The Banking System

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MANAGEMENT OF THE BANKING SYSTEM

Building on the achievements recorded in the preceding years, further progress continues to be made in enhancing the capacity and capability of domestic banking institutions. The enhanced competitiveness of the domestic banking institutions provided the foundations on which progressive infusion of greater competition could be pursued through further deregulation and liberalisation.

In line with the objective of preserving financial soundness and stability whilst achieving the goals of progressing into a more dynamic financial system, the main thrusts of policy measures in 2005 continued to place emphasis on enhancing the competitiveness of domestic banking institutions and preserving resilience of the financial sector. In this regard, efforts were directed towards improving the structural and operational efficiency of the banking institutions whilst introducing a more dynamic prudential regulatory framework, which is complemented with effective supervisory oversight and enhanced surveillance. Other key policy initiatives in 2005 included ensuring continuous access to financing for all segments of the economy and the further enhancement of infrastructure for consumer protection and education. These are in line with the broad thrust of Phase 2 Financial Sector Masterplan (FSMP) which aims to elevate the overall performance of the financial sector.

Policy measures in 2005 continued to focus on enhancing competitiveness of domestic banking institutions, strengthening the infrastructure for consumer education and protection, and ensuring continuous access to financing.

The banking system sustained its strong performance in 2005, both in terms of financial strength and operational efficiency. The banking sector registered RM12.4 billion in pre-tax profit and maintained the risk-weighted capital ratio (RWCR) above 13%. Non-performing loans (NPLs) ratio continued its downward trend to 4.6%, the lowest level since the advent of the Asian financial crisis. Supported by the strong financial position, the banking system was well-positioned to effectively support economic growth as evident from the expansion in lending activities. New loan approvals and disbursements increased by 11.4% and 8.4% respectively, whilst total outstanding loans expanded by 8.6% during the year.

The winding up of Pengurusan Danaharta Nasional Berhad (Danaharta) in December 2005 marked the successful completion of the final chapter in the financial sector restructuring efforts undertaken to address the vulnerabilities that surfaced in the aftermath of the Asian financial crisis. With financial system stability fully restored and continued strong performance by the banking sector, policies implemented during the year were successful in augmenting the resilience, capacity and efficiency of the banking institutions to effectively meet the needs of an increasingly competitive and dynamic economy.

Enhancing Structural and Operational Efficiency

The year 2005 continued to witness a changing structural landscape in the banking sector. Following the flexibility granted to domestic banking groups to rationalise their commercial banking and finance company businesses, the industry underwent a transformation which saw the consolidation of retail banking businesses into a single entity. All ten domestic banking groups have completed the rationalisation exercise on schedule to benefit from the stamp duty and real property gains tax exemptions granted by the Government which ended on 15 January 2006. The successful completion of the rationalisation exercise allows for more efficient use of the banking groups' capital and resources, which in turn will strengthen the potential of the entities to meet the increasingly more differentiated expectations and sophisticated demands of their customers.

As financial needs grow in complexity and the demarcation of the roles and functions of financial institutions becomes increasingly blurred, further institutional transformation continues to take shape in the continuously evolving Malaysian financial landscape. One of the strategic initiatives aimed to further strengthen the capacity and capability of domestic banking groups to contribute towards economic transformation and to face the challenges of liberalisation is the development of full-fledged investment banks through mergers between merchant banks, stockbroking companies and discount houses. These financial market intermediaries currently undertake and offer similar products and services. The integration will enhance their efficiency and effectiveness by minimising duplication of resources and overlapping of activities, leveraging on common infrastructure as well as reaping the benefits of synergies and economies of scale. It will also further strengthen the potential and capability of domestic financial institutions to capitalise on business opportunities, increase their competitive advantage and widen the range of financial and advisory activities and thereby strengthen their potential to compete effectively with international investment banks.

The emergence of investment banks is aimed at enhancing the dynamism and vibrancy of the capital market to contribute towards economic transformation as well as enable market players to better face challenges of liberalisation and globalisation. Recognising this, the framework for investment banks has been formulated based on three main principles. Firstly, the framework aims to enhance the scope of activities for the merged entity where investment banks will also be allowed to undertake fund management and unit trust businesses in addition to the activities conducted based on the types of licences held prior to the rationalisation. Secondly, the framework seeks to enhance the capacity for growth and business expansion through industry-wide rationalisation. And finally, it aims to minimise the regulatory burden that may arise from dual regulatory regime. To facilitate the establishment of investment banks, incentives via stamp duty and real property gains tax exemptions as well as tax credits for accumulated losses of the financial institutions involved in rationalisation were granted to all entities that are involved in the transformation into investment banks within the given timeframe.

Bank Negara Malaysia announced the framework for creation of investment banks in March 2005. Under the framework, an investment bank can be formed via various merger permutations, namely, via merger of merchant bank and stockbroking company within the same banking group or merger of two stand-alone discount houses with a stockbroking company. To further enable the development of a more resilient, competitive and dynamic financial system, the framework was extended to allow universal brokers to be transformed into an investment bank, via the acquisition of a discount house. All financial groups have been given up to 30 June 2006 to undertake the rationalisation exercise.

Upon completion of the rationalisation process, an investment bank will hold both a merchant banking licence as well as a dealer's licence which are issued pursuant to the Banking and Financial Institutions Act 1989 and the Securities Industry Act 1983 respectively. Hence, investment banks will be co-regulated by Bank Negara Malaysia and the Securities Commission. Towards this end, a clear demarcation of roles between the two regulators has been established. The Central Bank will be responsible for the prudential regulations governing the investment banks to ensure that the safety and soundness of the financial system remains intact, as well as to protect the interest of depositors. The Securities Commission will be responsible for the business and market conduct of investment banks in order to promote market integrity and provide investor protection. To attain these objectives, Bank Negara Malaysia and the Securities Commission are currently finalising the details of a Memorandum of Understanding which outlines all specific aspects of the cooperation and consultation between the two regulators to ensure smooth and efficient coordination of roles and responsibilities with respect to the supervision and regulation of investment banks. Further to this, to ensure that the investment banks are manned by capable and competent workforce, all personnel undertaking functions related to dealing in securities, fund management, investment advice, and futures activities are required to pass the relevant examinations and be licensed as representatives prior to undertaking such activities, as imposed by the Securities Commission.

The framework for investment banks aims to strengthen the capacity of domestic financial institutions to capitalise on business opportunities, increase competitive advantage and widen the range of financial and advisory activities and thereby strengthen their potential to compete effectively with international investment banks.

Bank Negara Malaysia and the Securities Commission had on 1 July 2005, jointly issued the *Guidelines on Investment Banking* which details the requirements and processes to set up investment banks as well as the regulatory framework within which investment banks would operate. Policies were formed taking into consideration the inherent risks of the newly merged entity and the international regulatory framework for investment banks. The Guidelines set a minimum capital funds unimpaired by losses at RM2 billion on a group basis, for investment banks that are part of a domestic banking group and RM500 million for stand-alone investment banks. These stand-alone investment banks have to comply with the minimum capital funds requirement by 31 December 2008, failing which they would be granted a restricted licence which excludes the ability to undertake deposit-taking activities. Investment banks will also be subjected to the *Investment Bank Capital Adequacy Framework* (IBCAF), which is based on the existing capital adequacy framework applicable to banking institutions. All investment banks, except stand-alone investment banks that do not fulfill the minimum capital funds requirement, will be allowed to mobilise deposits with a minimum size of RM500,000. Nevertheless, it is envisaged that in the longer term, the investment banks would increasingly tap the capital market to meet their funding needs. Recognising that the participation of foreign investors can provide an impetus towards enhancing the capacity and efficiency of domestic institutions through the transfer of skills, expertise and technical know-how as well as providing access to international tie-ups, and in line with the gradual liberalisation approach adopted in Malaysia, the limit for foreign equity participation in investment banks has been set at a higher level of 49%.

As outlined in the FSMP, one of the key strategic initiatives towards enhancing the capacity and capability of domestic banking institutions is through the gradual introduction of a more competitive environment to act as a catalyst towards performance improvement. As players in the financial system, the locally-incorporated foreign banking institutions (LIFBs) have contributed significantly to the development and vibrancy of the financial sector through capital investment, creation of employment opportunities, facilitation of economic activities as well as transfer of skills and technology. Supported by extensive research capability and international operations network, the LIFBs have and continue to introduce new business models, using information technology to enhance their risk management and delivery channels, and set the bar for customer service quality. This has had spillover effects on the domestic financial institutions. This, coupled with the diagnosis of their areas of strengths and weaknesses, and areas requiring further performance improvements under the benchmarking exercise, have resulted in an overall improvement of the domestic banking institutions which in turn has contributed towards the enhancement of banking services in the country.

With the strengthened competitiveness of the domestic banking institutions, the LIFBs were granted with greater flexibility through the establishment of up to four additional branches. Given that domestic banking institutions have a large presence in non-urban areas to fulfil the socio-economic objective of ensuring that rural areas have sufficient access to banking services and to further enhance the dispersion of bank branches across the country, the flexibility granted are subjected to a predetermined ratio of the additional branches in the market centres, urban areas and non-urban areas.

In line with efforts to further enhance the ability to provide a comprehensive range of innovative financial products and services to compete more effectively in the marketplace, banking institutions have forged strategic alliances with other types of local and foreign financial institutions. This move has brought about the growth of bancassurance, asset and wealth management activities, as well as provided platforms for trade in foreign equities, fixed income securities and unit trusts. Further to this, many banking institutions have also capitalised on the flexibility accorded to outsource their non-core operational functions as a means towards achieving greater operational efficiency. The outsourcing functions are carried out by third party service providers or by specially established subsidiaries to provide services to entities within banking groups. In tandem with the global trend towards outsourcing, Malaysia has also benefited from the establishment of regional processing and outsourcing centres in the country which serve the region. This stems from the presence of conducive business environment, skilled workforce, strong global exposure and low set up cost in Malaysia. To date, four foreign banking institutions have set up regional processing centres in Malaysia with the total investment amounting to RM343.1 million whilst 5,243 jobs have been created as at end-December 2005. There has also been growing interest by other foreign partners, including non-banking entities to set up business process outsourcing centres in the country to serve their regional and global operations.

To facilitate greater product innovation, banking institutions were accorded greater flexibility with respect to the offering of investment-linked to derivative (ILD) products. The revised *Guidelines on Offering of Investment-Linked to Derivative Products*, which was issued in April 2005, enabled banking institutions to structure ILD products on any asset class, subject to the aggregate notional amount not exceeding 100% of its capital base. Previously, this requirement was accompanied by additional restriction of notional amount not exceeding 30% of capital base on each approved asset class. The revised Guidelines also allowed banking institutions to offer Ringgit-denominated ILD products linked to foreign asset classes. Further to this, the offerings of non-principal protected ILD products to investors are also allowed, as long as the risks of the product are clearly highlighted and investors are informed that their maximum loss potential is limited to the amount of principal invested. Additionally, the approval period for ILD products was reduced from 21 days to 14 days to enable faster time-to-market. In line with ongoing efforts to augment growth and market reach of ILD products in Malaysia, in February 2006, the Bank further liberalised various requirements of the earlier Guidelines. Under the latest revision, the limit on the aggregate notional amount of the ILD products offered by banking institutions was removed, thus enabling banking institutions to engage in ILD products with greater flexibility. In addition, to accord banking institutions with greater operational efficiency, the products offered are deemed to be approved upon submission to Bank Negara Malaysia, subject to meeting all conditions as stipulated in the Guidelines, which covered aspects of risk management, product characteristics, product marketing and classification as well as disclosure requirements and regulatory compliance.

To further enhance consumers' access to a wider array of financial services that are offered by commercial banks, additional flexibility was granted in August 2005 to enable commercial banks to conduct factoring services either within their bank or through a separate entity. The separate legal entity can be in the form of a fully- or partially-owned subsidiary or a joint venture with any other parties, including foreign parties.

Given the increasingly dynamic and competitive operating environment, the banking sector is continuously challenged to improve their operational efficiency and risk management practices. This includes managing their loan portfolio effectively and efficiently. To provide banking institutions with greater flexibility and options in managing their exposures, the Bank had, in December 2005, issued the *Guidelines on the Disposal/Purchase of Non-Performing Loans by Banking Institutions*. With the issuance of the Guidelines, banking institutions are now able to sell outright their NPLs to eligible third parties, namely domestic banking institutions, LIFBs, domestic and foreign investors. Additionally, banking institutions are also allowed to purchase NPLs from other banking institutions. With this flexibility, banking institutions are accorded with an additional option to manage their balance sheets and to reallocate resources towards strengthening their business potential and to generate higher rates of returns. It also enables banking institutions to undertake greater product innovation and releases resources for higher investments in human capital development and technological infrastructure, rather than managing distressed assets. To ensure that the flexibility does not expose undue risk to the participating banking institutions, the banking system and the consumers, the flexibility is subjected to certain general conditions and prudential requirements. One such general condition includes the requirement for the sale and purchase of NPLs to domestic or foreign investors which are not licensed institutions under the Banking and Financial Institutions Act 1989, to be conducted via a locally-incorporated special purpose vehicle (SPV) with foreign equity participation capped at 49%; aimed at nurturing and growing the local asset management industry. To ensure the proper conduct of the sale of NPLs, the Guidelines also set out the broad roles and responsibilities of the board of directors and senior management, as well as the legal requirements and regulatory processes to undertake such activities.

The availability of a highly competent workforce that is customer centric, technology-savvy, flexible and agile in the evolving financial sector will increasingly be the defining factor in determining the success of an institution and ultimately contribute towards building a more resilient and dynamic financial sector. In view of this, continuous enhancement to human capital resources and intellectual capabilities is critical to drive the performance of the financial sector, in particular the banking industry. The International Centre for Leadership in Finance (ICLIF) continued to be committed to providing leadership development programmes for leaders in the financial services sector. In 2005, ICLIF conducted two sessions of its Global Leadership Development Programme under its structured advanced leadership programme as well as various specialised learning programmes on scenario planning and strategic thinking, leading change, leadership innovation and the directors' forum.

In addition, as part of the strategic plan to formulate enhanced training and educational portfolios intended to upgrade skills and sharpen competencies as well as enhance managerial and organisational capabilities of the banking industry workforce to meet future challenges, Institut Bank-Bank Malaysia (IBBM) is currently developing a *Banking and Finance Industry Competency Framework*. The framework will provide the foundation to guide IBBM in the design of relevant technical programmes and assist institutions of higher learning to align their curriculum in order to meet the industry's human resource needs for a pool of highly talented professionals. Further to this, the framework consists of two key output, namely, the core competency, which comprises the key knowledge, skills and attitudinal attributes required for bankers and the technical competency, which outlines the expected technical knowledge, skills and attitudinal attributes required for key tasks in the major banking sectors. In formulating the framework, IBBM had conducted a high-level focus group discussion in December 2005 to deliberate on the Core Competency Framework. The focus group discussion was participated by chief executive officers of major banking institutions and leading academicians. The discussion contributed towards the gathering of holistic and balanced input and insights necessary to refine the Core Competency Framework and form the foundation for further work on the technical competency phase.

Continuing efforts to ensure a steady supply of highly competent graduates in the banking and finance industry led to the signing of a Memorandum of Understanding (MoU) between IBBM and Universiti Malaya on 21 July 2005. The MoU will pave the way towards the development and enhancement of knowledge and skills of undergraduates pursuing specialisation in banking and finance through the enhancement of the banking and finance programme by the University as well as industrial attachments or internship opportunities at banking institutions for the undergraduates. The strategic partnership offers an opportunity for both entities to build on each other's strengths for the common objective of enhancing the quality of the workforce in the banking industry.

Promoting Banking System Soundness and Stability

The presence of a sound and stable financial system is key in achieving sustainable economic growth and prosperity. Under the continuously evolving financial landscape and global integration of financial markets, it is critical for the financial system to remain responsive and capable in managing the multitude of risks that arise. As such, due attention continued to be accorded towards ensuring that the fundamental elements of a safe and sound financial system remain intact. These include having a comprehensive and effective monitoring and surveillance framework, the presence of strong and dynamic prudential regulations and supervisory oversight, as well as having an efficient financial infrastructure and reliable financial safety nets.

During the year, efforts continued to be directed to further strengthen the surveillance of the banking system. The ability to detect and assess emerging vulnerabilities is critical in order to deploy appropriate policy measures to prevent or contain emerging risks in a timely manner. In this regard, initiatives continued to be undertaken towards monitoring and assessing the resilience of the banking system using a combination of relevant financial and macroeconomic indicators, qualitative information as well as on- and off-site surveillance. Throughout the year, domestic macroeconomic and financial market developments and their linkages, the financial system performance and their implications on financial system stability; the performance of specific economic sectors, including the household and corporate sectors and their implications on the banking system, as well as potential impact of regional or global developments on the health of the Malaysian banking system were monitored and assessed. In addition, efforts to develop the capability and tools for a more comprehensive surveillance framework both at the system and institution levels, to identify, measure, assess and predict emerging vulnerabilities are currently underway. These include formulating appropriate methodologies for the models and enhancing the dataset used for modelling. Further to this, the framework on stress testing is currently being reviewed and enhanced to provide guidance to the banking institutions on the implementation of stress testing as a risk management tool within the institutions. The revised guidelines on stress testing will accord banking institutions with the flexibility to develop or adopt stress tests that are most appropriate and effective for their respective business models. Instead of prescribing fixed parameters for conducting the stress tests, banking institutions will identify the risk factors or characteristics which commensurate with the nature of their activities, scale of their risk factors and their risk management infrastructure.

The supervisory activities undertaken in 2005 were also premised on the objective of promoting financial soundness and banking system stability to support the Bank's vision of having in place a dynamic, competitive as well as a stable banking system. The Bank continued with a supervisory approach which focused on continuous surveillance to ensure safety and soundness of the banking institutions and undertaking pre-emptive measures to contain emerging risks in a timely manner.

Attention was accorded towards the identification of significant business activities of the banking institutions, assessing the key risks in each significant business activity and the capability of the banking institutions concerned in managing these risks. A comprehensive approach to supervision of financial groups was carried out to evaluate the capacity and capability of the group's risk management and internal control systems. Bank holding companies and other risk-taking entities within the group were also assessed to facilitate early identification of possible contagion risks to banking institutions within the group. This was further supported by information obtained from other regulators, both domestic and international, to provide a holistic assessment of financial groups.

Recognising the importance of information systems (IS) in the banking business particularly with respect to risk management, product development and delivery of customer service, it is imperative that the integrity and robustness of IS are maintained. In this regard, supervisory initiatives were focused not only on security and control aspects of the IS environment, but also the governance of IS activities by the board of directors and senior management. In cases where most of the IS operations of the banking institution were outsourced to service providers, the scope of examination was also extended to these service providers. This is to ensure that banking institutions have adequate oversight over the services extended by their service providers and that the standards adopted by the service providers were on par, if not better, than the standards applied to the in-house IS environment of banking institutions.

The minimum requirements and standards for planning and managing IS environment and for establishing IS risk management measures were specified in the *Guidelines on Management of IT Environment* which was issued in May 2004. In the course of carrying out on-site examinations in 2005, it was observed that most banking institutions have either complied with these minimum standards, or were making substantial progress in that direction. Some banking institutions had also put in place more stringent controls, consistent with the size and complexity of their respective IS environment. In 2005, the Bank also continued its efforts to strengthen the resilience of the Malaysian financial system in the event of unexpected developments. The requirements for banking institutions to formulate a *Business Resumption and Contingency Plan (BRCP)* and on its testing were also prescribed in the Guidelines.

Effective corporate governance practices that enhance corporate accountability are key elements in the working of market discipline and transparency. In line with the move towards a 'principle-based' regulatory framework, greater responsibility is placed on the shareholders and boards of banking institutions to ensure that their institutions operate in a sound and safe manner, within the parameters set by the Bank. The adoption of sound corporate governance standards and practices ensures that licensed institutions are managed in a safe and sound manner with appropriate balance between risk-taking activities and business prudence so as to maximise returns to shareholders whilst protecting the interests of all stakeholders. To steer the banking sector towards this objective, the Bank had issued the *Guidelines on Corporate Governance for Licensed Institutions (Revised BNM/GP1)* in September 2005 to replace the *Guidelines on Directorship in Banking Institutions (GP1)*. The revised Guidelines were formulated based on the fundamental concepts of responsibility, accountability and transparency. It also contains broad principles relating to board matters, management oversight and audit.

The revised Guidelines place significant emphasis on a board's roles and responsibilities for proper stewardship of its institution as well as to ensure that the policies and procedures adopted by the banking institution are sound and prudent, and are adhered to at all levels of the organisation at all times. This is achieved via rigorous and diligent oversight over the licensed institution's functions and affairs, which include ensuring that the institution establishes comprehensive risk management policies, processes and infrastructure as well as an effective internal audit review process. The board is also charged with the task of establishing corporate values, visions and strategies that will guide the activities of the licensed institution as well as being aware of the types of material financial activities pursued by the institution. The roles of independent directors were also enhanced to provide essential independence and objectivity to the board, ensure effective check and balance as well as mitigate any possible conflicts of interest. The supervisory approach and methodology adopted, which included interviews and assessments of individual directors' performance has contributed towards better corporate governance. There was more active participation among directors and increase in awareness on the expectations on board members in overseeing the operations of a licensed institution.

Other salient features of the revised Guidelines include a clear demarcation of roles between the chairman and the chief executive officer (CEO), as well as a clear separation between shareholders and management of the licensed institution. These are aimed at ensuring an appropriate balance of role, responsibility, authority and

The *Guidelines on Corporate Governance for Licensed Institutions* places significant emphasis on Board oversight, the role of independent directors and the clear separation between management and shareholders of banking institutions.

accountability among the decision makers as well as not to impede the practice of sound corporate governance. Additionally, to ensure effective leadership, fit and proper standards for directors and senior management were further tightened, taking into consideration factors which include competency, character, integrity and probity of the individuals. This is to enhance the level of competence and capability of the board as a whole in order to effectively discharge its duties to oversee and actively contribute to the overall strategic and operational direction of their banking businesses. Given the critical roles of the deputy CEO and chief financial officer in a licensed institution, the revised Guidelines specified that the Bank will complement the Nominating Committee of the licensed institution by conducting limited vetting on the proposed candidates for the respective positions to ensure that only qualified individuals filled those positions.

In an effort to further impart and enhance knowledge of directors of financial institutions on corporate governance issues, IBBM had conducted a *Directors' Programme on the Recent Revised Corporate Governance Guidelines* in November 2005. The objective of the programme was to keep board members well informed of the corporate governance objectives and standards which would add to their effectiveness while discharging duties and responsibilities.

In preparation for the implementation of Basel II, banking institutions conducted detailed gap assessments in 2005 to assess their readiness to adopt the new capital adequacy framework. The results of these assessments that were submitted to the Bank had provided valuable insights on industry's aspirations and key challenges faced in implementing Basel II. While most banking institutions did not foresee major problems adopting the standardised approach beyond system enhancements, many of them highlighted that the low level of penetration of external ratings would limit the potential benefits to be derived from the Standardised Approach.

The gap assessments were followed by a series of bilateral discussions that was also used by the Bank as input in the formulation of the detailed supervisory guidance. These supervisory guidance, to be issued in 2006, would specify the design and areas of customisation under both the Standardised and Internal Ratings Based (IRB) approaches for credit risk. For the Standardised Approach, the detailing and customisation of the framework would involve the review of specific parameters such as the risk-weight mapping and supervisory collateral haircuts to ensure that they reflect local experience, and produce capital requirements that are comparable to those banking institutions under the IRB approach for similar types of risk being undertaken. Similarly, the appropriateness of exercising national discretions needs to be assessed thoroughly such that the discretions would not substantially reduce the risk sensitivity of the framework.

As for the IRB approach, the focus has been on the interpretation of the operational requirements under the approach where sufficient consideration is needed on promoting the adoption of global best practices amongst domestic banking institutions. While the adoption of global best practices would be the desired long-term objective, setting these practices as the minimum benchmark may prove to be unrealistic and hence discourage migration to the IRB approach. A key element in the process of developing the IRB industry guidance is balancing the need for specific technical details and applying a principle-based framework in areas where market practice is still evolving. Guidance that are too prescriptive may result in banking institutions being confined to requirements which may not be appropriate for their business models.

The concept papers to be issued by the Bank in 2006 would also discuss on the implementation of the Basic Indicator Approach and Standardised Approach for operational risk. The results of an operational risk survey conducted by the Bank during the year revealed that many banking institutions have already put in place an operational risk management framework and have initiated operational risk data collection efforts. Guidelines on sound operational risk management practices would be issued in 2006 as a foundation for improving the overall level of operational risk management in the industry.

Data and Systems Challenges in the Implementation of Basel II

The complexity of Basel II continues to pose challenges in the implementation of the new capital adequacy standards among banking institutions and bank supervisors in the global financial system. Implementation issues and challenges have been widely discussed as banking institutions and bank supervisors seek to learn from each others' knowledge and experience. One area that had attracted wide attention is the data and system readiness of banking institutions as they move closer towards the implementation deadline of Basel II in their respective jurisdictions. Indeed, the credibility of the modelling process of the various risk parameters and hence the computation of minimum capital under Pillar 1 of the new accord depends very much on the quality of data and system architecture and infrastructure established by the banking institutions.

Underlying the complex regulatory requirements of Basel II is the expectation for banking institutions to have in place, robust systems and data management infrastructure that would enable sound risk management processes. A fundamental aspect of this is an enhanced data infrastructure that would allow banking institutions to extract information across the various systems in a consistent and timely manner. This would include having the capability to obtain a single and consolidated view of their borrowers or group of borrowers that enables effective monitoring of borrowers and segmentation of exposures into appropriate portfolios according to their risk profile. While most banking institutions have already captured the information on the various credit exposures of their borrowers, this information often resides in database systems which are not fully integrated. Hence, the process of extracting consolidated view of borrowers and obligors would be exposed to errors and inefficiency such as data inconsistencies and duplications. Systems integration that is required involves standardising the customer identifier of each borrower and firmly establishing the linkages between borrowers and all their related parties and the exposures to these parties. To obtain an accurate risk profile of the various credit facilities granted to a borrower or group of borrowers, systems that maintain information on the borrower and the related credit facilities must also be fully integrated with the collateral management system.

The integration of the various systems capturing information related to the borrower would not only provide a strong foundation for an effective credit risk management system but also support a more efficient business decision making process. With enhanced capacity to monitor their respective borrowers, banking institutions would be able to promptly detect any deterioration in the creditworthiness of the borrower or its related parties. The integration with the collateral management systems would also facilitate a more effective monitoring of collateral performance, particularly financial securities. Effective monitoring of such collateral will ensure that any reduction in their value would allow banking institutions to undertake appropriate action to mitigate the resulting increase in risk. At the borrower level, the overall view of the customer would enhance the ability of banking institutions to assess customer profitability, thus facilitating the marketing of new products to these customers. With the enhanced infrastructure, banking institutions will also be in a better position to undertake better product pricing, more accurate customer and portfolio profitability analysis and more effective portfolio risk management. From a strategic perspective, such information could also be used as vital inputs for the development of the banks' future business expansion strategy to the more profitable segments.

Besides systems capability, the acceptability of internal estimates of the various risk drivers such as the Probability of Default (PD), Loss Given Default (LGD) and Exposure at Default (EAD) for the computation of capital adequacy under the Internal Ratings Based (IRB) approaches would be dependent on the quality and adequacy of input data used by the banking institutions in the modelling process. Lack of data could potentially result in a model that is not adequately robust to provide consistent results for the purpose of capital computation. There would also be difficulties in validating the model if the sample size of defaulted borrowers is either too small or have not been appropriately captured. The requirement for data that covers a full economic cycle that is typically a minimum period of ten years, for purposes of modelling the risk drivers also poses a challenge for banking institutions. In this context, a key consideration for banking institutions and supervisors in Asia would be to deal with the impact of abnormally high default incidences and loss rates during the period following the Asian financial crisis in 1997-1998. While the impact would dissipate naturally as banking institutions populate their database with new data over time, banking institutions would still need to come to agreement with their supervisor on the adjustment methodology to normalise the impact of the crisis data during the initial period of Basel II implementation. The objective is to ensure that the regulatory capital is neither understated relative to the actual risks nor too excessive that it becomes very costly for the banking institutions to conduct their business.

In the context of delivering good model performance, the data collection process is equally important in ensuring data quality. Sound data management processes and procedures are critical to ensure that data is consistently captured and sufficiently accurate. Central to this is the need for banking institutions to establish clear lines of authority and accountability in ensuring that high data quality and integrity standards are observed at all times. This can only be achieved in an environment where the importance of having sound data quality management practices is acknowledged both by the top leadership as well as the various business units within the banking institutions.

Given the intensity of the internal data requirements under the advanced approaches for the computation of capital requirements for credit and operational risk, there has been a tendency to overlook the importance of external data in the implementation of Basel II. In general, external data such as the default studies published by external credit assessment institutions (ECAIs) as well as external credit and operational loss databases may provide useful insights and be used to facilitate the adoption of the advanced approaches. In the context of corporate credit model development in particular, default and credit migration studies from ECAIs may provide valuable input for purposes of benchmarking the output of the models with the experience of ECAIs with local corporates. The default experience of the ECAIs which are usually publicly available may be useful for banks to validate the appropriateness of their model output. The default studies published by the ECAIs can also facilitate the calibration of PD estimates to the internal rating scales. Banks intending to adopt the IRB approaches have been provided the option to map their internal ratings with the rating scales used by ECAIs and subsequently attach the PD estimates attributed with the rating scale to their rating grades. Nevertheless, an important consideration in this process is for banking institutions to ensure the consistency and relevance of these external data to their own internal portfolio, both in terms of rating definition and criteria.

The ECAI ratings also act as an indicator of the relative riskiness of a corporate borrower under the Standardised Approach and are therefore used as the basis for the capital computation. While this may be appropriate in many developed countries with high rating penetration, default information associated with ECAI ratings in emerging markets could be amplified by the smaller sample size of rated borrowers. The result of these structural constraints must therefore be taken into account by both banks and regulators in emerging markets when ECAI ratings are used for purposes of risk management and capital computation. In this context, the pooling of ratings information amongst regional ECAIs should be explored by regional supervisors as a long-term initiative to enhance the credibility of external ratings as the basis for the capital computation under the Standardised Approach.

Given the significance of having robust data and systems infrastructure for the successful implementation of Basel II, Bank Negara Malaysia will be issuing industry guidance on data quality management and management information systems in 2006. Whilst the guidelines will be outlining broad supervisory expectations relating to data integrity and effective management information system within banks, the expectations would be the basis for more specific data requirements to be issued by the Bank for Basel II implementation. In particular, the guidelines will be used by the Bank in its pre-validation assessment on data and systems capabilities for effective Basel II implementation.

In an effort to facilitate industry Basel II implementation efforts on data, the Bank is also exploring other industry-wide initiatives that can be undertaken to accelerate the progress made by banks. In this regard, the possibility of leveraging existing infrastructure like the Central Credit Reference Information System (CCRIS) and the Fraud Information Database System (FIDS) would be explored. The central credit repository system such as the CCRIS could be enhanced with a single borrower group identifier mechanism to facilitate the monitoring of risk concentration on borrowers and their related parties. The information could be shared and used by all banking institutions as benchmarks to ensure that information on borrowers and their related parties captured internally are accurate. The CCRIS could also be further enhanced with the inclusion of ratings on banking institutions' corporate customers, thus facilitating supervisory surveillance and the assessment of the robustness of internal ratings systems among banks.

An industry-wide collection of data on operational risk losses is another initiative where the Bank sees potential benefits for the industry over the long-term. In Malaysia, the existing platform such as FIDS for the capturing of industry data on fraud is only a small portion of operational risk loss data that would be required by banking institutions for the modelling of operational risk. Given the time taken to develop a meaningful operational risk database, the possibility of developing an expanded operational loss database at the national or even at regional level should be explored by banking institutions and supervisors to support further development in operational risk management within the Asia-Pacific region.

From a capacity building perspective, the need to ensure and maintain a high standard of data quality and system capability is not confined to banking institutions. Supervisors will also need to reassess their existing reporting infrastructure from banks given the extensiveness of data required for purposes of more rigorous supervisory monitoring and risk assessment. While there would be a need to enhance the supervisory reporting framework to meet this objective, the challenge for supervisors would be to raise the supervisory reporting standards without putting undue and unnecessary burdens on the banking industry. For Bank Negara Malaysia, investment in data and system capability would complement the continuing efforts and investment to develop specialised skills and expertise for the assessment of banks' internal models and risk estimates. The risk specialist's assessment would be a fundamental basis for making supervisory judgments on the credibility and robustness of the capital calculation process under Basel II environment.

During the year, the Bank also engaged a series of discussions with local external credit assessment agencies (ECAIs) in its process to finalise the criteria for recognition of ECAIs for the implementation of the Standardised Approach. On the international front, Bank Negara Malaysia continued to participate in active dialogues with home supervisors of foreign banking institutions to gain greater clarity on the approaches undertaken by these regulators whilst forging greater cooperation with them for the implementation of Basel II. The Bank has been particularly involved in the work of the Executive Meeting of East Asia Pacific (EMEAP) Working Group on Banking Supervision, focusing on Basel II related issues that are common among member countries, such as the recognition of ECAIs and home-host issues relating to the validation of internal models.

In addition to the initiatives that are being carried out towards preparing for the adoption of Basel II, continued efforts are also being channelled to strengthen the risk management practices of the industry. As banking institutions undertake more investment, trading and hedging activities, it becomes increasingly essential for them to take into account the impact and potential effects of movements in the financial market. In this regard and to complement the Basel II initiatives, the implementation of the *Market Risk Capital Adequacy Framework (MRCAF)* which was issued in September 2004, took effect in April 2005. This represented a significant shift towards explicit provision of regulatory capital for potential losses arising from activities that expose banking institutions to market risk. Further to this, the recent period has witnessed a significant expansion in loans extended by banking institutions for the purchase of residential properties. To ensure that such expansion is undertaken in a prudent manner and that sufficient capital is maintained to support this increased exposure, the risk-weight imposed on housing loans secured by first charge that have turned non-performing was increased from 50% to 100%. In addition to the regulatory changes, the Bank also focused its supervisory resources on assessing the adequacy of risk management systems and market conduct practices in household lending. Despite the incorporation of market risk capital requirements into the existing RWCR framework and the increased risk-weight for housing loan NPLs, banking institutions remained sufficiently capitalised with the RWCR maintained at levels well above the minimum requirement of 8%.

In recent years, banking institutions have begun to engage in more credit derivative transactions to hedge themselves against counterparty risks and to reduce capital requirements without affecting their existing commercial relationship with the counterparty. In tandem with efforts to promote sound risk management practices by banking institutions, Bank Negara Malaysia had issued the *Guidelines on Regulatory Treatment for Credit Derivatives Transactions* in September 2005 which specify prudential rules and regulatory capital treatment for the four most common types of credit derivative products, namely, the credit default swap, first-to-default basket, total rate of return swap and credit-linked notes. The regulatory capital treatment aims to ensure sufficient allocation of capital by banking institutions, either in their position as buyers or sellers of the credit derivative products. In addition, the products offered must be subject to approval by the Bank and be supported by a robust risk management framework.

Enhancing Infrastructure for Consumer Protection and Further Promotion of Consumer Education

In 2005, the thrust of the initiatives on consumer protection and education continued to be directed towards empowering consumers to be better positioned to take responsibility for their own well-being. The strategies adopted were two-pronged. Firstly, strengthening the consumer protection regulatory infrastructure and secondly, enhancing consumer education initiatives.

One of the key elements in building the foundation for an effective consumer protection as outlined in the FSMP is the setting up of an explicit deposit insurance system. Following the completion of the development of a deposit insurance framework which culminated in the passing of the Malaysia Deposit Insurance Corporation Act 2005, the Malaysia Deposit Insurance Corporation (MDIC) commenced its operations in September 2005. This significant milestone marked a change in the approach towards providing protection to depositors and augured well with the continuous objective of enhancing the financial soundness of banking institutions through the promotion of sound financial, business and risk management practices.

Under the deposit insurance system, explicit deposit protection is provided to eligible deposits up to the prescribed limit of RM60,000 per depositor, per member institution. This amount is inclusive of principal and interest. A separate coverage of the same amount is provided for Islamic deposits, accounts held under joint ownership and trust accounts, sole proprietorships and partnerships. It is envisaged that the level of coverage will provide full protection for up to 95% of depositors. In addition to its payout function, the MDIC will also, under certain specific circumstances, undertake the resolution of banking institutions, when the need arises.

Another central objective of consumer protection is to ensure that consumers are not disadvantaged amidst the move towards a more market-driven financial sector. In strengthening consumer protection, efforts were directed towards ensuring that the public continue to have access to basic banking services at reasonable costs. Towards this end,

The Deposit Insurance System in Malaysia

One of the significant milestones achieved during the year was the successful establishment of the Malaysia Deposit Insurance Corporation (MDIC) in August 2005. Malaysia now joins more than 95 countries that have explicit deposit insurance systems. The establishment of the MDIC further strengthens the consumer protection framework in Malaysia and represents a major step forward in the ongoing development of the Malaysian financial system through enhanced discipline and strengthened risk management practices of member institutions, in line with the recommendation outlined in the Financial Sector Masterplan. The deposit insurance system has been carefully designed to meet the needs of Malaysians, and in particular, to provide equitable coverage for conventional and Islamic deposits. As an important component of the safety net, the deposit insurance system complements the role and functions of Bank Negara Malaysia in preserving overall financial stability.

Mandate

The MDIC is an independent statutory body established under the Malaysia Deposit Insurance Corporation Act 2005 (MDIA) with mandates to:

(i) administer a deposit insurance system;

(ii) provide insurance against the loss of part or all deposits of a member institution;

(iii) provide incentives for sound risk management in the financial system; and

(iv) promote or contribute to the stability of the financial system.

In carrying out its mandates of (ii) and (iv), the MDIC is required to minimise cost to the financial system.

Membership

Membership in the deposit insurance system is compulsory for commercial banks (including locally-incorporated subsidiaries of foreign banks operating in Malaysia) licensed under the Banking and Financial Institutions Act (BAFIA) 1989 and Islamic banking institutions licensed under the Islamic Banking Act (IBA) 1983. Banking institutions that focus mainly on wholesale deposits, namely merchant banks, discount houses and investment banks are automatically excluded from membership. The branches of domestic banking institutions operating abroad and other deposit taking institutions namely, development financial institutions, provident and pension funds including the Employees Provident Fund and Lembaga Urusan Tabung Haji (Pilgrimage Fund Management Board) and cooperative societies are also excluded from the deposit insurance system.

Coverage

Deposits which enjoy deposit insurance coverage include savings, demand, fixed, Islamic deposits (general investment and special investment deposits), banker's cheques, bank drafts and other payment instructions. Deposits that are not payable in Malaysia, foreign currency deposits, negotiable instruments of deposit or other bearer deposits, repurchase agreements and money market placements are not insured by the MDIC.

Eligible deposits are insured for up to RM60,000, inclusive of principal and interest. This limit is applied per depositor per member institution. Separate coverage is available for deposits that are held jointly or in trust, and deposits of sole proprietorships, partnerships or professional practices.

Islamic deposits are accorded a separate coverage limit of RM60,000, inclusive of principal and return on deposit. This separate coverage limit ensures equitable treatment and no competitive distortion between conventional and Islamic deposits.

Reimbursement of depositors' claims

Where a member institution is unable to meet its obligations to its depositors, the MDIC is required to reimburse depositors up to the RM60,000 insured limit as soon as possible. Reimbursing depositors on a timely basis is crucial to maintain confidence in the financial system.

Funding

The deposit insurance system is funded by annual premiums assessed against member institutions based on total insured conventional or Islamic deposits held as at 31 December.

The MDIC maintains and administers two separate deposit insurance funds for conventional and Islamic deposits. Investments held in the Islamic Deposit Insurance Fund are made in accordance with Shariah principles.

Governance structure

The MDIC is governed by a seven-member Board of Directors, comprising:

- a Chairman;
- Governor of Bank Negara Malaysia;
- Secretary General of Treasury;
- a representative from the public sector; and
- not more than three representatives with relevant private sector experience and at least one with relevant banking and financial sector experience.

Members of the Board are appointed by the Minister of Finance, with the exception of the Governor and Secretary General. Directors, officers and employees of banking institutions which are members of the deposit insurance system and their related parties are not allowed to be represented on the Board to avoid conflict of interest and unfair access to confidential information. The Board of Directors is responsible for the conduct of the business and affairs of the MDIC and has a statutory duty to act in the best interests of the deposit insurer in accordance with its mandate.

Collaboration and coordination

Bank Negara Malaysia is the primary supervisory and regulatory authority responsible for maintaining overall stability of the Malaysian banking system while the MDIC administers the deposit insurance system in a manner that contributes towards promoting public confidence in the financial system.

As part of its supervisory functions, Bank Negara Malaysia performs examinations on the health of financial institutions and provides the MDIC with reports on their findings. As such the MDIC relies extensively on the information provided by the Bank for assessing its risks. In addition, Bank Negara Malaysia may advise the MDIC that a financial institution is no longer viable. Upon such advice, the MDIC is required to find a least-cost resolution to deal with the troubled member institution. This may involve a wide range of intervention actions, including assumption of control, applying for the appointment of a receiver or presenting a petition for the winding-up of that member institution. This power, however, is only triggered when the Bank makes such a determination.

As a result, close collaboration and coordination between Bank Negara Malaysia and the MDIC is crucial to ensure the effectiveness and efficiency of both organisations in meeting their mandates. The importance of such a relationship dictates that a strategic alliance agreement be executed between the two organisations to clearly set out how they will collaborate and coordinate their activities in fulfilling their respective roles and responsibilities, with the objective of mitigating unproductive overlap and duplication of efforts. Such an agreement will also provide a platform for Bank Negara Malaysia and the MDIC to engage in active and continuous consultations to achieve optimal outcomes.

Conclusion

The establishment of the Malaysian deposit insurance system strengthens the consumer protection framework in Malaysia. Great care was taken in its design to complement the role and function of Bank Negara Malaysia as the primary regulator and supervisor in promoting the safety and soundness of the financial system for the benefit of all Malaysians.

the Bank had in 2004, introduced the basic banking services framework which required the offering of a basic savings account and a basic current account to all Malaysians including permanent residents. Further to this, banking institutions were directed to automatically convert previously designated plain vanilla savings account into basic savings accounts (BSA) in August 2005. The mandatory conversion would facilitate greater banking inclusion of all segments of the community. Concurrent with efforts to ensure financial access was the emphasis on ensuring fair and equitable banking fees and charges. In recent years, in tandem with increasing technological innovation and consumer demand for more innovative products, banking institutions have made substantial investments on hardware and software infrastructure as well as product development to make available financial products and services that are aligned to consumer demands and which are more efficient, reliable and secure. To defray part of the costs of such investments, fees were levied on products and services provided. To ensure that the cost imposed is fair and equitable to both consumers and banking institutions, guidelines outlining the guiding principles for the imposition of fees and charges on banking products and services for individuals and, small- and medium-sized enterprises (SMEs) were issued in mid-2005. Banking institutions were required to ensure that their existing fees and charges framework complies with these guiding principles and prior approval of the Bank was required for new fees or charges to be imposed on customers.

Another important component of the consumer protection framework is to put in place the appropriate institutional arrangements to ensure that consumers have sufficient avenues to seek assistance and redress when they face problems with their financial institutions. In this regard, the Bank is establishing a Credit Counselling and Debt Management Agency (CCDMA) that will provide an avenue for individual borrowers and potential borrowers to seek advice on managing their credit and to equip them with the necessary skills to manage their finances. In addition, the CCDMA will also assist consumers to pro-actively manage their debts via customised debt repayment plans. This service is available for all debts relating to housing loan, personal loan, credit card, charge card and hire purchase that have been obtained by individuals from financial institutions regulated by the Bank.

The Credit Counselling and Debt Management Agency (CCDMA) enhances the avenues for consumers to seek redress and assistance in managing their finances.

Efforts to improve consumer literacy levels continued to be directed at addressing the issue of asymmetry of information through the publication and dissemination of information on retail banking products and services via the consumer education programme, BankingInfo. This program is currently in its fourth year of operation. During the year, two new booklets, *Current Account* and *Investing Your Money* were published. These publications aim at providing basic information

Establishment of the Credit Counselling and Debt Management Agency

An important part of the strategies implemented in the Financial Sector Masterplan has been the development of the consumer protection framework and the enabling infrastructure to protect consumers' interests while at the same time enhancing consumers' financial capability to participate effectively in the financial system. The agenda covers a wide spectrum of initiatives involving infrastructure and institutional development and includes financial education, advisory services, distress management, rehabilitation and putting in place avenues for redress.

In this respect, Bank Negara Malaysia has already put in place a number of institutional arrangements to ensure that consumers have sufficient avenues to seek assistance and redress when they encounter difficulties in their interface with financial institutions. These avenues include dedicated complaint units at banking institutions and an independent dispute resolution mechanism at the Financial Mediation Bureau. In addition, Bank Negara Malaysia Laman Informasi, Nasihat dan Khidmat has been established to act as a centralised point of contact to facilitate a rapid and effective response for members of the public in matters related to the financial sector. These institutional arrangements will be complemented with the establishment of a Credit Counselling and Debt Management Agency (CCDMA) which will provide individuals with money management and credit counselling as well as debt management services. Scheduled to be operational in April 2006, this institutional arrangement aims not only at providing advisory services but also assisting individuals who are encountering difficulties in meeting their financial commitments.

Private consumption in the Malaysian economy has strengthened over the years, supported by positive consumer sentiments and increased access to banks' financing, notably in the area of consumer loans. This trend has been accompanied by an increase in the level of household indebtedness. For a number of consumption-driven economies, household debts have exceeded prudent levels in the range of 80-100% of GDP. Household indebtedness of the banking sector in Malaysia has, however, remained within prudent levels at 61.5% of GDP. Strong debt servicing capacity is also reflected in the levels of non-performing loans of the household sector which remained stable at below 8% of total outstanding household loans as at end-2005, much lower than the peak of 12.2% as at end-1998. This trend is expected to be sustained with household lending continuing to record robust growth. While prudent lending and borrowing practices will continue to be promoted with concerted efforts at educating consumers on wise financial management, there will be cases where consumers are affected by unexpected developments or cases in which they have overstretched themselves financially and are unable to meet their obligations.

The establishment of CCDMA is part of the many efforts by Bank Negara Malaysia to proactively ensure that the household sector continue to be resilient by providing an avenue for existing and potential individual borrowers to seek advice and assistance on managing their credit while at the same time promoting a sound and robust banking system by facilitating debt repayment efforts and minimising incidence of non-payment arising from poor debt management.

The CCDMA will provide free credit counselling, education and debt settlement services to consumers. Credit counselling and education is important as individuals have to be equipped with the necessary skills and tools to manage their finances for long-term financial sustainability and to prevent a recurrence of such a situation. The CCDMA will also assist consumers to proactively manage their debt via out-of-court procedures based on agreed repayment plans between the creditors and the debtors. Eligible individual borrowers will have access to assistance in restructuring debts relating to housing loans, hire purchase, credit card, charge card and personal loans that have been obtained from financial institutions regulated by Bank Negara Malaysia[1]. Cases involving multiple creditors may be referred directly to CCDMA while borrowers with single creditor should refer their cases to CCDMA when they have failed to reach an amicable work-out plan with their creditors. Amongst the services offered by the CCDMA are:

Details of Services Offered by CCDMA

Type of Service	Description
Counselling and Advice on Financial Management	One-to-one counselling and advice that cover financial budget, money management and credit issues. Assistance will be provided to consumers in analysing their financial situation and identifying all options available to help them to get back on track.
Debt Management Programme	A personalised debt repayment programme designed to provide eligible borrowers with solutions for their financial situation. The programme will include review of current financial condition, development of tailored financial solutions in collaboration with borrowers and banking institutions. The programme also provides ongoing counselling and education to consumers throughout the life of the programme and serves as an alternative means of debt settlement through out-of-court procedures based on the agreed repayment plans between banking institutions and the borrowers.
Financial Education	Education programmes for consumers, in particular, on the proper use of consumer credit and basic money management skills such as savings and budgeting as well as tips on how to use credit responsibly and debt management.

The CCDMA will be governed by a Board of Directors of whom the majority are independent directors. The Agency will be staffed by independent and experienced counselors who are experienced in credit counselling and debt restructuring. The CCDMA is located at Level 8, Maju Junction Mall, Kuala Lumpur.

The establishment of CCDMA marks another milestone in the development of a comprehensive consumer protection infrastructure and will contribute positively towards sustainable development of the consumer sector. Much progress has been achieved in developing and strengthening the consumer protection and education framework that aims at promoting a fair, equitable and transparent financial market as well as active consumerism.

[1] The institutions are commercial banks, merchant banks, Islamic banks, selected development financial institutions, insurance companies, takaful operators and credit and charge card issuers.

and tips on current account and investment for individuals. In addition, two information guides, *Looking for Housing Loan* and *Basic Banking Services* were also published during the year to provide quick and easy reference guides for consumers. Simple checklists to enable consumers to do comparison shopping for retail banking products or services are also provided.

To further promote greater access to timely, reliable and accurate information as well as to minimise the cost of information search, comparative information on credit cards and hire purchase products were published in the comparative tables in the BankingInfo website. These tables contain up-to-date and pertinent information and provide a convenient point of reference for consumers. The tables also serve to promote transparency and drive greater competition amongst financial services providers. With the publication of these tables, the total number of tables published thus far stands at five. Currently, efforts are being undertaken to disseminate such tables in hard copy format to enable consumers without internet access to have access to such information.

The publication of consumer education materials was complemented by dedicated outreach programmes targeting groups such as women, college and university students as well as retirees. The outreach programmes seek to educate consumers on financial matters such as banking products and services, budgeting and money management. Women, particularly housewives, have been identified as one of the priority target audience under the programme in view of the important role they play in managing the finances of the household and their relative limited sophistication on financial matters. The outreach programmes targeted at college and varsity students were geared towards proactively equipping them with the requisite knowledge and skills to manage their finances prior to their entry into the work force while outreach programmes for retirees were targeted towards empowering them to take greater responsibility and control for their post retirement financial needs. In 2005, a total of 25 outreach programmes were conducted reaching a total of more than 4,000 participants in these three categories.

To further enhance interface with the public and as part of its corporate social responsibility, Bank Negara Malaysia had established the Laman Informasi Nasihat Khidmat (Bank Negara Malaysia LINK) in February 2005. The Bank Negara Malaysia LINK acts a one-stop reference point for the public to seek information and clarification on issues relating to policies and operations of the Bank and the financial sector as well as acts as one of the platforms for consumer education. It provides face to face interaction to walk-in visitors, including individuals and SMEs, on general enquiries and public complaints, hence enhancing the effectiveness and efficiency of information search. The Bank Negara Malaysia LINK also offers support to the Bank's SME Unit in various matters associated with access to financing by SMEs such as loan applications and restructurings as well as information on various special funds provided by the Bank and other government ministries or agencies. This will greatly increase the outreach capabilities of the Bank in its efforts to promote the development of the SME sector. Further to this, the Bank Negara Malaysia LINK provides another platform for the Bank to educate members of the public on their roles and responsibilities as consumers of financial products and services, with the aim of enhancing the level of financial literacy among the banking public. Information to the public and SMEs is made available via various channels, including exhibitions, interactive information kiosks and booklets. Since its inception, the response has been encouraging, with more than 36,000 visitors received up to end-February 2006. The bulk of the queries relate to banking and insurance, SME financing, credit information, on-line applications for exchange control approvals, returned and dishonoured cheques, and currency.

Bank Negara Malaysia participated in a number of exhibitions and seminars throughout 2005. These participations serve as an important means for understanding and addressing public concerns on financial matters, as well as disseminating the information published thus far. Publicity campaigns via advertisements in major newspapers and radio stations were also undertaken to promote greater consumer awareness of the consumer education programme. In 2005, a total of 1.2 million booklets were taken up by the public while the BankingInfo website recorded 14 million hits, bringing the total number of hits since its launch in 2003 to 31 million (2004: 1.2 million booklets and 17 million hits).

Bank Negara Malaysia also played host to the Third International Forum on Financial Consumer Protection and Education during the year, which was attended by 42 participants from 34 organisations worldwide. The forum, themed *Fostering Greater Consumer Education and Protection*, was aimed to provide a platform for regulators worldwide to share information and insights, discuss challenges and issues as well as work together towards developing best practice standards on consumer protection and education issues.

To complement the policy move towards enhancing consumer protection and in line with rising consumer expectations, the scope of supervisory activities in 2005 was also extended to include assessment of the banking institutions' code of conduct in promoting fair market practices, disclosure standards as well as effective dispute resolution mechanisms to ensure that consumers are treated equitably and have access to adequate and timely information to facilitate effective decision making.

Ensuring Continued Access to Financing

As a primary mobiliser of financial resources that are channelled from savers to the various segments of the economy, the banking sector continues to play an important intermediation role in ensuring continued access to financing for all segments of the economy. The banking system remained the largest provider of funds in the economy, with an increase in loans outstanding of 8.6% to RM558.1 billion in 2005. With the continued growth in consumer spending, the bulk of this increase were channelled to the households and SMEs, which recorded an expansion of 15.1% and 8.7% respectively in 2005. Lending activities throughout the year thus were supportive in meeting the requirements of the various sectors of the economy, with most sectors recording sustained growth in loan approvals.

With the introduction of the new interest rate framework in April 2004, banking institutions have been better able to price interest-based products efficiently, based on their respective cost of funding and business strategy. Since the introduction of the new framework, BLRs quoted by almost all banking institutions in 2005, have been maintained at the same level (prior to the revision of the Overnight Policy Rate). This reinforces the notion that banking institutions are offering competitive rates even before the introduction of the new framework. Additionally, the removal of the maximum lending spread of 2.5 percentage points above BLR facilitated the continued innovation by banking institutions to meet the increasingly complex and sophisticated demands of customers. Indeed, some banking institutions have introduced new innovative interest-based products, which include unsecured personal loans to individuals and SMEs.

Ensuring continued access to financing for priority sectors remains an important priority of the Bank. In line with the objective of providing financing to the priority sectors in the most efficient manner, banking institutions also have an important role to play. Recognising this and the need to balance social responsibility with operational efficiency, banking institutions were given the flexibility to set their own targets for lending to SMEs and lower income group for the purchase of residential properties, based on their respective capacity and business strategy. In 2005, the definitions used for various priority sectors were further refined. The threshold for the purchase of low-cost houses was lowered from RM180,000 to RM60,000, whilst the definition of SMEs was aligned with that of the National SME Development Council. To further promote Bumiputera entrepreneurship, at least 50% of the target set by banking institutions for SME lending must be channelled to Bumiputera SMEs.

Recognising the increasingly significant role of SMEs in the economy, various efforts are underway to enhance the contribution of SMEs to the growth of the economy. In addition to the realignment of functions and institutional structure of DFIs, banking institutions have launched two new trade finance products, namely, Multi Currency Trade Finance (MCTF) and Indirect Exporter Financing Scheme (IEFS), to the SMEs with the aim of encouraging greater SME participation in the export market by lowering the financing cost and removing the requirement for collateral. The credit risk associated with this type of financing will be shared between the participating banking institutions and the EXIM Bank. Further to this, the Bank will be establishing two venture capital funds of RM150 million each to promote the agriculture sector, particularly in the areas of integrated farming and fisheries, as well as biotechnology-related industries.

Completion of Financial Sector Restructuring Exercise

The year 2005 witnessed the conclusion of the institutional arrangements which were established to strengthen the resilience of the banking sector during the Asian financial crisis. The last of the three specialised institutions, Pengurusan Danaharta Nasional Berhad (Danaharta) wound up its operations on 31 December 2005, having successfully fulfilled its mandate of addressing the NPL problems faced by the banking sector in the aftermath of the crisis. Over its lifespan, Danaharta had effectively resolved all of the NPLs acquired and recovered a total of RM30.4 billion, which represent a final lifetime recovery rate of 58%. Of the total amount recovered, RM26.7 billion have been realised in cash whilst the remaining RM3.7 billion are in the form of residual recovery assets which include restructured loans, securities, properties and other non-cash assets. Danaharta has also successfully redeemed all of its zero-coupon bonds which carried a total face value of RM11.1 billion.

The lifetime cost of operating Danaharta is estimated to be RM1 billion. As such, out of the initial seed capital of RM3 billion allocated for the establishment of Danaharta, RM2 billion worth of assets, comprising RM1.5 billion worth of residual recovery assets and RM0.5 billion in cash, were returned to its shareholder, Minister of Finance Incorporated. With the closure of Danaharta's operations and transfer of the control of assets to the Minister of Finance Incorporated, the latter had established a wholly-owned subsidiary, Prokhas Sdn. Bhd., on 1 January 2006 to act as the collection agent for the residual recovery assets and to convert these assets into cash at the best possible value.

All in all, the cost incurred by the Government for the financial sector restructuring efforts through Danaharta and Danamodal Nasional Berhad (recapitalisation agency) amounted to RM12.6 billion or 2.5% of the nation's gross domestic product. This is expected to decline further as a result of prospective returns from the remaining investments. The successful completion of the financial sector restructuring exercise has moulded a strong foundation for future development efforts to ensure that the banking sector remains effective and capable of meeting the changing demands of an evolving economy.

Moving Forward

In responding to the continuously evolving financial landscape as well as changing customer requirements and sophistication, significant efforts will continue to be directed towards the ongoing dynamic transformation of the domestic banking system into one that has the capacity and agility to withstand shocks and survive the increased financial market volatilities. With the second phase of the FSMP well underway, banking institutions will progressively face greater competition, both from within the banking sector and from non-bank financial institutions as well as the capital markets. The challenges of a more liberalised and deregulated environment necessitates the formulation and execution of coherent enterprise-wide strategies by banking institutions, coupled with intensifying efforts to enhance efficiency, productivity and innovation to ensure sustainable performance. In this regard, policy initiatives will continue to be centred on enhancing the dynamism and resilience of the banking system whilst ensuring the preservation of financial stability and protection of consumers, while at the same time ensuring the continued effective intermediation by the financial sector.

Banking Measures Introduced in 2005

In 2005, several initiatives were undertaken to strengthen the resilience of the financial system and to promote efficiency and competitiveness of the banking industry. In addition, measures were also undertaken to enhance consumer protection and public confidence in the banking sector.

Enhancing Safety and Soundness of the Banking System

❏ ***Risk-Weighted Capital Ratio Framework – Amendment to Risk Weight for Housing Loans Secured by First Charge***

To enhance the risk sensitivity of the existing capital adequacy framework, Bank Negara Malaysia revised the risk weight for non-performing housing loans secured by first charge from 50% to 100% in March 2005. The revision would ensure that banking institutions continue to maintain sufficient capital to support the expansion of financing for the purchase of residential properties.

❏ ***Guidelines on Electronic Broking System by Licensed Money Brokers***

The Guidelines were issued in August 2005 to ensure that the electronic broking system offered by money brokers operate in a manner that promotes the overall integrity and stability of the financial market. It also sets out regulatory processes, procedures, conditions, operational as well as regulatory requirements for operating an electronic broking system.

❏ ***Guidelines on Corporate Governance for Licensed Institutions (Revised BNM/GP1)***

As part of the ongoing efforts to enhance corporate governance among licensed institutions, the *Guidelines on Corporate Governance for Licensed Institutions* were issued in September 2005 to replace the *Guidelines on Directorships in the Banking Institutions*. The Guidelines prescribe broad principles and minimum standards as well as specific requirements for sound corporate governance, which licensed institutions and bank/financial holding companies are expected to adopt. The revised Guidelines are based on the fundamental concepts of responsibility, accountability and transparency, with greater emphasis on the role of the board and management. Amongst the key changes of the revised Guidelines are:

- Separation of the roles of Chairman and CEO;
- Separation between shareholders and management;
- Enhanced role and composition of independent directors. At least one-third of the board members must be independent directors and they are expected to display strong elements of independence on the board both in thought and actions;

- Establishment of three new board committees, namely the Nominating Committee, Remuneration Committee and Risk Management Committee; and
- Limitation on the number of Executive Director to not more than one.

❑ ***Guidelines on Regulatory Treatment for Credit Derivatives Transactions***

The *Guidelines on Regulatory Treatment for Credit Derivatives Transactions* were issued in October 2005, to specify the capital adequacy treatment for credit derivatives transacted by banking institutions licensed under the Banking and Financial Institutions Act 1989 (BAFIA). The Guidelines specify regulatory capital treatment for the four most common types of credit derivatives products, namely, the credit default swap, first-to-default basket, total rate of return swap and credit linked notes that are recorded in either the banking book or the trading book. Banking institutions that engage in credit derivatives transactions are required to obtain specific approval from Bank Negara Malaysia under the product approval process as set out under the *Guidelines on New Product Approval Requirements*, with the exception of products that are transacted based on common templates already approved by the Bank.

Promoting Competition and Efficiency within the Banking Sector

❑ ***Guidelines on Base Lending Rate, Lending Rates and Deposit Rates of Banking Institutions***

Effective March 2005, fixed deposits placed by corporations or large business enterprises and non-residents are on a negotiated basis regardless of the amount placed, hence contributing towards a more market oriented pricing environment for depositors. Other categories of depositors including individuals and small medium enterprises (SMEs) however will continue to be eligible for the Board rates for deposits up to RM1 million.

❑ ***Guidelines on Offering of Investments Linked to Derivative (ILD) Products***

In line with the effort to increase choices of ILD products for eligible investors, Bank Negara Malaysia added to its list, yield-enhancing investment products linked to foreign currency, commodities, equity and fixed income derivatives in April 2005. As the list of products expanded, *Guidelines on Offering of Investments Linked to Derivative Products* were issued to replace *Investments Linked to Derivatives Guidelines* issued on 12 May 2003. The Guidelines were further enhanced in February 2006 to incorporate the following changes:

- The cap on aggregate outstanding notional amount of ILD products offered to investors was removed; and
- 'File and Use' approach adopted for submission of applications pertaining to ILD products whereby ILD products are deemed approved upon submission to Bank Negara Malaysia subject to compliance with specified conditions in respect of risk management, disclosure, marketing and type of products offered.

❑ ***Investment in Units of Property Trust Funds and Unit Trust Funds***

Effective 20 May 2005, licensed banking institutions are allowed to invest in both property trust funds and unit trust funds, provided that:

- The investment shall not exceed 5% of the issue size of the fund or 5% of the licensed banking institution's capital funds, whichever is lower;
- The aggregate value of all such investments shall not exceed 10% of the licensed banking institution's capital funds; and
- The aggregate value of the investment in shares and interest-in-shares, unit trust funds, property trust funds and immovable properties does not exceed 50% of the licensed banking institution's capital base.

❑ ***Guidelines on Investment Banks***

Pursuant to Section 126 of BAFIA 1989 and Section 158 of the Securities Commission Act 1993, Bank Negara Malaysia and the Securities Commission (SC) jointly issued the Guidelines on Investment Banks on 1 July 2005 that specify the requirements, processes and regulatory framework for investment banks.

All financial groups involved were given a one-year period, commencing 1 July 2005 to be transformed into investment banks. In facilitating this process, the Government agreed to grant stamp duty and real property gains tax exemptions and tax credits for the accumulated losses of the acquiree financial institutions involved in the rationalisation. Foreign equity participation for investment banks was also increased to 49% to facilitate greater transfer of skills, expertise and technological know-how to the investment banks.

❑ ***Guidelines on Access to Interbank Market by Universal Brokers***
As part of the measures to strengthen the capacity and competitiveness of universal brokers, universal brokers that meet the following eligibility criteria were allowed to access the interbank market to undertake borrowing or lending of RM funds:
- Minimum shareholders' funds unimpaired by losses of RM100 million;
- Strong capital position as measured by capital adequacy ratio (CAR) imposed by Bursa Malaysia (Bursa);
- Satisfactory conduct of current credit facilities obtained from banking institutions; and
- Compliance with prudential and financial regulations imposed by SC and Bursa.

The Guidelines also stipulate the prudential requirements for universal brokers who wish to participate in the interbank market. The main requirements are as follows:
- Limit on aggregate interbank borrowings not exceeding two times its shareholders' funds, unimpaired by losses;
- A robust and effective risk management framework to identify, measure, monitor and manage risks; and
- A sound liquidity management framework that encompasses strategies to manage funds, ability to match near and short-term liquidity requirements and maintenance of sufficient credit lines, liquefiable assets in managing potential shortfall in liquidity.

These universal brokers are also allowed to borrow securities from the Bank via the repo arrangement to enhance their securities broking activity and will be subject to examination by the Bank and SC, where appropriate.

❑ ***Provision of Factoring Services by Commercial Banks***
With effect from 10 August 2005, all commercial banks are allowed to provide factoring services either as part of their commercial banking business or through a separate legal entity. The separate legal entity can be in the form of a fully or partially owned subsidiary or a joint venture with any other parties, including foreign parties. This is to encourage competition and participation of banking institutions in areas currently served by fringe institutions.

❑ ***Guidelines on the Disposal/Purchase of Non-Performing Loans (NPLs) by Banking Institutions***
To allow banking institutions greater flexibility in managing their balance sheets and in reallocating resources to strengthen their business potential and competitiveness, *Guidelines on the Disposal/Purchase of Non-Performing Loans (NPLs) by Banking Institutions* were issued in December 2005. The Guidelines allow banking institutions to undertake outright sale of their NPLs to eligible third parties, as well as to purchase NPLs from other banking institutions. It also specifies general conditions, requirements and processes as well as roles and responsibilities of the Board of Directors and senior management of banking institutions that wish to undertake such sale or purchase. The Guidelines prescribe that NPLs can only be sold to domestic banking institutions or locally incorporated foreign banking institutions in Malaysia, domestic investors or foreign investors through Special Purpose Vehicles (SPVs) with foreign equity participation capped at 49%. All NPLs sold to eligible third parties must be on a non-recourse basis.

❑ ***Establishment of New Branches by Locally-Incorporated Foreign Banks***
In line with the broad strategies outlined in the Financial Sector Masterplan, locally-incorporated foreign banks (LIFBs) are allowed to establish up to four additional branches within a period of one year with effect from 1 January 2006 subject to specified conditions. This operational flexibility represents the first of a phased approach of branch liberalisation. LIFBs are however, required to seek Bank Negara Malaysia's prior approval for the establishment of the new branches.

Enhancing Consumer Protection

❑ ***Imposition of Fees and Charges on Banking Products and Services***

As part of the measures to ensure access to banking services and to ensure that fees and charges levied are fair and equitable to both banking institutions and consumers, guiding principles were issued relating to the imposition of fees and charges for banking products and services. Banking institutions are required to ensure that their existing fees and charges comply with these principles and prior approval from Bank Negara Malaysia is required for any upward revision of existing fees and charges or for any introduction of new fees and charges imposed on individuals and/or SMEs.

❑ ***Access to Financing by Priority Sectors***

As in previous years, Bank Negara Malaysia continues to place emphasis on lending by banking institutions to the priority sectors, namely SMEs, bumiputera SMEs and low cost houses costing RM60,000[1] and below. Targets on new loans approved were set for the compliance period 1 January 2006 - 31 December 2007 based on various factors taking into account the capacity of the respective institutions. In addition, the interest rate charged by banking institutions for housing loans granted under the Guideline, namely low cost houses costing RM60,000[1] and below has also been capped at BLR + 1.75%.

❑ ***Basic Banking Services***

To ensure that all customers have access to banking services, under the Basic Banking Services (BBS) framework, all banking institutions that did not offer automatic conversion for previously designated plain vanilla savings account into Basic Savings Accounts were required to automatically convert all such accounts with effect from 1 September 2005.

❑ ***Comparative Tables on BankingInfo***

In December 2005, Bank Negara Malaysia expanded the scope of comparative tables to cover banking retail products on its consumer education website, BankingInfo. These tables allow consumers to perform comparative shopping and is part of the efforts to promote greater access to information and to encourage more informed decisions on managing their finances by consumers.

[1] For Sabah and Sarawak, the purchase price of low cost houses are capped at not more than RM72,000.

PERFORMANCE OF THE BANKING SYSTEM

Overview

Resilience of the banking system strengthened further in 2005 amidst favourable macroeconomic conditions with the key financial soundness indicators exhibiting encouraging trends. The banking system's exposure to the household sector remained within prudent levels and does not represent a threat to the overall systemic stability of the system. Key developments in the financial performance of the banking system are summarised as follows:

- The level of capitalisation remained above 13% amidst strong expansion in asset base and continued strong profit performance;
- The quality of the loan portfolio continued to improve, underpinned by lower incidence of new NPLs, higher reclassification of NPLs to performing status and recoveries. Specifically, the NPL ratio of the business sector declined further whilst the NPL ratio of the household sector remained relatively stable;
- Lending activities remained robust, driven primarily by lending to the retail sector in an environment of greater competition; and
- Exposure to market risks remained manageable.

Profitability

The banking system continued to record a strong profit performance in 2005 underpinned by favourable macroeconomic conditions and financial markets. Preliminary unaudited pre-tax profits for the year amounted to RM12.4 billion, an increase of 7% over the level achieved in the preceding year. Reflecting the continued diversification in business portfolio of banking institutions, growth in profits was driven mainly by higher revenue derived from lending and financing activities, sale of wealth management products, provision of remittance services as well as trading and investment activities. The higher profit was achieved amidst continuing efforts by banking institutions to further strengthen their balance sheets. As a result, return on average equity improved to 16.9%. Meanwhile, return on

Table 5.1
Banking System[1]: Income and Expenditure

	For the calendar year			
	2004	2005*p*	Annual change	
	RM million			%
Interest income[2]	40,755	43,757	3,002	7.4
Less: Interest expense	20,591	22,057	1,466	7.1
Net interest income	20,164	21,701	1,536	7.6
Add: Fee-based income	4,229	4,684	455	10.7
Less: Staff cost	5,662	6,309	647	11.4
Overheads	6,427	7,008	581	9.0
Gross operating profit	12,305	13,068	763	6.2
Less: Loan loss and other provisions	4,587	5,476	889	19.4
Gross operating profit after provisions	7,718	7,592	-125	-1.6
Add: Other income	3,852	4,788	936	24.3
Pre-tax profit	11,569	12,380	811	7.0
Of which:				
Commercial banks[3]	10,679	11,006	328	3.1
Merchant banks	814	1,340	526	64.6
Islamic banks	76	34	-43	-56.1
Return on assets (%)	1.4	1.4		
Return on equity (%)	16.3	16.9		
Cost to income[4] (%)	49.6	50.5		

[1] Includes Islamic banks.
[2] Effective January 2005, banking institutions no longer accrue interests on non-performing loan accounts.
[3] Includes finance companies.
[4] Only taking into account staff cost, overheads, net interest income and fee-based income.
p Preliminary
Note: Total may not add up due to rounding.

average assets remained unchanged at 1.4%, following corresponding increase in total assets during the year.

Gross operating profits for the year rose by 6.2% to RM13.1 billion on account of higher income from interest-related and fee-based activities. Net interest income grew 7.6% driven largely by the growth in interest income from loan and financing activities (+RM1.3 billion or 4%) despite competitive lending conditions, coupled with higher net income from interbank activities. The growth was, however, moderated by an increase in interest expense incurred during the year on deposits (+RM0.9 billion or 6.2%) in tandem with the higher amount of customer deposits accepted. Consistent with the strong expansion in lending activities, driven particularly by the retail segment, interest income as a percentage of interest-related assets increased by 11 basis points to 5.35 percentage points.

Competition in the lending market, particularly in the continuing buoyant retail segment, resulted in further reduction in the average lending rates during the year. The lending rates for new loans to consumers (excluding credit cards) averaged at 4.09% per annum in December 2005 (4.34% per annum in December 2004). The average lending rates on new passenger car loans recorded the most apparent reduction, falling by 219 basis points from 6.53% per annum in December 2004 to 4.34% per annum in December 2005. Consequently, gross interest margin of the banking institutions (measured as the difference between interest income and interest expense, expressed as a percentage of interest-related assets) remained almost unchanged at 2.65 percentage points. This was partly due to the higher base lending rate of banking institutions following the increase in the Bank Negara Malaysia Overnight Policy Rate in November 2005 which saw the 3-month KLIBOR rates trending upwards by 40 basis points to 3.20% per annum as at end-December 2005.

Revenue generated from fee-based activities posted a strong growth of 10.7% during the year, as a result of higher sales of wealth management products such as unit trust and bancassurance, and an increase in remittance services provided by banking institutions. Similarly, there was higher fees received from trade-related activities, such as guarantees and commissions from the issuance of bankers acceptances, following the growth in lending. Meanwhile, the greater usage of cards for purchases and other transactions has also contributed to the higher fee income of banking institutions. For the year as a whole, fee-based income for the commercial banks and finance companies as a group registered an increase of 11.1% to account for 17.3% of gross operating income.

Income derived by the merchant banks from fee-based activities, on the other hand, recorded a marginal decline of 0.4% to RM0.3 billion. Whilst higher income was generated from the extension of loans and financing, this was partially offset by a moderation in income from corporate advisory services. However, fee-based

Table 5.2
Weighted Average Lending Rates for New Loans

	Commercial banks	
	Average for December (% per annum)	
	2004	2005
Business loans	5.64	5.70
of which: SMEs	*6.20*	*6.36*
Household loans[1]	4.34	4.09
of which:		
Purchase of residential properties	*3.08*	*3.15*
Purchase of passenger cars	*6.53*	*4.34*

[1] Excludes credit card.

income remained as the major contributor to operating income of merchant banks, accounting for 44.7% of total income in 2005. With the creation of investment banks, competition in fee-based activities is expected to intensify, thus adding further pressure on revenue sustainability of the merchant banks. Meanwhile, revenue generated from trading and investment activities recorded a marked increase of 116.6%.

Although the banking system continued to incur substantial amounts in staff-related costs and improvements in IT systems and business processes during the year, the ratio of staff cost and overheads to gross operating income rose marginally to 50.5%. Such expenditures were necessary to enhance prospects for further business expansion and to retain existing talents and attract new skills into the industry given the growing mobility of labour. Investments in the acquisition and development of skills have been made to enhance the productivity and profitability of banking institutions. The banking institutions were able to generate RM2.10 in operating profits for every ringgit spent on their personnel. Meanwhile, the increase in overheads reflected the pursuit of aggressive marketing and sales strategies adopted by several banking institutions. Collectively, expenses incurred on marketing, administration and other general expenses accounted for 60.2% of total overhead expenses compared with 57.7% in 2004.

The encouraging business and operating environment and improving financial positions amidst favourable economic outlook have provided the impetus for banking institutions to continue to pursue balance sheet strengthening strategy. During the year, the banking sector set aside loan loss provisions totaling RM11.4 billion comprising specific provisions of RM9.7 billion (+9.8%) and write-offs of RM0.3 billion (+216.4%). Reflecting the higher provisioning amount, net interest margin (difference between interest income and interest expense minus overheads and provisions as a percentage of interest-related assets) showed a small decline of seven basis points to 0.37 percentage point in 2005. With this pro-active move by banking institutions, and the resultant strengthening of the balance sheets, the banking sector is better positioned to continue supporting economic developments and activities in the future.

Lending Activity

Lending activities of the banking system remained strong in 2005, supported by sustained economic growth and the resilient financing demand by both businesses and households. Strengthened resilience amidst favorable financial performance and improved asset quality had enabled the banking system to continue to meet the increased financing requirements by both the business and household sectors, thus contributing towards supporting the growth in business activity and private consumption. Meanwhile, the market lending rates remain competitive with rates on new loans by the commercial banks ranging between 5.62% to 6.23% per annum and 6.23% to 7.39% per annum for finance companies.

Their strengthened position has enabled the banking sector to continuously meet the increased financing requirements of the business and household sectors, thus contributing towards supporting the growth in business activity and private consumption.

The demand for financing continued to register an upward trend, with loan applications received by the banking institutions increasing by 11.7% to RM305.4 billion in 2005. New loan approvals remained relatively stable with

Table 5.3
Banking System[1]: Financing Activities

	For the year		Annual growth (%)
	2004	2005	
	RM billion		
Loan approvals	173.6	193.4	11.4
Loan disbursements	488.2	529.3	8.4
Loan repayments	461.6	489.2	6.0
	As at end-		Annual growth (%)
	2004	2005	
	RM billion		
Outstanding loans	513.9	558.1	8.6
Total banking system financing[2]	547.0	594.0	8.6
Total financing for the economy[3]	671.5	733.6	9.3

[1] Includes Islamic banks.
[2] Outstanding banking system loans plus private debt securities held by the banking system.
[3] Outstanding banking system loans plus outstanding private debt securities.

new loans approved expanding by 11.4% to RM193.4 billion to more than 3 million applications. On average, RM16.1 billion new loans were approved monthly in 2005 compared with RM14.5 billion recorded in the preceding year. With continued expansion in private sector activities, total disbursements rose by 8.4% to RM529.3 billion, mainly attributable to the drawdown by the manufacturing sector, which accounted for 24% (RM127 billion) of total disbursements. Meanwhile, undrawn loans increased by 7.9% to RM170.9 billion, much lower than the preceding year's increase of 16.7%, attributed mainly to unutilised credit card lines. As disbursements surpassed repayments, total outstanding loans rose strongly at an annual rate of 8.6% to RM558.1 billion as at end-2005. Total holdings of private debt securities (PDS) by banking institutions increased by 8.5% in 2005, compared with a decline of 3.1% in 2004. As a result, aggregate financing by the banking sector to support economic activities increased by 8.6%.

Lending to households

Outstanding household loans expanded by 15.1% in 2005 to RM304.4 billion, to account for 54.5% of outstanding loan portfolio of the banking system. Stable labour market conditions, increasing disposable income and attractive financing options contributed towards stronger consumer spending, hence stimulating demand for new financing as reflected by an 18% increase in loan applications received from individuals or 46.5% of total loan applications received by the banking sector. Total loans approved grew by 12% to RM97.2 billion, or 50.3% of total loans approved by the banking system during the year, whilst loan disbursements recorded a corresponding increase of 11.4% to RM145.2 billion, or 27.4% of the total disbursements in the banking system. Unutilised loans within this sector grew by 17.2% to RM79.5 billion, accounting for 46.5% of the total unutilised loans within the banking system. The increase in unutilised loans was mainly due to a higher increase in unutilised credit card lines, attributed to a larger number of credit cards issued and higher approved limits granted by the banking institutions to cardholders.

[A detailed analysis of lending to households is provided under sub-topic "Exposure to the Household Sector" in this chapter.]

Lending to businesses

Lending to businesses remained resilient in 2005, reflecting the stronger private sector investment and business activities during the year. Demand for new financing by businesses grew by a more moderate rate of 5.7% to RM158.5 billion in 2005 (2004:20%). The slower growth in new business loans was mainly attributable to a decline in loan applications from the construction sector, as well as slower increase in applications from the manufacturing sector and the wholesale and retail trade, restaurants and hotels sector. Notwithstanding the more moderate increase in loan applications, growth in new loan approvals was stable. Total loans approved increased by 9.8% to RM93.2 billion, accounting for 48.2% of total approvals within the banking system. Loan approvals to businesses were broad-based with 50.2% or RM46.8 billion of new loans approved were channelled to manufacturing, wholesale and retail trade, restaurants and hotels and construction sectors. Notably, loan approvals to the agriculture sector recorded a significant growth of 80% to RM5.2 billion.

Disbursements to the business sectors increased by 7.4% to RM360.1 billion, accounting for 68% of total loans disbursed by the banking system, of which 72.3% or RM260.2 billion were channelled to the manufacturing, wholesale and retail trade, restaurants and hotels and finance, insurance and business services sectors as the service and manufacturing sectors continue to benefit from strong consumer spending and higher exports of manufactured goods. As disbursements were relatively higher compared with repayments, total outstanding loans to the business sector expanded by 2.9% to RM225.6 billion as at end-2005. Meanwhile, total unutilised loans increased marginally by 0.2% to RM87.4 billion.

Lending to SMEs

The banking sector continued to support the financing needs of the SMEs with lending to SMEs continuing to drive growth of loans to businesses. Total outstanding loans to the SMEs expanded strongly by 8.7% to RM96 billion as at end-2005 to account for 42.6% of loans to businesses or 17.2% of total outstanding loans. Reflecting the increasing financing needs of the SMEs, the banking system received loan applications from more than 100,000 SMEs totaling RM59.7 billion, a 10.3% increase from the previous year. Advancement in credit analysis, assessment tools and methodologies, enhanced access to current customer information and the liberalisation in the pricing framework facilitated the increased provision of financing to the SMEs. During the year, RM35.8 billion new loans were approved to more than 85,000 SMEs, at lending rates which averaged between 5.72% to 6.43% per annum for the commercial banks. The approval rate was higher at 59.9%, whilst rejections remained low, constituting 18.5% of the total applications received from the SMEs. Loan disbursements were also higher. During the year, RM110.7 billion were disbursed to the SMEs, an increase of 10.2% from the preceding year, constituting 30.7% of the total disbursements to the business sectors. On a sectoral basis, lending to SMEs was generally diversified with almost two-thirds being channelled to the wholesale and retail trade, hotels and restaurants, manufacturing and construction sectors, reflective of the business focus of the majority of the SMEs.

With capacity building initiatives for SMEs in the pipeline, measures to enhance access to financing such as the establishment of the SME Bank, securitisation of SME loans, the introduction of new trade financing products for SMEs as well as the establishment of SME Portal will further improve access to financing for SMEs. This would encourage further lending by banking institutions to SMEs. In addition, in response to strong demand on SME special funds allocated by Bank Negara Malaysia, Fund for Small and Medium Industries 2 and New Entrepreneurs Fund 2 were further increased by RM250 million and RM350 million respectively. On aggregate, Bank Negara Malaysia has allocated a total of RM8.9 billion for the special funds for SMEs. Of this, a total of RM11.2 billion has been approved as at end-2005.

Financing through the bond market

The bond market sustained its growth momentum in 2005. A total of RM35.7 billion of PDS was issued, an increase of 27.1% compared to 2004, mainly by the utilities, construction and finance, insurance, real estate and business services sectors which accounted for 74.3% of total issuance. As a result, outstanding PDS in the market rose by 11.4% to RM175.6 billion as at end-2005. Total financing channelled to the economy, which included lending by the banking institutions, expanded by 9.3% to RM733.6 billion.

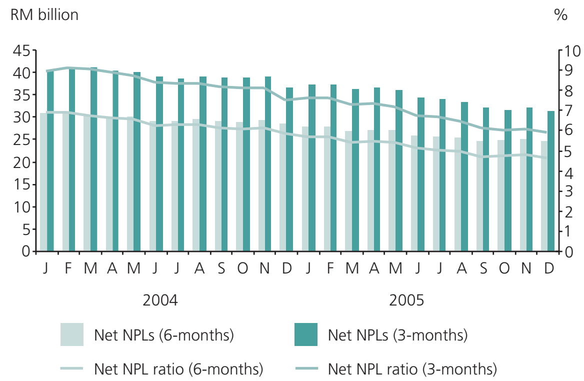
Asset Quality

Amidst sustained economic performance, the loan quality of the banking system improved further in 2005, with non-performing loans (NPLs) declining to record low levels since the Asian financial crisis. The improvement in asset quality during the year was attributed mainly to higher reclassification of NPLs to performing status and write-offs.

The net NPLs of the banking system on the 3-month classification basis declined by 14.6% to RM31.3 billion as at end-2005 (end-2004: RM36.7 billion), whilst net NPLs based on the 6-month classification decreased to RM24.7 billion as at end-2005 (end-2004: RM28.6 billion). Consequently, the net NPL ratio on the 3-month classification improved by 1.7 percentage points to 5.8% (end-2004: 7.5%). Based on the 6-month classification, the net NPL ratio improved by 1.2 percentage points to 4.6% (end-2004: 5.8%). The loan loss coverage of the banking system also strengthened with the declining NPL level as well as the adoption of more prudent provisioning policies by banking institutions. As at end-2005, the loan loss coverage ratio of the banking system improved to 59.2% on the 3-month basis and 65.4% on the 6-month basis (end-2004: 54.9% and 60.1% respectively). During the year, a few more banking institutions adopted the 3-month classification policy. Consequently, banking institutions that control 95.6% market share of total loans in the banking system have adopted the 3-month classification policy.

During 2005, the decline in NPLs was also due to the higher rate of reclassification of NPLs to performing status (+30.2%), following the overall improvement in the

Graph 5.1
Banking System[1]: Net Non-performing Loans



[1] Includes Islamic banks.

Graph 5.2
Banking System[1] : Ageing Profile of Loans in Arrears

[1] Includes Islamic banks.

Table 5.4
Banking System: Non-performing Loans and Loan Loss Provisions

	As at end-			
	2004		2005	
	Classification			
	3-month	6-month	3-month	6-month
	RM million			
Banking system				
Non-performing loans	60,379.8	50,711.5	53,558.4	45,196.1
Interest-in-suspense	8,469.4	8,105.6	7,332.6	7,108.8
Specific provisions	15,242.3	14,015.9	14,915.0	13,429.3
General provisions	9,488.7	8,367.5	9,459.4	9,016.2
Net NPL ratio (%)[1]	7.5	5.8	5.8	4.6
Total provisions/NPL (%)	54.9	60.1	59.2	65.4
Commercial banks[2]				
Non-performing loans	55,730.3	46,774.8	48,818.4	41,140.5
Interest-in-suspense	7,880.2	7,537.2	6,696.8	6,488.8
Specific provisions	14,289.8	13,094.8	13,864.0	12,416.6
General provisions	9,089.6	7,968.3	8,913.5	8,470.2
Net NPL ratio (%)[1]	7.1	5.5	5.5	4.4
Total provisions/NPL (%)	56.1	61.1	60.4	66.5
Merchant banks				
Non-performing loans	2,496.8	2,268.0	1,782.8	1,735.1
Interest-in-suspense	373.8	364.4	356.2	355.6
Specific provisions	455.4	457.5	463.5	464.6
General provisions	235.8	235.9	192.9	193.0
Net NPL ratio (%)[1]	19.4	16.8	12.1	11.5
Total provisions/NPL (%)	42.7	46.6	56.8	58.4
Islamic banks				
Non-performing loans	2,152.7	1,668.7	2,957.1	2,320.5
Interest-in-suspense	215.3	204.1	279.6	264.4
Specific provisions	497.2	463.6	587.6	548.1
General provisions	163.4	163.4	353.0	353.0
Net NPL ratio (%)[1]	13.4	9.3	10.5	7.6
Total provisions/NPL (%)	40.7	49.8	41.3	50.2

[1] Net NPL ratio = (NPL less IIS less SP) / (Gross loans less IIS less SP) x 100%.
[2] Includes finance companies.
Note: Total may not add up due to rounding.

repayment capacity of borrowers, and write-offs of loans (+3.1%). New classification of loans as NPLs increased by 5.6% mainly due to the tightening of the NPL classification policy of a number of banking institutions, but the increase was marginal vis-à-vis the improvement in the overall asset quality of the banking system. Loans-in-arrears (net of NPLs) of between one to three months have also declined by 3.5% during the year, accounting for 6.5% of total loans. Hence, risk arising from potential new NPLs in the banking system remained manageable.

The overall decline in NPLs of the banking system primarily reflected improvements in the loan quality of the business sector. Supported by strong external demand and sustained expansion in domestic demand, the repayment capacity of the business sector improved in 2005. NPLs for the business sector showed a marked decline of 15.8% to RM29.4 billion, accounting for 11.2% of total business loans as at end-2005 (end-2004: 13.7%). This was mainly attributed to declines in NPLs for the manufacturing, distributive (wholesale and retail trade and restaurants and hotels) and the construction sectors. The NPLs for the manufacturing sector showed the largest improvement by recording a decline of 24.8% and accounted for 10.8% of loans to the manufacturing sector as at end-2005 (end-2004: 13.8%). The NPL ratios for the distributive and construction sectors improved to 7.7% and 20.4% respectively (end-2004: 10% and 23.7% respectively).

In tandem with the improvement in NPLs for the business sector, the NPLs of SMEs also declined by 3.8% during the year. As at end-2005, NPLs of SMEs declined to

Table 5.5
Banking System[1]: Non-performing Loans by Sector

	As at end-				
	NPL by sector		Change	As percentage of total loans to the sector	
	2004	2005		2004	2005
	RM million		%		
Business enterprises	**34,907.0**	**29,383.3**	**-15.8**	**13.7**	**11.2**
of which SME loans	***10,589.1***	***10,191.9***	***-3.8***	***12.0***	***10.6***
Households	**19,047.6**	**21,468.6**	**12.7**	**7.6**	**7.5**
Others	**1,110.0**	**1,347.1**	**21.4**	**11.0**	**12.8**
Total	***55,064.7***	***52,199.0***	***-5.2***	***10.7***	***9.4***
Agriculture, hunting, forestry and fishing	679.7	601.6	-11.5	6.2	5.5
Mining and quarrying	90.3	123.7	37.0	9.1	15.3
Manufacturing	8,705.4	6,550.1	-24.8	13.8	10.8
Electricity, gas and water supply	1,296.6	1,221.2	-5.8	25.0	26.4
Wholesale and retail trade, restaurants and hotels	4,356.7	3,603.3	-17.3	10.0	7.7
Wholesale trade	*1,635.8*	*1,420.0*	*-13.2*	*6.4*	*5.2*
Retail trade	*1,252.9*	*1,123.8*	*-10.3*	*9.6*	*7.6*
Restaurants and hotels	*1,468.0*	*1,059.6*	*-27.8*	*30.4*	*21.7*
Broad property sector	26,726.6	26,885.6	0.6	12.8	11.7
Construction	*7,286.2*	*6,126.4*	*-15.9*	*23.7*	*20.4*
Purchase of residential property	*11,852.7*	*14,006.8*	*18.2*	*8.9*	*9.4*
Purchase of non-residential property	*4,432.1*	*4,125.1*	*-6.9*	*14.2*	*11.7*
Real estate	*3,155.6*	*2,627.3*	*-16.7*	*23.0*	*17.9*
Transport, storage and communication	778.0	639.6	-17.8	7.8	5.6
Finance, insurance and business services	1,882.9	1,778.3	-5.6	6.1	5.9
Consumption credit	2,579.4	2,698.1	4.6	8.1	7.3
Personal use	*1,878.4*	*1,923.1*	*2.4*	*10.9*	*9.7*
Credit cards	*663.9*	*743.7*	*12.0*	*4.7*	*4.5*
Purchase of consumer durable goods	*37.0*	*31.2*	*-15.6*	*11.8*	*11.4*
Purchase of securities	2,896.6	2,425.6	-16.3	14.9	11.6
Purchase of transport vehicles[2]	3,167.3	3,550.9	12.1	4.3	4.0
Community, social and personal services	795.3	773.8	-2.7	15.6	13.5

[1] Includes Islamic banks.
[2] Includes purchase of passenger cars.
Note: Total may not add up due to rounding.

RM10.2 billion to account for 10.6% of SME loans (end-2004: 12%). Improvements in the asset quality of SME loans were noted in sectors similar to those of the overall business sector, with NPLs of SMEs in the manufacturing sector recording the largest decline. The NPLs of SME in the manufacturing sector improved by 12.7% to account for 11.6% of SME loans to this sector. This was partly attributed to improvements in credit analysis, credit assessment tools and methodologies of banking institutions and enhanced access to current customer information.

[Please refer to the section on "Exposure to the Household Sector" for the analysis on the banking sector's exposure to the household sector].

With sustainable growth in economic performance envisaged in 2006, coupled with the continuous enhancements in the risk management infrastructure and practices of banking institutions, the declining trend in NPLs in the banking system is expected to continue in 2006.

Exposure to the Household Sector

Amidst uncertainties prevailing in the global environment, the level of consumer confidence remained high throughout the year. Private consumption was strong with continued high income levels, stable labour market conditions, improvements in business conditions and productivity gains. Borrowings by households continued to remain strong as reflected by the increase in the ratio of household debts from the banking sector to GDP to 61.5% as at end-2005, as compared to 45.3% in 2000. The debt service ratio of consumers also increased from 29.9% in 2000 to 38.8% in 2005. Nevertheless, the households' level of indebtedness as measured by the average debt-to-disposable income ratio remained at manageable levels that commensurate with the capacity of the sector.

Demand for financing remained strong in 2005, reflected by an 18% increase in loan applications received from the sector. Loans approved grew by 12% to RM97.2 billion,

The households' level of indebtedness as measured by the average debt-to-disposable income ratio remained at manageable levels that commensurate with the capacity of the sector.

whilst loan disbursements recorded an increase of 11.4% to RM145.2 billion. As a result, outstanding household loans expanded by 15.1% to RM304.4 billion, accounting for 54.5% of outstanding loans in the banking system as at end-2005. Lending activities within this sector were concentrated in mortgage financing, purchase of passenger cars and credit cards.

The demand for loans for the purchase of residential properties moderated in 2005, driven mainly by lower demand for the purchase of medium to lower-end properties, with loan approvals for the purchase of residential properties rising by 2.5% to RM36.6 billion. However, reflecting the continued high level of disbursements in 2005, outstanding loans to this sector grew by 12.5% (end-2004: 14.2%). The NPLs in this sector grew by 18.2%, to account for 9.4% of loans to this sector (end-2004: 8.9%). The average lending rates charged by the commercial banks for these loans remained competitive, at between 2.69% to 3.15% per annum.

The aggressive promotional activities by car dealers and manufacturers and the launching of attractive new models at competitive prices continued to boost consumer demand for motor vehicles during the year. Loan applications to finance the purchase of passenger cars increased by 34.4% to RM54.5 billion, while approvals grew by 26.1% to RM38.3 billion during the year. Hence, outstanding loans to this sector recorded a strong increase of 19.9% to RM86.2 billion as at end-2005. In terms of asset quality, vis-à-vis the increase in loans, the growth of NPLs to this sector moderated, to account for 4% of loans to this sector (end-2004: 4.3%).

A total of 2.6 million new credit cards were issued in 2005, bringing the total number of credit cards in circulation to approximately 8 million with approved limits of RM57.1 billion. Promotions to purchase consumer goods using credit cards, coupled with the competitive annual fee promotion contributed towards the stronger growth in credit cards during the year. Credit limits for new credit cards increased by 7.3% to RM12.6 billion, whilst the utilisation of credit card facilities remained strong with total disbursements expanding by 17.6% to RM42.7 billion. Nevertheless, the outstanding balance of credit cards remained a small proportion of outstanding loans of the banking system. While the outstanding loans for credit cards have increased from the previous year, the amount of revolving balance has remained relatively constant vis-à-vis 2004, accounting for about 40% of the outstanding credit card loans, indicating that 60% of card users have been servicing their credit card loans in full. The credit card NPLs accounted for 4.5% of total credit card loans and 1.4% of total NPLs in the banking system as at end-2005.

While enhancements in risk management infrastructure and capabilities of banking institutions have strengthened their capacity to manage risk emanating from their exposure to the household sector, there are emerging concerns on the ability of the household sector in managing their indebtedness. Hence, Bank Negara Malaysia has undertaken a series of pre-emptive measures to ensure sustainability of the household sector as follows:

- Conduct concerted efforts to educate consumers on financial management to enable them to make informed decisions and to manage financial risks in a proactive and constructive manner. This is part of the comprehensive consumer education programme initiated in 2003; and
- Establish a Credit Counseling and Debt Management Agency (CCDMA) to provide assistance in the form of professional advisory and debt management services to individuals facing debt problems that involve multiple financial institutions under the supervision of Bank Negara Malaysia. The CCDMA is expected to commence operations by 1 April 2006.

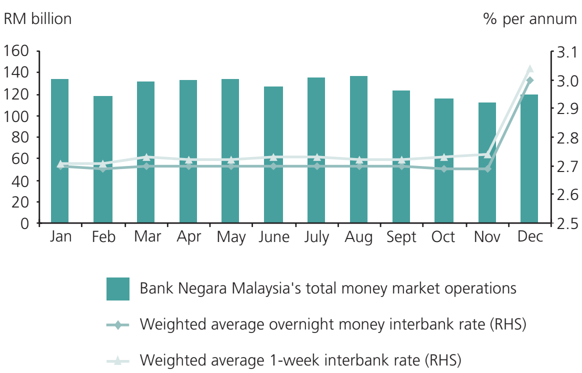
At the supervisory level, Bank Negara Malaysia has also undertaken measures to ensure that the banking institutions' exposure to the household sector does not pose undue risk to the stability of the financial sector, as follows:

- Increase the risk-weightage for mortgage NPLs from 50% to 100% for capital adequacy purposes; and
- Conduct thematic examinations on individual banking institutions, focusing on the adequacy and robustness of their risk management practices on lending to the household sector.

Liquidity Management

The banking system continued to operate within an environment of high liquidity in 2005. This was mainly attributed to the sustained large current account surplus, foreign direct investment throughout the year and portfolio inflows resulting in further increase in the international reserves from RM253.5 billion as at end-2004 to RM266.4 billion as at end-2005. To absorb the excess liquidity, Bank Negara Malaysia continued to undertake active liquidity management through its money market operations in the form of direct borrowings, repos and issuance of Bank Negara Bills and Negotiable Notes. For the first 11 months of 2005, the weighted average overnight interbank rate stabilised at 2.70% while the weighted average one-week interbank rate fluctuated within a tight range from 2.71% to 2.74% per annum. Arising from the increase in the overnight policy rate by 30 basis points to 3.0% at end-November 2005, the weighted average overnight and one-week interbank rates were higher at 3.0% and 3.04% per annum respectively as at end-2005. Total outstanding money market operations by Bank Negara Malaysia in the form of net direct borrowings, repos and issuance of Bank Negara Malaysia papers was RM119.9 billion at the end of 2005, as compared to RM142.6 billion as at end-2004.

Graph 5.3
Liquidity in the Banking System[1] in 2005



[1] Includes Islamic banks.

Table 5.6
Banking System: Liquidity Projection as at 31 December 2005

	Cumulative mismatch (RM billion)		Buffer as % of total deposits	
	1 wk.	1 mth.	1 wk.	1 mth.
Commercial banks[1]	51.7	66.6	10.2	13.1
Merchant banks	8.0	7.3	45.6	41.6
Islamic banks	7.7	6.7	24.1	21.2
Banking system	**67.4**	**80.7**	**12.1**	**14.5**

[1] Includes finance companies.
Note: Total may not add up due to rounding.

Throughout the year 2005, the banking system, as a whole, projected sufficient liquidity to meet any unexpected withdrawals for a period of up to one month. As at end-2005, the cumulative liquidity surplus of the banking system was projected at RM67.4 billion to meet estimated liquidity demands of up to one week and a surplus of RM80.7 billion to meet demands of up to one month. As a group, commercial banks, merchant banks and Islamic banks projected large surpluses in the one-month bucket amounting to 13.1%, 41.6% and 21.2% of their total deposit base respectively. On an individual basis, all banking institutions have projected surpluses, well above the regulatory requirement in the one-week and one-month buckets.

Interest Rate Risk

The banking system's exposure to interest rate risk (inclusive of price risk of Islamic exposures) is assessed using the duration-weighted net position (DWP) approach. The DWP approach estimates the potential impact on economic value of a banking institution for a 100 basis point shift in interest rates. However, the existing DWP approach adopted by Bank Negara Malaysia does not analyse separately the exposures arising from Islamic portfolio whereby the potential economic value impact could be mitigated by the *mudharabah*-based liabilities.

The banking system's DWP increased by 10.57% to RM4.2 billion as at end-December 2005, or 5.1% if expressed as a percentage of capital base of the banking system. During the year, total RM denominated interest sensitive assets grew by 9% from end-2004 with growth concentrated in the one to three months maturity tenure largely as a result of increased interbank lending, and in the seven to 10 years maturity tenure due to the rise in fixed rate hire purchase loans. The increase in RM

Table 5.7
Banking System: Impact of 1% Rise in Interest Rate on Capital Strength

	Duration-weighted net position					
	RM million		As a percentage of capital base (%)		Impact on risk weighted capital ratio (percentage point)	
	As at end-					
	2004	2005	2004	2005	2004	2005
Commercial banks[1]	-3,399	-3,690	-4.8	-4.8	-1.0	-1.1
Merchant banks	-366	-472	-7.3	-9.6	-3.9	-8.3
Banking system[2]	-3,764	-4,162	-5.0	-5.1	-1.1	-1.2

[1] Includes finance companies.
[2] Excludes Islamic banks but includes price risk of Islamic type exposures.
Note: Total may not add up due to rounding.

denominated interest sensitive liabilities was lower at 8%, mainly due to the issuance of debt papers and Cagamas funding that had remaining maturities of one to three months and four to seven years.

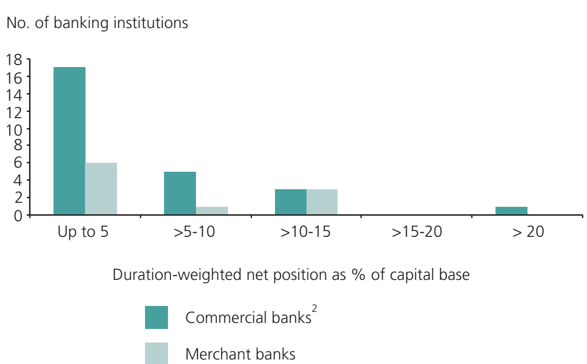
A majority of the banking system's interest rate risk was concentrated in the three to five and five to 10 years maturity buckets, which together accounted for 70% of total net DWP as at end-December 2005. This was primarily attributed to the increase in fixed rate loans with remaining maturities of more than five to 10 years of 24% or RM9.1 billion. The increase was due to the expansion of hire purchase portfolio among banking institutions that have relatively lower credit exposure to the retail segment in 2005. As the variable rate hire purchase financing has only been recently introduced, fixed rate hire purchase continue to be the predominant type of financing registering an increase RM21.5 billion to RM95.5 billion as at end-2005.

Despite the increase in fixed rate loans during 2005, part of the economic value impact arising from Islamic fixed rate loans which rose by RM9.2 billion to RM41 billion during the year, would have been absorbed by the *mudharabah*-based liabilities which amounted to RM20.7 billion as at end-2005, should the loss-absorbing nature of such liabilities be reflected by the DWP approach. Over the long term, the use of Islamic variable rate financing which accounted for 13.5% of total Islamic loans as at end-2005 would also mitigate risk arising from the fixed rate products typical of Islamic financing.

As a group, the DWP of commercial banks recorded an increase of 8.6% to RM3.7 billion as at end-December 2005, due to higher fixed rate loans with remaining maturity of more than five to 10 years mainly in the form of motor vehicle financing. Merchant banks also recorded an increase in their DWP from RM0.4 billion to RM0.5 billion as at end-December 2005 as a result of expansion in their holdings of debt securities with remaining maturities of more than seven years and taking on net long interest rate forwards, forward rate agreements and futures positions in the more than five year maturity tenure.

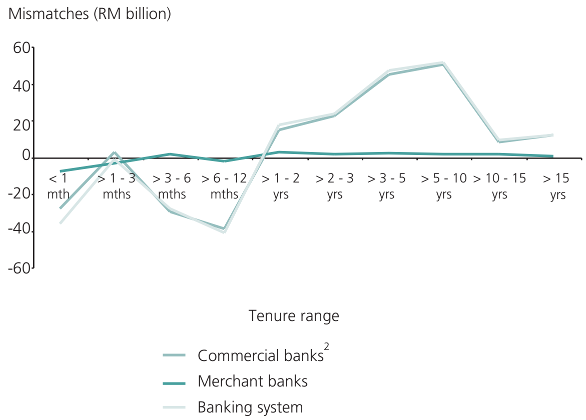
The impact of the higher holdings of private debt securities was also reflected in the increase in the banking system's interest rate risk by 37.4% to RM2 billion or 2.45% of capital base as at end-December 2005, as measured under the Market Risk Capital Adequacy framework which was introduced by Bank Negara Malaysia in September 2004.

Graph 5.4
Banking System[1] : Distribution by Duration Weighted Net Position as a Percentage of Capital Base as at 31 December 2005



[1] Excludes Islamic banks but includes price risk of Islamic type exposures.
[2] Includes finance companies.

Graph 5.5
Banking System[1]: Net Interest Rate Position Mismatches as at 31 December 2005



[1] Excludes Islamic banks but includes price risk of Islamic type exposures.
[2] Includes finance companies.

Table 5.8
Banking System: Impact of Trading Book Interest Rate Risk on Capital Strength as at 31 December 2005

	RM millions Interest rate risk		Total interest rate risk/Capital base (%)	
	2004	2005	2004	2005
Commercial banks[1]	906	1132	1.3	1.5
Merchant banks	522	830	10.9	16.8
Banking system[2]	1,428	1,962	1.9	2.5

[1] Includes finance companies.
[2] Excludes Islamic banks but includes price risk of Islamic type exposures.
Note: Total may not add up due to rounding.

Equity Risk

Equity exposure continues to pose minimal risk to the banking system. Total equity holdings by banking institutions remained relatively unchanged at RM3 billion as at end-2005 as compared to RM3.1 billion as at end-2004. This represented only 0.3% of the banking system's total assets as at end-2005. The lack of movement in total equity holdings reflected fewer restructuring exercises that were completed by banking institutions, as well as the more modest performance of the stock market during the year.

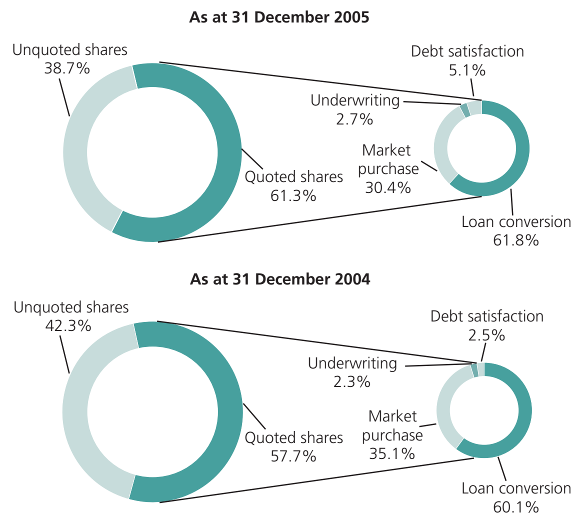
The holdings of quoted shares by the banking system recorded an increase of 3.5% during 2005, despite the declining trend for the major part of the year. Quoted shares held by the banking system registered a decline of 18.2% in the first three quarters of the year, to RM1.4 billion as at end-September 2005, reflecting cautious sentiments in the stock market, influenced by underperformance of major counters in the KLSE and concerns over unfavourable external factors such as rising oil prices, which triggered the selling down of shares. However, the decline in holdings of quoted shares by the banking system was mitigated by several conversions of loans into quoted shares through restructuring activities. Consequently, there was an increase in the holdings of quoted shares in the fourth quarter of 2005 by 26.6% to RM1.8 billion as at end-2005.

Investments in unquoted shares by the banking system recorded an overall decline of 11%, from RM1.3 billion as at end-2004 to RM1.2 billion as at end-2005. This was largely attributed to the decline in the holding of unquoted shares amongst commercial banks, by 12.2%, from RM1.2 billion as at end-2004 to RM1.1 billion as at end-2005, as a result of several share redemption activities by corporate borrowers that had been previously involved in debt restructuring.

Only the merchant banks as a group recorded an increase in equity holding of 9.1%, mainly from quoted shares received from loan equity conversions. As a result, the ratio of quoted shares to capital base rose from 6.4% as at end-2004 to 7.1% as at end-2005. The majority of banking institutions maintained an equity risk exposure of less than 2% of their capital base as at end-2005.

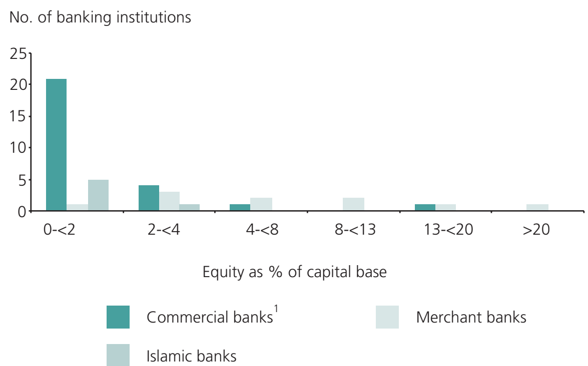
Reflective of the lower volatility of the Kuala Lumpur Composite Index (KLCI) in 2005, the potential maximum loss in equity value for the banking system based on a 10-day volatility of the KLCI as at end-2005 was lower at 4.5% or 0.1% of capital base, compared to 7.7% or 0.2% of capital base as at end-2004.

Graph 5.6
Banking System[1]: Composition of Equity Investments



[1] Includes Islamic banks.

Graph 5.7
Banking System: Distribution by Equity as a Percentage of Capital Base as at 31 December 2005



[1] Includes finance companies.

Table 5.9
Banking System: Equity Exposure

	Equity[1] holdings (RM million)		Equity[1] / Capital base (%)		Potential equity[1] loss/ Capital base (%)	
	As at end-					
	2004	2005	2004	2005	2004	2005
Commercial banks[2]	1,409.3	1,449.5	1.9	1.9	0.1	0.1
Merchant banks	320.8	351.2	6.4	7.1	0.5	0.3
Islamic banks	34.8	26.5	1.8	0.8	0.1	0.0
Banking system	1,764.8	1,827.2	2.2	2.2	0.2	0.1

[1] Amount of investment in quoted shares.
[2] Includes finance companies.

Foreign Exchange Risk

The exposure of the banking system to foreign exchange risk remained manageable in 2005 with the net open foreign currency positions (NOP) trending downwards, particularly in the second half of the year. Foreign currency liabilities, mainly in the form of foreign currency interbank borrowings, increased during the year as banking institutions undertook forward exchange arbitrage activities in the currency swap market. The NOP declined from RM3 billion to RM0.8 billion during the year, with the most substantial reduction of RM2.9 billion recorded in November. As a percentage of the banking system's capital base, the NOP contracted from 3.7% in 2004 to 1% in 2005.

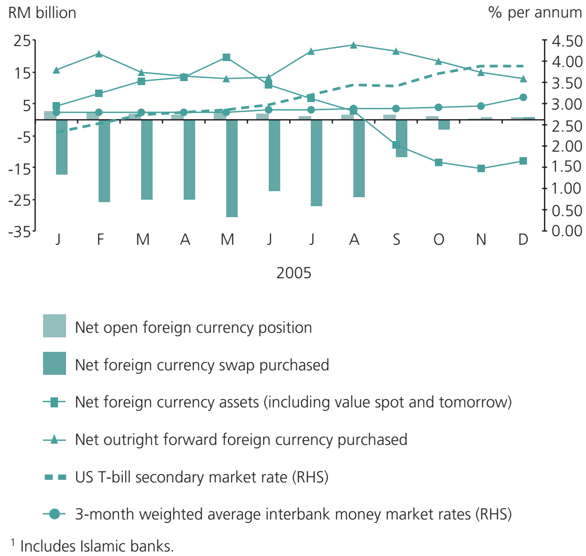
Total foreign currency assets of the banking system, mostly in the form of interbank foreign currency placements, was high in the first half of 2005, with the outstanding amount equivalent to RM61 billion as at 30 June 2005. This was mainly as a result of continuous repatriation of export earnings, sustained foreign direct investment and significant inflows of portfolio investment. The rise in the interbank foreign currency placements that reached the maximum outstanding amount of RM43.1 billion at end-May was also attributed to the increase of RM3.7 billion in foreign currency deposits accepted by the banking institutions as domestic investors took the opportunity of investing in non-ringgit assets following the liberalisation of the foreign exchange rules in April 2005. During the second half of the year, the trend in the inflows of the short-term funds reversed. This reflected the decline in the foreign currency interbank placements by RM2.7 billion and subsequently the fall in total foreign currency assets by RM3 billion.

Total foreign currency liabilities that remained relatively stable in the first half of the year, trended upwards in the second half of 2005 due mainly to the increase in foreign currency interbank borrowings by banking institutions. Although US dollar interest rates rose steadily during the second half of 2005, banking institutions were still borrowing foreign currency in the interbank money market as they entered into swap transactions to hedge their own arbitrage activities in anticipation of the strengthening of ringgit which was reflected in the forward discount. The expansion in foreign currency liabilities of the banking system was also attributed to the increase in foreign currency intra-group placements by selected foreign banking institutions in view of the relatively low exposure of foreign currency risk of the Malaysian subsidiaries. As a result, the net foreign currency asset position that reached its peak of RM19.7 billion in May turned into a net foreign currency liabilities position of RM12.9 billion at the end of 2005.

Table 5.10
Banking System: Foreign Currency Exposure

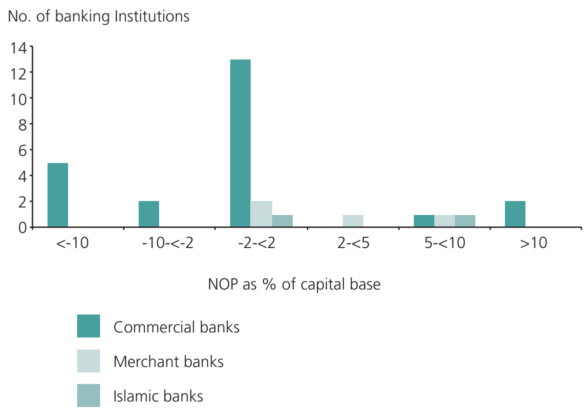
	NOP (RM million)		NOP/Capital base (%)	
	As at end-			
	2004	2005	2004	2005
Commercial banks	2,904	571	4.2	0.8
Merchant banks	48	88	1.0	1.8
Islamic banks	54	125	2.8	2.2
Banking system	3,006	784	3.7	1.0

Graph 5.8
Banking System[1]: Components of Foreign Currency Exposure



[1] Includes Islamic banks.

Graph 5.9
Banking System: Distribution of Net Open Foreign Currency Position as at 31 December 2005



In the foreign currency forward market, the forward premiums in the USD/RM rate narrowed considerably and turned into a deep forward discount of 55 basis points reflective of the interest rate differentials increasingly in favour of the US dollar. Nevertheless, there was still strong demand from customers to sell foreign currency forward contracts especially in July and August which eased off subsequently following the shift to a new exchange rate regime. As a result, banking institutions' foreign currency forward contracts purchased mainly from domestic non-bank entities rose from RM36.1 billion as at end-January to RM42.9 billion as at end-August 2005. To manage the foreign currency forward contracts purchased, banking institutions undertook foreign currency swap transactions which resulted in the increase in foreign currency swap payable by 39.8% to RM72.7 billion in July 2005.

Capital Strength

Capitalisation in the banking system was sustained at strong levels throughout the year. This development was underpinned by continued capital management activities by the banking institutions to lower the cost of capital and maximise value to shareholders. This included higher dividend payments and share buybacks as well as issuance of tier-2 capital and hybrid capital instruments. The strong capital position enabled the banking institutions to absorb the effects of capital-related measures introduced during the year which were aimed at further enhancing the risk-sensitivity of the capital framework. Following this, the risk weighted capital ratio (RWCR) remained comfortably above 13% during the year. The RWCR was 13.1% as at end-2005, whilst the core capital ratio stood at 10.2%. At the micro level, the impact of the inclusion of market risk factor in the computation of risk-adjusted capital on merchant banks was relatively substantial, resulting in a 5.4 percentage points decline in the RWCR to 17.5%.

The capital base grew by RM2.3 billion largely on account of higher tier-2 capital which accounted for 83% of the growth in total capital. Nonetheless, tier-1 capital remained as the major component, accounting for 70.6% of total capital. The increase in tier-1 capital during the year mainly emanated from the inclusion of RM2.5 billion of audited profits and the exercise of ESOS totaling RM0.2 billion. In regard to tier-2 capital, there were seven issuances of subordinated debts totaling RM3.9 billion, of which RM2.2 billion was denominated in USD, hence enabling the issuers not only to benefit from the relatively lower US interest rates but also to enhance their presence in the international capital and debt markets.

Table 5.11
Banking System: Constituents of Capital

	As at end-		Annual change	
	2004	2005		
	RM million		RM million	(%)
Tier-1 capital	64,920.4	65,685.0	764.6	1.2
Tier-2 capital	23,611.6	27,338.6	3,727.0	15.8
Total capital	88,532.0	93,023.5	4,491.6	5.1
Less:				
Investment in subsidiaries and holdings of other banking institutions' capital	7,294.7	9,526.6	2,231.9	30.6
Capital base	81,237.3	83,496.9	2,259.6	2.8
Risk assets:				
0%	210,391.3	210,324.5	-66.8	0.0
10%	14,669.8	8,226.9	-6,442.9	-43.9
20%	120,316.9	102,207.7	-18,109.2	-15.1
50%	136,487.1	145,916.2	9,429.2	6.9
100%	471,839.2	503,180.5	31,341.4	6.6
Total risk-weighted assets	565,613.1	635,610.9	69,997.8	12.4
Risk-weighted capital ratio (%)				
Banking system	**14.4**	**13.1**	**-1.3**	
Commercial banks[1]	14.1	12.9	-1.2	
Merchant banks	22.9	17.5	-5.4	
Islamic banks	12.3	14.2	1.9	

Note: Total may not add up due to rounding.
[1] Includes finance companies.

Risk-weighted assets recorded a double-digit growth of 12.4% during the year. This expansion was brought about by a combination of factors, namely expansion in lending activities, particularly in the SME and consumer segments, the inclusion of market risk in the capital adequacy framework and higher capital charge on mortgage NPLs. (*Please refer to the section on Lending Activity for details on the performance of fund-based operations of the banking system*). The increase in risk-weight for mortgage NPLs to 100% since March 2005 only resulted in a marginal decline of 0.1 percentage point in the RWCR. The implementation of a market risk framework beginning April 2005, however, resulted in a larger decline of 0.8 percentage point in the RWCR. With the inclusion of market risk in the risk-adjusted capital framework, the level of capital positions of banking institutions has now become more reflective of the various risks facing the banking institutions instead of merely credit risk.

By asset category, growth in the 50% risk-weight category was consistent with the continued expansion in mortgage financing, whilst the increase in assets in the 100% risk-weight category was attributable to other lending activities of the banking system and the re-categorisation of mortgage non-performing loans. Assets in the 10% and 20% risk-weight categories, however, declined partly due to the maturity of Cagamas debt securities held by the banking institutions, and outstanding claims on OECD and non-OECD banks, respectively.

Malaysia's Anti-Money Laundering and Counter Financing of Terrorism (AML/CFT) Programme

Overview

Malaysia's Anti-Money Laundering and Counter Financing of Terrorism (AML/CFT) regulatory regime under the Anti-Money Laundering Act 2001 (AMLA) continues to evolve in order to keep pace with new global trends and internationally accepted standards, that is, the Financial Action Task Force on Money Laundering's (FATF) 40+9 Recommendations. As with other jurisdictions, Malaysia's efforts were expanded during the year by extending the AMLA regulatory net to non-financial businesses and professions, strengthening the AML/CFT legislative framework and ensuring proper implementation of measures to counter money laundering and the financing of terrorism.

Malaysia, as the lead shepherd for money laundering in the Association of Southeast Asian Nations (ASEAN), has taken efforts to enhance the skills and knowledge of personnel involved in the fight against money laundering and terrorism financing both at the national and regional level. Various training workshops were organised/co-organised by Bank Negara Malaysia and the Southeast Asia Regional Centre for Counter Terrorism (SEARCCT). These training workshops were participated by regulatory and law enforcement agencies. Besides training workshops, regular dialogues and awareness programmes were conducted for new as well as existing AMLA reporting institutions in Malaysia. The face-to-face interactions have gained the willing commitment, compliance and co-operation of the reporting institutions in playing their critical role in implementing the national AML/CFT measures.

The National Co-ordination Committee to Counter Money Laundering (NCC) that consists of 13 Ministries and Government agencies continues to play its role in mobilising and garnering the co-operative efforts from the relevant domestic agencies. Among others, the NCC established the AMLA Investigation Reference Guide and is now in the process of establishing the Financial Investigators Accreditation Programme. The Ministry of Foreign Affairs, which is a member of the NCC, has forwarded the AMLA Information Booklet to Malaysian missions abroad to apprise these missions of the efforts taken by Malaysia to enhance its AML/CFT regime.

During the year, the first offender under the AMLA, a snatch thief, was successfully convicted after he pleaded guilty to five counts of money laundering charges amounting to RM83,216. He was sentenced to three years imprisonment on each of the five charges. Another six persons are also being prosecuted for money laundering offences involving a total of 193 charges and amounting to RM71.3 million.

As the fight against money laundering and terrorism financing requires global collaborative efforts, Malaysia participates actively in global AML/CFT initiatives. At the international front, Malaysia achieved the distinction of being selected at the 8th Asia/Pacific Group on Money Laundering (APG) Annual Meeting as the representative for the South East Asia region in the APG Steering Group (for a period from July 2005-July 2006). The APG Steering Group was established at the APG Annual Meeting in September 2003. The membership includes a representative from each of the five broad geographical areas within the APG, namely North Asia, Pacific Islands, South Asia, South East Asia and 'Others'. The purpose of the APG Steering Group is to provide the APG Co-chairs and APG members with strategic advice on the structure, functioning and support for the APG. Among the roles played by the members of the Steering Group is to provide advice on issues of strategic importance, obtain feedback from sub-regional members on key issues and influence the APG members to participate in the APG activities.

Enhancing AML/CFT Regime

New AMLA Reporting Institutions

Under the AMLA, a reporting institution is required to file a Suspicious Transaction Report (STR) directly to Bank Negara Malaysia if there are reasons to suspect any transaction involving the proceeds of any unlawful activities that are listed in the Second Schedule to the AMLA. Since the enforcement of the AMLA on 15 January 2002, the AMLA reporting institutions include financial institutions from the conventional, Islamic and offshore sectors and non-financial businesses and professions such as lawyers, accountants, company secretaries as well as the only licensed casino in Malaysia.

During 2005, the AMLA reporting obligations were invoked on licensed gaming outlets, Bank Pertanian Malaysia and notaries public with effect from 31 March 2005 and on offshore trading agents and listing sponsors with effect from 20 October 2005. Notaries public are required to report to Bank Negara Malaysia any suspicious transaction in the course of carrying out the following activities for their clients:

(i) buying and selling of immovable property;
(ii) managing of client's money, securities or other property;
(iii) managing of accounts including savings and securities accounts;
(iv) organising of contributions for the creation, operation or management of companies; or
(v) creating, operating or managing of legal entities or arrangements and buying and selling of business entities.

Increase Reporting Obligations

Bank Negara Malaysia adopts an incremental approach in invoking the AMLA provisions on the reporting institutions. This approach ensures that sufficient time is given to the reporting institutions to put in place an effective and efficient AML/CFT system before the rest of the reporting obligations are invoked on them. In this regard, the statutory requirement to report suspicious transactions was initially invoked on Pos Malaysia Berhad with effect from 15 January 2003 and on stock brokers and futures brokers with effect from 31 March 2004. Subsequently, the remaining reporting obligations under Part IV of the AMLA were invoked on Pos Malaysia Berhad with effect from 31 March 2005 and on the stock brokers and futures brokers with effect from 20 October 2005. These remaining reporting obligations include, among others, retention of records for a minimum period of six years, conducting customer due diligence as well as establishing internal reporting and compliance programme that are designed to safeguard the institutions from being used as conduits by criminals.

Increase Predicate Offences

In 2005, the number of money laundering predicate offences in the Second Schedule to the AMLA was increased from 168 to 185 serious offences from 27 pieces of legislation. The new predicate offences are from the Customs Act 1967, Islamic Banking Act 1983, Payment Systems Act 2003, Takaful Act 1984, Futures Industry Act 1993, Securities Commission Act 1993 and Securities Industry Act 1983.

Compliance Monitoring

Given the diversity in the types of AMLA reporting institutions and the large number of non-financial businesses and professions, Bank Negara Malaysia has established appropriate mechanism to effectively monitor the reporting institutions' compliance with the AMLA reporting obligations and the relevant AML/CFT guidelines. Compliance monitoring may be by way of completing Bank Negara Malaysia's self-assessment questionnaires by the reporting institutions or AML/CFT focused internal audit.

In line with the non-integrated approach, the relevant functional supervisory authority conducts AMLA compliance examinations on the reporting institutions under their purview. The AML/CFT examinations are carried out as part of the functional supervisory authority's overall examination on the financial institutions concerned. For this purpose, a comprehensive AMLA supervisory framework providing the banking supervisors with a documented set of uniform processes was formulated and established to guide them in their examination of financial institutions' AML/CFT measures. The core areas of AML/CFT examination encompass the following:

i) AML/CFT infrastructure;
ii) institution's compliance with internal AML/CFT policies and procedures;
iii) identification of account holders;
iv) monitoring of transactions;

v) record-keeping;
vi) detection and reporting of unusual and suspicious transactions;
vii) training and awareness programmes for employees;
viii) internal audit of the AML/CFT initiatives; and
ix) roles and responsibilities of the AML compliance officer.

The AML/CFT examination reports are forwarded to the Financial Intelligence Unit (FIU) and the findings are uploaded into the FIU's compliance database to ensure continuous monitoring of the reporting institutions' compliance with the AMLA requirements. For reporting institutions that are from unregulated industries and from industries where the regulatory authorities are not empowered to conduct examinations, Bank Negara Malaysia will supervise these institutions for AMLA compliance.

Financial Intelligence

Since May 2004, Bank Negara Malaysia has implemented the Financial Intelligence System (FINS) that enables the reporting institutions to submit STRs through a secure web in an efficient and secure on-line environment. Bank Negara Malaysia is in the process of enhancing the FINS with more powerful and advanced intelligence analytical software. Phase II of the FINS will also incorporate i-2 tools that will assist Bank Negara Malaysia's analysts in establishing financial links among STRs. Based on the analysis of STRs, Bank Negara Malaysia is able to provide financial intelligence to the relevant law enforcement agencies. The financial intelligence provided has enabled the law enforcement agencies to effectively conduct financial investigation on the perpetrators and to establish the underlying predicate offences as well as money laundering offences. Hence, Bank Negara Malaysia will enhance the effectiveness of its financial analysts by leveraging on information technology to better detect criminal activities and to enable timely dissemination of financial intelligence to law enforcement agencies.

Capacity Building

AMLA Awareness Programme

In 2005, Bank Negara Malaysia continued its nationwide awareness programme to ensure that the reporting institutions effectively implement the AML/CFT measures. A series of briefing sessions were held for various categories of the reporting institutions, particularly for the new reporting institutions as well as their respective regulatory and supervisory authorities in order to apprise them of their obligations under the AMLA.

In July 2005, a total of 10 nationwide AMLA briefing sessions were conducted for banking institutions and licensed gaming outlets, namely the number forecast companies. The briefing sessions for banking institutions were organised by the Institute of Bankers Malaysia (IBBM) while for licensed gaming outlets, they were conducted in collaboration with the Betting Control Unit, Ministry of Finance. The main focus of the AMLA briefing sessions for banking institutions is on 'Know Your Customer (KYC) Policy' and on the importance of conducting customer due diligence when establishing business relations while the sessions for gaming outlets were on the submission of STRs.

During the year, Bank Negara Malaysia was also invited by the Malaysian Association of Company Secretaries to conduct briefing sessions on AML/CFT for its members. In total, three sessions were conducted in Sabah and one in Johor Bahru. As the number of company secretaries is large and their trade associations are fragmented, these briefing sessions have proven to be an effective outreach to the industry to ensure that their members fully understand their roles in preventing and detecting criminal activities.

Dialogue Sessions

Bank Negara Malaysia continues to conduct regular dialogue sessions with the reporting institutions. These dialogue sessions were effective in updating the reporting institutions on the latest AML/CFT measures and to gather feedback on the effectiveness of the AML/CFT measures. The dialogue sessions also provide a platform for the reporting institutions to raise their concerns and exchange ideas on the best practices to implement the AML/CFT measures effectively. With better understanding and co-operation from the reporting institutions, Malaysia's AML/CFT regime will be more effective and efficient.

Compliance Officer Networking Group (CONG)

The banking institutions have established the Compliance Officer Networking Group (CONG), which is an informal consultative forum to discuss and share AML/CFT issues and concerns. Since its establishment in 2003, the banking institutions have benefited from the consultative deliberations at the meetings of the compliance officers from the CONG. Members of the CONG participate in creating industry standards, suggest best practices, reinforce the necessity of compliance and co-operation with the authorities and amongst themselves in order to minimise the potential of being exploited by money launderers and terrorist financiers.

The insurance sector also plays an important role in the AML/CFT regime. The inclusion of investment products with the usual portfolio of insurance policies increases the potential for the insurance sector to be exploited as money laundering conduits. As a result, the respective insurance associations are following the example of the banking sector in setting up their own CONG. The General Insurance Association of Malaysia (PIAM), the Life Insurance Association of Malaysia (LIAM), the Insurance Brokers Association of Malaysia and the Malaysian Takaful Association have proposed that separate CONGs be established for the general insurers, life insurers, insurance brokers and takaful operators respectively as issues raised may be different for different types of insurance businesses. PIAM has established a CONG for general insurers in 2005 while LIAM has established a CONG for life insurers in January 2006. The remaining insurance associations will establish their CONGs in due course.

Computer-Based Training Centre

Bank Negara Malaysia has collaborated with the United Nations Office on Drugs and Crime (UNODC) to establish an AML Computer-Based Training Centre (CBTC) for the relevant agencies in Malaysia. The CBTC was launched at the FIU in Bank Negara Malaysia on 30 May 2005. The UNODC's interactive AML computer-based training programme consists of 13 modules on legal, regulatory and law enforcement AML measures. Participants are assessed through a series of quizzes, pre-tests and post-tests to determine their knowledge on AML/CFT measures. This e-learning training initiative helps to enhance the knowledge of personnel from the law enforcement agencies and ensure greater outreach to relevant sectors involved in the fight against money laundering and financing of terrorism. As at 31 December 2005, a total of 48 officials from various NCC agencies have signed up for the AML Computer-Based Training programme and 22 have completed the training, while the rest are at various stages of completion.

World Bank E-Learning AML/CFT Programme

Apart from the UNODC computer-based training programme, the World Bank has also developed an e-learning AML/CFT programme, which is currently accessible to seven countries, namely Malaysia, Thailand, Vietnam, Indonesia, the Philippines, Cambodia and Laos PDR. The e-learning programme consists of seven modules covering the following topics that are related to AML/CFT:

Module 1 - Effects on Economic Development and International Standards;
Module 2 - Legal Requirements to meet International Standards;
Module 3 - (a) Regulatory and Institutional Requirements;
(b) Compliance Requirements for Financial Institutions;
Module 4 - Building an Effective Financial Intelligence Unit;
Module 5 - Domestic (inter-agency) and International Co-operation;
Module 6 - Combating the Financing of Terrorism; and
Module 7 - Investigating Money Laundering and Terrorist Financing.

The World Bank allows countries to customise the e-learning programme to their domestic AML/CFT regime. As such, Bank Negara Malaysia is currently customising the modules by including the Malaysian AML/CFT laws and measures. Upon completion of the customisation, the Bahasa Melayu version will also be developed. The World Bank e-learning programme will be accessible to the government and private sectors in the following format:

i) hardcopy;
ii) CD-ROM; or
iii) on-line learning management system.

The flexibility given by the World Bank also allows the government and private sector's training institutions to modify the modules to suit their training requirements.

Training Initiatives

To stay ahead of money launderers who are increasingly creative in structuring their activities in order to avoid detection by law enforcement officers, Bank Negara Malaysia continues to upgrade the expertise of law enforcement personnel through formal workshops and seminars. The training workshops and seminars were conducted by both internal and external resource persons and experts.

During the year, Bank Negara Malaysia has organised/co-organised and participated in the following training initiatives:

i) The AMLA Advance Net Worth Analysis Workshop, Port Dickson, 20-24 June 2005;
ii) Financial Intelligence Training, Kuala Lumpur, 5-9 September 2005;
iii) Terrorism Financing Typologies Workshop, Kuala Lumpur, 14-17 November 2005; and
iv) AML Seminar and Workshop, Labuan, 23-24 November 2005.

Financial Investigators Accreditation Programme

At the 19th NCC Meeting on 9 November 2004, members agreed to develop the Accreditation of Financial Investigators Programme for AMLA investigators. The objective of the Accreditation Programme is to develop financial investigators with the relevant skills in conducting financial investigations. The proposed accredited training programme consists of the following nine modules:

i) UNODC Anti-Money Laundering Computer-Based Training;
ii) Legal Aspects on Financial Investigation under the AMLA;
iii) AMLA Investigation: Process & Procedure;
iv) Basic Net Worth Analysis Workshop;
v) Advance Net Worth Analysis Workshop;
vi) Forensic Accounting;
vii) Introduction to Computer Forensics;
viii) Attachments with commercial banks & insurance companies; and
ix) Training on Visual Investigative Analysis Software

It is anticipated that the first batch of accredited financial investigators will graduate by the end of 2006.

Challenges Ahead

The year ahead will be very challenging for Malaysia as it is scheduled for a second round of Mutual Evaluation jointly by the APG and the Offshore Group of Banking Supervisors (OGBS) in early 2007. The OGBS will evaluate the AML/CFT regime of the offshore sector in the Labuan International Offshore Financial Centre. The APG evaluation team will assess the effectiveness of Malaysia's AML/CFT system and its compliance with the FATF's 40+9 Recommendations based on the revised 2004 Methodology for Assessment. To carry out this massive and important exercise, various working groups have been established under the NCC to focus on all the 250 assessment criteria. Malaysia's current AML/CFT measures, laws, regulations, guidelines and framework are being reviewed to identify gaps and to formulate rectification measures.

Going forward, Bank Negara Malaysia will continue to be vigilant and respond to evolving AML/CFT threats as well as AML/CFT standards and trends by fine-tuning its legal and regulatory measures, including the invocation of the AMLA reporting obligations on other categories of financial and non-financial businesses and professions as recommended by the FATF.