRATEGIES

1.1 Introduction

The financial need of future has to be considered and the special program to accumulate certain amount of money depends on your financial goal based on personal investment. Personal investment is the use of your personal funds to earn a financial return. The overall goal of investing is to earn money with money. But that goal is completely useless for the individual because it is so vague. The specific goals that you want to accomplish must be the driving force behind your investment program.

Investment goals must be specific and measurable and must be tailored to the particular financial needs of the individual. It is good if the investment goals be stated in terms of money (RM100,000) or in terms of the particular things they desire (a house). The following questions may help you establish valid investment goals:

1. The purposes of investment: What will I use the money for, and what will the consequences be if I do not obtain it?
2. The amount of investment: How much money do I need to satisfy my investment goals?
3. The source of investment: How will I obtain the money?
4. The period of investment: How long will it take me to obtain the money?
5. The risk and return: How much risk am I willing to assume in investment program?
6. The economic conditions: What possible economic or personal conditions could alter my investment goals?
7. The review of investment: Considering my economic circumstances, are my investment goals reasonable?
8. Spending vs. saving: Am I willing to make the sacrifices necessary to ensure that I meet my investment goals?

1.2 PERFORMING A FINANCIAL CHECKUP

You must remember that investment planning is the last things you do if there is a surplus above your monthly income. Simply, do not obsess with the financial advertisements urging you to investment through various packages of investment loans. It is advisable before considering making an investment, your financial status should be in good shape and start learning to live within your means. Potential investors must learn to live within their means before their investment program can become a reality. Do not spend more than you make. Avoid using credit if necessary.
or on emergency. If possible, try to limit installment payments to 10 percent of your net monthly pay. The surplus of monthly income can be used to start a savings program or finance other investment projects.

1.3 BASIC INVESTMENT PRINCIPLES

Revisit your attitude toward risk

You may have a clear idea of how risk-tolerant or risk-averse you are. But is your attitude toward risk appropriate for your present circumstances? Consider your investment objectives, age and investment time frame, and make sure your balance of risk and return potential is consistent with your objectives. Rethink your attitude toward risk, if necessary, to improve your chances of reaching your objectives.

Generally speaking, investors with long time horizons can accept a certain percentage of the risk associated with potentially higher-return investments, such as stocks, since they have time to recover from even prolonged market downturns. The opposite is typically true for investors with short time horizons. Since these investors will soon need access to their retirement assets, they usually require more stable investment alternatives, such as certain types of fixed income investments, that offer steady cash flows and safety of principal.

Asset Allocation -- Risk and Reward

Portfolio Mix (%)  Stocks  Bonds  Cash

Average return all years  Largest one-year gain  Largest one-year loss

Source: Ned Davis Research, Inc.

Note: This chart shows how different portfolio mixes of stocks, bonds and cash would have performed over the period January 1926-December 2001. For example, a portfolio consisting of 60% stocks, 30% bonds and 10% cash would have averaged an annual return of 9.3% over that period. The greatest one-year gain would have been 30.1%. The greatest one-year loss would have been 29.1%. Figures do not represent any actual investment’s performance or yield. There is no guarantee of similar results in the future.
Diversity

Diversification is an investment strategy in which you spread your investment dollars among different markets, sectors, industries, and securities. The goal of the strategy is to protect the value of your overall portfolio in case a single security or market sector takes a serious downturn and drops in price.

A well-diversified stock portfolio, for example, might include small-, medium-, and large-cap domestic stocks, stocks in six or more sectors or industries, and international stocks.

Studies indicate that diversification can help insulate your investments against market and management risks without sacrificing the level of return you want. Finding the diversification mix that’s right for you depends on your age, your assets, your tolerance for risk, and your investment goals.

Diversification, or the allocation of your assets among different investment alternatives or investment funds, can offer several advantages. For example, a combination of different investments, such as fixed-income and equity investments, generally provides for a balance of risk and return potential. You also can make smoother transitions in your customized mix of investments to meet your changing objectives. For instance, a young investor might seek investments with a high potential for return. But as years go by, and especially as retirement nears, he or she might want to focus more on preserving wealth. This investor could start with a high concentration in equity investments and gradually shift to fixed-income investments as his or her circumstances change.

Lastly, diversification can help ease investment concerns. The investment markets often respond differently to changes in economic conditions. If you spread your money among different asset classes, you may reduce the effects that a downturn in one asset class could have on your overall account’s value.

Reasons to diversify

There are two important reasons to diversify your investment portfolio:

1. To take maximum advantage of market conditions
2. To protect yourself against downturns

Tackling advantage of different markets

Each of the traditional asset classes — stocks, bonds, and cash — tends to produce its strongest returns under different market conditions than the other asset classes do.

For example, stocks often shine when corporate earnings are strong and financial markets are expanding. Yet this same
environment frequently has the opposite effect on bonds, so that they provide lower than average returns.

On the other hand, bond returns often rise in a period when stock values drop. That may happen when interest rates go up or when corporate earnings don't meet investor expectations. If you have some money in both stocks and bonds, you'll be in a position to benefit from owning the one that's up, while limiting your losses on the one that's down.

Protection against downturns

If your investments are narrowly focused — for example, if you own stock in just one company or stock in three companies in the same industry or area of the economy — the value of your portfolio can drop sharply if that company or industry provides disappointing returns. But if you own stocks of different-sized companies in different parts of the economy, even if some investments go down in value, others may remain stable or go up. In any case, different types of stocks are not as likely to lose value at the same rate or at the same time.

Keep a long-term outlook

As you review your investment allocation, you should concentrate on your long-term objectives. Avoid making investment decisions based on recent trends in investment performance. Instead, consider the long-term potential of your investments. The past performance of any investment does not guarantee future results. Historical, long-term average performance of an investment alternative can, however, serve as a better indicator of future potential than performance over any single, brief period. In general, the longer your investment time frame, the less you should concern yourself with short-term ups and downs in the market, and vice versa.

Caution: Retirement does not signal the end of a long investment horizon. You may spend 30 years or more in retirement, based on present-day life expectancies. It may be prudent to maintain an equity position in your investment plan during retirement. Equity investments generally can offer better long-term return potential than other investments. They may help give your retirement nest egg greater lasting potential. Equities also typically fluctuate more in value, which increases risk to principal, but you can help reduce the risk through diversification.

Dollar-cost averaging

Dollar-cost averaging is the common name for a strategy in which you invest a fixed amount of money at regular intervals in the same investment alternative. It requires regular investments, regardless of short-term market ups and downs, according to the schedule you establish. Your fixed contribution amount buys more units when prices are low and fewer units when prices are high. The objective is to invest gradually over time — rather than agonize over when to invest and then worry if you picked the right time.
Note: Dollar-cost averaging neither guarantees a profit nor ensures against a loss. Bear in mind that to dollar-cost average, you must be economically able to continue purchases as scheduled through periods of high and low price levels.

While Mutual of America is precluded by regulations from providing you with specific investment advice, our salaried staff of consultants can help you obtain a better understanding of the interest and investment alternatives available through our variable accumulation products. Please call your local regional office if you would like to speak with one of our consultants.

For more than 55 years, Mutual of America has managed its business operations in a prudent manner. During that time, we have emphasized investment basics, maintained a long-term perspective and stayed the course. We will continue to dedicate ourselves to delivering innovative retirement savings products and services while adhering to the values that have been fundamental to our success.

The specific mix of investments in any portfolio must be individually determined and would depend upon the investor’s age, financial goals, current financial position, life-style, and attitude toward risk, as well as upon the economic climate and other factors. Once set, the proportions should be changed only when a significant event alters the economic picture or the investor’s own circumstances.

Dollar-cost averaging and asset allocation are two investment strategies which provide for automatic decision-making, lowering the costs and risks involved with investment choices.

**Risk Tolerance**

Everyone handles risk differently. That’s because some people can live with — or can afford to take — more risk than others.

The younger you are, the more investment risk you generally can afford to take. That’s because you have the time to wait for a rebound when there is a downturn in the market. But if you’re retired or are nearing retirement, you may be counting on income from your investments. That increases the likelihood that you’ll want to avoid the risk of losing principal even if you make yourself more vulnerable to inflation risk.

Your life situation also plays a role in how much risk you are willing to take. If you have children who will be going to college in the next few years, or aging parents who depend on you for financial support, you may need to keep more of your portfolio in stable, fixed-income investments, to help cover your short-term expenses. Or, if you’re taking the risk of building your own business, you might be more comfortable making investments that you know you can count on.

Your personality matters as well. There’s no way around the fact that most investments will drop in value at some point. That’s what risk is all about. But most experts agree
CHAPTER 4 - INVESTMENT CHOICES AND RISK MANAGEMENT

that it's counterproductive to make investments that either make you so nervous you can't sleep or mean you'll sell in panic at the first sign of a downturn. However, if you're uncomfortable with risk, they also encourage you to learn more about the long-term rewards of well-planned risk-taking.
CHAPTER 6 – INVESTMENT CHOICES AND RISK MANAGEMENT

TOPIC 2
RISK MANAGEMENT

2.1 DEFINITION OF RISK MANAGEMENT

Risk management and insurance is the study of methods used by organizations and individuals to manage activities whose outcomes cannot be forecasted exactly, i.e., measures taken to reduce the risk of damage to physical assets, exposure to legal liability, or injury to employees or customers. In organizations, the purpose of risk management is to enable the organization to progress toward its goals and objectives on a direct, efficient, and effective path. As such, risk management is a central management function, devoted to the management of uncertainty and its effect on the organization’s progress toward its mission.

Risk management is an element of virtually any area of management specialization. Risk management and insurance focuses on a special category of risks: risks that are controllable in the sense that managers’ actions can affect the process giving rise to uncertainty. For example, safety procedures and damage control programs of an organization can have a dramatic effect on the injury rates for employees and on the amount of damage resulting from natural events and acts of humans. Management of employee benefit programs also can have significant effects on the cost of providing these programs.

2.2 RISK BASICS

A risky situation is one which exposes a person to a chance of injury or loss. Risk is present when there is: (1) lack of control, (2) lack of information, or (3) lack of time (MacCrimmon, 14). Methods used to manage and, hopefully, lessen risk aim at improving the picture with respect to these three elements.

What are the Risks?

The first step in managing risk is to be aware of the risks which exist. We each hold items of value, non-monetary and monetary, which might be lost or injured by negative outcomes.

Non-monetary assets are involved in most business and financial decisions. They include a person’s health, job security, chance for promotion, reputation, credit rating, personal and business relationships, and personal freedom. Risk is involved in any situation which poses a threat of loss or harm to any of these valued items.

Most obviously, risk is involved in decisions where a loss of value to monetary assets may result. Assets such as bonds, stock, real estate, or cash will be affected by an individual’s investment decisions.
Investment risks may be classified into four categories: opportunity, emotional, systematic, and unsystematic. Opportunity risk is present when a decision-maker has a number of investment choices. The rates of return, as well as other performance measures, are usually investigated to guard against making the wrong investment choice.

Emotional risk is the "sleep-at-night" factor. A person's comfort level with a particular investment will be affected by such factors as their current financial position, emotional state, and stage of life.

Systematic risks are reflected in the daily ups and downs of the financial markets. They can't be lessened by switching investments within a particular market (say, switching one stock for another), but may be reduced by spreading investments between markets, for example, by selling stocks and buying bonds.

Unsystematic risks exist for individual investments: a particular company may not have the cash flow to pay off its debt, or keep its operations going. These risks are effectively handled by diversifying investments over at least 5-10 individual companies.

2.3 RISK AND RETURN

One of the more basic relationships in investing is that between risk and reward. Investments that offer potentially high returns are accompanied by higher risk factors. It is up to you to decide how much risk you can assume. Always keep in mind your current and future needs.

Risk

There are many types of risk. The one most people think of is market risk, which is the risk that market prices can fluctuate. If you have a short investment horizon, generally something less than five years, this risk is important since the market could be down at the time you most need the money. On the other hand, if you have a long time horizon, for example when saving for retirement, you may be unconcerned with market risk. The investment has the opportunity to come back prior to the time you need the funds.

Another risk, which many people don't think about, is purchasing power risk. This is the risk that your investment will not keep up with inflation and you will not be able to maintain your desired standard of living. A bank CD for example might pay interest of 3% and have no market risk. Your principal does not fluctuate in value and you are insured against loss. However, if inflation exceeds 3% you will lose purchasing power.

You need to assess how much risk you can tolerate. One easy way to measure this is how well do you sleep at night. If you lie awake worrying about your investments, your risk tolerance is probably too low for your current investment strategy. In general the
CHAPTER 6 – INVESTMENT CHOICES AND RISK MANAGEMENT

The longer your investment horizon the greater the amount of risk you can afford to take. Your financial advisor can also assist you in measuring your risk tolerance.

Risk can also be reduced through diversification. Rather than buying one stock, buy a basket of 20 to 30 stocks. This reduces your overall risk. You can also reduce risk by combining different investment types such as stocks, corporate bonds, and government bonds. These securities are not highly correlated (i.e., they tend not to go up or down at the same time).

Return

Why would one want to take on more risk? Because it generally comes with a higher expected return. While stocks may have the greatest market risk, they also provide that highest market return over the long haul. Stock returns have averaged between 10 and 11% since the early part of this century. Corporate bonds on the other hand have averaged between 6 and 7% and government bonds closer to 5%.

As you can see, the lower the risk the lower the expected return. You must balance the amount of risk you are willing to tolerate with the amount of return you expect to achieve. There is no such thing as a high return/low risk investment.

Balancing risk and return

Understanding the relationship between risk and return is essential to understanding why people make some of the investment decisions they do.

First is the principle that risk and return are directly related. The greater the risk that an investment may lose money, the greater its potential for providing a substantial return. By the same token, the smaller the risk an investment poses, the smaller the potential return it will provide.

For example, a startup business could become bankrupt or it could become a multimillion-dollar company. If you invest in the stock of this company, you could lose everything or make a fortune. In contrast, a blue chip company is less likely to go bankrupt, but you’re also less likely to get rich by buying stock in company with millions of shareholders.

The second principle is that if you can get a better-than-average return on an investment with less risk, you may be willing to sacrifice potentially greater return to avoid greater risk. That’s sometimes the case when interest rates go up. Investors pull their money out of stocks, which are more risky, and put it in bonds, which are less risky, because they’re not giving up much in the way of potential return and they’re gaining more safety.
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The third principle is that you can balance risk and return in your overall portfolio by making investments along the spectrum of risk, from the most to the least. Diversifying your portfolio in this way means that some of your investments have the potential to provide strong returns while others ensure that part of your principal is secure.

2.4 RISK MANAGEMENT PROCESS

Risk management consists of risk perception, risk analysis, and risk preparedness. Risks may be divided into three tiers. In the lower band, the public readily accepts risks because benefits are felt to outweigh the disadvantages. In the upper band, risks are regarded as completely unacceptable and must be reduced even at very high cost or, if not possible, the activities must cease. The intermediate region is one in which decisions on risk reduction are made by trading off associated costs and benefits.

Traditionally, the field of risk management has three elements - identification of risks, risk assessment and implementation of solutions and plans. Risk Assessment consists of identification, quantification, evaluation, acceptance, aversion, control.

| Risk Management
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<td><strong>Risk Determination</strong></td>
<td><strong>Risk Estimation</strong></td>
<td><strong>Risk Aversion</strong></td>
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<td><strong>Risk Identification</strong></td>
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Risk assessment is defined as "the overall process of risk identification, quantification, evaluation, acceptance, aversion and management." Risk management is the managerial response based on the resolution of various policy issues such as acceptable risk. Risk management decisions are made by considering risk assessments within the context of political, social and economic realities. Such decisions are frequently controversial due to the difficulty in determining risks that are acceptable to the public.

Risk assessment includes risk determination and risk evaluation. Risk management includes risk assessment and risk control. Risk determination involves the related processes of risk identification and risk estimation. Risk identification is the process of observation and recognition of new risk parameters or new relationships among
existing risk parameters, or perception of a change in the magnitudes of existing risk parameters. Risk, at the general level, involves two major elements: the occurrence probability of an adverse event and the consequences of the event. Risk estimation, consequently, is an estimation process, starting from the occurrence probability and ending at the consequence values.

Risk evaluation is a complex process of developing acceptable levels of risk to individuals, groups, or the society as a whole. It involves the related processes of risk acceptance and risk aversion. Risk acceptance implies that a risk taker is willing to accept some risks to obtain a gain or benefit, if the risks cannot possibly be avoided or controlled. The acceptance level is a reference level against which a risk is determined and then compared. If the determined risk level is below the acceptance level, the risk is deemed acceptable. If it is deemed unacceptable and avoidable, steps may be taken to control the risk or the activity should be ceased. The perception and the acceptance of risks vary with the nature of the risks and depend upon many underlying factors. The risk may involve a "dead" hazard or a common hazard, be encountered occupationally or non-occupationally, have immediate or delayed effects and may effect average or especially sensitive people or systems.

Risk aversion is the control action, taken to avoid or eliminate the risk, regulate or modify the activities to reduce the magnitude and/or frequency of adverse effects, reduce the vulnerability of exposed persons, property or in this case urban systems, develop and implement mitigation and recovery procedures, and institute loss-reimbursement and loss-distribution schemes.

2.5 RISK MANAGEMENT TECHNIQUES

Four basic risk management techniques are: avoidance, modification, retention and sharing. Let's take a closer look at each.

Avoidance
Whenever an organization cannot offer a service while ensuring a high degree of safety, it should choose avoidance as a risk management technique. Do not offer programs that pose too great a risk. In some cases avoidance is the most appropriate technique because a nonprofit simply doesn't have the financial resources required to fund adequate training, supervision, equipment, or other safety measures, always ask, "Is there something we could do to deliver this program/conduct this activity safely?" If you answer "yes," risk modification may be the more practical technique.

Modification
Modification is simply changing an activity to make it safer for all involved. Policies and procedures are examples of risk modification. An organization concerned about the risk of using unsafe drivers may add DMV record checks to its screening process, or an annual road test for all drivers. An organization concerned about the lack of male and female chaperones for an overnight camping trip may decide to host a day-long hike and picnic instead.
Retention
There are two ways to retain risk. The first is by design. A nonprofit may decide that other available techniques aren’t suitable and it will therefore retain the risk of harm or loss. Nonprofits make conscious decisions to retain risk every day. For example, when a nonprofit purchases liability insurance and elects a $1,000 deductible or self-insured retention, it’s retaining risk. This can be a rational and appropriate approach to managing risk. Where organizations get into trouble is when risk is retained unintentionally. The unintentional retention of risk can be the result of failing to understand the exclusions of an insurance policy, insufficient understanding of the scope of risk an organization faces or simply because no one has taken the time to consider the risk and how it can be addressed.

Sharing
Risk sharing involves sharing risk with another organization through a contract. Two common examples are insurance contracts that require an insurer to pay for claims expenses and losses under certain circumstances, and service contracts whereby a provider (such as a transportation service or caterer) agrees to perform a service and assume liability for potential harm occurring in the delivery of the service.

2.6 Risks You Can Control

If you want the financial security and sense of accomplishment that comes with investing successfully, you have to be willing to take some risk. In most cases, risk means the possibility you’ll lose some or even all of the money you invest.

Taking risk doesn’t mean you have to take flying leaps into untested waters — it means anticipating what the potential problems with a certain investment might be, and putting a strategy in place to manage, or offset them.

There is some risk you can avoid. For instance, there’s risk in concentrating all of your savings in just one or two stocks or bonds. There’s investment risk in choosing to put your money into one company rather than another. And there’s management risk that a company’s officers may make serious errors. These are examples of what’s known as nonsystemic risk because the potential problem lies in the individual investment, not the investment marketplace.

You can manage nonsystemic risk by allocating and diversifying your portfolio, or spreading your assets among a variety of investments. That way, if one of your investments goes down significantly in value, those losses may be offset to some degree by gains, or even stable values, in some of your other investments.

2.7 Risks You Can’t Control

There is some risk, called systemic risk, that you can’t control. But if you learn to accept risk as a normal part of investing, you can develop asset allocation and
CHAPTER 6 – INVESTMENT CHOICES AND RISK MANAGEMENT

diversification strategies to help ease the impact of these situations. And knowing how to tolerate risk and avoid panic selling is part of a smart investment plan.

1. **Market risk.** This is the possibility that the financial markets will drop in value and create a ripple effect in your portfolio. For example, if the stock market as a whole loses value, chances are your stocks or stock funds will decrease in value as well until the market returns to a period of growth. Market risk exposes you to potential loss of principal, since some companies don’t survive market downturns. But the greater threat is the loss of principal that can result from selling when prices are low.

2. **Interest rate risk.** This is the possibility that interest rates will go up, if that happens, inflation increases, and the value of existing bonds and other fixed-income investments declines, since they’re worth less to investors than newly issued bonds paying a higher rate. Rising interest rates also usually mean lower stock prices, since investors put more money into interest-paying investments because they can get a strong return with less risk.

3. **Recession risk.** A recession, or period of economic slowdown, means many investments could lose value and make investing seem riskier.

4. **Currency risk.** Currency fluctuations affect the value of your overseas investments and may also affect the value of domestic investments in companies whose products can be undersold by overseas producers.

5. **Political risk.** With the increasing interaction of the world’s markets, political climates around the world can affect the value of your domestic and international investments. A period of instability, for example, can drive the value of your investments down, while political stability and growth can increase their value.
3.1 MUTUAL FUND OR UNIT TRUST

Mutual funds are an excellent way to invest in stocks, bonds and other securities. They are a good choice of investment because:

- They are managed by professional money managers, so most of the investment research is done for you. (Most investors don’t have the time or know-how to do all the necessary research.)
- You diversify your investment risk by owning shares in a mutual fund, instead of buying individual stocks or bonds directly.
- Transaction costs are often lower than what you would pay if you invested in individual securities (the mutual fund buys and sells large amounts of securities at a time).

Before getting into our discussion of mutual funds, there are three important points to keep in mind:

- Mutual funds are not guaranteed or insured by any bank or government agency. Even if you buy through a bank and the fund carries the bank’s name, there is no guarantee. You can lose your investment.
- All mutual funds have costs that lower your investment returns. Thus, even an index fund that mirrors a broad market index cannot perform as well as its mirror index, since the fund has transaction and operating costs that the index does not.

How to Choose a Mutual Fund

Once you determine your asset allocation model, you can implement the recommended portfolio with mutual funds. You need only six to ten funds to achieve diversification and your asset allocation objectives, as opposed to having to buy many more individual securities to achieve the same results.

Keep in mind that mutual funds ALWAYS carry investment risks. Some carry more risk than others; a higher rate of return typically involves a higher risk. You shouldn’t buy a touted “hot” fund without knowing, and being willing to accept, the risk. The type of risks that attend a mutual fund depend on the type of fund. Risks are discussed
CHAPTER 6 – INVESTMENT CHOICES AND RISK MANAGEMENT

later in the section on "Types of Mutual Funds and Their Varying Risk Factors."
Once you identify the asset classes that will be represented in your portfolio, it's time
to select specific funds in those categories—i.e., funds that meet your investment
goals. To choose wisely, it's necessary to assess:

- A fund's risk/reward history and characteristics, which should match your own
  financial profile;
- A fund's philosophy and investment style, which should match your own
  investment goals;
- A fund's costs, including loads and ongoing expenses; and
- The customer service available from the fund.

What about Recommendations?

Most sources of mutual fund recommendations are inadequate. They either depend
solely on past performance or fail to take into account your particular needs.
Newsletters and magazines, for example, often simply recommend last year's hot
fund—which, even though it may remain hot for the current year, may be totally
wrong for you.

Comparing Performance

A fund's past performance is not as important as you might think. Advertisements,
rankings, and ratings tell you how well a fund has performed in the past. But studies
show that the future is often different. This year's "No. 1" fund can easily become next
year's dog.

Here are some tips for comparing fund performances:

- **Check the fund's total return.** You will find it in the Financial Highlights of the
  prospectus (near the front). Total return measures increases and decreases in the
  value of the investment over time, after subtracting costs. This is just one of many
  return measures.
- **Find out how the fund ranked in its investment category class.** There are various
  rating systems available to show how a fund ranked among its peers.
- **See how the total return has varied over the years.** The Financial Highlights in the
  prospectus show yearly total return for the most recent 10-year period. An
  impressive 10-year total return may be based on one spectacular year followed
  by many average years. Looking at year-to-year changes in total return is a
  good way to see how stable the fund's returns have been.
- **Check the fund's Sharpe ratio.** The Sharpe ratio is intended to give investors an
  understanding of the fund's performance relative to the risk. The Sharpe ratio is
  calculated by subtracting the average monthly return of the 90-day Treasury
  Bill—basically a risk-free return—from the average monthly return of the fund. The
difference—the “excess” return—is then annualized and divided by the fund's annual standard deviation (a common measure of volatility).

3.2 WORKING ASSET ALLOCATION

Asset allocation is a strategy for building and managing your investment portfolio. You allocate your assets by deciding how much of your principal to invest in different asset classes, or investment categories. For example, you might invest some of your money in stocks, some in bonds, and some in cash or cash equivalents. The allocation you choose has a major impact on your investment return, and on the level of risk you take as an investor.

Asset allocation determines the investment returns you achieve because different asset classes—stocks, bonds, and cash equivalents—typically react differently to changes in the financial markets and to broader economic conditions. For example, a market that produces strong stock returns may cause bond returns to slump, and vice versa. But, if you spread your investments across different asset classes, you may be able to limit, or offset, potential losses in one asset class with stable values, or even gains, in another.

Choosing the specific asset classes you’ll include in your portfolio is the first step. Next, you have to consider what percentage of your total portfolio you want to allocate to each of those classes.

What is asset allocation?

Asset allocation Asset allocation is a strategy, advocated by modern portfolio theory, for maximizing gains while minimizing risks in your investment portfolio. Specifically, asset allocation means dividing your assets among different broad categories of investments, including stocks, bonds, and cash.

An asset allocation model—specifically the percentages of your portfolio allocated to each investment category—that's appropriate for you depends on many factors, such as how much time you have to invest, your tolerance for risk, the direction of interest rates, and the market outlook.

Many experts advise you to adjust or rebalance your portfolio at least once a year to bring it back in line with your model or to realign your model as your financial goals change. Brokerage firms regularly revise the allocations they recommend as they take changing economic conditions and their sense of future developments into account.
CHAPTER 6 – INVESTMENT CHOICES AND RISK MANAGEMENT

**Stocks for growth**

Stocks, bonds, and cash equivalents are all considered asset classes — as are real estate, collectibles, precious metals, futures and options, and other alternative investments. Each asset class carries different types and levels of risk and serves a different purpose in your portfolio, such as providing capital preservation or potential growth.

**Bonds for income**

Bonds are also known as fixed-income or income-producing investments because when you buy a bond, you receive interest payments on a regular schedule. And the bond issuer promises to pay back your principal, or original investment, when the bond matures.

Cautious investors, or investors approaching a major financial goal such as retirement, may allocate more of their assets to bonds than to stocks not only because bonds pay regular income, but because their prices are usually less volatile than stocks.

But that doesn’t mean that bonds are invulnerable to market changes, or are always risk-free investments. Bond prices change in response to supply and demand that’s driven by changes in the interest rates. The prices of some bonds, such as zero coupon bonds, can be highly volatile in the secondary markets. And high-yield bonds, sometimes called junk bonds, can be very high-risk investments because of the danger that the bond issuer will default, and fail to make its interest payments, or even fail to pay back your principal.

A portfolio weighted in bonds provides:
- Regular interest payments
- Lower risk and volatility
- More modest returns
But a portfolio heavily weighted in high-quality corporate bonds, municipal bonds, and Treasuries, will almost certainly fluctuate in value less than a portfolio that is concentrated in stocks. The trade-off is that high-quality bonds generally provide more modest rates of return over the long term than stocks.

**Capital preservation**

Cash and cash equivalent investments, such as money market funds, certificates of deposit, and Treasury bills, are low-risk investments that pay interest. Their short terms and stable values mean they generally provide smaller returns than the other major asset classes. But they have one big advantage — they’re highly liquid, which means you can turn them into cash at any time without a major loss in value.

The rate of interest that cash investments pay is often not enough to offset the effects of inflation, or the gradual erosion of the buying power of your money. So if you're seeking long-term growth, you'll want to limit the amount of money you allocate to cash investments. Nonetheless, cash investments can play a role in a well-balanced portfolio — to provide liquidity to meet shorter-term goals, emergency expenses, and to make new investments when the opportunity arises, or to provide a buffer against the fluctuation in value of more volatile securities.

**Allocation models**

An asset allocation model is a formula for distributing your total assets among different types of investments — primarily stock, bonds, and cash, or the mutual funds that buy those investments. One classic example calls for putting 60% of your portfolio in stocks, 30% in bonds, and 10% in cash.

The key is to choose a model that has the highest likelihood of helping you achieve your financial goals at a level of risk you’re comfortable taking. Then, as your life situation and tolerance for risk changes, or as you get closer to reaching a particular goal, you’ll want to adjust your allocation.

For example, you might have as much as 90% of your portfolio in stock early in your career, but over time, you might reduce the amount of stock to 40% to lower the volatility of your portfolio as you near retirement. Similarly, a major life change that affects your financial situation, such as the arrival of children or responsibility for the care of an elderly relative, may mean that you want to lower the level of risk in your portfolio. You can work with your financial adviser to determine an initial allocation model and refine it as time goes by. You’ll find that investment professionals regularly revise the allocations they’re suggesting in response to shifts in the market or their expectations.
for the future. But, in fact, the changes from month to month or even year to year tend to be within a fairly narrow range.

Allocation and return

More than any other investment strategy, how you allocate your portfolio can have a major impact on your investment return.

Asset allocation has a dramatic long-term impact, as you can see by comparing the pre-tax value of three hypothetical $100,000 portfolios after 20 years. The first portfolio, emphasizing stocks, outperformed the portfolios with larger percentages allocated to corporate bonds and cash.

The account value assumes all earnings were reinvested, and are figured using the average annual returns for each investment category for 1926 through 2003: large-company stocks at 10.4%, corporate bonds at 5.9%, and cash investments at 3.8%.

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<th>Allocation</th>
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<tr>
<td>Stocks</td>
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<td>Bonds</td>
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<td>Cash</td>
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As you can see, the portfolio emphasizing stocks dramatically outperforms the portfolios with larger percentages allocated to bonds and cash. Most experts agree that to get the best long-term returns, you'll need to have substantial holdings in stocks and stock mutual funds.
CHAPTER 6 - INVESTMENT CHOICES AND RISK MANAGEMENT


Keynote address by Roger Smook at the Risk Assessment and Management Congress in Ogaki, Japan - September 1997

ACTIVITIES

1. Define asset allocation and diversification?
2. Diferenciate risk and return?
3. Briefly explain the mutual fund investment?
4. What types of risk you cannot control?
UNIT 7

FINANCIAL RULES AND REGULATIONS AND ITS IMPACTS ON INDIVIDUAL AND ORGANIZATION

Unit Objectives: At the end of this lesson, students will be able to:

1. Understand the financial rules and regulations
2. Explain the issues and problems in financial regulations

Content:

Topic 1: The Financial Rules and Regulations
Topic 2: Issues and Problems in Financial Regulations
CHAPTER 7 – FINANCIAL RULES AND REGULATIONS AND ITS IMPACTS ON INDIVIDUAL AND ORGANIZATION

TOPIC 1
THE FINANCIAL RULES AND REGULATIONS

1.1 CENTRAL BANK OF MALAYSIA ACT 1958 (REVISED 1994)

The Act provides for the administration, objectives of the Central Bank. It also enumerates the powers and the duties of the Central Bank in relation to issuance of currency, maintenance of external reserve, authorized business of the bank, specific powers to deal with all institutions, its relationship with the Government and financial institutions. The Act also contains general provisions on the Bank's accounts, powers to compound etc.

1.2 BANKING AND FINANCIAL INSTITUTIONS ACT 1989 (BAFIA)

The BAFIA which came into force on October 1, 1989 provides for the licensing and regulation of institutions carrying on banking, finance company, merchant banking, discount house and money-brokering businesses. It also provides for the regulation of institutions carrying on scheduled business comprising non-bank sources of credit and finance, such as credit and charge card companies, building societies, factoring, leasing companies and development finance institutions. Non-scheduled institutions which are engaged in the provision of finance may be subject to Part X and XI of the BAFIA as the Minister of Finance may decide.

The objective of the Banking & Financial Institutions Act, 1989 (BAFIA) is "to provide new laws for the licensing and regulation of the institutions carrying on banking, finance company, merchant banking, discount house and money-brokering business, for the regulation of institutions carrying on certain other financial businesses, and for the matters incidental thereto or connected therewith. BAFIA was introduced to provide for an integrated supervision of the Malaysian financial system and also to provide the Central Bank with the power to speedily investigate and prosecute, if necessary any illegal activities in an attempt to reduce white-collar crime.

1.3 EXCHANGE CONTROL ACT 1953

The Act restricts dealings in gold and foreign currencies, payments to and from residents, issuance of securities outside Malaysia, imports and exports and settlements. The Act also empowers the Controller for Foreign Exchange to grant permissions and consent on the foregoing and to enforce the provisions of the Act.
1.4 ISLAMIC BANKING ACT 1983

An Act to provide for the licensing and regulation of Islamic banking business. The Act inter alia has provisions on the financial requirements and duties of an Islamic Bank, ownership, control and management of Islamic banks, restrictions on its business, powers of supervision and control over Islamic bank and other general provisions such as penalties etc.

Since the 1970s, Islamic banking has emerged as a new reality in the international financial scene. Its philosophies and principles are however, not new, having been outlined in the Holy Qur'an and the Sunnah of Prophet Muhammad (p.b.u.h) more than 1,400 years ago. The emergence of Islamic banking is often related to the revival of Islam and the desire of Muslims to live all aspects of their lives in accordance with the teachings of Islam.

In Malaysia, separate Islamic legislation and banking regulations exist side-by-side with those for the conventional banking system. The legal basis for the establishment of Islamic banks was the Islamic Banking Act (IBA) which came into effect on 7 April 1983. The IBA provides BNM with powers to supervise and regulate Islamic banks, similar to the case of other licensed banks. The Government Investment Act 1983 was also enacted at the same time to empower the Government of Malaysia to issue Government Investment Issue (GII), which are government securities issued based on Shariah principles. As the GII are regarded as liquid assets, the Islamic banks could invest in the GII to meet the prescribed liquidity requirements as well as to invest their surplus funds.

The first Islamic bank established in the country was Bank Islam Malaysia Berhad (BIMB) which commenced operations on 1 July 1983. In line with its objectives, the banking activities of the bank are based on Shariah principles. After more than a decade in operations, BIMB has proved to be a viable banking institution with its activity expanding rapidly throughout the country with a network of 80 branches and 1,200 employees. The bank was listed on the Main Board of the Kuala Lumpur Stock Exchange on 17 January 1992.

The long-term objective of BNM is to create an Islamic banking system operating on a parallel basis with the conventional banking system. However, similar to any banking system, an Islamic banking system requires three vital elements to qualify as a viable system, i.e.:

- a large number of players;
- a broad variety of instruments; and
- an Islamic money market.

In addition, an Islamic banking system must also reflect the socio-economic values in Islam, and must be Islamic in both substance and form. Recognising the above, BNM adopted a step-by-step approach to achieve the above objective. The first step to spread the virtues of Islamic banking was to disseminate Islamic banking on a nation-wide basis, with as many players as possible and to be able
to reach all Malaysians. After a careful consideration of various factors, BNM decided to allow the existing banking institutions to offer Islamic banking services using their existing infrastructure and branches. The option was seen as the most effective and efficient mode of increasing the number of institutions offering Islamic banking services at the lowest cost and within the shortest time frame. Following from the above, on 4 March 1993 BNM introduced a scheme known as "Skim Perbankan Tanpa Faedah" (Interest-free Banking Scheme) or SPTF in short.

In terms of products and services, there are more than 40 Islamic financial products and services that may be offered by the banks using various Islamic concepts such as Mudarabah, Musharakah, Murabahah, Bait Bithaman Ajil (Bai’i Murajal), Ijarah, Quasah, Jilid, Al-Bai’i, Istisna’ and Ijarah Thumirra Al-Bai’. To link the institutions and the instruments, the Islamic Interbank Money Market (IIMM) was introduced on 4 January 1994.

In October 1996, BNM issued a model financial statement for the banking institutions participating in the SPI requiring the banks to disclose the Islamic banking operations (balance sheet and profit and loss account) as an additional item under the Notes to the Accounts.

As part of the effort to streamline and harmonise the Syariah interpretations among banks and takaful companies, BNM established the National Syariah Advisory Council on Islamic Banking and Takaful (NSAC) on 1 May 1997 as the highest Syariah authority on Islamic banking and takaful in Malaysia.

On 1 October 1999, a second Islamic bank, namely Bank Muamalat Malaysia Berhad (BMMB) commenced operations. The establishment of BMMB was the effect of the spin-off following the merger between Bank Bumiputra Malaysia Berhad (BBMB) and Bank of Commerce (Malaysia) Berhad (BOCB). Under the merger arrangement, the Islamic banking assets and liabilities of BBMB, BOCB and BBMB Kewangan Berhad (BBMBK) were transferred to BMMB, while the conventional operations of BBMB, BOCB and BBMBK were transferred to BOCB accordingly. In addition, BMMB was given 40 branches of BBMB and BBMBK in various locations throughout Malaysia and a staff workforce of 1,000, migrated from BBMB, BOCB and BBMBK.

1.5 INSURANCE ACT 1996

The provisions of the Act deal with the licensing of insurers, insurance brokers, adjusting and reinsurance. It also deals with setting up of subsidiary and offices, establishment of insurance fund, direction and control of defaulting insurers, the control on management of licensee, accounts of licensee, examination and investigation powers of the Central Bank, winding-up, transfer of business of licensee. The Act also provides for matters relating to policies, insurance guarantee scheme fund, enforcement powers of the Central Bank, offenses and other general provisions.
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1.6 TAKAFUL ACT 1984

An Act to provide for the registration and regulation of takaful business in Malaysia and for other purposes relating to or connected with takaful. "Takaful" in this context means a scheme based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants in case of need whereby the participants mutually agree to contribute for that purpose.

The concept of takaful (Islamic insurance) was first introduced in Malaysia in 1785 when the first takaful operator was established to fulfill the need of the general public to be protected based on the Islamic principles. The legal basis for the establishment of takaful operators was the Takaful Act which came into effect in 1984.

Insurance as a concept does not contradict the practices and requirement of Shariah. In essence, insurance is synonymous to a system of mutual help. However, Muslim jurists are of the opinion that the operation of conventional insurance does not conform to the rules and requirements of Shariah as it involves the elements of uncertainty (Gharar) in the contract of insurance, gambling (Matiq) as the consequences of the presence of uncertainty and interest (riba) in its investment activities.

Takaful is an insurance concept in Shariah whereby a group of participants mutually agree among themselves to guarantee each other against defined loss or damage that may inflict upon any of them by contributing as tabarru’ or donation in the takaful funds. It emphasizes unity and co-operation among participants. Takaful is not a new concept as it had been practised by the Muhajirin of Mecca and the Ansar of Medina following the hijra of the Prophet over 1400 years ago.

Tabarru’ is the agreement by a participant to relinquish as donation, a certain proportion of the takaful contribution that he agrees or undertakes to pay, thus enabling him to fulfill his obligation of mutual help and joint guarantee should any of his fellow participants suffer a defined loss. The concept of tabarru’ eliminates the element of uncertainty in the takaful contract. The sharing of profit or surplus that may emerge from the operations of takaful is made only after the obligation of assisting the fellow participants has been fulfilled. Thus, the operation of takaful may be envisaged as a profit sharing business venture between the takaful operator and the individual members of a group of participants.

Takaful operations are regulated and supervised by BNM since 1988 with the appointment of the BNM Governor as the Director-General of Takaful. In October 1993, the ASEAN Takaful Group (ATG), a grouping of takaful operators in Brunei, Indonesia, Malaysia and Singapore was formed to enhance mutual co-operation and to facilitate the exchange of business among takaful operators in ASEAN. In 1997, the Malaysian takaful industry took a leap forward with the formation of ASEAN Retakaful International (L) Ltd. (ARIL) as an offshore retakaful

PUSAT PENDIDIKAN LUSAR
CENTRE FOR EXTERNAL EDUCATION
company in Labuan. The establishment of ARIIL was to create a vehicle for more dynamic retakaful exchanges among ATG members and providing additional retakaful capacity for further reduce their dependence on conventional reinsurance.

TYPES OF BUSINESS

The takaful business carried on by the Malaysian takaful operators are broadly divided into family takaful business (Islamic "life" insurance) and general takaful business (Islamic general insurance).

Family Takaful Business

In general, a family takaful plan is a combination of long-term investment and mutual financial assistance scheme. The objectives of this plan are:

- to save regularly over a fixed period of time;
- to earn investment returns in accordance with Islamic principles; and
- to obtain coverage in the event of death prior to maturity from a mutual aid scheme.

Each contribution paid by the participant is divided and credited into two separate accounts, namely:

- The Participants’ Special Account (PSA)
  A certain proportion of the contribution is credited into the PSA on the basis of tabarru’. The amount depends on the age of the participant and the cover period.
- The Participants’ Account (PA)
  The balance goes into the PA which is meant for savings and investments only.

Examples of covers available under family takaful business are as follows:

- Individual family takaful plans;
- Takaful mortgage plans;
- Takaful plans for education;
- Group takaful plans; and
- Health/Medical takaful.

General Takaful Business

The general takaful scheme is purely for mutual financial help on a short-term basis, usually 12 months to compensate its participants for any material loss, damage or destruction that any of them might suffer arising from a misfortune that might afflict upon his properties or belongings. The contribution that a participant pays into the general takaful fund is wholly on the basis of tabarru’. If at the end of the period of takaful, there is a net surplus in the general takaful fund, the same shall be shared between the participant and the operator in
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accordance with the principle of al-Mudharabah, provided that the participant has not incurred any claim and/or not received any benefits under the general takaful certificate.

The various types of general takaful scheme provided by the takaful operators include:

- Fire Takaful Scheme;
- Motor Takaful Scheme;
- Accident/Miscellaneous Takaful Scheme;
- Marine Takaful Scheme; and
- Engineering Takaful Scheme.

Family Takaful:

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<th>Individual plan</th>
<th>Mortgage</th>
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<td>Annuity</td>
<td>Employees Provident Fund</td>
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General Takaful:

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<td>Fire</td>
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<td>Marine, aviation and</td>
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<td>Transit</td>
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Miscellaneous        Includes:

- Personal accident
- Workmen corporation
- Liability
- Engineering
- House owners
1.7 EMERGENCY (ESSENTIAL POWERS) ACT, 1979 ESSENTIAL (PROTECTION OF DEPOSITORS) REGULATIONS 1986

An Act to give the Central Bank the powers to investigate the affairs of any person it suspects or has reason to believe is a deposit-taker. It empowers the Bank to freeze the properties of the deposit-taker and other persons associated with the deposit-taker, assume control over the deposit-taker, and to appoint receivers and managers. The Act also enumerates the powers of the Managers, provisions on priority of payment and cost.

1.8 LOAN (LOCAL) ORDINANCE, 1959

An Ordinance to authorize the raising of loans and matters connected thereto within the Federation by the Government for the purposes of the Development Fund. The Act amongst other things appoints the Central Bank as the agent of the Government and enables the raising of the loans by way of book-entry i.e. scripless.

1.9 TREASURY BILLS (LOCAL) ACT 1946 (REVISED 1977)

An Act to provide for issue of Treasury Bills in Malaysia. The Act amongst other things appoints the Central Bank as the agent of the Government and permits the issue by way of book-entry i.e. scripless.

1.10 GOVERNMENT INVESTMENT ACT 1983

An Act to confer on the Minister power to receive investments of moneys for a fixed period and to pay dividend thereon. The Act amongst other things appoints the Central Bank as the agent of the Government and allows the issue of the investment by way of book-entry i.e. scripless.

1.11 THE HIRE PURCHASE ACT 1967

Hire Purchase is a system of acquiring goods on credit whereby the seller of the goods is regarded as the dealer, the purchaser is regarded as the hirer and the finance company as the owner. The ownership of the goods bought on hire purchase does not pass to the hirer at the time of the hire purchase agreement or upon delivery of the goods. The ownership of the goods remains in the finance company until the hirer has fully settled the price agreed upon in the hire purchase agreement. A hire purchase agreement, commonly known as H.P, agreement, in respect of the goods must be in writing and printed in type of a size not smaller than the type known as 10-point Times. Any oral agreement is not a valid hire purchase agreement.

The main legislation governing the hire purchase transactions in Malaysia is the Hire Purchase Act 1967, which came into force on 11 April 1968 after hire purchase became an increasingly popular method of acquisition. Only the following goods can be bought on hire purchase in Malaysia:
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a. all consumer goods
b. motor vehicles namely
   i. invalid carriages
   ii. motor cycles
   iii. motor cars including taxi cabs and hire cars
   iv. goods vehicles where the maximum permissible laden weight does not exceed 2,540 kilograms
   v. buses, including stage buses

The most common type of hire purchase agreement in Malaysia is for the purchase of motor vehicle.

1.12 THE FUTURES INDUSTRY ACT 1993 (FIA)

The Kuala Lumpur Commodity Exchange (KLCE), established in 1980, caters for futures trading in commodities. Presently, the futures contract traded at the KLCE is the Crude Palm Oil (CPO) futures. All futures contracts traded on the KLCE is registered and cleared by the clearing house known as: the Malaysian Derivative Clearing House Bhd. (MDCH).

With effect from 16 April 1997, the KLCE functions under the supervision of the Securities Commission and is regulated by the Futures Industry Act 1993 (FIA) which replaces the Commodities Trading Act (CTA).

On November 17, 1998, Commodity and Monetary Exchange of Malaysia (COMMEX Malaysia) announced the merger between COMMEX Malaysia (formerly known as The Kuala Lumpur Commodity Exchange, KLCE) and its subsidiary, Malaysia Monetary Exchange Berhad (MME) would take place on December 7, 1998.

Commodity Futures

Futures contracts and options on futures contracts exist for a wide range of products, including agricultural products such as rubber, cocoa and crude palm oil, natural resources such as petroleum and gas, precious metal such as gold and tin, financial instruments such as stock indices, and interest rates, and currencies such as the US Dollar and the British Pound. At COMMEX Malaysia, the underlying products for its contracts are Crude Palm Oil and the 3-month Kuala Lumpur Inter-Bank Offered Rate (KLIBOR). More contracts will be introduced in the future pending on the needs for more risk management instruments of the industries.

What Is Futures?

Futures are contracts that are legally binding agreements, made on the trading floor of a futures exchange (or via an electronic screen dealing system), to buy or sell the underlying product at a specific time in the future for a specific price determined today.
A futures contract can either require physical delivery of the underlying product or be cash settled. A cash-settled contract requires a cash amount to be paid on the contract expiration day which reflects the difference between the initial futures price and the price of the underlying product at settlement. Deliverable contracts, on the other hand, require the buyer to take delivery of the physical commodity and the seller to deliver. In most cases, actual delivery seldom takes place as the contracts are closed out prior to the expiration date. A trader who has bought a futures contract can close out by selling the same number and type of futures contract he bought and vice versa. The CPO Futures contract is a deliverable contract and the KLIBOR futures is cash-settled.

What Is Futures Exchange?

A future exchange is a centralized and organized marketplace for trading futures. It is made up of members, committees and staff. All futures exchanges have a clearing house to clear and guarantee its members trade.

The Clearing House

All transactions at the Exchange must be executed by or through an exchange member and every trade must be cleared by a firm that is a member of the clearing house. Once a trade has been cleared, all connections between the original buyer and seller are severed and the clearing house assumes the opposite side of the trade, that is, it becomes the buyer to every seller and the seller to every buyer, thus minimizing counterparty risk.

Margins

One of the most important financial safeguards in assuming performance on futures contracts is the margin system. Margin is the amount of money buyers and sellers of futures contracts must deposit into their accounts to assure contract performance. The brokerage firm established the margin its customers must maintain depending on certain minimums set by the clearing house.

If a change in the futures price results in a loss on an open futures position, funds will be withdrawn from the customer's margin account to cover the loss. In the event that his account balance falls below a certain level, the customer must promptly deposit additional money to comply with the minimum margin requirement.

On the other hand, if a price change results in a gain, the amount of the gain is credited to the customer's margin account. These margin accounts are settled daily and a customer may choose to make a withdrawal from his margin account at any time on condition that the balance does not fall below the minimum margin requirement. After an open position has been closed out, any money in the margin account not required to provide margin for other open positions (or to cover any losses) can be withdrawn by the customer.
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What Is Options Contract?

An options contract is a standardized agreement that gives (the buyer) the right, but not the obligation, to buy or sell a specified quantity and quality of an underlying product at a specified price within a specified time period. The seller of the option has a contingent liability or an obligation to fulfill if the buyer chooses to exercise that right.

The buyer of the option pays a premium for this privilege to only complete the deal if price movements are favorable. Consequently, the buyer is protected against undesired market movements but still able to gain from movements in his favor. The seller of the option, on the other hand, receives the premium but incurs an obligation in the event that the option buyer chooses to exercise his option.

An option contract, being a contract at law, creates a legal relationship between both the buyer and the seller. This relationship can remain in place until the option is exercised or, allowed to lapse, i.e., not exercised prior to expiration. Alternatively, it is possible for the two parties to the contract to enter into an “opposite” contract and for these contracts to be offset against each other.

1.13 CONSUMER CREDIT REGULATIONS IN MALAYSIA

Introduction

There is a variety of consumer credit available in Malaysia provided by various types of financial and other institutions. Some forms of consumer credit are subjected to legislative control while others may lie within a certain gray area or are totally not subjected to any regulations at all.

There are a few laws that govern some forms of consumer credit in Malaysia but different authorities administer these laws. These laws are:

1. Hire-Purchase Act, 1967;
2. Moneylenders Act, 1951;
3. Pawnbrokers Act, 1972;
4. Banking and Financial Institutions Act, 1989; and
5. Islamic Banking Act, 1983

The Hire-Purchase Act, 1967 is under the jurisdiction of the Ministry of Domestics Trade and Consumer Affairs and regulates the business of hire purchase financing which is normally carried out by Credit Companies licensed under the Moneylenders Act, 1951 (or being granted exemption) and Finance Companies licensed under the Banking and Financial Institutions Act, 1989 (BAFIA). The Moneylenders Act 1951 and Pawnbrokers Act 1972 are administered by the Ministry of Housing and Local Government. The Moneylenders Act 1951 is to regulate money lending activities whilst the Pawnbrokers Act 1972 regulates the business of pawnbroking carried out by pawn shops. The BAFIA 1989 and Islamic
Banking Act 1983 is under the purview of the Ministry of Finance and administered by the Central Bank of Malaysia (Bank Negara Malaysia). The BAFIA 1989 regulates the business of commercial banks and finance companies while the Islamic Banking Act 1983 regulates the business activities of Bank Islam Malaysia.

Problems Related To Consumer Credit

I. Banks and Finance Companies

Banks and Finance Companies are deposit-taking institutions and deal mainly with business loans. However, they too provide consumer credit in the form of housing loans, personal loans and loans through credit cards. Finance companies are also involved in hire purchase financing. Although the BAFIA regulates banks and finance companies, it only provides protection for depositors and not consumers i.e. borrowers of loans. For instance, interest rate on loans is regulated through guidelines issued by the Central Bank and at present is pegged at Base Lending Rate (BLR) plus a spread of 2.5%, while interest rate for credit card loans are not regulated at all and vary from 1.75% to 2% per month. For credit card loans, the Central Bank guidelines only stipulate that the minimum monthly repayment is to be at 5% of total credit usage. All other terms and conditions are stipulated and imposed by the banks and finance companies via the loan agreement signed.

Finance companies also engage in hire purchase financing. In hire purchase financing, finance companies charge interest rates in accordance with the provisions of the Hire-Purchase Act 1967 which caps interest rate at a maximum of 10% per annum on a fixed term basis.

Although banks and finance companies are well-regulated by the Central Bank through the BAFIA, consumer interest is not protected. Coupled with the fact that various interest rates imposed are based on different methods of calculation, there is little wonder that there is a lot of confusion and unhappiness amongst consumers.

II. Credit Companies

Credit companies whether licensed or exempted under the Moneylenders Act, 1951 give out business or personal/consumer loans as well as carry on hire purchase financing. While carrying out hire purchase financing it is subjected to the provisions of the Hire-Purchase Act just like the Finance Companies. Licensed Credit Companies can only operate from the premise the address of which is stated in the license and the Act also limits the maximum interest rate that can be charged i.e. 12% per annum for secured loans and 18% per annum for unsecured loans. The companies granted exemption from the Act can operate from anywhere they like and charge any rate of interest they wish. As there is no provision in the Act to govern the terms and conditions of loans given, the companies can and do impose terms and conditions in their favor and at
the expense of the consumers. The companies that are exempted from the law can and do impose interest rates at their whims and fancies, which in most cases are exorbitant in nature.

There is also the problem of illegal moneylenders i.e. those who are unlicenced and are not given exemption from the law. Most of these if not all of them charge exorbitant interest rate which could be as high as 25% per month. They are also very high handed and intimidating in their methods of recovering the loans in cases of non-repayment by the borrowers. These are the infamous loan sharks.

III. Pawn Shops

Pawn shops are licensed under the Pawnbrokers Act 1972 and carry out pawnbroking which is a quick and convenient source of credit. However, there are quite a number of problems related to pawnbroking. The interest rate allowed to be charged under the law is 2% per month or 24% per annum which is rather high considering the fact that loans given out are more than covered by the value of the collateral.

Consumers are also at the receiving end in this business and one common complaint is that gold objects such as gold chains and gold bangles when pawned are not weighed or measured and hence the weight or length of which is not recorded in the pawn ticket or receipt. Subsequently when the objects are redeemed there are complaints that the gold objects are shorter in length or lighter in weight insinuating that the pawn shop owners had skimmed gold from the objects. Due to the length or weight of gold objects not being initially recorded there is no way of verifying the truth of the complaints.

Another complaint is that in the case of objects pawned, which are lost due to theft, robbery or fire, the pawn shop owner is only liable to pay compensation of the pawned sum plus another 25% of the pawned sum. This is grossly inadequate compensation considering the original purchase value of the object. However, the pawnshop owner’s action is legal because the Pawnbrokers Act provides for it.

IV. Credit Sale

Besides loans granted via credit card being a consumer credit activity which is not regulated by law, there is another form of unregulated consumer credit i.e. credit sale. This activity is carried out by some large retail outlets of consumer durable goods such as furniture and household electrical and electronic products. Consumers are required to pay in weekly instalments up to 104 instalments (2 years) or in monthly instalments up to 24 instalments (2 years). However if the instalments are totalled up, the amount payable is more than double the cash price. This simply means that a very exorbitant interest rate is charged on naive customers who feel that the instalment payment is very small.
Credit sale does not come under the purview of the Hire-Purchase Act because it is not financed by a third party and therefore there is no ‘hiter’ to talk about. The customer need not pay a 10% down payment on the price charged. The credit is provided by the vendor. It does not come under the purview of the Moneylenders Act because no actual money changes hand from the lender to the borrower. Further more the Moneylenders Act only defines a “moneylender” but does not define “money lending”. Thus in a credit sale, the vendor is a seller and not a moneylender.
TOPIC 2
ISSUES AND PROBLEMS IN FINANCIAL REGULATIONS

2.1 WHAT IS BANKRUPTCY?

Bankruptcy is a way to deal with debts that you are unable to settle as and when they fall due. The bankruptcy proceedings free you from excessive debts allowing you to make a fresh start subject to some restrictions and ensure that your assets are shared out to repay creditors. A person who has been judged by a law-court to be unable to pay his debts as they fall due is a bankrupt. Anybody can go bankrupt, including members of a partnership.

Why the Bankruptcy Law?

Bankruptcy law provides for the development of a plan that allows a debtor, who is unable to settle his debts and to pay through the division of his assets among his creditors. Under the supervised division, the interests of all creditors will be treated with some measure of equality. The courts have had to take account of the existence of companies operating within the jurisdiction that have subsequently become insolvent. Malaysia’s bankruptcy law is based on English law.

Take bankruptcy seriously. You do not have to become bankrupt because you are in debt. Bankruptcy involves the closing down of your business, giving up any possessions of value and your interest in your property and the inability to obtain new credit. You will be subject to certain restrictions. Bankruptcy damages your standing in the community. Get advice from your lawyer, if bankruptcy proceedings are taken against you or you are thinking of making yourself bankrupt. If being a bankrupt will not be better off then you were before, why do it? Consider alternative to bankruptcy that may produce better result than going into it.

How Am I Made A Bankrupt?

In bankruptcy proceedings, your total judgment debt must be more than RM30,000. Bankruptcy notice will be issued and served on you. If you did not respond within the time limit for full settlement or negotiation of settlement proposal, you have committed an act of bankruptcy. The court will make a Receiving and Adjudication order after the bankruptcy petition has been presented. There are two types of Bankruptcy petition - Debtor's petition where you present the petition and Creditors' petition which will be presented by your creditors.
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Even if you refuse to acknowledge or agree to the order, a Receiving and Adjudication order can still be made. Thus you are advise to cooperate fully once bankruptcy proceedings have begun. If you dispute the creditors’ claims, make sure you try and reach a settlement before the Receiving and Adjudication Order. The Receiving and Adjudication Order is made if not contested on the bankruptcy petition hearing. You are being declared a bankrupt once the Receiving and Adjudication Order is made.

Duties as a Bankrupt Person?

When the Receiving and Adjudication Order has been made you must go to the offices of the Official Assignee or Jabatan Pemegang Harta and provide information relating to your financial affairs and hand over your assets to the them including all your books, bank statements relating to your property and financial affairs. You must stop using your bank and similar account immediately. You also must not obtain any credit either alone or with other people. It is an offence for you to conduct any business be it directly or indirectly in a different name from that in which you were made bankrupt.

The court will take a small percentage of your monthly income within your means to pay to the Official Assignee. If you have extra money in your account, the Official Assignee can also claim the amounts which is more than you need for your normal living expenses to pay your creditors.

What Are The Restrictions As A Bankrupt?

Once you have been adjudged a bankrupt, you cannot hold certain public offices. Bankruptcy damages your standing in the community. The Official Assignee will administer all your assets, trace and monitor your conduct. Your assets will be disposed to pay the costs and creditors. The Official Assignee may also recover property if you disposed of it in a way which was unfair to your creditors. It is a offence for you to obtain any credit either alone or with others. You are not allowed to conduct business be it directly or indirectly in a different name from that in which you were made bankrupt. You cannot be concerned in any promotion or managing a company without the permission from the Official Assignee.

Travel restrictions would come into force and you will lose your passport. You can obtain a passport under some reason with the permission of the Official Assignee. You can only open a bank account with the approval of the Official Assignee for crediting your monthly income. Certain conditions and limitations will be imposed. The court may order you to pay part of your wages or income to the Official Assignee if your income is more than you need to live on.

How A Person Can Be Discharged From Bankruptcy?

If you have paid your debts in full, the court will annuls the Receiving and Adjudication Order thus you will become free from bankruptcy immediately.
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However, the Bankruptcy Act 1967 has been amended, giving discretionary powers to the Official Assignee to allow certain categories of bankrupts to be discharged. The Act was amended to facilitate the discharge of some bankrupts to give them a “second chance” to become actively involved in business again.

There are also other categories of bankrupts who will also get reprieve under the amended Act. They are guarantors of loans, those who suffered due to financial turmoil, and bankrupts who are sick, old and jobless. The Official Assignee applies several criteria - your conduct and behavior as a bankrupt before and after bankruptcy, the reason for being declared a bankrupt, age, financial status and ability to repay debts. Thus if you have carried out your duties as a bankrupt you can apply to the Official Assignee for your discharge. Examples: Making regular payments to the Official Assignee and full cooperation during the bankruptcy proceedings.

You will not be automatically discharged from bankruptcy. You have to apply to the Official Assignee for your discharge after 5 years from the date of your Receiving and Adjudication Order. The Official Assignee does this by issuing a “Sijil Pelepasan Pegawai Pemegang Harta” or “Official Assignee’s Discharge Certificate” to you. The Official Assignee may still refuse or delay your discharge.

How To Check Whether A Person Have Been Adjudged A Bankrupt?

You should proceed to the Official Assignee Office or Jabatan Pemegang Harta and obtain a copy of search form from the counter. A copy of the search form costs RM1. Photocopies of the form are also acceptable. Fill up the form and submit it. The Official Assignee Office will then forward your request to the head office in Kuala Lumpur where the search will be conducted. The official result of the search will then be sent to the address provided in the search form. The fee to conduct a bankruptcy search on an individual is RM5.

2.2 WEAKNESSES OF THE EXISTING LAWS

Moneylenders Act 1951

The Moneylenders Act 1951 is under the jurisdiction of the Ministry of Housing and Local Government but licenses are issued by State Governments and Kuala Lumpur City Hall and license fees become state revenue.

One main feature of this Act is that it caps interest rate on loans given out by moneylenders at 12% per annum for secured loans and 18% per annum for unsecured loans. However monitoring and enforcement is strikingly lacking because the Act only provides the police with powers to enforce. Therefore there is nothing to stop moneylenders from manipulating their activities for their own benefits and at the expense of borrowers. For example a loan of RM1,000.00 is given out but the borrower may have actually been given a lesser sum of RM900.00. This will mean that the actual interest charged is higher than
what is stated in the loan agreement or in the IOU chit and which may exceed what is allowed in the Act hence circumventing its provisions.

This Act also provides discretionary powers for the Minister to grant exemptions to companies. Companies granted exemptions under this Act can carry out moneylending activities without being subjected to the provisions of the Act. Although the provision of an exemption has been tightened somewhat in the 1980s, there are already a large number of companies throughout the country being granted this exemption and there is no time limit to the exemption given.

It is understood that amendments have been put in place to provide powers for the police and also enforcement officers of the Ministry of Housing and Local Government to combat the menace of illegal moneylenders or loan sharks. The amendments will probably be tabled in the next sitting of Parliament.

**The Pawnbrokers Act 1972**

The Pawnbrokers Act 1972 is also under the jurisdiction of the Ministry of Housing and Local Government. The license is issued by the state government and Kuala Lumpur City Hall and fees collected become state revenue.

This Act allows interest rate to be charged at 2% per month or 24% per annum which is extremely high considering the fact that all loans given out are secured by collaterals of value about 3 to 4 times higher than the loan given out. This interest rate is very much higher that what is chargeable under the Moneylenders Act 1951 which is only 12% per annum for secured loans.

The Act also provides that only 25% of the pawned value of the goods will be paid as compensation in case of loss due to theft, robbery or fire. This quantum of compensation is grossly inadequate.

The Act and its regulations under it do not require the objects pawned especially gold ornaments to be weighed or measured and the measurements to be stated in the pawn ticket or receipt to be given to the person who pawns the ornament. This had resulted in many complaints such as the gold ornaments redeemed are shorter in length or lighter in weight compared to its original state implying that pawnshop owners had skimmed off gold from the ornaments.

The Act provides for pawnshop owners to forfeit objects pawned and not redeemed within the stipulated period of time if the pawned value is less than RM100.00. This may have resulted in pawnshop owners giving out smaller loans on purpose to capitalize on this provision. For objects where the pawned value exceeds RM100.00 and which are not redeemed, then the pawnshop owner had to follow a certain procedure before the objects are auctioned off by a licensed auctioneer. Even then, there are complaints that pawnshop owners collude to ensure that they are able to get back the goods pawned at the shops at the lowest possible price.
CHAPTER 7 – FINANCIAL RULES AND REGULATIONS AND IT IMPACTS ON INDIVIDUAL AND ORGANIZATION

The Hire-Purchase Act 1967

This Act is under the jurisdiction of the Ministry of Domestic Trade and Consumer Affairs. It does not set down any licensing requirements but provides for the regulation of hire purchase activities.

The rate of interest charged is the annual effective rate of interest. It is very much higher for example in the case of a hire purchase loan, if an interest rate of 8.5% per annum is charged for a loan taken out for five years then the actual annual effective rate of interest is actually about 16.5% per annum.

Another area where complaints are common regarding hire purchase is that of repossession fees and storage fees. When the borrower defaults in repayment, the hirer will use agents to repossess the hired goods (in most instances motor vehicles) and then charges repossession fees and storage fees (if the borrower takes time to settle the repayment due and collects his goods late). The fee varies from hirer to hirer and from circumstance to circumstance and totally beyond control of the borrower. The Act or the regulations under it does not have a schedule of fees which the borrower may refer to so as to ensure the fees charged are reasonable and allowable under the law.

Conclusion

There are many problem areas in the field of consumer credit in this country. The interests of consumers are not protected. In areas where no laws exist to regulate the transaction, the consumer is at a very disadvantageous position. Where laws exist, the laws have weaknesses that work to the detriment of consumers.
http://www.sc.com.my
http://www.miit.com.my
http://www.lawyerscom.my/
Yap Kon Lim, Consumer Credit Regulations in Malaysia: A Country Report

ACTIVITIES

1. List and briefly describe the financial rules and regulations in Malaysia?
2. What is a bankruptcy?
3. What Are The Restrictions As A Bankrupt?
4. What are the weaknesses of the Moneylenders Act 1951
UNIT 8

DEVELOPMENT OF FINANCIAL SERVICES AND IMPACTS TOWARDS INDIVIDUAL AND ORGANIZATION

Unit objectives: At the end of this lesson, students will be able to:

1. Understand the role of good cash management in the personal financial planning process.
2. Describe today's financial services marketplace.
3. Understand the key aspects of electronic banking.

Content:

Topic 1: The Role of Cash Management in Personal Financial Planning
Topic 2: Financial Services Marketplace
Topic 3: Electronic Banking Services
1.1 INTRODUCTION

Many people are guilty of occasionally or not so occasionally, neglecting to balance checkbook or making a bill payment after the due date. Keeping track of cash and paying bills are both important, although not necessarily enjoyable, tasks associated with cash management, a foundation component of financial plan.

Cash management includes all your decisions related to cash payments and short-term liquidity investments. There are three general reasons for holding cash.

a. **Managing Monthly Expenses**

Everyone has bills, rent, food, utilities, car payments and other expenses must be paid as they come due. To pay your bills easily, you need to have sufficient cash in transaction account. A transaction account, commonly called a current account, is an account that allows you to regularly make deposits, write checks, withdraw funds or make electronic payments in a timely fashion and at minimal cost.

Many people find it convenient to deposit their paycheck each month into a current account and then to pay their bills from the account. There’s a cost to using this banking service in the form of lost interest earnings. It’s usually fairly easy to make transfers between accounts, the time and effort required to make multiple transfers each month as bills come due would be probably outweigh the minimal interest that could be earned.

b. **Preparing for Cash Emergencies**

Life is full of unpredictable events. Maybe the car needs a new RM2,000 transmission. More serious emergencies might involve the loss of a job or temporary disability. In order to meet your emergency cash needs, it’s important to manage your financial assets so that you can access cash when needed. For most households, this should include a cash reserve an accumulation of liquid assets that you can turn to in the event or emergency.

Today, there are many other options for emergency cash flow needs. In addition to traditional savings account, you can arrange for credit cards and home equity lines of credit that can be accessed in the event of an emergency but that otherwise incur no interest.
3. Making a Temporary Investment

The third reason you might hold cash is in anticipation of a near-term need for the funds. Perhaps you’re saving for a vacation or a new car. Maybe you’re planning to apply the funds to the purchase of a new home. Or you may have sold some other assets recently and haven’t yet decided how to reinvest the funds.

During the recent ups and downs in the stock market, many investors used cash accounts to temporarily store funds as they bought and sold stocks.
CHAPTER 2 – DEVELOPMENT OF FINANCIAL SERVICES AND IMPACTS TOWARDS INDIVIDUAL AND ORGANISATION

TOPIC 2
FINANCIAL SERVICES MARKETPLACE

2.1 FINANCIAL SERVICES MARKETPLACE

Thanks to advanced technology and less restrictive regulations, the pace of change in the financial services industry is accelerating. With a click of a mouse, you can check your bank account balances, pay your bills, open a current account and search online for the best rates on saving instruments. Consumers can choose services from many financial institutions competing for their business. No longer must we go to one place for our current account, another for credit cards or loans and yet another for stock brokerage services, depending on what's best for your needs.

Before 1980, very little competition existed in the financial marketplace. The distinctions among various kinds of financial institutions were clear. Commercial banks offered current account and short-term loans. Savings and loans offered savings accounts and real estate mortgage loans. Brokerage firms assisted in trading securities and insurance companies offered life, disability, health, auto and home owner's insurance.

The financial services industry as we know it today embraces all institutions that market various kinds of financial products (such as current account and savings accounts, credit cards, loans and mortgages, insurance and mutual funds) and financial services (such as financial planning, taxes, securities, brokerage, real estate, trusts, retirement and estate planning). In effect what used to be several distinct industries is now, in essence, one industry whose firms are differentiated more by organizational structure than by name or product offerings.

2.2 TYPES OF FINANCIAL SERVICES

Banks and other financial institutions offer services to meet a variety of needs. These services fall into four main categories.

a. Savings
   Safe storage of funds for future use is a basic need for everyone. These services, commonly referred to as time deposits, include money in savings accounts and certificates of deposit. Selection of a savings plan is commonly based on the interest rate earned, liquidity, safety and convenience.
b. **Payment Services**
The ability to transfer money to other parties is a necessary part of daily business activities. Checking accounts and other payment methods, commonly called demand deposits.

c. **Borrowing**
Most people use credit at some time during their lives. Credit alternatives range from short-term accounts, such as credit cards and cash loans to long-term borrowing such as a home mortgage.

d. **Other Financial Service**
Insurance protection, investment for the future, real estate purchases, tax assistance and financial planning are additional services you may need for successful management. With some financial plans, someone else manages your fund. A trust is legal agreement that provides for the management and control of assets by one party for the benefit of another.

e. **Electronic Banking**
Banking by telephone, home computer and other online services continue to expand, with 24-hour access to various transactions. Most banks and other financial institutions have 'cyber' branches that provide the following: direct deposit of paychecks, automatic payment transfer funds, automatic teller machine (ATM) and a debit card.

### 2.3 TYPES OF FINANCIAL INSTITUTIONS

In spite of the growing number of firms entering the financial services field, individuals and families continue to make the vast majority of their financial transactions at traditional financial institutions: commercial banks, savings and loan associations, savings banks and credit unions. Although these are organized and regulated by different agencies, they commonly are referred to as 'banks' because of their similar products and services. Unlike their nonbanking counterparts, such as stock brokerages and mutual funds, they accept deposits. Probably the two biggest advantages of these depository institutions are that they are familiar and convenient. Further, although most people have current and savings accounts, a much smaller number own stocks, bonds or mutual funds. As a result, many people are not accustomed to dealing with brokerage firms and other types of financial service companies.

a) Commercial Banks  
b) Savings and Loan Association  
c) Savings Banks  
d) Credit Unions  
e) Nondepository Financial Institutions
2.4 DEPOSITORY INSTITUTIONS

c. Commercial Banks
A commercial bank offers a full range of financial services, including current, saving and lending, along with many other services. Commercial banks are organized as corporations with individual investors (stockholders) contributing the capital the banks need to operate.

d. Savings and Loan Associations
The savings and loan association (S&L) specialized in savings account and loans for mortgages. In recent years, savings and loan associations have expanded their services to include checking accounts, specialized savings plans, loans to businesses and other investment and financial planning services. Like banks, savings and loan associations have either federal or state charters.

e. Savings Banks
Savings bank is a special type of financial institution, similar to savings and loan associations and located primarily in the New England States. In addition to offering a number of different interest-paying checking accounts, they accept a variety of savings deposits on which they pay interest at a rate on par with that paid by savings and loans. Because most savings banks are mutuals, depositors are their actual owners.

f. Credit Union
A credit union is a user-owned, nonprofit, cooperative financial institution. Traditionally, credit union members had to have a common bond such as work and community affiliation. Most credit unions offer credit cards, mortgages, home equity loans, direct deposit, cash machine, safe deposit box and investment services.

g. Nondepository Institutions

1. Life Insurance Companies
A life insurance company sells products called life insurance policies, intended to provide financial security for dependents in the event of the death of policy owner. Its primary source of funds is therefore the payments made to purchase the policies, usually called the policy premiums. These companies invest the collected premiums in stocks, bonds and other financial assets. Many life insurance products include savings and investment features and thus can be considered an alternative to other savings account. In addition, life insurers are active lenders in the home mortgage market.
II. Finance Companies
Making loans to consumers and small businesses is the main function of finance companies. These loans have short and intermediate terms with higher rates than most other lenders charge. Some finance companies have expanded their activities to offer other financial planning services.

III. Stock Brokerage Firms
A brokerage firm is a company that facilitates investors’ purchases of stocks, bonds and other investments. An investor generally keeps money in an account with a brokerage firm and authorizes an employee of the firm, called a broker, to take money out of the account to pay for new purchases for the investor and to deposit money received from the sales of the investor’s securities. The brokerage firm usually makes its money by changing a commission for each purchase and sale. Today, more banks are competing for the brokerage business, in turn traditional brokerage firms are offering a variety of cash management services and products.

IV. Mutual Funds Companies
A mutual fund is an investment company that sells shares to investors and then invests the pool of funds in a selection of financial securities. Some mutual fund companies have low-risk mutual fund investment account options that also allow limited check writing.

V. Financial Services Firms
Recently, many financial institutions that had previously fit into one category or another have been trying to redefine themselves as multiservice financial institutions in an attempt to provide one-stop shopping for their customers and to take advantage of their existing market penetration. For example, Merrill Lynch, formerly a brokerage firm and investment bank, and CitiGroup, formerly a commercial bank. All these firms offer a fairly complete menu of checking and savings accounts, insurance products, consumer and mortgage loans and mutual fund investments.
2.6 EVALUATING FINANCIAL INSTITUTIONS

With so many different financial institutions to choose from, how should you decide which to use? This decision should be based on how each financial service provider rates based on the "Four P’s."

- **Products**
- **Price**
- **People**
- **Place**

a. **Products**
The ideal financial institution will provide you with all the products you need to manage your cash effectively. These products include not only current account and savings account but also many others. In choosing among financial service providers, it's a good idea to begin with a list of the products and services you'd like to have. You'll want to find out which institutions offer the greatest number of products and services you want, and you'll also want to compare the products and services qualitatively.

b. **Price**
Price includes both the interest you earn on liquid asset accounts and the fees you pay for cash management services. Whereas many financial institutions offer similar selections of products, the pricing of these products may vary dramatically. Financial institutions also differ substantially in the fees they charge for various services.

c. **People**
The level of customer service, although somewhat less important today than it once was because of the widespread use of electronic transactions, should still be an important factor in your decision.

d. **Place**
Finally, consider the location of the institution. Where are the ATMs located? Where is the main office? In deciding between a nearby institution and one that is farther away but offers a slightly better interest rate or lower costs, remember to consider whether the cost advantage will outweigh the inconvenience of travelling the greater distance when you need to visit the institution in person.
2.6 ISLAMIC FINANCIAL SYSTEMS

Islamic finance is emerging as a rapidly growing part of the financial sector in the Islamic world. Islamic finance is not restricted to Islamic countries, but is spreading wherever there is a sizable Muslim community. According to some estimates, more than 100 financial institutions in over 45 countries practice some form of Islamic finance, and the industry has been growing at a rate of more than 15 percent annually for the past five years. The market's current annual turnover is estimated to be $70 billion, compared with a mere $5 billion in 1985, and is projected to hit the $100 billion mark by the turn of the century.

The growth in Islamic finance initially coincided with the current account surpluses of oil-exporting Islamic countries. But its continued growth in the face of eroding oil revenues reflects the influence of other factors, such as the desire for sociopolitical and economic systems based on Islamic principles and a stronger Islamic identity. In addition, the introduction of broad macroeconomic and structural reforms—financial systems, the liberalization of capital movements, privatization, and the global integration of financial markets—have paved the way for the expansion of Islamic finance.

2.7 WHAT IS ISLAMIC FINANCE?

Islamic finance was practiced predominantly in the Muslim world throughout the Middle ages, fostering trade and business activities with the development of credit. In Spain and the Mediterranean and Baltic states, Islamic merchants became indispensable middlemen for trading activities. In fact, many concepts, techniques, and instruments of Islamic finance were later adopted by European financiers and businessmen.

In contrast, the term “Islamic financial system” is relatively new, appearing only in the mid-1980s. In fact, all the earlier references to commercial or mercantile activities conforming to Islamic principles were made under the umbrella of either “interest-free” or “Islamic” banking. However, describing the Islamic financial system simply as “interest-free” does not provide a true picture of the system as a whole. Undoubtedly, prohibiting the receipt and payment of interest is the nucleus of the system, but it is supported by other principles of Islamic doctrine advocating risk sharing, individuals’ rights and duties, property rights, and the sanctity of contracts. Similarly, the Islamic financial system is not limited to banking but covers capital formation, capital markets, and all types of financial intermediation.

Interpreting the system as “interest-free” tends to create confusion. The philosophical foundation of an Islamic financial system goes beyond the interaction of factors of production and economic behavior. Whereas the conventional financial system focuses primarily on the economic and financial aspects of transactions, the Islamic system places equal emphasis on the ethical, moral, social, and religious dimensions, to enhance equality and fairness for the
good of society as a whole. The system can be fully appreciated only in the context of Islam's teachings on the work ethic, wealth distribution, social and economic justice, and the role of the state.

The Islamic financial system is founded on the absolute prohibition of the payment or receipt of any predetermined, guaranteed rate of return. This closes the door to the concept of interest and precludes the use of debt-based instruments. The system encourages risk-sharing, promotes entrepreneurship, discourages speculative behavior, and emphasizes the sanctity of contracts.

2.8 PRINCIPLES OF AN ISLAMIC FINANCIAL SYSTEM

The basic framework for an Islamic financial system is a set of rules and laws, collectively referred to as shariah, governing economic, social, political, and cultural aspects of Islamic societies. Shariah originates from the rules dictated by the Quran and its practices, and explanations rendered (more commonly known as Sunnah) by the Prophet Muhammad. Further elaboration of the rules is provided by scholars in Islamic jurisprudence within the framework of the Quran and Sunnah. The basic principles of an Islamic financial system can be summarized as follows:

a. Prohibition of interest

Prohibition of riba, a term literally meaning "an excess" and interpreted as "any unjustifiable increase of capital whether in loans or sales," is the central tenet of the system. More precisely, any positive, fixed, predetermined rate tied to the maturity and the amount of principal (i.e., guaranteed regardless of the performance of the investment) is considered riba and is prohibited. The general consensus among Islamic scholars is that riba covers not only usury but also the charging of "interest" as widely practiced.

This prohibition is based on arguments of social justice, equality, and property rights. Islam encourages the earning of profits but forbids the charging of interest because profits, determined ex post, symbolize successful entrepreneurship and creation of additional wealth whereas interest, determined ex ante, is a cost that is accrued irrespective of the outcome of business operations and may not create wealth if there are business losses. Social justice demands that borrowers and lenders share rewards as well as losses in an equitable fashion and that the process of wealth accumulation and distribution in the economy be fair and representative of true productivity.

b. Risk sharing

Because interest is prohibited, suppliers of funds become investors instead of creditors. The provider of financial capital and the entrepreneur share business risks in return for shares of the profits.
c. Money as "potential" capital.
Money is treated as "potential" capital—that is, it becomes actual capital only when it joins hands with other resources to undertake a productive activity. Islam recognizes the time value of money, but only when it acts as capital, not when it is "potential" capital.

d. Prohibition of speculative behavior.
An Islamic financial system discourages hoarding and prohibits transactions featuring extreme uncertainties, gambling, and risks.

e. Sancity of contracts.
Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard.

f. Shariah-approved activities.
Only those business activities that do not violate the rules of shariah qualify for investment. For example, any investment in businesses dealing with alcohol, gambling, and casinos would be prohibited.

2.9 ISLAMIC FINANCIAL INSTRUMENTS
Some of the more popular instruments in Islamic financial markets are trade with markup or cost-plus sale (mudaraba). One of the most widely used instruments for short-term financing is based on the traditional notion of purchase finance. The investor undertakes to supply specific goods or commodities, incorporating a mutually agreed contract for resale to the client and a mutually negotiated margin. Around 75 percent of Islamic financial transactions are cost-plus sales.

Leasing (tijara). Another popular instrument, accounting for about 10 percent of Islamic financial transactions, is leasing. Leasing is designed for financing vehicles, machinery, equipment, and aircraft. Different forms of leasing are permissible, including leases where a portion of the installment payment goes toward the final purchase (with the transfer of ownership to the lessee).

Profit-sharing agreement (mudaraba). This is identical to an investment fund in which managers handle a pool of funds. The agent-manager has relatively limited liability while having sufficient incentives to perform. The capital is invested in broadly defined activities, and the terms of profit and risk sharing are customized for each investment. The maturity structure ranges from short to medium term and is more suitable for trade activities.

Equity participation (musharakah). This is analogous to a classical joint venture. Both entrepreneur and investor contribute to the capital (assets, technical and managerial expertise, working capital, etc.) of the operation in varying degrees and agree to share the returns (as well as the risks) in proportions agreed to in
CHAPTER 3 – DEVELOPMENT OF FINANCIAL SERVICES AND IMPACTS TOWARDS INDIVIDUAL AND ORGANISATION

advance. Traditionally, this form of transaction has been used for financing fixed assets and working capital of medium- and long-term duration.

Sales contracts. Deferred-payment sale (bay’ mu’ajjal) and deferred-delivery sale (bay’-salam) contracts, in addition to spot sales, are used for conducting credit sales. In a deferred-payment sale, delivery of the product is taken on the spot but delivery of the payment is delayed for an agreed period. Payment can be made in a lump sum or in installments, provided there is no extra charge for the delay. A deferred-delivery sale is similar to a forward contract where delivery of the product is in the future in exchange for payment on the spot market.

2.10 ISLAMIC BANKING IN MALAYSIA

Since the 1970s, Islamic banking has emerged as a new reality in the international financial scene. Its philosophies and principles are however, not new, having been outlined in the Holy Qur’an and the Sunnah of Prophet Muhammad (p.b.u.h.) more than 1,400 years ago. The emergence of Islamic banking is often related to the revival of Islam and the desire of Muslims to live all aspects of their live in accordance with the teachings of Islam.

In Malaysia, separate Islamic legislation and banking regulations exist side-by-side with those for the conventional banking system. The legal basis for the establishment of Islamic banks was the Islamic Banking Act (IBA) which came into effect on 7 April 1983. The IBA provides BNM with powers to supervise and regulate Islamic banks, similar to the case of other licensed banks. The Government Investment Act 1983 was also enacted at the same time to empower the Government of Malaysia to issue Government Investment Issue (GII), which are government securities issued based on Syariah principles. As the GII are regarded as liquid assets, the Islamic banks could invest in the GII to meet the prescribed liquidity requirements as well as to invest their surplus funds.

The first Islamic bank established in the country was Bank Islam Malaysia Berhad (BIMB) which commenced operations on 1 July 1983. In line with its objectives, the banking activities of the bank are based on Syariah principles. After more than a decade in operations, BIMB has proved to be a viable banking institution with its activities expanding rapidly throughout the country with a network of 80 branches and 1,200 employees. The bank was listed on the Main Board of the Kuala Lumpur Stock Exchange on 17 January 1992.

The long-term objective of BNM is to create an Islamic banking system operating on a parallel basis with the conventional banking system. However, similar to any banking system, an Islamic banking system requires three vital elements to qualify as a viable system, i.e.:

- a large number of players;
- a broad variety of instruments; and
- an Islamic money market.
In addition, an Islamic banking system must also reflect the socio-economic values in Islam, and must be Islamic in both substance and form. Recognising the above, BNM adopted a step-by-step approach to achieve the above objective. The first step to spread the virtues of Islamic banking was to disseminate Islamic banking on a nation-wide basis, with as many players as possible and to be able to reach all Malaysians. After a careful consideration of various factors, BNM decided to allow the existing banking institutions to offer Islamic banking services using their existing infrastructure and branches. The option was seen as the most effective and efficient mode of increasing the number of institutions offering Islamic banking services at the lowest cost and within the shortest time frame. Following from the above, on 4 March 1993 BNM introduced a scheme known as “Tabung Perbankan Tanpa Faedah” (Interest-free Banking Scheme) or SIFIT in short.

In terms of products and services, there are more than 40 Islamic financial products and services that may be offered by the banks using various Islamic concepts such as Mudharabah, Musyarakah, Mudabalah, Bai’ Bithaman Ajil (Bai’ Muraqabah), Ijarah, Gharzial Hasan, Ijarah Thumma Al-Bai’. To link the institutions and the instruments, the Islamic Interbank Money Market (IIMM) was introduced on 4 January 1994.

In October 1996, BNM issued a model financial statement for the banking institutions participating in the SIFIT requiring the banks to disclose the Islamic banking operations (balance sheet and profit and loss account) as an additional item under the Notes to the Accounts.

As part of the effort to streamline and harmonise the Syariah interpretations among banks and takaful companies, BNM established the National Syariah Advisory Council on Islamic Banking and Takaful (NSAC) on 1 May 1997 as the highest Syariah authority on Islamic banking and takaful in Malaysia.

On 1 October 1999, a second Islamic bank, namely Bank Muamalat Malaysia Berhad (BMMB) commenced operations. The establishment of BMMB was the effect of the spin-off following the merger between Bank Bumiputra Malaysia Berhad (BBMB) and Bank of Commerce (Malaysia) Berhad (BOCB). Under the merger arrangement, the Islamic banking assets and liabilities of BBMB, BOCB and BBMB Kewangan Berhad (BBMBK) were transferred to BBMB, while the conventional operations of BBMB, BOCB and BBMBK were transferred to EOCB accordingly. In addition, BBMB was given 40 branches of BBMB and BBMBK in various locations throughout Malaysia and a staff workforce of 1,000, migrated from BBMB, BOCB and BBMBK.
### Table 6.1: Range of Islamic Banking Products and Services in Malaysia

#### Deposit

<table>
<thead>
<tr>
<th>Products / Services</th>
<th>Applicable Concept</th>
</tr>
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<tbody>
<tr>
<td>Current account-i</td>
<td>Wadiah Yad Dhamanah/Mudharabah</td>
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<tr>
<td>Savings account-i</td>
<td>Wadiah Yad Dhamanah/Mudharabah</td>
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<tr>
<td>General investment account-i</td>
<td>Mudharabah</td>
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<tr>
<td>Special investment account-i</td>
<td>Mudharabah</td>
</tr>
<tr>
<td>Specific investment account-i</td>
<td>Mudharabah</td>
</tr>
</tbody>
</table>

#### Financing

<table>
<thead>
<tr>
<th>Products / Services</th>
<th>Applicable Concept</th>
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</thead>
<tbody>
<tr>
<td>Benevolent loan-i</td>
<td>Qard</td>
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<tr>
<td>Block discounting-i</td>
<td>Bai’ Dayn</td>
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<td>Bridging finance-i</td>
<td>Istisna/Bai’ Bithaman Aji</td>
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<tr>
<td>Bungalow lots financing-i</td>
<td>Bai’ Bithaman Aji</td>
</tr>
<tr>
<td>Cash line facility-i</td>
<td>Bai’ Inah/Bai’ Bithaman Aji/Murabah</td>
</tr>
<tr>
<td>Club membership financing-i</td>
<td>Bai’ Bithaman Aji</td>
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<tr>
<td>Computer financing-i</td>
<td>Bai’ Bithaman Aji</td>
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<td>Contract financing-i</td>
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<td>Equipment financing-i</td>
<td>Bai’ Bithaman Aji</td>
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<td>Floor stocking financing-i</td>
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<td>Hire purchase-i</td>
<td>Ijarah Thumma Bai’</td>
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<td>Home/house financing-i</td>
<td>Bai’ Bithaman Aji/Istisna / Variable Rate Ijarah</td>
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<td>Ijarah Thumma Bai’</td>
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<td>Land financing-i</td>
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<td>Tour financing</td>
<td>Bai Bithaman Ajil</td>
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<td>Umroh &amp; visitation financing</td>
<td>Bai Bithaman Ajil</td>
</tr>
<tr>
<td>Working capital financing</td>
<td>Murabahah/Bai Bithaman Ajil</td>
</tr>
</tbody>
</table>

**Treasury / Money Market Investment**

<table>
<thead>
<tr>
<th>Investment Products</th>
<th>Applicable Concepts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government investment issues</td>
<td>Bai al-Inah</td>
</tr>
<tr>
<td>Malaysian Islamic treasury bills</td>
<td>Bai al-Inah</td>
</tr>
<tr>
<td>Bank Negara negotiable notes</td>
<td>Bai al-Inah</td>
</tr>
<tr>
<td>Cagamas papers</td>
<td>Bai Bithaman Ajil Mudharabah</td>
</tr>
<tr>
<td>Commercial papers</td>
<td>Murabahah</td>
</tr>
<tr>
<td>Negotiable debt certificate</td>
<td>Bai Bithaman Ajil</td>
</tr>
<tr>
<td>Negotiable instrument of deposit</td>
<td>Mudharabah</td>
</tr>
<tr>
<td>Sell and buy back agreements (Repo)</td>
<td>Bai al-Inah</td>
</tr>
<tr>
<td>Foreign exchange</td>
<td>Ujrah</td>
</tr>
</tbody>
</table>

**Trade Financing**

<table>
<thead>
<tr>
<th>Products / Services</th>
<th>Applicable Concepts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accepted bills</td>
<td>Murabahah/Bai Dayn</td>
</tr>
<tr>
<td>Bank guarantee</td>
<td>Kafalah</td>
</tr>
<tr>
<td>Export credit refinancing</td>
<td>Murabahah/Bai Dayn</td>
</tr>
<tr>
<td>Letter of credit</td>
<td>Wakalah/Murabahah/Ijarah/Bai Bithaman Ajil</td>
</tr>
<tr>
<td>Shipping guarantee</td>
<td>Kafalah</td>
</tr>
<tr>
<td>Trust receipt</td>
<td>Wakalah/Murabahah</td>
</tr>
</tbody>
</table>

**Card Services**

<table>
<thead>
<tr>
<th>Products / Services</th>
<th>Applicable Concepts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Charge card</td>
<td>Qard</td>
</tr>
<tr>
<td>Credit card</td>
<td>Bai Inah/Bai Bithaman Ajil</td>
</tr>
<tr>
<td>Debit card</td>
<td>Ujrah</td>
</tr>
</tbody>
</table>

**Banking Services**
2.11 TAKAFUL IN MALAYSIA

The concept of takaful (Islamic insurance) was first introduced in Malaysia in 1985 when the first takaful operator was established to fulfil the need of the general public to be protected based on the Islamic principles. The legal basis for the establishment of takaful operators was the Takaful Act which came into effect in 1984.

Insurance as a concept does not contradict the practices and requirements of Shariah, in essence, insurance is synonymous to a system of mutual help. However, Muslim jurists are of the opinion that the operation of conventional insurance does not conform to the rules and requirements of Shariah as it involves the elements of uncertainty (Gharar) in the contract of insurance, gambling (Maysir) as the consequences of the presence of uncertainty and interest (Riba) in its investment activities.

Takaful is an insurance concept in Shariah whereby a group of participants mutually agree among themselves to guarantee each other against defined loss or damage that may inflict upon any of them by contributing as tabarru’ or donation in the takaful funds. It emphasizes unity and co-operation among participants. Takaful is not a new concept as it had been practised by the Muhajirin of Mecca and the Ansar of Medina following the hijra of the Prophet over 1400 years ago.

Tabarru’ is the agreement by a participant to relinquish his donation, a certain proportion of the takaful contribution that he agrees or undertakes to pay, thus enabling him to fulfil his obligation of mutual help and joint guarantee should any of his fellow participants suffer a defined loss. The concept of tabarru’ eliminates the element of uncertainty in the takaful contract. The sharing of profit or surplus that may emerge from the operations of takaful is made only after the obligation of assisting the fellow participants has been fulfilled. Thus, the operation of takaful may be envisaged as a profit sharing business venture between the takaful operator and the individual members of a group of participants.
Takaful operations are regulated and supervised by BNM since 1988 with the appointment of the BNM Governor as the Director-General of Takaful. In October 1995, the ASEAN Takaful Group (ATG), a grouping of takaful operators in Brunei, Indonesia, Malaysia and Singapore was formed to enhance mutual cooperation and to facilitate the exchange of business among takaful operators in ASEAN.

In 1997, the Malaysian takaful industry took a leap forward with the formation of ASEAN Retakaful International (L) Ltd. (ARIL) as an offshore retakaful company in Labuan. The establishment of ARIL was to create a vehicle for more dynamic retakaful exchanges among ATG members and providing additional retakaful capacity for further reducing their dependence on conventional reinsurance.

2.11 TYPES OF BUSINESS

The takaful businesses carried by the Malaysian takaful operators are broadly divided into family takaful business (Islamic "life" insurance) and general takaful business (Islamic general insurance).

a. Family Takaful Business

In general, a family takaful plan is a combination of long-term investment and mutual financial assistance scheme. The objectives of this plan are:

- to save regularly over a fixed period of time;
- to earn investment returns in accordance with Islamic principles; and
- to obtain coverage in the event of death prior to maturity from a mutual aid scheme.

Each contribution paid by the participant is divided and credited into two separate accounts, namely:

- **The Participants' Special Account (PSA)**
  A certain proportion of the contribution is credited into the PSA on the basis of tabarru'. The amount depends on the age of the participant and the cover period.

- **The Participants' Account (PA)**
  The balance goes into the PA which is meant for savings and investments only.

Examples of covers available under family takaful business are as follows:

- Individual family takaful plans;
- Takaful mortgage plans;
- Takaful plans for education;
- Group takaful plans; and
- Health/Medical takaful.
b. General Takaful Business

The general takaful scheme is purely for mutual financial help on a short-term basis, usually 12 months to compensate its participants for any material loss, damage or destruction that any of them might suffer arising from a misfortune that might inflict upon his properties or belongings.

The contribution that a participant pays into the general takaful fund is wholly on the basis of tabarur. If at the end of the period of takaful, there is a net surplus in the general takaful fund, the same shall be shared between the participant and the operator in accordance with the principle of al-Mudharabah, provided that the participant has not incurred any claim and/or not received any benefits under the general takaful certificate.

The various types of general takaful scheme provided by the takaful operators include:

- Fire Takaful Scheme;
- Motor Takaful Scheme;
- Accident/Miscellaneous Takaful Scheme;
- Marine Takaful Scheme; and
- Engineering Takaful Scheme.

**Family Takaful:**

<table>
<thead>
<tr>
<th>Individual plan</th>
<th>Mortgage</th>
<th>Health</th>
<th>Education</th>
<th>Travel</th>
<th>Family plan</th>
<th>Waqaf</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group plan</td>
<td>Group family</td>
<td>Group medical</td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

| Annuity          | Employees Provident Fund | Retirement |

**General Takaful:**

<table>
<thead>
<tr>
<th>Motor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fire</td>
</tr>
<tr>
<td>Marine, aviation and transit</td>
</tr>
</tbody>
</table>

**Miscellaneous**

- Includes: Personal accident
- Workmen corporation
- Liability
- Engineering
- House owners
3.1 INTRODUCTION TO ELECTRONIC BANKING

Electronic banking (e-banking) technology represents a variety of different services, ranging from the common automatic teller machine (ATM) services and direct deposit to automatic bill payment (ABP), electronic transfer of funds (ETF), and computer banking (PC banking). The term electronic banking often refers to online banking or internet banking. However, electronic banking is an upper construct including also telephone banking, WAP-banking as well as Net-television banking. The term online banking in parallel with internet banking excluding other electronic delivery channels, because the internet is widely seen as the most important channel in the era.

E-banking comprises various formats or technologies, including telephone (both landline and cell phones) banking, direct bill payment, electronic funds transfer (EFT), and most recently, PC or online (internet) banking. Daniel (1999) defined the term electronic banking as the provision of information or services by a bank to its customers, via a computer or television. It may be in the form of a public access kiosk in a location such as a railway station or airport. In its very simplest form, e-banking can mean the provision of information about the bank and its products via a page on the World Wide Web (WWW).

The provision of banking services through electronic channels (e-channels) namely ATMs, PC banking, phone banking and banking kiosks have provided an alternative means to acquire banking services more conveniently. More specifically, ATM or the automatic teller machines, is the most commonly used electronic distribution channel that enables bank customers to conduct their banking transactions (deposits, withdrawal or balance enquiry) 24-hours a day. Central Bank of Malaysia (BNM) defines internet banking as to bring products and services offered by banking institutions through access devices including personal computers and other intelligent devices. The Monetary Authority of Singapore (MAS) also provides a similar definition, where internet banking refers to the provision of banking services and products via electronic networks and delivery channels based on internet technologies, including web-based applications and wireless networks.

3.2 ELECTRONIC BANKING IN MALAYSIA

A traditional understanding of electronic banking in Malaysia is where customers use ATMs to make withdrawals and check balances. However, electronic banking also involves online financial services such as depositing cash, submitting loan applications, share trading and more. Internet banking, or the
other hand, although an extension of electronic banking, goes beyond these transactions and represents a different delivery channel on a separate platform.

An early step in the process of transitioning to the online mode was the introduction of Automated Teller Machines (ATMs) in the early 1980s, followed by the introduction of telebanking and PC banking in the late 1980s. Technology is always a key part of banking operations, as the finance industry requires technology to remain competitive and attractive. In Malaysia, there are six main components of e-banking, namely, Automated Teller Machine (ATM), phone banking, mobile phone banking, personal computer banking (PC banking), Automated Banking Centres (Kiosks) and Internet banking.

In Malaysia, KAWANKU was the first ATM distribution channel to be introduced by Malayan Banking (Maybank) Berhad in 1981. Since then all other commercial banks have adopted this banking channel to better serve their customers. On August 8, 2001, Hong Leong Bank Berhad launched its phone-banking call centre. The RM15 million investments provides an integrated call centre that gives not only 24-hour customer service but also serve as an important channel for the bank to introduce products and services to their customers. Besides, the growth of mobile phone banking in Malaysia is rising steeply in comparison to fixed phone lines. In the year 2002, mobile communications is expected to grow by 35 percent despite the sluggish economic condition. Personal computer banking has been around in Malaysia since the latter half of the 1980s. PC banking in Malaysia tends to be more popular among corporate customers. Another evolution in banking services is the Automated Banking Centre (ABC). Hong Leong Bank Berhad launched is first ABC at its Bangsar Baru branch on September 3, 1999.

The history of e-banking in Malaysia all started with the launching of Maybank2u.com from Maybank by BNM Governor Dato’ Dr. Zeti Akhtar Aziz on June 9, 2000. Not long after that, Southern Bank Berhad and Hong Leong Bank followed Maybank in introducing e-banking facilities to its customers. Currently, most of the 10 Malaysian local banks have introduced e-banking to a certain extent; whereas most foreign banks have introduced e-banking in full force. Based on the Malaysian Central Bank’s report (BNM), as at 31 December 2004, there were 23 commercial banks in Malaysia. In total, there are 1,960 commercial bank branches and 4,098 ATM networks in Malaysia. In addition, the number of commercial banks with internet services has been increased from 3 banks in 2000 to 13 banks in 2004.

Given below is a summary table of e-banking services offered by Malaysian domestic banks.
### Table 8.2: E-Banking Services in Malaysia

<table>
<thead>
<tr>
<th>Bank</th>
<th>Service</th>
<th>Features</th>
</tr>
</thead>
<tbody>
<tr>
<td>Southern Bank</td>
<td>PC Banking</td>
<td>Real-time fund transfers, credit-card payments, access account balances</td>
</tr>
<tr>
<td></td>
<td></td>
<td>and auto alerts.</td>
</tr>
<tr>
<td>Hong Leong Bank</td>
<td>Bank@Home</td>
<td>Fund transfers, balance enquiries, statement downloads, bill payments,</td>
</tr>
<tr>
<td></td>
<td></td>
<td>cheque-book request, cheque-status enquiry, stop cheque and credit-card</td>
</tr>
<tr>
<td></td>
<td>e-banking</td>
<td>Account Summary, Funds Transfer, Credit Card Service, Bill Payments,</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Service Request</td>
</tr>
<tr>
<td>HSBC Bank</td>
<td>Hexagon</td>
<td>A desktop-banking system via the HSBC Group's proprietary worldwide</td>
</tr>
<tr>
<td></td>
<td></td>
<td>communications network. Services include transfer of funds within own</td>
</tr>
<tr>
<td></td>
<td></td>
<td>accounts and third-party accounts.</td>
</tr>
<tr>
<td>Multi-Purpose Bank</td>
<td>Multi-Link</td>
<td>Basic banking services - account balance enquiry, fund transfer, bill</td>
</tr>
<tr>
<td></td>
<td></td>
<td>payments and product info. Also offers desktop share-trading via JB</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Securities Sdn Bhd.</td>
</tr>
<tr>
<td>PhileoAllied Bank</td>
<td>PALDIRECT</td>
<td>Provides banking, share investing, news and information, utility-bill</td>
</tr>
<tr>
<td></td>
<td>PALWORLD</td>
<td>payments, insurance, travel, electronic shopping and communications</td>
</tr>
<tr>
<td></td>
<td>RHB Online</td>
<td>Balance enquiry, fund transfer, remittance services, fixed-deposit</td>
</tr>
<tr>
<td></td>
<td></td>
<td>placements, credit-card payments, brokering and bill payments.</td>
</tr>
</tbody>
</table>

### The Electronic Banking Challenge

One of the biggest challenges in the development of electronic commerce has been for banks and merchants to overcome the issues of customer identification and account verification for online purchases. While the credit card systems have a process in place to verify and authorize transactions, the Internet poses challenges for merchants to not only validate that funds are available in an account, but to positively identify that the customer is in fact authorized to use that account for purchases.

Early in the life of e-Commerce, this situation led to the development of the SET protocol (Secure Electronic Transactions). While the initial version of SET was written in 1995, it has yet to be implemented for a number of reasons.
In the physical world, merchants can validate the identity of the accountholder by comparing the signature on the credit card with the signature on the sales slip. But in a virtual world, where the customer is not present, the merchant does not know if that person is authorized to use the account number provided for the transaction. The danger in the e-Commerce environment is that without some additional controls, the exposure to losses from fraudulent usage is exponentially greater.


ACTIVITIES
1. What are the primary reasons people need to hold cash?
2. Explain the types of financial service in market?
3. What is the difference between depository and non-depository institution?
4. Name three principles of Islamic Financial System and discuss for each principles?
5. What are the four key factors you should use in evaluating providers of financial services?
UNIT 9

ANALYSIS, APPROACHES AND STRATEGIES TO GLOBAL MARKETABILITY AND ITS IMPACTS TO INDIVIDUAL FINANCIAL ATTITUDES

Unit objectives: At the end of this lesson, students will be able to:

1. Able to analyse the strategies of the global markets in the use of money in daily life.
2. Knowing the importance of financial planning.
3. Understand the Challenges in Global Market.

Content:
Topic 1: Analysis on the strategies of the global market.
Topic 2: Global market and its local cultures and values.
Topic 3: The influences on local values and cultures from the global markets.

The objective of this unit: After studying this chapter, you will be able to

1. Analyse the strategies and approaches used in marketing financial products to the consumers.
2. Defining the global market and its cultures and values.
3. Explain the influences of global market towards local values and cultures.
9.1 GLOBALIZATION: THE STRATEGY OF DIFFERENCES

Ten years ago, globalization seemed unstoppable. Today, the picture looks very different. Even Coca-Cola, widely seen as a standard-bearer of global business, has had its doubts about an idea it once took for granted. It was a Coke CEO, the late Roberto Goizueta, who declared in 1996: “The labels ‘international’ and ‘domestic’... no longer apply.” His globalization program, often summarized under the tagline “think global, act global,” had included an unprecedented amount of standardization. By the time he passed away in 1997, Coca-Cola derived 67 percent of its revenues and 77 percent of its profits from outside North America.

But Goizueta’s strategy soon ran into trouble, due in large part to the Asian currency crisis. By the end of 1999, when Douglas Daft took the reins, earnings had slumped, and Coke’s stock had lost nearly one-third of its peak market value—a loss of about $70 billion. Daft’s solution was an aggressive shift in the opposite direction. On taking over, he avowed, “The world in which we operate has changed dramatically, and we must change to succeed... No one drinks globally. Local people get thirsty and... buy a locally made Coke.”

Unfortunately, “local” didn’t seem to be any better a description of Coke’s market space than “global.” On March 7, 2002, the Asian Wall Street Journal announced: “After two years of lackluster sales... the “think local, act local” mantra is gone. Oversight over marketing is returning to Atlanta.” If the business climate can force Coke, which historically was (and is) more profitable internationally than domestically, to seesaw back and forth on globalization in this way, think of the pressures on the typical large company, for which international business is usually much more profitable than domestic business.

Why is globalization proving so hard to get right? The answer is related in part to how companies frame their globalization strategies. In many if not most cases, companies see globalization as a matter of taking a superior (by assumption) business model and extending it geographically, with necessary modifications, to maximize the firm’s economies of scale. From this perspective, the key strategic challenge is simply to determine how much to adapt the business model—how much to standardize from country to country versus how much to localize to respond to local differences.
Recently, as at Coke, many companies have moved toward more localization and less standardization. But no matter how they balance localization and standardization, all companies that view global strategy in this way focus on similarities across countries, and the potential for the scale economies that such commonalities unlock, as their primary source of added value. Differences from country to country, in contrast, are viewed as obstacles that need to be overcome.

**New Meaning for "Place" Among the 4 P's**

When you begin to evaluate selling your products and services worldwide, focus on the three P's of global marketing: Portability, Population, and Politics. You could think of these three concerns as corollaries to "place" in Philip Kotler's 4 P's cosmology of product, price, promotion, and place.

Where you sell drives different marketing strategies. For example, instead of worrying about placement on end-caps in a grocery store, you will instead find yourself wondering about where that end-cap is geographically located and how the buyer's behavior might differ from your usual 47-year-old Lexus buyer living in Scottsdale.

If you're thinking like that, you have already made the critical leap of applying trusted marketing nostrums and best practices to new opportunities in other countries. From our conversations with many companies that have gone global, we find that they tend to be less disciplined than that. Instead, they decide to market to "Germany" rather than to particular demographic segments there. But first things first: Before you get to whether people from a particular postal code in Berlin are more likely to buy your wares, you should review their international marketability.

Consider what you naturally do before you enter any market. You ask questions like "Does this product fill a demonstrable need? Can people in our target markets use what we’re selling? How will we support it? If we sell it and they don’t want it, how do we accept returns?" You can probably think of a dozen of your own questions, but they all come down to the potential marketability of your product and what you have to sell and how you sell it.

1. **Who needs what you sell?** For each candidate country, figure out whether there’s a real need for your product lines. If you already have some presence in a country – a sales office or a distributor, for example – talk to your in-market colleagues to learn what’s hot. Supplement their knowledge with research from that country’s government or your own – the CIA and the U.S. Department of Commerce offer firms an enormous amount of data on other countries and export opportunities.

Turn to trade and industry groups. If you can afford it, commission primary research based on local polling, marketing, or work with public relations agencies. With this information you can determine the needs of specific markets, begin to quantify the market opportunity for your offerings, and calculate the impact of new or existing competitors in those arenas. Remember your usual analytical tools as you drill down into the product/country matrix: Michael Porter's Five Forces may push you in one
CHAPTER 9 - ANALYSIS, APPROACHES AND STRATEGIES TO GLOBAL MARKETABILITY AND ITS IMPACTS TO INDIVIDUAL FINANCIAL ATTITUDES

direction over another as you consider the actions of competitors, the threat of substitutes, barriers to market entry, the power of suppliers, and the clout of buyers.

2. **Determine whether your products can be sold outside your home market.** Rather than offering your entire product line to a new country, pick a few products that you think might travel well - and push them hard with localized marketing. Success with these products will establish your beachhead in new markets.

This is a research task for your product management staffers worldwide. Many products are somehow tied to language, culture, country, or an ethnic group living in one or more countries. In their current form, perhaps due to their intrinsic design, they are unsuitable for sale abroad. Some signs of trouble would be the need to substantially redevelop, reengineer, or repackage a product. Rigorous market certification tests or stringent manufacturing controls might rule out your offering.

However, many products can be quickly repackaged for global markets. Simple translation or a more sophisticated market adaptation could make online products globally ready. Some physical products like consumer electronics might require minimal packaging changes and a translated owner's manual. And still other products might be suitable as-is for a given English-speaking and tolerant demographic. Rely on local input and primary research such as those focus groups to determine whether such products make sense.

3. **If you sell, can you also service?** Figure out whether you can promote, sell, deliver, and support your offering beyond your domestic markets. The sale doesn't begin and end with a transaction. Before you sell anything, you have to market it and promote it. Once you've sold it, you have to deliver the product or service, handle anything that a customer might choose to return, and support it.

The web can be a false friend. While it's a great place to market and sell goods, it doesn't help when someone has a problem with something they bought from you. That's why online stores such as Best Buy and Sears let you buy online but pick up, return, or get service at their physical locations in the U.S. You could finesse this logistics problem with a specialist like DHL or UPS that can manage the cross-border shipping, customs brokering, and other issues. Or you might just bite the bullet and establish a physical presence in a country to deal with such issues. That "permanent establishment" has its own set of issues such as cumbersome taxation and stringent employment rules, which we will discuss in a future column.

Different strategies to different elements of a business.

Correctly choosing how much to adapt a business model is certainly important for extracting value from international operations. But to focus exclusively on the tension between global scale economies and local considerations is a mistake, for it blinds companies to the very real opportunities they could gain from exploiting differences. Indeed, in their rush to exploit the similarities across borders, multinationals have discounted the original global strategy: arbitrage, the strategy of difference. Of course,
we're all familiar with arbitrage in its traditional, and least-sustainable, form - the pure exploitation of price differentials. But the world is not so homogeneous as to have removed arbitrage from a company's strategic tool kit.

In fact, many forms of arbitrage offer relatively sustainable sources of competitive advantage, and as some opportunities for arbitrage disappear, others spring up to take their place. I do not claim that arbitrage to exploit differences is any more a complete strategic solution than the optimal exploitation of scale economies. To the contrary: if they are to get their global strategies right in the long term, many companies will have to find ways to combine the two approaches, despite the very real tensions between them.

Reconciling difference and similarity

One would think companies that try to exploit differences would not find it easy to exploit similarities as well. And indeed, a large body of research on the horizontal versus the vertical multinational enterprise has shown that there are fundamental tensions between pursuing scale economies and playing the spreads. (See the table "Conflicting Challenges.") The data indicate that there is some merit to classifying companies according to the primary way they add value through their international operations over long periods of time. But that either/or characterization of globalization strategies is very broad. Finer-grained analysis of case studies—particularly of companies that have in various ways been global innovators—suggests that it is possible to combine the two approaches to some extent.

For a start, it's possible to apply different strategies to different elements of a business. CEMEX pursued a financial strategy of arbitraging capital cost differences even as it implemented a standardized operational strategy. It set up complete, uniform production-to-distribution chains in most of its major markets, reinforced by cross-border scale economies in such areas as trading, logistics, information technology, and innovation (in the broadest sense of the term). Mixing and matching was possible in this case because, to a large extent, CEMEX can choose how to raise capital independently from the way it chooses to compete in product markets.

Some companies have gone further. Consider the case of GE Medical Systems (GEMS). The division that Jeffrey Immelt built up between 1997 and 2000 before he was tapped to take over from Jack Welch as CEO, Immelt pushed for acquisitions to build up scale because, for the leading global competitors, an R&D-to-sales ratio of at least 8 percent represented a significant source of scale economies. But he also implemented a production strategy that was intended to arbitrage cost differences by concentrating manufacturing operations—and, ultimately, other activities—wherever in the world they could be carried out most cost effectively. By 2001, GEMS obtained 15 percent of its direct material purchases from, and had located 40 percent of its own manufacturing activities in, low-cost countries.

Even the best management can only go so far in melding the two strategies.
Like CEMEX, GEMS was able to pursue both approaches because it could organize its operations into relatively autonomous bundles of activities (like product development) in which economies of scale and standardization were essential and those (like procurement and manufacturing) where arbitrage economies were being pursued. What’s more, it was able to coordinate its widely dispersed operations by applying centrally developed learning templates.

In particular, Immelt applied the “pitcher-catcher concept,” developed elsewhere in GE, in which for each move, a pitching team at a high-cost existing plant works with a catching team at a low-cost new location, and the move is not considered complete until the performance of the catching team meets or exceeds that of the pitching team. As a result, GEMS (and GE) seems to have managed to move production to low-cost countries faster than European competitors such as Philips and Siemens while also benefiting from greater scale economies.

But even the best management can get only so far in melding the two strategies. Acer, one of the world’s largest computer manufacturers, supplies a cautionary tale of what can happen when companies go too far. Acer entered early into the contract manufacturing of personal computers, operating in low-wage Taiwan, and made good money with that arbitrage play. But in the early 1990s, it began to push Acer as a global brand, particularly in developed markets. This two-track approach turned out to be problematic. The branded business grew to significant volumes but continued to generate losses because the competitive environment was particularly tough for a late mover.

Meanwhile, customers for Acer’s contract-manufacturing arm worried that their business secrets would spill over to its competing line of business. They also feared that Acer could cross-subsidize its own brand with profits from its contract-manufacturing operations and so undercut their prices. In 2000, the strategy blew up when IBM canceled a major order, reducing its share of Acer’s total contract-manufacturing revenues from 53 percent in the first quarter of 2000 to only 26 percent in the second quarter of 2001.

Acer responded by making some hard choices. Contract manufacturing has remained focused on customers in developed countries—and will gradually be spun off into a separate company. Meanwhile, sales of its own branded products have been focused on the East Asia region, particularly Greater China, where the contract customers cannot sell at a low enough price to compete. With this move, the company has acknowledged that the logic of exploiting similarities often calls for targeting countries similar to a company’s home base, whereas the logic of arbitrage involves exploiting one or more of the differences inherent in distance.

The future of the globalization process is by no means obvious. Markets may integrate further once economic conditions improve. But some argue that the process could actually shift into reverse, toward even greater economic isolation, if the experience between the two World Wars is any precedent. Whatever the ultimate direction, though, the differences that make arbitrage valuable as well as the similarities that create scale economies will remain with us for the foreseeable future. That spells
opportunity for those companies that have the imagination to see the full range of possibilities.

**Conflicting Challenges**

The challenges facing companies pursuing economies of scale through adoption or aggregation are fundamentally different from those that companies face when pursuing absolute economies through arbitrage.

<table>
<thead>
<tr>
<th>Adaptation or Aggregation</th>
<th>Arbitrage</th>
</tr>
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<tbody>
<tr>
<td><strong>Competitive Advantage</strong></td>
<td>To achieve scale and scope economies through standardization</td>
</tr>
<tr>
<td><strong>Why globalize at all?</strong></td>
<td>To reap absolute economies through specialization</td>
</tr>
<tr>
<td><strong>Configuration</strong></td>
<td>To minimize the effects of distance by concentrating on foreign countries that are similar to one’s home business</td>
</tr>
<tr>
<td><strong>Why locate in foreign countries?</strong></td>
<td>To exploit distance by operating in a more diverse set of countries</td>
</tr>
<tr>
<td><strong>Coordination</strong></td>
<td>By business; to achieve economies of scale across borders by placing a greater emphasis on horizontal relationships</td>
</tr>
<tr>
<td><strong>How should international operations be organized?</strong></td>
<td>By function; to achieve absolute economies by placing a greater emphasis on vertical relationships (efficiently matching supply and demand across borders, for instance)</td>
</tr>
<tr>
<td><strong>Control Systems</strong></td>
<td>Excessive standardization, on the one hand; variety, complexity, or both, on the other</td>
</tr>
<tr>
<td><strong>What are the strategic dangers?</strong></td>
<td>Narrowing differences between countries</td>
</tr>
<tr>
<td><strong>Corporate Diplomacy</strong></td>
<td>The appearance of and backlash against, cultural or other forms of domination (especially by U.S. companies)</td>
</tr>
<tr>
<td><strong>What public issues need to be addressed?</strong></td>
<td>The exploitation or bypassing of suppliers, channels, or intermediaries</td>
</tr>
</tbody>
</table>


### 9.2 INTERNATIONAL SERVICES MARKETING

When discussing international services marketing, it is easy to forget that some services were international in scope long before the term "scientific management" was ever invented or the first marketing course was taught. Shipping was an essential ingredient in opening up early trade routes, with banking and insurance following and then...
CHAPTER 9 – ANALYSIS, APPROACHES AND STRATEGIES TO GLOBAL MARKETABILITY AND ITS IMPACTS TO INDIVIDUAL FINANCIAL ATTITUDES

Facilitating them. In time, large companies emerged to operate international marine freight and passenger services, developing a network of agents in different ports to represent them.

Early technologies

With the early enhancement of technologies relating to radio, telegraph and telephone in the early twentieth century came international telecommunication companies. Perhaps the most famous of these – still in existence today – was Cable & Wireless which, in the early twentieth century, knitted together the global territories of the British Empire. Both the opportunity and the need for international delivery of a wide array of services have grown dramatically in recent years, either displacing or complementing parallel delivery of similar services by purely domestic operations. Some firms – such as hotel chains – follow their customers into new markets; others extend their geographic reach in search of new opportunities to increase their sales and expertise.

As more and more organizations offer services in foreign markets – often around the world – and as international trade in services increases, important questions are being raised concerning the design and implementation of international service marketing strategies. Research on internationalization of services has been more limited than for manufactured goods and has tended to focus on methods of entry into foreign markets (Vonderembse and Chadwick, 1989; Johanson, 1990; Itoch and Sivakumar, 1998). But there are other issues, too. What do we mean by international strategy? How do the distinctive characteristics of service businesses affect development of a transnational or even global strategy? What should be the basis of competition against other international players? These are questions for government policy makers as well as corporate managers. A good starting point is to draw a distinction between domestic, multi-domestic and transnational strategies.

What is a transnational strategy?

Transnational strategy involves the integration of strategy formulation and implementation across all the countries in which the company elects to do business, in contrast to a multidomestic (or “multi-local”) approach that provides for independent development and implementation of strategy by management units within each country (Hout et al., 1982; Prahalad and Doz, 1987; Yip, 1989). In its broadest form, transnational strategy becomes global in form and we speak of globalization. However, just because we can see a growing number of well-known service brand names popping up all over the world does not necessarily mean that the companies behind the brands have a truly transnational strategy. Many allegedly global strategies today are basically multidomestic in nature. For instance, even though many retail banks now have offices and even networks outside their countries of origin, in most instances, there is still little integration of strategy across countries.

9.3 CHANGES IN FINANCIAL SERVICES INDUSTRY

Significant changes
The US financial services industry has undergone significant change in the last two decades, and the forces of dynamic changes are even more aggressively challenging today’s financial institutions (Stiebeler et al., 1997). First, rapidly changing electronic technology has reshaped how consumers interact with their financial institutions (Federal Reserve Board, 1997; Freedman and Goodlet, 1998; Kimball et al., 1997; White, 1996). Second, deregulation has made competition borderless, allowing not only interstate branching, which has encouraged consolidation, but also entry of foreign financial institutions into the US market (Avery et al., 1997; Freedman and Goodlet, 1998; Krishnan et al., 1999; Orlow et al., 1996).

Most recently, financial liberalization intensifies competition not only within banking institutions (i.e., commercial banks, savings and loans, and credit unions) but also with other non-banking financial firms, such as securities and insurance. The changing marketplace has forced financial institutions to be adaptive to remain competitive. In an effort to cut costs, many financial institutions have eliminated branch offices, since the largest expenses for financial institutions include labor costs and real estate (Orlow et al., 1996). This phenomenon has prevailed in the marketplace during the past decade, reducing the number of branch offices by 6 percent from 1985 to 1995 (Avery et al., 1997).

Enthusiasm for electronic banking technologies

This move away from face-to-face interaction with consumers has also been encouraged by the current enthusiasm for electronic banking technologies (Hitt and Frit, 1999). Technological advancements have created a number of self-service technologies for consumers to interact with financial institutions from their-mail to telephone to newer computer technology. As new technologies have emerged, an increasing number of consumers have adopted some form of electronic banking technologies (Kimball et al., 1997).

According to McCormick and Rose (1994), the percentage of all transactions occurring at branch offices through face-to-face interaction declined from 71 percent in 1980 to 50 percent in 1993. However, still for a large number of consumers, electronic technologies and other direct dealings with financial institutions without human interactions can be unmitigated goods. Kennickell and Kwasl (1997) reported that a personal visit to a financial institution is still the most common way for consumers to do their financial business: 86.7 percent of households that use at least one financial institution reported personal visits to branch offices as the main way for their personal finances. As Greenspan (2000, p. 2) rightly put, “...we should not lose sight of the exceptional economic value of franchises based on old-fashioned, face-to-face interpersonal banking. The newer technologies may be awesome but human nature does not change – we still appreciate a face across the desk more than a computer screen.” Therefore, before following the current trend of eliminating face-to-face interpersonal banking in favor of electronic banking, financial institutions need to carefully examine how consumers want to conduct their financial business. Marketers in financial service institutions have long recognized the importance of satisfying customers (Hestett et al., 1997; Krishnan et al., 1999), a focus that has become even more critical in today’s intensely competitive environment.
9.4 FACE-TO-FACE SELLING VERSUS DIRECT MARKETING

Revolutionized the delivery of financial services

Over the last two decades, advances in information technology have revolutionized the delivery of financial services. Financial institutions have traditionally delivered services through face-to-face interactions with customers at branch offices. Recently, however, the human interaction feature of services marketing has been challenged by other channels of delivery, so-called "self-service technology," spurred by electronic technology (Biltnor et al., 2003; Meuter et al. 2000; Krishnan et al., 1999; Prendergast and Marr, 1994).

Both financial institutions and consumers found value in non-human delivery. For many firms, direct channels such as automated telephone services and computer banking cut operating costs, since the largest expenses for financial institutions are labor costs and real estate (Orloff et al., 1996). A typical branch has total annual operating expenses of $1.4 million.

However, setting up electronic delivery channels also incurs large fixed costs (Hitt and Frei, 1999), although the variable costs are minimal once the initial investment is made. Instead of cost savings, therefore, Hitt and Frei (1999) argued that the value of electronic direct marketing channels is to retain customers who are interested in utilizing these innovative channels of service delivery. Furthermore, electronic delivery of financial services also allows financial institutions to compete in a national and even global market, rather than be confined to a local market (Orloff et al., 1996).

Non-traditional delivery provides convenience

For consumers, non-traditional delivery provides convenience (Avery et al., 1997; Krishnan et al., 1999; McCormick and Rose, 1994). Direct delivery of financial services through mail, phone, and computer banking enables consumers to conduct financial business at home during their off hours. In addition to greater convenience consumers find alternative delivery channels less costly due to increasing number of financial institutions that charge for human interaction. Consumers are also more technologically savvy than ever (Kimball et al., 1997), reducing their uneasiness involving technological innovation.

At the same time, both financial institutions and consumers indicate the importance of human interactions, and the literature of relationship building has developed mainly on interpersonal interaction with customers (Baker et al., 1998). Although consumers' use of electronic banking technology continues to grow, the speed of growth has not met many industry enthusiasts' expectations. According to Reeves and Bednar (1996), a random sample of bank customers in Arkansas reported human interaction in service delivery as an important determining factor of customer satisfaction. Kwast et al. (1998) also found that many households and small business customers still consider the proximity of branch offices when choosing a financial institution.

Rise in professional service providers
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In spite of a growth in consumer sophistication with respect to technology, there has been a rise in professional service providers who assist consumers with transactions that are perceived to be "too technical, too important, or too difficult to be made unaided" (Kimball et al., 1997, p. 4). Just as consumers obtain advice from professionals on the purchase of cars, vacations, and children’s camp, they appreciate guidance on financial services. That is, when counseling, consulting, or teaching is involved, face-to-face selling can be the most effective channel.

For financial institutions, face-to-face interaction is the richest method for establishing a close relationship with their customers, because it involves more verbal and visual information and feedback (Alba et al., 1997; Randampully, 1998). As Alba et al. (1997) illustrated, face-to-face interaction gives customers a chance to see and feel not only the information provided to them, but also the salespersons’ tone of voice, friendliness, and empathy. In fact, several scholars (Humphrey, 1997; Orlow et al., 1996) have warned that ties between customers and financial institutions may erode as human interactions decrease.

Addressing this potential problem, several scholars proposed a “high tech and high touch” sales approach for the financial services industry (Kelly, 1989; Orlow et al., 1996). Instead of eliminating human interactions in delivering financial services, their suggestions are to cultivate personal relationships (e.g., customizing services) with customers using the cost savings released from nonhuman delivery of services (Pine et al., 1995).

It is also important to consider what types of financial services should only be delivered via a specific channel (e.g., face-to-face selling as opposed to direct marketing). Bateson (1985) is among the few researchers who have examined consumers’ preference for different delivery channels. He found that there are distinctive consumer preferences toward both types of channels, controlling all other factors, such as cost and location. In other words, there is a group of consumers that desires human interactions, and there is another group that wants to use electronic services, given the same cost and location.

Limited to routine banking transactions

Using New Zealand data, Prendergast and Marr (1994) conducted interviews with industry experts and consumers. Based on their findings, they suggested that electronic banking should be limited to routine banking transactions, while high involvement transactions such as lending or investment advice should remain personal interactions. That is, the activities that customers conduct through different channels should vary. For example, ATMs should be continuously used for cash transactions, while computer banking at home should be used for account transfers. The role of human staffs should change from administrators who handle routine transactions to salespeople who help to sell financial products and services to consumers. McCormick and Rose (1994) also noted the importance of changing roles of human staffs.

Several researchers noted demographic differences between consumers who have or have not adopted alternative methods of financial services delivery, such as ATMs.
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(Amel, 1986; El-Haddad and Almahmeed, 1992; Marshall and Haslop, 1988; Swinyard and Ghee, 1984; Taube, 1988) and other electronic banking technologies (Hilt and Frei, 1999; Kenickell and Kwast, 1997). In general, consumers who have adopted alternative channels are younger, more affluent, more likely to be married and homeowners. Consumers' level of financial assets was also found to be an important determinant of using methods other than traditional face-to-face banking (Kenickell and Kwast, 1997).

Two different channels of marketing financial products

In sum, it is well acknowledged that both financial institutions and consumers see the benefits in two different channels of marketing financial products and services: face-to-face and direct means. There is also some evidence that there exist differences across different types of financial products and services (i.e., routine transaction versus more complicated financial products and services) and individual differences in consumer's preferences toward channels across different consumer characteristics. However, which segments of consumers prefer which channels for which financial products and services have not been fully investigated.
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TOPIC 2
GLOBAL MARKET AND ITS LOCAL CULTURES AND VALUES

2.1 WHAT IS GLOBALIZATION

What is globalization? While the term ‘globalization’ is relatively new—the word ‘globalize’ was coined only in 1944—the phenomenon of globalization itself is not. To ‘globalize’—meaning “to make worldwide in scope or application”—entails contact and interaction, across borders and continents, and the spread of cultural, economic, and political ideas (particularly by way of trade, industry, technology, the arts, letters, and music, and religion) throughout the world. Thus, the earliest, genuinely world-wide, ‘wave’ of globalization was not that marked by the series of economic, social, and political changes which followed the Second World War or the recent collapse of the Soviet Union, but that of the empires of Western Europe—Spain, England, France, and Portugal—in the sixteenth and seventeenth centuries, and the concurrent missionary activities of Christianity. And there have been other ‘waves’ of globalization since then.

Although the globalization we speak of today is predominantly economic [i.e., focused on trade and investment, and, particularly, global competition and deregulation], as the preceding definition indicates, this process is intermingled with a number of political and cultural conditions and values, and it is primarily because of these latter conditions and values that globalization has had the effects it has.

The response to this globalization has been mixed. (It is worth noting that this response is not one that is divided simply along ‘east/west’ or ‘north/south’ lines, but reflects a conflict that exists within many nations of the world.) Perhaps the principal reason why there has been such a response is that it is often identified with international capitalism and, as a political and cultural process, associated with interests that have their origins in the West. Saskia Sassen and Mahdi Elmandjra, have advanced a sustained theoretical critique of globalization, and in developing countries, such as India, there have been mass demonstrations against it (e.g., over policy decisions made by the World Bank).
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Still, the ‘vehicles’ of globalization (e.g., telecommunications, computer technology, air travel, etc.) have provided means of preserving ‘local’ culture and traditions, particularly for minority or immigrant cultures. Moreover, globalization has brought about an increased consciousness of principles of justice, equality, and rights (e.g., through human rights declarations, conventions, and education), has encouraged people to demand that these rights be respected, and has even led to the creation of institutions broader than the nation state, whereby life, liberty, and security of the person can be defended, and whose authority leaders of nation states cannot simply ignore.

In any event, and however beneficial or negative its effects, globalization is a fact. Given the increasing levels of integration of national economies, the pervasiveness of new technologies—particularly, information technology—and the opportunities for travel and trade throughout the world, globalization and its accompanying forces and features are not going to disappear. To oppose globalization unequivocally would be no more successful than the Luddite opposition was to industrialization. There is, then, no question of whether we should allow or oppose globalization; it is, rather, whether we can manage or control it.

Globalization, therefore, presents us with a number of challenges—and these challenges include: how to react to the ideas and values that seem to be part of globalization; whether one can find a way of directing or transforming the process to address problems like poverty, oppression, and lack of education, that affect people the world over; and whether it is possible to limit the influence of globalization in certain spheres and, thereby, allow for the continuity of local cultures and traditions.

The key to a constructive response to globalization, then, is to find a point from which a broad range of groups and individuals—including those who already have a role in promoting economic, political, and social globalization—can identify common interests and use them to decide how to direct it. I would suggest that we can find such a point by looking at the example of ecumenism and inter-religious dialogue. If we consider what is involved in ecumenism, we can discern elements of a global ethic and a way of decision-making that would acknowledge the relative merits of globalization and yet direct its activities. Such an approach could allow a wide range of participants to [come to] ‘have a place at the table,’ and ensure that the ideologies of a few do not arbitrarily make a rule for all.

2.2 LOCAL CULTURES AND VALUES

With this increasing globalization, it creates a growing number of service companies who conduct their business with customers of different cultures. For these service providers, it is especially important to ask if there are differences between intra-cultural and inter-cultural service encounters. Particularly needed is information about whether “culture shock” occurs in service encounters due to culturally-bound expectations and perceptions.

The impact of globalization on culture, for example, depends on whether one thinks that local cultures should be protected from outside influence, or whether one thinks
CHAPTER 7 - ANALYTICAL APPROACHES AND STRATEGIES TO GLOBAL MARKETABILITY AND ITS IMPACTS ON INDIVIDUAL FINANCIAL ATTITUDES

- homogenization and heterogenization may actually operate in tandem or even reinforce each other


ACTIVITIES

1. Briefly define the globalization?
2. What do you need to consider for creating your product markets?
3. What are the reasons to think that globalization might undermine cultural diversity?
4. What are the impact of globalization on culture?
UNIT 10

ISSUES AND CHALLENGES OF FINANCIAL PLANNING IN GLOBAL MARKET

Unit objectives: At the end of this lesson, students will able to:

1. Understand the concept globalization, poverty and consumption
2. Knowing the resources availability and needs fulfillment
3. Understand the relationship between cost of living and quality of life

Content:

Topic 1: Globalization, Poverty and Consumption
Topic 2: Resources Availability and Needs Fulfillment
Topic 3: Cost of Living and Quality of Life
1.1 Globalization

Globalization (or globalisation), although often described as the cause of much turbulence and change, is in fact the umbrella term for the collective effect. The change itself. Globalization (i.e. the aggregate change we observe in our factories, storefronts, indeed generally across our economies and lifestyles) is caused by four fundamental forms of capital movement throughout the global economy. The four important capital flows are:

- Human Capital (i.e. Immigration, Migration, Emigration, Deportation, etc.)
- Financial Capital (i.e. Aid, Equity, Debt, Credit & Lending, etc.)
- Resource Capital (i.e. Energy, Metals, Minerals, Lumber, etc.)
- Power Capital (i.e. Security Forces, Alliances, Armed Forces, etc.)

Most of the stresses and complexities confronted in the general macro affairs of countries, communities, and the interactions between them, can be traced to these four flows. Connectivity available via cheaper telecommunications and modes of travel—made more accessible to more people, facilitates these interactions at a rate unprecedented in history. Cultural and political frictions at all levels can thus be explained as arising from the difference in opinion between two or more parties about the origination, treatment, timing, ownership or value of one or more of the capital flows.

Meaning

The International Monetary Fund defines globalization as “the growing economic interdependence of countries worldwide through increasing volume and variety of cross-border transactions in goods and services, free international capital flows, and more rapid and widespread diffusion of technology”. Meanwhile, the International Forum on Globalization defines it as “the present worldwide drive toward a globalized economic system dominated by supranational corporate trade and banking institutions that are not accountable to democratic processes or national governments.” While notable critical theorists, such as Immanuel Wallerstein, emphasize that globalization cannot be understood separately from the historical development of the capitalist world-system the different definitions highlight the ensuing debate of the roles and relationships of government, corporations, and the individual in maximizing social welfare within the globalization paradigms. Nonetheless, it is clear that globalization has economic, political, cultural and technological aspects that may be closely interwoven. Given that these aspects
are key to an individual's quality of life, the social benefits and costs brought upon them by globalization generate strong debate.

**Characteristics**

Globalization/internationalisation has become identified with a number of trends, most of which may have developed since World War II. These include greater international movement of commodities, money, information, and people; and the development of technology, organizations, legal systems, and infrastructures to allow this movement. The actual existence of some of these trends is debated.

- **Economically**
  - Increase in international trade at a much faster rate than the growth in the world economy
  - Increase in international flow of capital including foreign direct investment
  - Creation of international agreements leading to organizations like the WTO and OPEC
  - Development of global financial systems
  - Increased role of international organizations such as WTO, WIPO, IMF that deal with international transactions
  - Increase of economic practices like outsourcing, by multinational corporations.

- **Culturally**
  - Greater international cultural exchange
  - Spreading of multiculturalism, and better individual access to cultural diversity, for example through the export of Hollywood and Bollywood movies. However, the imported culture can easily supplant the local culture, causing reduction in diversity through hybridization or even assimilation. The most prominent form of this is Westernization, but Sinicization of cultures also takes place.
  - Greater international travel and tourism
  - Greater immigration, including illegal immigration
  - Spread of local foods such as pizza, Chinese and Indian food/Pakistani food to other countries (often adapted to local taste)
  - World-wide Fads and Pop Culture such as Pokémon, Sudoku, Numa Numa, Origami, Idol series, YouTube, MySpace, and many others.
  - Increasing usage of foreign phrases, Example... "Amigo" and "Adios" are Spanish terms many non-speaking Spanish people in the US understand. Most Americans understand some French, Spanish or Japanese without actually knowing the language.
CHAPTER 10 - ISSUES AND CHALLENGES OF FINANCIAL PLANNING IN GLOBAL MARKETS

- Development of a global telecommunications infrastructure and greater transborder data flow, using such technologies as the internet, communication satellites and telephones.
- Increase in the number of standards applied globally; e.g. copyright laws and patents
- Formation or development of a set of universal values
- The push by many advocates for an international criminal court and international justice movements (see the International Criminal Court and International Court of Justice respectively).
- It is often argued that even terrorism has undergone globalization, with attacks in foreign countries that have no direct relation with the own country

1.2 THE CONCEPT OF POVERTY

Poverty is multi-dimensional. It is, of course more than a lack of income. Poverty is also associated with lack of access to basic education, health services and information, shelter, clean water and sanitation. Economic growth increases the income of the population and tends to reduce the number of poor people. Economic growth also increases the government's revenue, which can be used to provide basic social services and infrastructure. But economic growth alone is rarely sufficient to reduce poverty significantly.

Investing in increasing access to, and provision of basic social services not only helps to provide opportunities for the poor, but also contributes to sustainable economic growth. Malaysia's impressive improvements in the social sectors can be seen in key human development indicators. Between 1970 and 2000, life expectancy at birth rose sharply for females and males, the combined figure being from 64.2 to 72.8 years, while the infant mortality rate fell from 40.8 to 7.0 per 1,000 live births. Over the corresponding period, the adult literacy rate rose from 60 percent to 94 percent, and since 1990 primary school enrolment has been universal for both girls and boys.

1.3 POVERTY DEFINITION

In Malaysia, the incidence of absolute poverty has traditionally been determined reference to a threshold poverty line income (PLI). This PLI based on what is considered to be the minimum consumption requirements of a household for food, clothing and other non-food items such as rent, fuel and power. There is no separate PLI for urban and rural households. The proportion of all households living below this threshold is the proportion living in poverty – that is the poverty rate. Poverty rates are available for household categories only, they are not available for individuals separately.

The concept of hard-core poverty was first used by the Malaysian government in 1989 to help identify and target poor households whose income is less than half
of the PLI. It is one indication of the severity of poverty. The term hard-core poverty in Malaysia does not however indicate the duration of time spent living below the poverty line.

The concept of relative poverty is used to assess income disparities between income groups. It is measured here by using income disparity ratios of income groups (top 20 percent and bottom 40 percent) and urban and rural dwellers.

1.4 MALAYSIAN POVERTY LINE

Malaysia’s Poverty Line Income (PLI) is based on the minimum requirements of a household for three major components: food, clothing and footwear and other non-food items such as rent, fuel and power, furniture and household equipment, medical care and health expenses, transport and communications and recreation, education and cultural services.

For the food component, currently the minimum expenditure is based on a daily requirement of 9,910 calories for a family of five persons, while the minimum requirements for clothing and footwear are based on standards set by the Department of Social Welfare. The other non-food items are based on the level of expenditure of the lower income households as reported in the Malaysian Household Expenditure Survey (HES). The PLI is calculated to reflect differences in prices and household size in Peninsular Malaysia, Sabah and Sarawak.

Table 10.1: Poverty Line Incomes, 1990-2002

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<tbody>
<tr>
<td>Peninsular Malaysia</td>
<td>370</td>
<td>425</td>
<td>510</td>
<td>529</td>
</tr>
<tr>
<td>Sabah</td>
<td>544</td>
<td>601</td>
<td>685</td>
<td>690</td>
</tr>
<tr>
<td>Sarawak</td>
<td>452</td>
<td>516</td>
<td>594</td>
<td>600</td>
</tr>
</tbody>
</table>

($BA per month per household) *

* Adjusted based on average household size of 4.6 in Peninsular Malaysia, 4.9 in Sabah and 4.8 in Sarawak.

1.5 TRENDS IN POVERTY RATES

Malaysia’s poverty rate has declined dramatically over the past three and a half decades. About half of Malaysian households lived below the poverty line in 1970 falling to 16.5 percent in 1990 and to just 5.1 percent in 2002. Malaysia’s poverty has been a predominantly rural phenomenon. In 1970, 49.3 percent of Malaysian households were below the poverty line. The number of poor rural households as a percentage of the total number of households was 44 percent, the remaining 5.3 percent being urban.
The rural poverty rate in 1970 was two-thirds of its 1960 level; it more than halved in the next 10 years and was halved again from 1990 to 2000. The urban poverty rate was halved every 10 years from 1970 to 1990. By 2002, just 2 percent and 11.4 percent respectively of urban and rural households were living in poverty. Although the urban poverty rate is very low, rapid urbanization that has occurred over the decades means that the number of the urban poor is now considered significant.

1.6 CONSUMPTION

Consumption is the value of goods and services bought by people. Individual buying acts are aggregated over time and space. Consumption is normally the largest GDP component. Many persons judge the economic performance of their country mainly in terms of consumption level and dynamics.

Composition

First, consumption may be divided according to the durability of the purchased objects. In this vein, a broad classification separates durable goods (as cars and television sets) from non-durable goods (as food) and from services (as restaurant expenditure). These three categories often show different paths of growth. Second, consumption is divided according to the needs it satisfies. A commonly used classification identifies ten chapters of expenditure:

- Food
- Clothing and footwear
- Housing
- Heating and energy
- Health
- Transport
- House furniture and appliances
- Communication
- Culture and schooling
- Entertainment

People in different positions in respect to income have systematically different structures of consumption. The rich spend more for each chapter in absolute terms, but they spend a lower percentage in income for food and otherbasic needs. The percentage values of an aggregation over all the household in a country can thus be used for judging income distribution and the development level of the society. The rich have both higher levels of consumption and savings. In differentiated product markets, the rich can usually buy better goods than the poor. This happens also because they tend to use different decision making rules. In other words, consumption depends on social groups and theirbehaviours, as well as their proneness to advertising.
Third, for exactness' sake, one should distinguish "consumption" as use of goods and services from "consumption expenditure" as buying acts. For durable goods this difference may be relevant, since they are used for long time periods. Fourth, only newly produced goods enter into the definition of consumption, whereas the purchase of, say, an old house is not considered consumption, since it was already counted in the GDP of the year in which it was built.

Determinants

Current income is the most relevant determinant of consumption. Other things equal, a higher price level (inflation) reduces the real current income, thus real consumption. Further, cumulated savings in the past can be squeezed in case of necessity and give rise to a jump in consumption. Expectations on future income, especially if concerning short-term credible events, may also play an important role. At household level, there are many possible rules set to control monthly, weekly or even daily consumption expenditure. They relate not only to income but also to the following factors among others:

- general lifestyles, in particular attitudes toward savings or consumption as "values" in itself;
- a standard level of consumption: the family tries to maintain over time;
- decisions regarding active saving strategies, like an investment scheme for pension aims;
- the relative success of past investment in shares or other financial instruments; in fact, a stock-exchange boom is likely to promote an euphoria tide with growing consumption;
- opportunities of consumer credit, depending in turn by interest rates and marketing strategies by banks and special consumer credit institutions;
- past decisions on durables. For instance, a family having bought a car will reduce expenditure on public transport in favour e.g. of fuel;
- status symbols diffusion, "social musts";
- new employment perspectives, also as far as the corresponding investments in human and physical capital are concerned;
- innovative sale proposals in terms of both new products and new services, effectively advertised;
- temporary money (cash) excess.

According to age of the decision-maker, individual and household consumption varies, both in values and composition. Thus, aggregate consumption may be influenced by demographic factors, such as an older and older population, even though one should not rely too much on these relationships since demographic variables are extremely slow in changes, whereas consumption clearly reacts to economic climate.
## Table 10.2: Equity in Consumption between Asian and World Countries

<table>
<thead>
<tr>
<th>Income and Consumption</th>
<th>Asian</th>
<th>World</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>* Asia is home to 75% of the world’s poor</td>
<td>* Nearly 1.3 billion live on less than 1 US Dollar and close to 1 billion cannot meet basic consumption requirements</td>
</tr>
<tr>
<td>Nutrient</td>
<td>* Average cereal consumption and calorie intake in Asia is one third that in developed countries</td>
<td>* About 840 million people are malnourished, The overall consumption of the richest fifth of the world’s population is 16 times that of the poorest fifth</td>
</tr>
<tr>
<td></td>
<td>* 70% of the world’s severely stunted, underweight and wasted children, with South Asia alone accounting for almost half this number</td>
<td></td>
</tr>
<tr>
<td>Health services</td>
<td>* At least one in three Asians has no access to safe drinking water and at least one in two has no access to sanitation</td>
<td>* More than 880 million people lack access to health services</td>
</tr>
<tr>
<td></td>
<td></td>
<td>* 2.6 billion lack access to basic sanitation</td>
</tr>
<tr>
<td>Education</td>
<td></td>
<td>* More than 850 million adults were illiterate.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>* More than 260 million children are out of school at the primary and secondary level</td>
</tr>
</tbody>
</table>
2.1 FINANCIAL AND NON-FINANCIAL NEEDS

Financial Needs

It was found by experience that most of the clients are most interested in the following:

1. **Maintaining a comfortable standard of living after retirement**
   For most of peoples the primary goal after retirement is maintaining the same standard of living that was enjoyed during working years. Many peoples see retirement as an opportunity to enhance their lifestyle.

2. **Maintaining Economic Self-Sufficiency**
   A vast majority of peoples do not want to become a financial burden to their children in the senior years. Maintaining a level of financial independence during lifetime is a key goal in their financial planning. Most peoples regard the following as essential for economic self-sufficiency.
   - Investing money in such a away as to minimize potential losses
   - Obtaining health insurance coverage
   - Income outpaces inflation

3. **Providing Family Members**
   Peoples who bear financial responsibility for others (like a spouse) generally have concern for the financial welfare after their death. These concerns are usually greater if the dependent is under special medical care or assistance.

4. **Transferring Wealth**
   Peoples are generally interested in transferring wealth to the next generation in a way that minimizes loss.

5. **Insurance Needs**
   - Business insurance
   - Mortgage insurance
   - Health insurance
   - Home and contents insurance
   - Motor vehicle insurance
   - Term insurance
CHAPTER 10 – ISSUES AND CHALLENGES OF FINANCIAL PLANNING IN GLOBAL MARKETS

6. Estate Planning
   - Needs for wills
   - Choice of executor
   - Age at which beneficiaries become entitled to estate
   - Allowable investments for estate trustees

7. Investment Strategies
   - Specification of maximum gearing limits
   - Specification of interest rates of borrowings
   - Consideration of self-managed funds

8. Tax Strategies
   - Ensuring tax is minimized legally
   - Establishment of an appropriate business structure
   - Remuneration planning

Non-Financial Needs
Most of the issues previously relate to financial needs. In addition to financial goals, most peoples also have several non-financial or personal goals. These may include:

   - Maintaining health and fitness during the retirement years
   - Selling a family residence and relocating upon retirement
   - Learning to manage leisure time and adapting to non-working lifestyle
   - Planning for other future lifestyle changes
3.1 QUALITY OF LIFE

The quality of life is defined as encompassing personal advancements, a healthy lifestyle, access and freedom to pursue knowledge and attaining a standard of living which surpasses the fulfillment of the basic and psychological needs of the individual to achieve a level of social well-being compatible with the nation's aspirations.

The Malaysian Quality of Life Index (MQLI) an aggregate measure of the quality of life is computed using 42 indicators representing eleven components of life. These aspects are income and distribution; working life; transport and communication; health; education; housing; environment; family life; social participation; public safety and culture and leisure.

The quality of life in Malaysia improved during the period from 1990 to 2002. All components of the MQLI recorded improvements with the exception of public safety and environment. The improvement in the health index was indicated by improvements in life expectancy at birth, doctor-population ratio and infant mortality rate. With the exception of 1998, due mainly to the effects of the Asian financial crisis, the income and distribution index improved over the period 1990 to 2002.

Table 10.3: Changes in Component Indices and The Malaysian Quality of Life, 2002 - Base Year 1990 = 100

<table>
<thead>
<tr>
<th>Components</th>
<th>Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income and distribution</td>
<td>107.51</td>
</tr>
<tr>
<td>Working Life</td>
<td>119.86</td>
</tr>
<tr>
<td>Transport and Communications</td>
<td>120.88</td>
</tr>
<tr>
<td>Health</td>
<td>115.84</td>
</tr>
<tr>
<td>Education</td>
<td>117.35</td>
</tr>
<tr>
<td>Housing</td>
<td>116.48</td>
</tr>
<tr>
<td>Environment</td>
<td>98.22</td>
</tr>
<tr>
<td>Family Life</td>
<td>107.15</td>
</tr>
<tr>
<td>Social Participation</td>
<td>110.55</td>
</tr>
<tr>
<td>Public Safety</td>
<td>80.08</td>
</tr>
<tr>
<td>Culture and Leisure</td>
<td>114.13</td>
</tr>
<tr>
<td>MQLI</td>
<td>109.82</td>
</tr>
</tbody>
</table>
3.2 COST OF LIVING AND CONSUMER PRICE INDEX

Cost of living, amount of money needed to buy the goods and services necessary to maintain a specified standard of living. The cost of living is closely tied to rates of inflation and deflation. In estimating such costs, food, clothing, rent, fuel, lighting, and furnishings as well as expenses for communication, education, recreation, transportation, and medical services are generally included. The Consumer Price Index (CPI), a measurement of the cost of living prepared by the Malaysian Bureau of Labor Statistics, tracks changes in retail prices of an average "market basket." Changes are compared to prices in a previously selected base year, from which figures the percentage increases or decreases in the cost of living can be calculated. In addition to changes over time, such analyses must also consider regional variations in the cost of living, and the relative weighting of the components of the index must be reappraised periodically.

Consumer Price Index (CPI) is seen as a general indicator of the change in retail prices paid by households for goods and services. It is the most widely used indicator of inflation for consumption expenditure. CPI measures the changes in the general level of prices of a fixed basket of goods and services which represents the items which are normally consumed by an average household in Malaysia with reference to the base period. The CPI is designed to provide a broad measure of changes in retail prices experienced by Malaysian households as a group and should not be expected to exactly reflect the experience of any individual household.

The CPI basket includes those goods and services which are important in terms of the size of the expenditures made by Malaysian households. It is neither practical, nor necessary, to include all the items that consumers buy since many items show similar price changes. Hence, by selecting representative items (or samples) carefully, it is possible for the index to reflect price changes for a much wider range of goods than just those observed directly.

The current series of the CPI is based on the prices of about 430 representative items which reflect the combined price movements each month of the thousands of items that are bought by households in Malaysia. These 430 items are selected based on the Household Expenditure Survey (RES) 1993/94. These items are chosen, not only because they represent the spending habits of Malaysian families, but also because their prices are associated with specific quantities of goods offered for sale. Without this quantity/price relation it is extremely difficult to measure price changes. The weight of an item in the CPI is derived from the expenditure on that item as estimated by the Household Expenditure Survey. This survey provides data on the average expenditure on selected items, such as rice, fresh meat, fresh fruits, but fare and so on, that were purchased by the selected households during the survey period.
3.3 INFLATION

Percentage increases in price level. When most prices grow, there is inflation, provided the other prices don’t drop too heavily. If inflation is not compensated by nominal increases of income, people become poorer. High and variable inflation makes economic price forecasting more difficult and decision-making processes may be negatively affected. Extremely high inflation attracts too much daily attention from households and decision-makers, distracting them from more important tasks.

Basic types of inflation

Different types of inflations can have widely different determinants, effects and remedies. There is no strictly binding definition of ranges of intensity in price increase. Still, some indications can be given as it follows.

- **Hyperinflation** is the most extreme inflation phenomenon, with yearly price increases of three-digits percentage points and an explosive acceleration.

- **Extremely high inflation** could range anywhere between 50% and 100%
- **High inflation** is a situation of price increase of, say, 30%-50% a year. Both kinds can be stable or dangerously accelerate to enter in an hyperinflation condition.

- **Moderate inflation** can be differently defined around the world, given the different inflation histories. As an indication only, one could consider an inflation as moderate when it ranges from 5% to 25-30%. For some countries, the higher part of this range is already “high inflation”.

- **Low inflation** can be characterized from 1-2% to 5%. Around zero there is no inflation (price stability). Below zero, a country faces deflation.


*Malaysian Quality of Life*. (2004). Economic Planning Unit, Prime Minister's Department, Malaysia.


**ACTIVITIES**

1. What are the four main capital flows in describing globalization?
2. The globalization definition by International Monetary Fund?
3. Discuss the concept of poverty?
4. Identify the chapters of expenditure?
5. Briefly explain the financial and non-financial needs of consumers?