# The Banking System

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## MANAGEMENT OF THE BANKING SYSTEM

Significant progress was achieved in strengthening the capacity and capability of domestic banking institutions in 2004. With the financial sector restructuring programme effectively completed and the foundation for an efficient, effective and resilient banking system firmly in place, the domestic banking institutions are well positioned to operate in a more deregulated and liberalised environment, as envisaged in the second phase of the Financial Sector Masterplan (FSMP). In addition to capacity building, policy measures in 2004 also focused on widening access to financing by key economic sectors, strengthening the consumer protection framework and preserving overall system resilience.

The banking sector exhibited a strong performance in 2004, with risk-weighted capital ratio (RWCR) sustained at levels above 13% throughout the year, while the net non-performing loan (NPL) ratio reached a record low of 5.9% at the end of the year, the lowest level since the Asian financial crisis. The strengthened balance sheet enabled the banking system to continue to support the economic needs of the nation. Total new loans approved and disbursed grew by 13.6% and 10.6% respectively, resulting in 8.5% growth in total outstanding loans in 2004.

### Progress of Danaharta

Of the three agencies established to spearhead the financial sector restructuring in the wake of the Asian financial crisis, only Danaharta remained in operation in 2004. Over its lifespan, Danaharta acquired adjusted loan rights amounting to RM52.4 billion, with an expected recovery rate of 59%. As at 31 December 2004, RM29 billion or 94% of the expected recoveries of RM30.8 billion have been received by Danaharta, of which RM23.6 billion have been realised in cash whilst the balance are held in the form of restructured loans, securities, properties and other non-cash assets. Danaharta has cumulatively distributed RM16.4 billion in cash and 66,472,341 units of securities to the Government and the respective financial institutions, in accordance with the 80:20 surplus recovery sharing agreements it has with these institutions.

**Table 5.1**
**Danaharta: Loan Recovery as at 31 December 2004**

| | Adjusted loan rights acquired[1] (RM billion) | | Expected recovery rate (%) | |
|---|---|---|---|---|
| | Acquired NPLs | Managed NPLs | Acquired NPLs | Managed NPLs |
| Plain loan restructuring | 1.4 | 4.1 | 91 | 97 |
| Settlement | 3.4 | 8.0 | 82 | 75 |
| Schemes of arrangement | 2.6 | 7.5 | 72 | 76 |
| Schemes under Special Administrators | 2.3 | 2.7 | 46 | 27 |
| Foreclosure | 9.8 | 4.4 | 28 | 49 |
| Others | 1.9 | 3.2 | 49 | 47 |
| Legal action | 0.2 | 1.0 | 9 | 4 |
| **Total** | **21.6** | **30.8** | **50** | **65** |
| **Overall** | **52.4** | | **59** | |

[1] Comprising total loan rights acquired of RM47.7 billion and accrued interest of RM4.7 billion.
Note: Total may not add-up due to rounding.

Source: Pengurusan Danaharta Nasional Berhad

To date, Danaharta has successfully redeemed 12 tranches of its zero-coupon bonds with aggregate face value of RM10.3 billion. With a cash and cash equivalent balance of RM1 billion as at 31 December 2004, Danaharta is well positioned to redeem the remaining three tranches of bonds with a total face value of RM0.8 billion, maturing in March 2005. Given this progress, Danaharta is on track to unwind its operations in 2005 and close the final chapter of the financial sector restructuring exercise.

### Thrust of Policy Measures in 2004

The main thrust of policy measures in 2004 continued to focus on enhancing the performance and competitiveness of the domestic banking institutions and on ensuring that these institutions are ready for a more liberalised operating environment. In particular, efforts were directed at facilitating further improvements in the domestic banking institutions' operational efficiency and flexibility. These initiatives were implemented

**Banking policies in 2004 were focused on providing an enabling environment for banking institutions to improve their efficiency and increase access to financing, while preserving overall financial stability.**

together with the introduction of strengthened prudential regulations to preserve financial stability and sustain public confidence.

Other key policy thrusts during the year included enhancing access to financing by key economic sectors and continued efforts at strengthening consumer education and protection. As financial products become more complex, the focus was to ensure that consumers have access to the necessary information to make well-informed decisions as well as introducing measures designed to enhance consumer protection and redress mechanism.

**Enhancing Domestic Capacity**

Building on the momentum of earlier capacity building initiatives, policy direction continued to focus on further enhancing structural and operational efficiencies of the domestic banking institutions. This was to enable the domestic banking institutions to remain competitive and respond to rapidly changing customer requirements in an effective and efficient manner. Consequently, further enhancements to the benchmarking exercise were made in 2004. The spectrum of financial performance and service quality indicators monitored, analysed and shared with the banking institutions was expanded to provide a wider range of information, particularly on the data, ratio and trend analysis pertaining to banking institutions' profitability, productivity and asset quality vis-à-vis their peers.

Bank Negara Malaysia had also completed a study to assess customers' expectations and satisfaction on the quality of products and services offered by banking institutions. The study involved a nationwide survey of more than 3,000 retail, small and medium enterprises (SMEs), and corporate customers of banking institutions. To complement the survey, a business process review was also conducted to gauge banking institutions' level of customer-centricity, their ability to capture information relating to service performance and customer satisfaction levels, as well as the use of these information in quality enhancement initiatives. The detailed results were shared with banking institutions to enable them to measure their performance relative to the industry and formulate measures to improve customer satisfaction and retention.

The survey indicated general satisfaction with the products and services offered, but a high degree of mobility among retail customers accentuates the need for banking institutions to continuously improve customer relationships by identifying and responding to customer needs. Retail customers cited quality interface with bank staff, better complaint management, and efficient delivery channels, loan application and approval processes as their core needs. Emerging needs include higher product innovation and flexibility, as well as improved information and greater transparency on the terms and conditions of financial products and services. The survey also indicated an even higher degree of mobility among SMEs and corporate customers. These customers also highlighted the need for relationship managers to be more proactive in introducing products and services packages to suit their business needs. Complaint management, hotline accessibility, efficient and transparent loan application and approval process and, in particular, reasons for rejection, were cited as important to the SMEs and corporate customers.

Overall, the results of the study combined with findings from the business process review highlighted the need for banking institutions to identify and respond to customer needs in order to retain customers and remain competitive. The key is to increase investment in staff training and promote customer-centric culture to support the alignment of organisational structure and business models towards meeting customers' needs and expectations. Given the importance of enhancing service quality in ensuring sustainable financial performance of the institution, commitment of management is vital in driving efforts towards building customer-centric institutions.

As domestic banking groups attained critical size and gained economies of scale from consolidation, efforts were directed at further creating the enabling environment for domestic banking groups to streamline their operations, attain operational efficiency and meet increasing customer demand for a comprehensive range of financial products and integrated delivery channels. Policy in this area culminated in the formulation of an integrated commercial bank and finance company (or Bafin) framework. The legal infrastructure for the Bafin

The establishment of the legal infrastructure for the Bafin framework allowed banking institutions to streamline retail operations, enhance efficiency and meet customers' demand for comprehensive product packages and integrated delivery channels.

framework, as incorporated in the Banking and Financial Institutions (Amendment) Act 2003, came into force on 15 January 2004. It provides the option for domestic banking groups to conduct commercial banking and finance company business through a single lending entity that holds both licences. To facilitate Bafin mergers, exemptions from stamp duty and real property gains tax were provided by the Minister of Finance for mergers completed before 15 January 2006.

In 2004, five out of ten finance companies, accounting for 55% of the total finance companies assets, successfully merged with their respective commercial bank. The new Bafin entities are Alliance Bank Berhad, EON Bank Berhad, Hong Leong Bank Berhad, Malayan Banking Berhad and Public Bank Berhad. The merged entities have undergone the processes of capital rationalisation, staff redeployment and reorganisation, branch relocation and delivery channel consolidation to gain economies of scale and scope post-mergers. It is envisaged that further cost-savings and operational efficiencies will emerge in the near future as the merged entities complete their adjustment and rationalisation of resources.

Human intellectual capital plays a pivotal role in driving the performance and competitiveness of banking institutions. The International Centre For Leadership In Finance (ICLIF) and Institut Bank-Bank Malaysia (IBBM) provide the avenues for banking institutions to ensure continuous learning and competency building among all levels of their workforce. In 2004, ICLIF conducted two sessions of its flagship Global Leadership Development Programme, a Directors' Forum and a seminar on scenario planning for senior management of banking institutions, while the ICLIF Alumni Association was launched to provide a platform for professional networking.

**ICLIF Forging Ahead to Realise Its Vision**

Bank Negara Malaysia established the International Centre For Leadership In Finance (ICLIF) with the objective of providing a focused and coordinated approach towards the development of world-class leaders in finance to cater for the needs of the rapidly transforming Asian region. ICLIF, officially launched on 28 October 2003, is entrusted with the role of developing excellent leaders with keen regional and international insights. ICLIF provides leading-edge learning opportunities and experiences through effective leadership development programmes.

**Development of ICLIF's Leadership Competency Model (LCM)**
One of the key initiatives of ICLIF during the year was to develop LCM. The model supports ICLIF's initiatives by crystallising and articulating the essential skills and behaviours required by leaders to navigate and successfully manage challenges in a fast changing regional and global environment.

The LCM was formulated through a participatory process involving strategic insights from interviews with industry leaders and benchmarked against the best practices adopted by renowned regional and global companies. The preliminary Model was validated by a panel of global experts and subsequently further refined in a Validation Seminar attended by 42 Malaysian Leaders from both the public and private sectors.

**Leadership Development Programmes Conducted in 2004**
In 2004, ICLIF commenced its Leadership Development Programmes which are broadly divided into three categories:

- ***The Structured Advanced Leadership Programme*** is ICLIF's core programme on Leadership Development which encompasses the Global Leadership Development Programme or GLDP. The programme aims to grow and nurture talent across the financial industry and the corporate sector with strong emphasis on leadership and leadership development.

  The design of the GLDP is based on the High Impact Leadership Model jointly developed by Linkage Incorporated and renowned leadership guru, Professor Warren Bennis of the Marshall School of Business – University of Southern California. It focuses on Leadership Competencies, Skills and

Responsibilities. In addition, broader leadership issues such as globalisation, global marketing issues and macro-economic trends are also covered. The programme also provides an opportunity for the participants to strengthen their networking and participate in shared learning experiences and discussions with leaders of other organisations.

To date ICLIF has successfully conducted a summer and a fall session of the GLDP for 2004. A total of 42 participants comprising 31 from the finance industry from Malaysia, the Asian region and Africa and 11 from the corporate sector attended the two sessions. Resource persons for the programme are drawn from prestigious institutions including Peter F. Drucker Graduate School of Management – Claremont Graduate University, Marshall School of Business – University of Southern California, Harvard Business School and Stanford Graduate School of Business.

- ***The Specialised Learning Programmes*** are designed to provide learning on focused and technical issues confronting leaders in promoting excellence in their organisations. The programmes offered under this category are:

  (i) The Scenario Planning Programme, which aims to provide leaders with the capability to assess the current developments in their business environment, draw the implications of such developments and to act strategically to stay ahead. In particular, participants review current technological changes and explore medium and long-term impact of such changes on the industry, corporations and their own businesses.

  (ii) The Directors Forum, which is conducted in association with INSEAD, is designed to transcend the normal coverage of compliance and legal requirements. Participants are given good insights into best practices to improve Board effectiveness, Board's relationship with management, shareholders and regulators and Board's role in the strategy, performance and values of its organization. The rights and responsibilities of shareholders with particular focus on minority shareholders as well as factors which facilitated or blocked Board effectiveness were also discussed.

- ICLIF's ***Seminars and Workshops***, in particular its 'Saturday Seminar Series' are designed to provide the platform for corporate leaders, regulators and academicians to meet and exchange views on current and emerging issues. It also provides opportunities for participants to exchange views with leading experts and industry leaders. In 2004, the Human Resource Seminar was also conducted to discuss the role of leadership development in nation building with particular focus on ICLIF's Vision and Mission and its linkage to the Financial Sector Masterplan and Vision 2020. A Banking Seminar on 'Deposit Insurance' was also organised in collaboration with Bank Negara Malaysia.

**Official Launch of ICLIF Alumni Association (IAA)**

With the rapid changes taking place in the financial and corporate landscape in the country and the greater integration in the region and the world, networking among leaders and captains of industries is most valuable in contributing towards greater understanding and in increasing the potential for collaborative efforts that are of mutual interest.

In November 2004, the IAA was officially launched. The establishment of the IAA represents an important part of ICLIF's commitment to provide a platform for members to maintain active networking and productive collaborative alliances. It is also in line with the philosophy that leadership development is a continuous journey.

During the year, efforts to reposition IBBM as an effective training provider and adviser for the industry gained momentum with the formulation of a strategic development plan that identified strategic areas to be progressively implemented to enhance the training infrastructure of IBBM. One key initiative is the enhancement of IBBM's educational and qualification portfolios, which included the development of an industry competency framework and the restructuring of its existing Continuing Professional Development programme. This would place IBBM in a position to design and offer relevant and customised management and technical programmes to meet current and future needs of the banking industry. Forging strategic alliances with related parties has been identified as a possible way of strengthening the capacity and capability of IBBM. In this regard, IBBM has entered into a collaborative arrangement with a local public university to produce a pool of banking and finance graduates equipped with the relevant knowledge and exposure to the industry.

**Ensuring Continuous Access to Financing**

The strong financial position has enabled the banking system to continue supporting economic growth through lending expansion. During the year, both households and businesses, especially the SMEs, gained increased access to financing. Total outstanding loans grew by 8.5% in 2004, with loans to households and SMEs increasing by 14.4% and 7.7% respectively. Given the important role of the banking system as the main provider of funds in the economy, policy initiatives during the year were focused on ensuring that lending activities were supportive of private sector economic activity and that all sectors of the economy has access to financing. These were complemented by safeguards to maintain financial stability by ensuring observance of prudential lending norms and effective risk management.

Continued focus on lending to the household sector has led to further increase in the share of loans to the sector to 51.4% of total outstanding loans as at end-2004 (end-2003: 48.8%). Strong lending to this sector was accompanied by rising income levels and stable employment conditions which enhanced the capacity of households to continue accumulating net financial assets. The household balance sheet remained healthy, while the exposure of the banking system to the sector was within prudential levels.

A key policy initiative to enhance access to financing was the introduction of the New Interest Rate Framework in April 2004. In addition to enhancing the effectiveness of monetary policy transmission through the introduction of the Overnight Policy Rate as a rate that reflects monetary policy stance, the new framework was also aimed at promoting efficient pricing of interest-based products by banking institutions. Towards this end, the policy of setting a ceiling base lending rate (BLR) by Bank Negara Malaysia was removed and, instead, banking institutions are free to set their own BLR to reflect their funding and other cost structures, as well as business strategies. The maximum lending spread of 2.5 percentage points above BLR was also removed. The removal of these limits provided flexibility for the banking institutions to price their interest-based products, allowing greater use of differentiated pricing strategies to match risk profile of different customers and market segments. In addition, flexibility to price products was key in ensuring continuous innovation by the banking institutions to meet the growing demands for customised and complex financial products. To ensure fair pricing and safeguard consumers' interest, attention is also given to having a comprehensive consumer protection framework in place.

Since its introduction, there has been no change in the BLRs quoted by banking institutions (except one), reflecting that the respective BLRs were already at a competitive level. The average lending rates charged on new loans approved since April 2004 did not exhibit any increasing trend, while average lending rates on new loans for certain customer segments continued to decline. It was also noted that following the introduction of the new interest rate framework, a number of banking institutions have introduced new innovative interest-based products, such as unsecured personal loans for individuals and SMEs.

Efforts taken in these recent few years to enhance access to financing by SMEs have yielded positive results. In 2004, RM31.6 billion of loans were approved to more than 92,000 SME accounts, while loan disbursements to SMEs grew by 15.3%. Loans to SMEs accounted for about 40% of total outstanding loans to businesses (27% in 1998). At the same time, the SME Special Unit in Bank Negara Malaysia had received a lower number of enquiries and complaints related to financing and loan restructuring from SMEs in 2004.

**The New Interest Rate Framework allows greater use of differentiated pricing strategy, promotes efficient risk-price matching and innovation, and enhances access to financing by certain customer segments.**

During the year, initiatives focused on strengthening the overall infrastructure to promote the development of SMEs and ensure enhanced access to financing by them. A significant milestone was the establishment of the National SME Development Council, in August 2004. This represented an achievement of a two-year effort by Bank Negara Malaysia in collaboration with a number of government agencies to effectively promote the development of SMEs. The roles, structure and achievements of the National SME Development Council are set out in more details in the White Box entitled **Report on Small and Medium Enterprise Development Framework**.

The Small Debt Resolution Committee was established by Bank Negara Malaysia in 2003 to support viable SMEs that are constrained by NPLs. The Small Debt Resolution Scheme has received 228 applications involving NPLs totalling RM180.2 million, of which 116 cases have been successfully resolved. Additional financing of RM10.5 million was approved to eligible borrowers as part of the NPL resolution package to assist these viable SMEs to overcome short-term cashflow problems and ensure continuation of their businesses. As part of the initiatives to enhance access to financing by SMEs, the allocations for the Fund for Small and Medium Industries 2 (FSMI2) and the New Entrepreneurs Fund 2 (NEF2) were increased by RM2.5 billion and RM850 million respectively in 2004 to support the higher demand for loans under these special funds. This brought the total allocations for the FSMI2 and NEF2 to RM4.5 billion and RM2 billion respectively. As at end-2004, a total amount of RM6.1 billion or 93.2% of these two funds has been approved to more than 9,000 SME accounts. As part of the efforts to promote lending to SMEs, banking institutions submitted their lending targets to Bank Negara Malaysia. In cases where the targets were deemed insufficient, the banking institutions were encouraged to review those targets. For the period from July 2003 to December 2004, the banking system as a whole approved RM44.8 billion loans to SMEs, exceeding their collective target of RM26.7 billion by 67.4%.

Bank Negara Malaysia also uplifted the restrictions on the provision of bridging finance for property development in September 2004. These restrictions, which include total ban on provision of bridging finance for development of office buildings, shop houses and shopping complexes, were imposed in 1999 to address oversupply situation and high property sector exposure by the banking system. Considering the stable and positive outlook for the property market, these restrictions were uplifted and under the new Guidelines, the Board of Directors of each banking institution is now responsible for ensuring that any proposed development projects to be financed would not contribute to a worsening of property overhang situation. This is in line with the move to accord greater responsibility and accountability to the Board of Directors in the overall business strategies of the institutions.

During the year, work was initiated to increase access to financing by agriculture and agro-based industries. The agriculture sector has been identified as the third engine of growth, and a comprehensive set of policies have been outlined in the Third National Agriculture Policy (NAP3) to develop and promote the sector. It is estimated that a total of RM32 billion of investment would be required in the sector over the period 2000-2010, of which RM21 billion would involve investment by the private sector. Therefore, financing is vital in ensuring the success of the Government's aspiration to promote the sector. As the banking system is the largest provider of credit to the sector, additional financing to this sector would involve improving the utilisation of funds of the banking system. Government policy initiatives in the pipeline encompass enhancing the viability of the agriculture sector and agro-based industries, including through risk mitigation efforts such as guarantee and insurance schemes. Focus will also be placed on improving access to financing for start-ups and new ventures in new growth areas such as biotechnology and aquaculture.

### Promoting Active Consumerism

Bank Negara Malaysia continued to place priority on ensuring that consumers are better able to make informed choices and achieve fair deals in their financial arrangements. In meeting this objective, efforts have been directed at enhancing financial literacy levels of the banking public as well as to strengthen the regulatory infrastructure. Efforts to enhance financial literacy levels continued to be aimed at improving consumers' ability to make financial decisions with confidence and, in particular, empower consumers to make wise savings and investment decisions. The consumer education programme, known as BankingInfo, which has now entered into its third year, continued to provide pertinent information to facilitate informed decision-making. The booklets are being translated into Mandarin and Tamil to enable larger segments of the population to have access to key financial information. BankingInfo has also leveraged on a diverse distribution network via existing branches of banking institutions, complaint and consumer bureaus, official websites as well as via participations in seminars and conferences organised by various organisations throughout the year to enhance the outreach of the programme. The BankingInfo website, to-date, has received an encouraging response of more than 17 million hits and about 3 million booklets were taken up by the public (end-2003: 6.4 million hits and 1.2 million booklets ).

The full impact of any financial literacy initiative will only be seen over the medium and long-term period. As such, future generations become an important target for personal finance education so that the benefits of such education can be realised in the future. In this connection, since 1996, Bank Negara Malaysia together with the Education Ministry has embarked on a School Adoption Programme to inculcate smart financial management habits among students by providing simple and practical education about basic money management. Through this programme, about 7,000 schools have been adopted by banking institutions which play a leading role in educating school children on basic financial knowledge through student financial clubs using Students Pocket Money Book as a teaching tool. In October 2004, the online version of the Pocket Money Book was launched to enhance the distribution of the pocket book. The programme to inculcate smart financial management habits has also been extended to cover a wider target audience, including women, teachers and workers through the use of Household Account Books to assist families in the management of household income, savings and investments.

## Bank Negara Malaysia has implemented a comprehensive consumer protection framework in the areas of disclosure, access to basic financial services, regulatory oversight and redress mechanism.

Given the wide use of financial services and that consumers do not have access to the same level of information or requisite understanding and bargaining power, it is vital for consumers to be given access to information in a clear and transparent manner and are treated fairly in their dealings with financial institutions. Towards this end, Bank Negara Malaysia has implemented a consumer protection framework, comprising four main areas, namely, providing consumers with adequate information; ensuring consumers have access to basic financial products and services; strong regulatory oversight to ensure fair practices by banking institutions; and establishing an effective redress mechanism.

Access to reliable, relevant and timely information is a critical pre-condition to facilitate informed decisions. Significant attention has, therefore, been given to promote a higher level of disclosure and transparency in the financial system. A concept paper on the proposed 'Guidelines on Product Transparency and Disclosure by the Banking Institutions' was issued to the banking industry in 2004. The proposed Guidelines set out the minimum standards for the banking sector on general and specific disclosure requirements at key stages of financial arrangements, and disclosure requirements in relation to advertisements. Effective 1 February 2005, banking institutions are required to comply with the following:

- Banking institutions shall make available at all their branches and websites, the fees and charges imposed on retail products and services for individuals and SMEs; and
- The conditions and effects of any changes to the terms and conditions of the products and services, including fees and charges, shall be communicated to the relevant customers at least 21 days before the changes occur to allow customers to make any adjustment they deem necessary to their banking arrangements.

To minimise the cost of information search amongst consumers, Bank Negara Malaysia has in 2004, developed comparative tables on key rates, namely BLRs, fixed deposit rates for balances up to RM1 million and exceeding RM1 million, long term fixed deposit rates and negotiable instrument of deposit rates. These comparative tables are published in the BankingInfo website, providing consumers with up-to-date information on the rates offered by different institutions and thus allowing for 'comparative shopping'. Moving forward, comparative tables on commonly offered deposit and credit products would be developed in the immediate term.

Ensuring that Malaysians have access to basic banking services is an issue of fundamental significance in strengthening the consumer protection infrastructure. In December 2004, Bank Negara Malaysia announced the framework on basic banking services which aims at ensuring that the banking public has access to basic banking services at minimal costs. Effective 1 February 2005, commercial banks and finance companies are required to offer a basic savings account (BSA) and a basic current account (BCA), without an overdraft facility, to all Malaysians including permanent residents. The BSA and BCA will allow access to services such as cheque and cash deposits, account enquiries, withdrawals, fund transfer within the same banking institution, bill payment facility, as well as Interbank-GIRO. These accounts entitle accountholders to have access to at least 16 monthly transactions per account of which

14 are free and 2 (namely Interbank-GIRO transactions) will be charged a minimal fee of not more than RM0.50 per transaction. Details of the BSA and BCA are as per the table below. For banking institutions without either ATM and/or GIRO facilities, consumers will be able to perform their transactions over-the-counter (OTC) subject to the overall limit.

In addition, Bank Negara Malaysia has also introduced a framework governing the imposition of fees and charges on retail banking products and services. Under this framework, banking institutions are required to obtain Bank Negara Malaysia's approval prior to any upward revision of existing fees and charges or for any introduction of new fees and charges imposed on individuals and/or SMEs. For existing fees and charges, banking institutions have been required to provide rationale and justification for imposing such charges. In this regard, Bank Negara Malaysia will ensure these charges are appropriate, reasonable and adequately reflect cost and cost savings.

Access to appropriate redress mechanisms is key to preserving consumers' confidence. This is critical to enable consumers to resolve conflicts through an equitable process. In Malaysia, the Banking Mediation Bureau and the Insurance Mediation Bureau have long been in existence to provide consumers with an avenue to resolve disputes without entailing lengthy and expensive legal action. These mechanisms were further

**Summarised Features of the BSA and BCA**

<table>
<tr><th>No.</th><th></th><th colspan="2">Parameters</th></tr>
<tr><td>1</td><td>Eligibility</td><td colspan="2">• Must be Malaysian citizens or permanent residents. For BCA, the requirement for an applicant to be at least 18 years old and to have an introducer remain unchanged.<br>• Entitled to 1 BSA and 1 BCA per individual per banking institution.</td></tr>
<tr><td>2</td><td>Features</td><td>Basic Savings Account (BSA)<br>• Initial deposit requirement to open a BSA is not more than RM20.<br>• Should earn interest irrespective of account balance.<br>• No service or maintenance charge.<br>• Minimum balance requirement of not more than RM20.<br>• Free mini statement.</td><td>Basic Current Account (BCA)<br>• Initial deposit requirement to open a BCA is not more than RM500.<br>• No charges on the issuance of cheque book except for stamp duty incurred.<br>• Service charge of RM10 half yearly for balances less than RM1,000 as per existing ABM rules.<br>• Free monthly statement.</td></tr>
<tr><td>3</td><td>Minimum Number of Monthly Transactions</td><td colspan="2">Accountholders are entitled to at least 16 transactions per month per account comprising:<br>a) Six free OTC visits for account enquiries, withdrawals, fund transfers within the same banking institution and bill payments. OTC visit is defined as one visit to the bank's counter irrespective of the number of transactions performed;<br>b) Eight free ATM cash withdrawal transactions. There is no limit on ATM transactions that are not cash withdrawals (e.g. balance enquiry or fund transfer within the same banking institution); and<br>c) Two Interbank-GIRO transactions for which a maximum fee of RM0.50 per transaction may be charged.<br><br>Note: For banking institutions without ATM and/or GIRO facilities, accountholders will be able to perform these transactions OTC.</td></tr>
<tr><td>4</td><td>Internet Banking Facility</td><td colspan="2">BSA and BCA accountholders of banking institutions which have internet banking services are entitled to unlimited online account enquiries, fund transfers within the same banking institution and payment of bills, at no charge.</td></tr>
<tr><td>5</td><td>Other Fees and Charges</td><td colspan="2">a) Replacement of ATM/bankcard (not more than RM12).<br>b) Closure of BSA and BCA within 3 months of account opening (not more than RM20).</td></tr>
</table>

enhanced with the establishment of a Financial Mediation Bureau (FMB) to expand the scope of arbitration, increase accessibility by consumers and improve efficiency. The FMB, which was launched on 20 January 2005, serves as a one-stop centre for the resolution of a broad range of retail consumer complaints against financial institutions regulated by the Bank. The scope of the FMB has been expanded to cover Islamic banks, takaful operators, development financial institutions, as well as selected payment system operators and non-bank issuers of credit and charge cards. This will provide increased access to the Bureau as an avenue for redress for a wider spectrum of the public. To ensure nationwide accessibility, the FMB plans to progressively establish five regional offices in the near future.

The FMB is governed by a Board of Directors and chaired by an independent Chairperson. Five of the nine directors are independent members representing the public interest with the balance from the banking and insurance industries. The Bureau is staffed by independent mediators who are experienced in judicial matters. The framework and governance structure is aimed at ensuring that consumers have access to a fair and equitable resolution process.

**Maintaining Financial Stability**

Preserving financial system stability is a key policy objective of the Bank. The resilience of banking institutions and stability of the system is important in safeguarding depositors' interest, and in ensuring uninterrupted intermediation process, a critical element for macroeconomic stability. Bank Negara Malaysia adopts a comprehensive approach in preserving financial stability, which encompasses surveillance at both individual institution and system levels; regulations to ensure prudent practices by banking institutions; and supervisory activities. This is complemented by market discipline, as a tool to act as check and balance to the management of banking institutions. In addition, concerted efforts were also accorded to put in place and develop relevant financial safety nets in reinforcing public confidence in the financial system.

During the year, efforts were directed at further strengthening the effectiveness of the surveillance of the banking system. The aim is to develop a comprehensive and effective banking system surveillance framework that is capable of detecting emerging vulnerabilities and weaknesses that can undermine financial stability as well as assessing the capacity of the banking system to withstand shocks. Initial work has started towards developing additional tools to enhance ongoing surveillance and analyses of banking system resilience. This includes forward-looking surveillance tools both at the system and institution levels to identify, measure, assess and predict emerging vulnerabilities. Additionally, focus was also placed on enhancing existing stress test methodology to ensure its effectiveness and relevance.

In the area of prudential regulations, work in 2004 focused on several aspects, including enhancements to the existing capital framework and the strengthening of corporate governance. These were complemented by the improvement made in the disclosure requirement and the development of a deposit insurance system. The year 2004 saw intensified efforts at the global front as both regulators and the banking institutions prepare to implement the new regulatory capital framework, Basel II. The framework that was finalised by the Bank for International Settlements in June 2004, will be adopted by the Group of Ten (G-10) countries by end-2006, except for the advanced approaches which will be implemented by end-2007. The final framework introduced significant changes from the third Consultative Paper issued in April 2003, with respect to the treatment for expected losses (EL) and unexpected losses (UL), treatment for securitisation exposures, credit risk mitigation and treatment for qualifying revolving retail exposures.

In Malaysia, the earlier assessment conducted by Bank Negara Malaysia on the readiness of banking institutions for Basel II, had provided the basis for the implementation of the new framework. Four key principles are adopted by the Bank to determine Basel II implementation strategies, namely:

- Ensuring that risk management standards amongst all banking institutions are enhanced over time;
- Adoption of a more flexible timeframe that allows for the implementation of capacity building measures. This is based on the recognition that domestic players are at different levels of sophistication, thus more time should be accorded to institutions intending to adopt the more advanced approaches;
- Implementation should not be based on regulatory mandate. The adoption of advanced approaches should be supported by strong business justification; and
- Ensuring a more effective supervisory process for the adoption of more advanced approaches. This will be achieved through the use of an enhanced supervisory methodology to assess internal models and advanced risk management systems.

The adoption of Basel II in Malaysia is in tandem with the overall policy agenda to promote higher standards of risk management amongst Malaysian banking institutions as the banking sector progresses with greater competition and liberalisation. While the potential capital savings may be one of the main attractions of Basel II, the real benefit to be gained is the integration of risk management practices within the banking institution. Under the new framework, key decision making such as on product pricing, portfolio management and new business development eventually will have to be made based on risk-adjusted returns and capital considerations. The convergence of risk management practices with daily banking operations would also facilitate the nurturing of a strong risk culture within the banking industry overtime. In the longer term, the objective is to promote greater convergence between regulatory capital and economic capital employed by banking institutions.

While both options for credit risk, namely the Standardised and Internal Ratings Based (IRB) approaches would be allowed in Malaysia, banking institutions would need to determine the most appropriate approach based on their cost and benefit analysis and ability to meet all minimum supervisory requirements set by the Bank for International Settlements and Bank Negara Malaysia. Banking institutions that choose to adopt the Standardised Approach for credit risk would be required to comply with the new framework by January 2008. At the same time, these banking institutions are also expected to comply with the Basic Indicator Approach for the operational risk. Subject to prior approval of the Bank, the Standardised Approach for operational risk, under which the capital charge will be determined based on specific risk factors attached to eight pre-determined business lines, may also be adopted by such banking institutions. While most banking institutions may consider adopting the Standardised Approach for credit risk as a more reasonable interim strategy before the adoption of the more advanced approaches, the emphasis would nevertheless be on the development of a sound and well functioning internal rating systems that would ensure a more natural progression towards more advanced approaches in the future.

For banking institutions intending to adopt the IRB approaches, the compliance deadline is January 2010. These banking institutions would be given the flexibility to migrate to the advanced approaches directly from the existing capital accord, provided they can demonstrate to the Bank their ability to meet and comply with all the requirements and regulatory expectations for the implementation of the more advanced approaches. Banking institutions that comply with the IRB approaches for credit risk from January 2010, are also required to provide capital for the operational risks based on any of the three approaches, namely the Basic Indicator Approach, the Standardised Approach or the Advanced Measurement Approach, subject to prior approval of the Bank. All banking institutions would be required to conduct a one-year parallel capital adequacy calculation under the new approaches prior to their respective year of migration to Basel II.

The more flexible time frame for the implementation of the advanced approaches for both credit and operational risks takes into account the need to minimise disruption to the capacity building initiatives that are currently being undertaken by the banking institutions. The progressive approach recognises the greater challenges with respect to meeting the more stringent minimum requirements for the advanced approaches. One of the challenges for the adoption of the Advanced IRB approach would be the requirement for banking institutions to provide robust loss estimates that reflect domestic market experience. The longer time frame will provide sufficient time for banking institutions to enhance their data management infrastructure, collect the necessary data required to estimate the risk parameters and improve their analytical skills. On data collection, the more flexible timeline would also allow banking institutions to accumulate the internal loss data on defaulted loans, for the retail and qualifying SME portfolios, that is required even for the Foundation IRB approach.

Given the wide-ranging impact of Basel II on the business conducted by banking institutions, well-coordinated strategies and a structured approach to implementation would be critical in ensuring a smooth rollout by individual institutions. Therefore, a key success factor for the banking institutions is to have in place a proper governance structure and implementation taskforce to spearhead their Basel II initiatives to ensure projects are not conducted in isolation. It is imperative that all relevant stakeholders and business units within the banking institutions recognise the implications of the new capital framework and are involved in the implementation process. Having a well-defined role for and the proactive

**The real benefit to be gained from Basel II is the integration of risk management practices within the banking institution as key decisions will have to be made based on risk-adjusted returns and capital considerations.**

involvement of the Board of Directors and senior management of banking institutions in the overall process is critical. Effective Board oversight, and the commitment and continuous support of senior management, is crucial towards ensuring that Basel II-related initiatives are consistent with the long term risk management agenda of the banking institutions.

To ensure that banking institutions adopt a proactive attitude in addressing the various challenges arising from Basel II, Bank Negara Malaysia has issued a set of fundamental requirements to the banking industry in September 2004 that highlights key regulatory expectations on banking institutions and the requirement for banks to put in place a formal governance framework, conduct gap analysis and engage in discussions with the Bank on their respective Basel II initiatives.

In line with Bank Negara Malaysia's prime objective of continuously enhancing the banking system's financial stability through the promotion of sound risk management practices, the Market Risk Capital Adequacy Framework (MRCAF) was implemented to introduce more risk sensitivity to the existing regulatory capital requirements by explicitly providing for potential losses arising from market risk. The MRCAF is in conformity with international regulatory standards by adopting the Bank for International Settlements' recommendation on 'Amendment to the Capital Accord to Incorporate Market Risk, January 1996'. The implementation of the MRCAF is timely as the banking institutions emerge from the Asian financial crisis and get increasingly involved in treasury and capital market activities, particularly in innovative and financially complex products, that are sensitive to movements in market rates. With the implementation of the MRCAF, all banking institutions and discount houses must incorporate their market risk capital requirements into the existing risk-weighted capital adequacy framework and be subject to the overall minimum risk-weighted capital ratio requirement of 8%.

Following efforts to strengthen corporate governance in banking institutions, coupled with increasing demand for greater public disclosure and enhancement of financial reporting by investors, the 'Guidelines on Financial Reporting for Licensed Institutions' (GP8) was revised in October 2004. In addition to setting out the minimum disclosure requirements, licensed institutions are also encouraged to disclose additional information in their financial statements to ensure that all material activities are reported and well understood by users of the financial statements. Among the major changes in the revised Guidelines are the adoption of fair value accounting, the requirement for interim financial reports to be prepared on a quarterly basis and the extension of the application of the revised Guidelines to discount houses, money brokers and financial holding companies. These enhancements would further improve the transparency, comparability, relevance and timeliness of information relating to licensed institutions' operations and financial condition, which are critical elements for effective application of market discipline. By aligning disclosure requirements to international standards, the revised GP8 would also enhance the comparability of financial statements. This will enable stakeholders to benchmark licensed institutions' performance and financial condition against their international peers, thereby further enhancing market discipline on domestic financial institutions.

As part of concerted efforts outlined in the FSMP to further strengthen the existing depositor protection infrastructure, work on the establishment of a deposit insurance system in Malaysia proceeded during the year. A key objective of the system is to provide a reasonable level of explicit protection to depositors on their deposits held with the commercial banks, Islamic banks and finance companies. The concept paper issued to the industry in November 2004 proposes the establishment of a statutory body responsible for the administration of the deposit insurance system, as well as to undertake the resolution of banking institutions deemed no longer viable by Bank Negara Malaysia. At the same time, the statutory body will also be mandated to strengthen the incentives for sound risk management in the banking system in promoting the stability of the financial system.

The deposit insurance system will provide separate deposit insurance coverage for the conventional and Islamic banking systems. All commercial banks and finance companies currently licensed under the Banking and Financial Institutions Act 1989, as well as all Islamic banks currently licensed under the Islamic Banking Act 1983 are required to become members of the system so as to prevent adverse selection that would undermine the viability of the deposit insurance system. The rationale for separate deposit insurance coverage for the Islamic banking system is to ensure similar treatment with conventional deposits coupled with the required consistency of administration of the deposit insurance system with Shariah tenets in respect of Islamic deposits. Deposit insurance coverage in both systems would be extended to all depositors, whether corporate or individuals, up to a prescribed coverage limit. One of the underlying principles governing the coverage limit of the deposit insurance system is that it should be sufficient to promote confidence among the large majority of depositors, particularly those who are not in the position to effectively assess and monitor the financial condition of banking institutions. The relationship between the coverage limit and moral hazard is also accorded careful consideration given the need to maintain sufficient incentives for large depositors to effectively exert market discipline over member institutions.

The deposit insurance system will be funded by annual premiums received from member institutions, where a flat rate will be imposed for the initial two years of the implementation of the system. Thereafter, a risk differential premium framework will be implemented, consistent with the mandate of the deposit insurer to strengthen incentives for sound risk management of its member institutions. The framework would be designed to encourage member institutions to improve their risk management systems and business practices in order to qualify for the lower premiums after the initial two-year interim period. The deposit insurance framework is in the final steps of preparation and is expected to be operational in 2005.

In an effort to further improve the level of Information Security (IS) management amongst banking institutions, Bank Negara Malaysia had issued the 'Guidelines on Management of Information Technology Environment' (GPIS 1) in May 2004. The Guidelines outline the minimum responsibilities and requirements for planning and managing the banking institutions' IS environment, as well as for establishing preventive measures to mitigate the risks pertaining to the environment. The Guidelines also include the requirements and best practices in the areas of board and management oversight, system security, system development, operations, communications network and business resumption and contingency plans. The implementation of these minimum requirements and best practices would enable the institutions to minimise the risks associated with service interruption, unauthorised access to customers' information, fraud and loss of customers' confidence.

In July 2004, Bank Negara Malaysia conducted a survey on the disaster recovery capabilities of all commercial and Islamic banks to assess their readiness in ensuring the availability of essential banking services during a disaster situation. The information from the survey shows that all banking institutions have already put in place the necessary business resumption and contingency plans for their critical business functions, although there are areas for improvement in some of these institutions. Subsequently, the banking institutions also benefited from the assessment as they were provided with a benchmark comparing their performance with the rest of the industry. In this regard, banking institutions are expected to make further improvements in disaster recovery readiness thus ensuring the availability of critical banking services with minimal interruptions to the public in the event of a disaster.

Fraud prevention is another critical area in maintaining stability and public confidence in the banking and payment systems. During the year, a number of measures were put in place to enhance fraud prevention mechanisms. In July 2004, Bank Negara Malaysia issued the 'Guidelines on Minimum Security Standards for Cheques' which set out, among others, the minimum standards for security features on cheques, cheque fraud detection facilities and security management in cheque printing. Following the success of the migration to chip-based Automated Teller Machines (ATM) cards in eliminating ATM card forgery, a similar initiative is currently being undertaken by the credit card industry where magnetic strip credit cards are being replaced by the Europay-Mastercard-Visa (EMV) credit cards during the year. Full conversion to EMV environment, which include converting all credit card terminals to be EMV-compliant, is expected to be completed by end-2005.

**Moving forward**

Greater competition in the banking sector is likely to ensue as the domestic financial landscape evolves over time. This is particularly the case in the second phase of the FSMP, where greater operational flexibility will be accorded to the incumbent foreign banking institutions. In this more liberalised environment, continued enhancements of operational efficiency, and product and services innovation are necessary to ensure the competitiveness of domestic banking institutions. In terms of business focus, it is envisaged that as the economy transforms and consumers grow more affluent, banking institutions would need to strengthen capabilities in the areas of personal financial advisory services, wealth management, consumer banking and SME financing. In addition, the domestic banking groups would increasingly expand their presence in the region to further diversify their earnings and enhance performance. The policy directions in this environment will focus on strengthening the efficiency, effectiveness and resilience of the banking sector with a careful balance made on promoting efficiency and market-driven system, with the objective of maintaining financial stability and consumer protection.

## Banking Measures Introduced in 2004

In 2004, further initiatives were undertaken to strengthen the safety and soundness of the financial system and promote competition and efficiency in the banking industry. In addition, measures were implemented to ensure continuous access to financing as well as to enhance consumer protection and confidence in the banking sector.

### Measures to Enhance Safety and Soundness

***Incorporation of Market Risk into the Risk-Weighted Capital Ratio***

The market risk capital adequacy framework was issued for implementation in September 2004. The commercial banks, merchant banks, finance companies and discount houses, collectively known as the licensed institutions, are now required to incorporate their market risk positions into the risk-weighted capital ratio (RWCR) and comply with the minimum RWCR by the second quarter of 2005. Even with the incorporation of market risk, the minimum RWCR requirement remains at 8%.

Under this framework, only interest rate risk and equity risk in the trading book are included, while for foreign exchange risk, both trading and banking book positions are incorporated. Nevertheless, licensed institutions are expected to have in place adequate measures to manage their interest rate and equity risk exposure in the banking book. In line with Bank Negara Malaysia's efforts to enhance corporate governance in licensed institutions, the Board is charged with the responsibility of approving policies and strategies on market risk management and ensuring that adequate measures are in place to monitor and control such risks.

***Capital Treatment on Holdings of Other Licensed Institutions' Instruments***

The capital framework issued in 1989 required holdings of other licensed institutions' capital instruments to be deducted from the capital base. In tandem with the development of the domestic capital market and international regulatory practices, Bank Negara Malaysia revised the capital treatment to facilitate trading and market making activities of capital instruments issued by licensed institutions. The revised capital treatment, issued in July 2004, specified that the holdings of other licensed institutions' capital instruments would be exempted from capital deduction if it does not exceed 10% of the licensed institution's capital base. However, the capital treatment for the holdings of capital instruments issued by related companies or companies within the same banking group remains unchanged.

***Regulatory Treatment for Residential Mortgage-backed Securities***

The regulatory treatment, issued on 17 September 2004, accorded a 20% risk weight for the first tranche of residential mortgage-backed securities issued by Cagamas MBS Berhad, a wholly-owned subsidiary of Cagamas Berhad, under the RWCR framework. In addition, holdings of subordinated residential mortgage-backed securities are required to be deducted from capital base. Holdings of residential mortgage-backed securities issued by Cagamas MBS Berhad together with other credit facilities granted to Cagamas MBS Berhad are subjected to the single customer credit limit of licensed institutions.

***Regulatory Treatment for Ringgit-denominated Bonds Issued by Multilateral Institutions***

Issued in October 2004, ringgit-denominated bonds issued by Multilateral Development Banks and Multilateral Financial Institutions were accorded a 0% risk weight under the RWCR framework and classified as liquefiable assets under the New Liquidity Framework.

***Implementation of Basel II***

In April 2004, Bank Negara Malaysia announced the implementation approach and timeline of the new Basel Capital Accord (Basel II). Basel II would be implemented in two phases. In particular, as a minimum, banking institutions will be required to implement the Standardised Approach for credit risk and basic indicator approach for operational risk under Basel II in 2008. However, banking institutions which meet the requirements set by Bank Negara Malaysia will be allowed to adopt the Internal Ratings Based approach in January 2010 without having to comply with the Standardised Approach for credit risk in 2008. The decision whether to migrate directly to the Internal Ratings Based approach in 2010 rests entirely with the Board of Directors based on the banking institution's gap and impact analysis as well as cost-benefit considerations. In September 2004, the minimum requirements on governance structure, gap analysis and development of implementation plans with regard to Basel II were issued to the banking institutions.

***Guidelines on Minimum Security Standards for Cheques***

As part of Bank Negara Malaysia's continuing efforts to combat rising cheque frauds and to maintain consumers' confidence in using cheques, various measures were undertaken to deter counterfeiting and fraudulent alterations of cheques as well as to facilitate easier detection of such activities. Bank Negara Malaysia issued, in July 2004, the Guidelines on Minimum Security Standards for Cheques which specify the minimum requirements with regard to the role of banking institutions in payment and collection of cheques drawn by or paid in by customers. In addition, the Guidelines set the minimum standards for security features on cheques, cheque fraud detection facilities and security management in cheque printing. Banking institutions are also expected to educate consumers on the risks involved in the use of cheques and the safeguards to be adopted to help prevent cheque fraud.

***Guidelines on Management of IT Environment (GPIS 1)***

To strengthen and enhance the level of information technology (IT) management in banking institutions, Bank Negara Malaysia issued GPIS 1 in May 2004. The Guidelines place the responsibility on the Board and senior management in implementing good IT governance and risk management practices. The Guidelines set the minimum requirements on system security, system development and operations in an IT environment to ensure appropriate controls are in place to safeguard the institution's systems, data and information. To ensure timely resumption of critical IT operations in the event of a disaster, banking institutions are required to establish an appropriate business resumption and contingency plan. The implementation of the requirements and best practices would enable the institutions to minimise the risks associated with service interruptions, unauthorised access to customers' information, fraud and loss of customers' confidence.

***Disaster Recovery Capabilities of Banking Institutions***

In July 2004, Bank Negara Malaysia initiated a survey covering 25 institutions to assess the state of readiness of banking institutions' disaster recovery capabilities and to gather information on recovery strategies. The findings of the survey were shared with the industry to further improve their IT disaster resumption arrangements. Bank Negara Malaysia will continue to review the business resumption contingency plans of banking institutions during its on-site IT audit and monitor the testing of disaster recovery plans through reports submitted by banking institutions.

**Measures to Enhance Competition and Efficiency in the Banking Industry**

***New Interest Rate Framework***

To enhance the effectiveness of the monetary policy transmission process and the efficiency of financial market operations, Bank Negara Malaysia introduced a new interest rate framework in April 2004. The framework also aims to facilitate more efficient pricing of financial products. Effective 26 April 2004, the ceiling on Base Lending Rate (BLR) and the maximum lending spread of 2.5 percentage points above the BLR or cost of funds were removed. Banking institutions were given the flexibility to determine the BLR based on their own cost structure and lending strategies. This flexibility is expected to facilitate greater product innovation and customisation within the banking industry to meet the differentiated needs of the growing economy.

***Revised Regulatory Treatment for New Cagamas Debt Securities***
As a measure to further improve the efficient functioning of the domestic bond market, Bank Negara Malaysia revised the regulatory treatment for new Cagamas debt securities issued after 4 September 2004. The risk weight for holdings of new Cagamas debt securities was increased from 10% to 20% under the RWCR framework. In addition, holdings of new Cagamas debt securities together with other credit facilities granted to Cagamas Berhad are subjected to the single customer credit limit of licensed institutions.

***Single Customer Credit Limit – Discount Houses***
With effect from 1 October 2004, the Single Customer Credit Limit (SCCL) requirement was extended to the discount houses to ensure excessive exposure in holdings of Private Debt Securities (PDS) to a single issuer is avoided. The SCCL imposed on a single issuer is set at 35% of the approved capital funds of the respective discount houses for all new investments in PDS.

***Deduction of Ringgit Debt Securities from Eligible Liabilities***
In October 2004, commercial banks and merchant banks were allowed to deduct their holdings of the following ringgit-denominated debt securities in the trading book from eligible liabilities in the computation of Statutory Reserve Requirement (SRR):
- Specified RENTAS securities issued through the Principal Dealers network;
- All corporate debt securities including Cagamas securities; and
- Ringgit-denominated securities issued by Multilateral Development Banks and Multilateral Financial Institutions.

The deduction would reduce the holding cost of these papers for the commercial banks and merchant banks. This aims at promoting secondary trading of such securities in the bond market and levelling the playing field for commercial banks and merchant banks with that of the other players in the bond market.

***Innovative Tier-1 Capital Instruments***
Effective December 2004, licensed institutions are allowed to issue innovative Tier-1 capital instruments for inclusion in Tier-1 capital under the RWCR framework. The issuance of such instruments is, however, subject to the prior approval of Bank Negara Malaysia and the fulfilment of minimum requirements specified in the Guidelines.

**Measures to Enhance Consumer Protection**
Financial innovation and innovative developments in technology have increased the range and complexity of products and services offered by a myriad of service providers. This in turn, has provided consumers with a wider range of options to manage their personal finances. To ensure that consumers are equipped to make financial decisions that meet their needs and are given a fair deal by financial institutions, Bank Negara Malaysia has put in place a long-term and structured consumer education and protection framework.

***Basic Banking Services Framework***
To ensure that consumers have access to basic banking services and that these services are provided at minimal costs, Bank Negara Malaysia implemented a basic banking services framework with effect from February 2005. Under this framework, all banking institutions are required to offer at least one basic savings account (BSA) and one basic current account (BCA) to all Malaysians, including permanent residents. The framework provides an account holder with at least 14 free transactions per month, including eight ATM cash withdrawals. In addition, BSA and BCA account holders can perform at least two Interbank GIRO transactions per month at not more than RM0.50 per transaction, while those who subscribe to internet banking services are entitled to unlimited online account enquiries, fund transfers within the same banking institution and payment of bills, at no charge. The basic savings account earns interest irrespective of the account balance.

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

In an effort to ensure that consumers and small and medium enterprises (SMEs) have access to financial products and services, apart from the BSA and BCA, at reasonable costs, Bank Negara Malaysia issued Guidelines to govern the imposition of fees and charges by banking institutions in December 2004. Banking institutions are required to obtain the prior approval of Bank Negara Malaysia for any upward revision of existing fees and charges or for any new fees and charges to be imposed on products and services offered to individuals and SMEs. In this regard, banking institutions are required to justify the imposition of or increase in fees and charges as well as the conditions under which the fees may be imposed.

To promote greater market transparency, the Guidelines also require banking institutions to publish all fees and charges imposed on products and services offered to individuals and SMEs at all branches and on their websites. Banking institutions are also required to notify their customers at least 21 days before making any change to the terms and conditions of products and services including fees and charges.

***Financial Mediation Bureau***

It is important that, in the event of disputes involving products or services offered by financial institutions, consumers have recourse to an inexpensive and effective avenue to seek redress. In this regard, Bank Negara Malaysia spearheaded efforts to enhance the dispute resolution mechanism for consumers to resolve conflicts through an impartial and equitable process.

On 20 January 2005, the Financial Mediation Bureau (FMB) was launched, as a result of the merger between the Banking Mediation Bureau and the Insurance Mediation Bureau and, as such, is an integrated agency for the resolution of disputes against financial institutions under the supervision of Bank Negara Malaysia. The FMB's scope was expanded to cover disputes against Islamic banks, takaful operators, development financial institutions as well as selected payment system operators and non-bank issuers of credit and charge cards to ensure that customers of these financial service providers have access to the dispute resolution mechanism. The scope of the FMB was also expanded with regard to product coverage, type and nature of complaints as well as limits of awards. The FMB provides consumers with a fast and efficient avenue to seek legal redress as an alternative to resolutions through the court process. In addition, consumers benefit from the convenience of a single bureau and consistent processes and procedures applied across the different financial service providers.

***Deposit Insurance***

In furthering efforts to strengthen the consumer protection framework and enhance the financial safety net of the banking system, Bank Negara Malaysia issued, in November 2004, a concept paper to the banking industry on the introduction of a Deposit Insurance System in Malaysia. The key objective of the deposit insurance system is to provide a reasonable level of protection to depositors on their deposits held with banking institutions. The concept paper detailed some of the features being considered for a deposit insurance system.

***Comparative Tables***

To facilitate meaningful comparison and minimise the cost of information search amongst consumers, Bank Negara Malaysia has published comparative information on key rates, namely base lending rates, fixed deposit rates and negotiable instrument of deposit rates via BankingInfo website. Moving forward, comparative tables on commonly offered deposit and credit products will be developed.

***Concept Paper on Product Transparency and Disclosure***

As part of Bank Negara Malaysia's continuous efforts to promote greater market transparency, a concept paper on product transparency and disclosure by the banking institutions was issued in March 2004. Frequently, the risks and costs of financial products and services are not adequately disclosed in the promotional material and that important terms and conditions may not be given due prominence. To ensure that consumers understand the nature and extent of the risks involved, the concept paper requires that the information be worded and presented in a clear, concise and effective manner. Specific information that must be disclosed includes risk factors, yield, pricing, fees and charges, terms and timeliness of information being disseminated to consumers using standard definitions and terminology. The disclosure requirement also applies to advertisements to ensure that the marketing and promotional material are not misleading.

***Complaint Handling***

Effective complaint handling is vital to ensure that customer complaints are promptly investigated and resolved in a satisfactory manner. Complaints that are carefully recorded and properly analysed to identify the problems and root causes would enable banking institutions to address the shortcomings in their operations. Starting from June 2004, banking institutions are required to submit a half-yearly report on the number and nature of complaints received. Bank Negara Malaysia will continue to play a role in handling customer complaints against banking institutions to ensure that complaints are dealt with promptly and efficiently to ensure customers are treated fairly by banking institutions.

***Revised Guidelines on Financial Reporting for Licensed Institutions (BNM/GP8)***

Following the issuance of two concept papers to the banking industry, the revised guidelines on financial reporting for licensed institutions were issued for implementation in October 2004. The primary objective of the revised Guidelines is to ensure compliance with international accounting standards and consistent disclosure of all material and exceptional items among financial institutions to facilitate evaluation, assessment and comparison of the financial position and performance of the institutions.

The revised Guidelines set out the minimum disclosure requirements and licensed institutions are encouraged to disclose additional information in their financial statements. The major changes to the Guidelines are as follows:

- Licensed institutions are required to prepare interim financial reports on a quarterly basis;
- Interim financial reports prepared on a quarterly and half-yearly basis are not required to be published in the newspapers. Instead, licensed institutions shall make available the interim financial reports in their websites;
- Licensed institutions are required to segregate their securities portfolio into 'held for trading', 'held-to-maturity' and 'available-for-sale' categories;
- Licensed institutions are given two options to account for their derivative transactions; and
- Interest accrued and recognised as income prior to the date the loans are classified as non-performing shall be reversed out of income. Subsequently, interest earned on non-performing loans shall be recognised as income on a cash basis.

The first set of financial statements prepared under the revised BNM/GP8 would be for the financial year ending 31 December 2005.

**Measure to Improve Access to Financing**

***Upliftment of Restrictions on the Provision of Bridging Finance for Property Development***

The restrictions on the provision of bridging finance facilities for property development, introduced in 1999 to address the property market overhang, were uplifted in September 2004. To ensure that the upliftment does not lead to oversupply in the property market, banking institutions are required to consider the impact of the project that it proposes to finance on the property market in the surrounding vicinity. This is in addition to the standard viability assessment on the project itself. Banking institutions are also required to provide its board of directors, whose concurrence is required to approve bridging finance facilities, with adequate information to assess such impact.

**Financial Sector Masterplan**

The implementation of the Financial Sector Masterplan (FSMP) is on track and on schedule. Another 14 recommendations of the FSMP were fully completed during the year, bringing the total number of fully completed recommendations to 45, which accounts for almost half of the recommendations with milestones. Another 28 recommendations are being implemented on a continuous basis, where initiatives are continuously being taken to attain the desired outcomes. Details of the completed recommendations are as listed in the accompanying table.

**Completed Recommendations**

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| | **Banking Sector** |
| R3.4 | Liberalise restrictions on salaries and staff mobility in the banking industry to enable the industry to attract the best talent and reward them accordingly |
| R3.5 | Uplift restriction on employment of expatriates to attract the best international talents to meet the demand for expertise in specific areas of banking |
| R3.6 | Establish board committees, namely Nominating, Remuneration and Risk Management Committees to further enhance corporate governance standards |
| R3.7 | Allow group rationalisation through cross-selling of products and consolidation of back-office processes as well as facilitate the merger of commercial banks and finance companies to further enhance efficiency and competitiveness |
| R3.9 | Streamline the regulation of discount houses and merchant banks to enhance and allow fair competition among players |
| R3.12 | Encourage outsourcing of non-core functions to gain greater strategic focus and efficiency |
| R3.14 | Encourage the development of new delivery channels to increase the range of products and services to further enhance competitiveness |
| R3.15.1 and R3.15.2 | Simplify the product notification process to provide incentive for the development of new and innovative products, and outline a set of guidelines providing criteria for product notification and specific product approval requirements |
| R3.16a | Introduce the New Interest Rate Framework to provide banking institutions with greater flexibility, thus promoting more efficient pricing of products |
| R3.18 | Encourage participation of banking institutions in areas currently served by fringe institutions to promote a level playing field and preserve consumer protection and investors' interests |
| R3.21 | Implement risk-based supervision with supervisory focus on high risk areas and greater attention on weak institutions |
| R3.22a | Incorporate market risk into the capital adequacy framework to introduce more risk sensitivity to the existing regulatory capital requirements |
| R3.23 | Develop a formal and informal enforcement action framework to ensure banking institutions take remedial actions on weaknesses highlighted |
| R3.27 | Increase efficiency and competition in the payments system to support the needs of the economy while maintaining its safety and integrity |
| R3.28 | Allow market forces to shape developments in the payments system to promote greater competition and increase innovation in payments system |
| R3.33 | Allow banking institutions to rationalise their branch network to improve the dispersion of their branches in the country |
| R3.37 | Expand the role of the Banking Mediation Bureau with the establishment of the Financial Mediation Bureau to strengthen consumer protection framework and to widen avenues for consumers to seek redress |
| | **Insurance Sector** |
| R4.1 | Remove restrictions on outsourcing to enable insurers to further develop core competencies and effective business strategies |

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| R4.2 | Allow eligible insurers to use the internet as a distribution channel to enhance competitiveness and efficiency of the insurance industry |
| R4.3 | Promote the growth of bancassurance as a cost-effective alternative distribution channel by implementing a more flexible regulatory framework on remuneration structures governing bancassurance arrangements |
| R4.6 | Relax the restrictions on employment of expatriates to accelerate the development of skills and expertise in the industry |
| R4.16 | Increase the statutory minimum paid-up capital of insurers to enhance their financial resilience and ability to compete effectively in a more deregulated and liberalised market |
| R4.17 | Strengthen 'fit and proper' regulations for board members and senior management of insurance companies, including minimum qualification standards and training requirements for directors, to promote sound corporate governance |
| R4.18 | Establish board committees with specific responsibilities and enhance disclosure standards on compensation to directors and senior management to further strengthen governance structures and processes and promote greater transparency |
| R4.19 | Raise the entry requirements for the agency force to uphold high standards of professionalism and competencies among insurance intermediaries |
| R4.20 | Introduce additional compulsory exams as part of the continuing education programmes for agents to upgrade their knowledge and skills on an on-going basis |
| R4.21 | Further strengthen performance-based supervision to maintain stability under more deregulated and competitive market conditions |
| R4.22 | Develop an enforcement action framework to ensure timely and consistent supervisory intervention processes to address institutional risks |
| R4.25 | Establish the Financial Mediation Bureau to strengthen the consumer protection framework and widen avenues for consumers to seek redress |
| R4.26 | Introduce 'best advice' regulations to enhance consumer protection and professionalism in the sale of life insurance products by insurance intermediaries |
| R4.27 | Strengthen regulations on unfair trade practices to ensure sound business practices and fair treatment of consumers |
| R4.29 | Allow financial and non-financial institutions to acquire interests in direct insurers to create business synergies |
| **Islamic Banking and Takaful** | |
| R5.3 | Build strong management through the establishment of board committees, benchmarking and employment of experienced and qualified staff |
| R5.5 | Increase the number of Islamic banks to stimulate greater competition and accelerate international integration by issuing Islamic banking licences to qualified domestic and foreign banking institutions |
| R5.6 | Increase the number of takaful operators to accelerate the expansion of takaful industry |
| R5.10 | Establish a comprehensive legal infrastructure for consumers to seek legal redress arising from Islamic financial transactions |
| **Development Financial Institutions** | |
| R6.4 | Introduce a systematic framework for sourcing funds to ensure appropriate and adequate funding for the operations of development financial institutions (DFIs) |
| R6.7 | Establish a legislative framework to regulate and supervise DFIs to ensure that DFIs' policies and objectives are consistent with the national policy objectives |
| R6.8 | Establish a single Regulatory and Supervisory Authority (RSA) to strengthen the supervision of DFIs |

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| **Alternative Modes of Financing** | |
| R7.2 | Establish a RM500 million venture capital fund to increase the availability of venture capital financing and stimulate new ventures |
| R7.3 | Introduce further tax incentives for the venture capital industry to promote the growth of venture capital |
| R7.4 | Liberalise the MESDAQ listing requirements to facilitate the exit of venture capital companies from their investments |
| R7.5 | Establish two Islamic venture capital funds with a combined initial fund size of RM22.1 million |
| **Labuan International Offshore Financial Centre** | |
| R8.3 | Adopt a consultative and market driven approach to create a conducive tax and business environment to enhance the competitiveness and attractiveness of Labuan |
| R8.6 | Strengthen Islamic banking and finance as well as takaful to develop Labuan with a strategic focus on Islamic products and services |
| R8.7 | Enhance Labuan International Financial Exchange (LFX) to be a one-stop financial exchange for residents and global companies |

In the initial phase of the implementation of the FSMP, efforts were focused on enhancing the capability and capacity of domestic financial institutions. These efforts were continued in 2004 with further institutional development initiatives as well as measures to strengthen the regulatory and supervisory framework, and enhance the consumer education and protection framework.

**Achievements**

Measures implemented since the release of the FSMP four years ago, have yielded positive results and strengthened the respective building blocks of the financial sector. It has contributed towards enhancing the capacity and capabilities of domestic financial institutions, promoting a more efficient and stable payment systems infrastructure, providing a robust infrastructure to ensure overall stability of the financial sector as well as putting in place a comprehensive consumer protection infrastructure.

In the banking sector, domestic banking institutions have maintained their market share, despite a more competitive operating environment. As at end-2004, domestic banking institutions commanded 78% share of gross loans and 77% of total deposits (end-2003: 78.3% of gross loans and 77.9% of total deposits). Domestic banking institutions also maintained its position as the main financier for business enterprises with a market share of 78.7% (end-2003: 79%) and further enhanced its position as the main lender to small and medium enterprises (SMEs) with a market share of 84.8% (end-2003: 82.7%), particularly to the manufacturing sector where its market share increased from 76.3% in 2003 to 82% in 2004.

Financial performance of domestic banks continued to be strong. Return on average assets and return on average equity (excluding dividends received from banking subsidiaries) stood at 1.04% and 11.9% respectively (end-2003: 1.02% and 11.3% respectively). Initiatives taken to improve operational efficiency continued to show positive results. The cost to income ratio has declined marginally from 52.6% in 2003 to 51.9% in 2004. Better productivity levels were recorded, as exhibited by an improvement in pre-tax profit per RM employee cost, from RM1.49 in 2003 to RM1.55 in 2004. Customer service efficiency levels have also shown further improvements especially in the turnaround time for loan and credit card processing.

In addition, initiatives previously taken to enhance risk management capabilities have placed domestic banking institutions in a stronger position to compete more effectively with the foreign banks. With better risk management capabilities, domestic banking institutions are better equipped to price their products and services more competitively whilst ensuring that their risk exposures remained within reasonable levels. Better insight into their exposure levels and management capabilities also enable domestic banking institutions to be more innovative in their product and business development strategies. Furthermore, the mergers between commercial banks and finance companies have enabled domestic banking institutions to capitalise on synergies and economies of scale to further enhance cost-efficiency levels.

For the banking system as a whole, the introduction of the New Interest Rate Framework, which was aimed at promoting a more efficient pricing mechanism for interest-based products, provided banking institutions with greater flexibility in pricing their products and services. This flexibility is also expected to spur greater product innovation by the banking institutions to meet the growing demands of customers who value greater choices and customised financial products.

Similar to the banking industry, the insurance sector has also recorded performance improvements among domestic insurers. Domestic players maintained a strong market position with a market share of 72.7% (end-2003: 73.3%) in the general sector. In the life sector, domestic insurers have successfully leveraged on their comparative advantages to increase their combined market share to 35.8% of life premiums (end-2003: 31.8%) following the comparatively higher new business growth registered by domestic life insurers compared with foreign insurers.

The development of bancassurance as a major distribution channel has contributed significantly to the growth of domestic life insurers. Domestic life insurers controlled 82.9% (end-2003: 79.2%) of total premiums generated through bancassurance in 2004. Leveraging on effective bancassurance strategies, domestic insurers were also able to correspondingly increase their market share of the fast growing investment-linked insurance market which has enjoyed strong demand from consumers in recent years. Domestic insurers accounted for 44.8% of new investment-linked premiums generated in 2004, an increase from 33.6% in 2003.

The implementation of a more flexible policy on remuneration structures governing bancassurance arrangements in December 2004 is expected to provide appropriate incentives for the continued long-term development of bancassurance as a cost-effective distribution channel.

In line with efforts to strengthen Malaysia as an Islamic financial services centre and the growing popularity of Islamic financial services worldwide, Islamic banking has strongly emerged as an efficient and effective financial intermediation channel and has become an integral component of the overall Malaysian financial system. The Islamic banking sector continued to show strong growth, as assets grew to RM94.6 billion as at end-2004 to account for 10.5% of the total assets of the banking system (end-2003: 9.7% or RM82.2 billion). Islamic deposits and financing have increased to RM72.9 billion and RM57.9 billion respectively, to account for 11.2% and 11.3% of the deposits and loans of the banking system (end-2003: 10.4% and 10.3%). The takaful sector has remained stable with assets constituting 5.6% (RM5 billion) of the insurance and takaful industry’s total assets, and accounted for 5.1% of total premiums and contributions of the industry.

Significant milestones have been achieved in the regulatory framework of Islamic banking and takaful to strengthen the institutional capacity and resilience of the players. The Revised Rate of Returns Framework is expected to enhance the capacity and efficiency of the Islamic banking institutions in managing their Islamic banking operations. Recognising that good corporate governance reinforces sound regulation and supervision as well as contributes towards maintaining market confidence, the new guidelines on directorship for both Islamic banks and takaful operators are expected to further strengthen transparency and accountability.

Additional measures to strengthen Shariah and legal infrastructure were also undertaken. To further enhance competitiveness, Islamic financial institutions are now exempted from any additional stamp duty and tax payment arising from instruments and transactions executed in fulfilling Shariah requirements to enable tax neutrality between Islamic and conventional finance. The Regional Centre for Arbitration in Kuala Lumpur was chosen to arbitrate cases for Islamic banking and takaful. This would complement the specialised High Court that is assigned to adjudicate all Islamic banking and finance cases. Following the amendments to the Central Bank of Malaysia Act 1958, the stature of the Shariah Advisory Council (SAC) has been elevated as the sole authority on Shariah matters pertaining to Islamic banking and finance that fall under the purview of Bank Negara Malaysia. The SAC will serve as the reference point by the court or arbitrator in the resolution of disputes that involve Shariah issues on Islamic banking and finance cases. The Guidelines on Governance of the Shariah Committee for the Islamic financial institutions were also issued to specify amongst others, the new structure, roles and functions of the Shariah Committees of the Islamic banks, the conventional banks participating in Islamic Banking Scheme and takaful operators, and the requirements for the appointment of Shariah committee members.

In line with Malaysia's aspirations to become the leading Islamic financial centre, the Labuan Offshore Financial Services Authority (LOFSA) has continued with its efforts to develop the Labuan International Offshore Financial Centre (IOFC). Currently, there are two full-fledged Islamic banks, three Islamic investment banks and one full-fledged takaful/retakaful operator that operate in Labuan IOFC. To further strengthen Islamic financial services in Labuan IOFC, LOFSA has established various working groups comprising market experts to assist in formulating strategies to develop and promote Islamic capital market, international Islamic trust and waqf, Islamic fund management, Islamic insurance or takaful and Islamic trade finance. In addition, there is greater co-operation and collaboration amongst regulatory agencies in the area of financial markets and takaful to meet the requirements of Islamic banking and financial institutions. Labuan IOFC's reputation as an offshore Islamic financial centre was further enhanced following secondary listings of two sukuks from the Middle East, which were listed on the Labuan International Financial Exchange (LFX). To pave the way to further develop Islamic capital market with an enhanced global reach, the LFX signed a Memorandum of Understanding with the Bahrain-based International Islamic Financial Market (IIFM) in 2004 to set a framework for greater cooperation between LFX and IIFM. This is to capitalise on the potential to expand the investor base for the investment of funds mobilised from OIC countries.

To complement the role of the banking and insurance sectors in supporting the national economic development objectives, the DFIs have continued to perform their intermediation role as niche providers of funding and ancillary services to targeted sectors. In line with the recommendations of the FSMP, initiatives remained focused on enhancing the efficiency and effectiveness of the industry, through capacity and capability building efforts, to ensure that DFIs continue to be able to provide financial and advisory support to their respective targeted sectors.

As part of the efforts to ensure that DFIs remain focused in their respective roles, Bank Negara Malaysia had conducted a review on the mandated roles and activities of DFIs. Following the Bank's proposal, the Government has announced the merger of the Export-Import Bank of Malaysia Berhad and Malaysia Export Credit Insurance Berhad, as well as the rationalisation of the roles and functions of Bank Pembangunan dan Infrastruktur Malaysia Berhad and Bank Industri & Teknologi Malaysia Berhad. This would enable these DFIs to be more focused, thus more effective in serving the targeted sectors.

Efforts were also undertaken to enhance the capacity and capability of DFIs in providing non-financial services to their targeted clients. A joint project between Bank Negara Malaysia and the Japan International Cooperation Agency to enhance the advisory capabilities of selected major DFIs for SMEs commenced in October 2004. It is envisaged that the provision of advisory services can be used to supplement the financial assistance available to SMEs, thus enhancing the effectiveness of the DFIs in developing and nurturing SMEs. To enable Bank Negara Malaysia to effectively monitor the performance of the DFIs, a computerised online reporting system known as Development Financial Institutions Statistical System (DFISS) has been developed, thus enabling the DFIs to submit statistical data electronically. The system enables Bank Negara Malaysia to obtain accurate information in a timely manner to facilitate the monitoring of DFIs' performance. In order to address the unique features of each DFI, DFISS captures both generic and specific information relating to their businesses.

The initiatives undertaken thus far have resulted in the creation of a financial sector which is stronger, more resilient and in a better position to face greater competitive pressures. The ability of domestic banking institutions and insurance companies to continue recording strong financial performance despite the increasingly competitive operating environment, is testament to the fact that they have grown in strength and capabilities. In addition, the regulatory framework has been further enhanced to cope with the challenges of the increasingly complex financial market. Financial institutions have adopted better risk management practices in their business operations, which have also provided them with greater ability and flexibility to respond to the increasing demands and expectations from customers. The achievements and the narrowing of the performance gaps between the domestic and foreign-owned institutions provide a platform for further liberalisation and deregulation as envisaged under Phase 2 of the FSMP.

**Policy Thrusts in Phase 2**

As outlined in the FSMP, the operating environment will be gradually deregulated and liberalised to develop a financial sector that is more efficient, dynamic and capable of supporting the changing needs of the economy effectively and in the most efficient manner. Competitive pressures will be progressively infused into the banking and insurance industries so as to elevate the delivery of service and overall performance of the financial sector.

Nevertheless, efforts to enhance the capacity and capability of the domestic institutions will continue to ensure that they remain competitive in a more liberalised environment. In tandem with efforts to promote greater efficiency and competitiveness, emphasis will also be focused on further enhancing resilience and stability of the financial system that will contribute towards overall economic growth and development. Regulatory frameworks will continue to be revised to ensure that they remain relevant and responsive to the changing financial landscape, and to keep in tandem with the developments in the international markets. Consumer education initiatives will continue to be pursued to promote better informed and active consumers, which will play an increasingly important role towards attaining a world-class financial system in Malaysia.

With the strong interconnectedness between the financial sector and overall economic development, policy initiatives will continue to be focused on improving access to financing in order to support further economic growth. This include specific focus towards strengthening the infrastructure and access to financing for the SMEs and new growth areas such as the agriculture and agro-based sectors.

**i) Banking Sector**

Phase 2 of the FSMP implementation will see more efforts channelled towards infusing greater competition into the banking sector. This will be gradually undertaken through the levelling of the playing field between domestic and incumbent foreign banking institutions and, in the process, enhance the quality of banking services and provide customers with the opportunity to choose from a wider array of products and services. In order to ensure that a core group of domestic banking institutions continues to remain strong and capable to compete effectively in a more liberalised operating environment, capacity and capability building initiatives will continue to be undertaken. At the same time, initiatives will continue to be taken to further enhance the regulatory framework so as to provide a more conducive platform for the market to function effectively and efficiently while preserving the resilience and stability of the financial sector. Recognising the role that can be played by consumers in instilling greater sense of market discipline, consumer education programmes will continue to be pursued. Under a more market-oriented operating environment, it is important to ensure that the necessary infrastructure for consumer protection is well in place, including the presence of an effective mechanism to monitor and prevent collusive behaviour amongst banking institutions. Therefore, anti-trust regulations for the banking sector will be developed over the long-term, which will define the guiding approaches to address anti-competitive behaviour and unfair practices of banking institutions, and the remedies for dealing with such behaviours.

As a participant in the global financial system, the Malaysian banking system is expected to operate at international standards. Attestation by an independent third party will add credibility to the institution concerned and, in the process, promote discipline through market forces. However, to achieve this objective, there needs to be an enhanced level of consumer awareness and understanding of financial information. Another prerequisite is the transparency and accountability of rating agencies that undertake the assessment to ensure that the ratings given are based on a comprehensive and consistent methodology.

As the financial market becomes increasingly complex, the need for a more comprehensive and responsive risk management system becomes critical to ensure the soundness of each banking institution and the resilience of the banking sector as a whole. In this regard, a more sophisticated and differentiated treatment of different risk classes will be developed to take into account the risk profile of loan exposures to different sectors of the economy, in addition to the incorporation of market risk into the capital adequacy framework. This measure is aimed at ensuring that the capital of each institution supports the type of risk to which it is exposed. A more detailed and robust capital adequacy framework will enable banking institutions to effectively manage their risk and capital held. All these measures will be undertaken as part of the implementation of Basel II.

The increasingly complex operating environment translates into greater challenges for regulators to effectively perform their oversight functions. With the changing dynamics of risk characteristics, inter-linkages between risk exposures and the development of specialised products, the tools with which regulators conduct the surveillance function are continuously being updated. The use of technology will also be further assimilated into the regulatory function to provide Bank Negara Malaysia with integrated real-time information. Robust surveillance models will promote a better understanding of the impact of specific movements in the market on the stability of the financial sector and the economy. Through an early warning system, Bank Negara Malaysia will be better able to take corrective actions early and thus prevent extensive adverse effect on the financial sector. Such detailed information will also facilitate the analysis and policy formulation process by providing an assessment of the possible impact of any particular change in risk factors on the overall stability of the banking sector.

A key component of the efforts to ensure financial stability is the development of deposit insurance. As part of the financial safety net, a Deposit Insurance Scheme will be introduced to protect depositors in the event of a bank failure. The deposit insurance system will cover both conventional and Islamic banking institutions.

**ii) Insurance Sector**

The implementation of Phase 2 in the insurance sector will focus on consolidating the capacity building initiatives in order to achieve the desired outcome of a core of strong domestic market leaders that will be well-positioned to compete effectively in a progressively more liberalised environment. This will be undertaken through strategies that provide both the appropriate incentives for performance improvements, as well as a sound supporting framework for financial and market stability.

Following the capacity building measures implemented under Phase 1, a gradual levelling of the playing field between domestic and foreign insurers will be implemented in Phase 2. This will encompass both the gradual removal of remaining operating restrictions applicable to foreign insurers, as well as further deregulation across the board in key areas that will allow insurers greater flexibility to individually pursue innovative business strategies. The deregulatory measures to this end are expected to drive increased competition in the market, thereby accelerating performance improvements among domestic insurers.

More importantly, the development of the necessary supporting infrastructure as well as adjustments to the prudential regulatory and supervisory framework will be simultaneously undertaken to ensure that insurers continue to adopt sound financial and business practices in the more deregulated environment envisaged under Phases 2 and 3 of the implementation of the Masterplan. This will include the strengthening of reserve requirements and the risk management framework governing the significant activities of insurers, establishing an institutional framework to support sound pricing policies following the progressive deregulation of price tariffs for motor and fire business, and enforcing higher standards of disclosure and fair practices in the sale of insurance products.

To achieve a more efficient utilisation of capital, a Risk-Based Capital Framework is being implemented to better align the solvency regime with the risk profiles of individual insurers. Implementation of the framework will provide insurers with substantially greater flexibility to implement appropriate investment strategies that would improve performance and at the same time, achieve better asset-liability matching of insurance funds to support the long term viability of life insurers.

The supporting framework for more effective performance-based supervision will also continue to be strengthened in Phase 2. This includes the implementation of a more rigorous and risk-focused supervisory framework with effect from 2004. The Bank's surveillance capabilities with respect to key risks and trends in the industry will also be further strengthened with enhancements to reporting requirements and the more effective integration of global developments into domestic market analyses and projections to identify trends that may have an impact on the stability of the domestic market.

**iii) Islamic Banking & Takaful Sector**

The focus for Islamic banking and takaful under Phase 2 will be to enhance performance and upgrade the infrastructure of the Islamic banking and takaful industry. The strengthening of these components will provide the foundations for future sustainable progress in the building of an intermediation system that is robust, resilient, and competitive. Bank Negara Malaysia will continue to focus on a three-pronged strategic initiative where efforts will be focused on positioning Malaysia as a leading centre for educational excellence in Islamic banking and finance, establishing Malaysia as a leading name in Islamic banking and takaful consultancy; and positioning Malaysia's financial institutions as global Islamic financial players.

Given the structure of Islamic banking, the design of the regulatory framework for Islamic banking accords emphasis to full financial disclosure, prudent risk management and adherence to Shariah principles. This will also serve as a firewall to prevent the transmission of risks from investment deposits to demand deposits thus enhancing transparency, depositors' protection and systemic stability.

It has become increasingly evident that, in the long run, dedicated standards need to be promoted for the development of Islamic investment vehicles as well as a robust Islamic capital market. The Islamic Financial Services Board will develop the prudential regulatory and supervisory standards for Islamic banking operations to guide Islamic banking operations, promote disclosure-based principles, enhance transparency, and help nurture the development of the Islamic capital market. In addition, the Malaysian Accounting Standards Board will also set the accounting standards for Islamic financial business.

**iv) Development Financial Institutions Sector**

DFIs will continue to play an important role in supporting the development strategies of the nation by complementing the banking sector to meet the changing financing requirements of the economy. In this regard, it becomes increasingly important for DFIs to be effective, efficient and dynamic in response to the demands of identified target growth sectors. Efforts that were undertaken in Phase 1 to build the capacity and capability of the DFIs will be continued in Phase 2. Greater emphasis will be placed on strengthening the financial and operating conditions as well as enhancing the corporate governance, risk management practices and human resource development of the DFIs. This is aimed at ensuring that the financial intermediation process, through the DFIs, will operate effectively and efficiently to support Malaysia's economic transformation.

**v) Labuan International Offshore Financial Centre**

Labuan IOFC has demonstrated positive and encouraging results in every sector of offshore business covering offshore banking, insurance and insurance-related activities, leasing and capital market activities, and is positioning itself as a leading integrated offshore business centre. Going forward, LOFSA will continue to promote and diversify further the financial players and activities in the IOFC. Business development programmes will be undertaken, aimed at expanding offshore financial services opportunities from other regions. LOFSA will continue to promote and enhance global awareness on Labuan IOFC's position as an attractive and cost-efficient offshore business centre. Most importantly, LOFSA will promote the development of Islamic banking and retakaful business to cater for the growing demand for Islamic finance products. Further development to build a sustainable, progressive and efficient Islamic financial centre will continue to reinforce Malaysia's current potential as a leading Islamic financial centre. In addition, LOFSA will continue to direct efforts to strengthen the capital market, e-commerce and the ancillary activities. Also important is the development of an active secondary market for both conventional and Islamic financial instruments listed on the LFX.

**vi) Alternative Mode of Financing - Venture Capital and Credit Enhancements**

The development of venture capital financing will continue to be promoted in view of its importance in nurturing new growth areas as well as to serve as an alternative source of financing in the economy. Further efforts will be directed towards greater capacity building in terms of skills upgrade and access to private sector financing. To accelerate the development of the venture capital industry, a network of business angels, diversified sources of funds and a large pool of highly skilled knowledge workers are required. In addition, constraints in the supply of innovations need to be addressed with the improvement of deals flows through the development of a critical mass of high growth-potential investees. In order to assist the cultivation of better entrepreneurship culture, further concerted efforts will aim at providing the necessary business and regulatory environment, ensuring access to financing at earlier stages of innovation and reviewing existing policies relating to commercialisation of ideas.

Another area of focus is the credit enhancement initiatives to facilitate lending, especially in the agriculture sector. Initiatives are being taken to enhance financing activities to include the provision of guarantees on agriculture-related loans granted by the banking institutions to high risk but commercially viable ventures, as well as increasing the range of ancillary services deemed essential for sound development of the agriculture sector. In addition, agriculture insurance could play an important role in transforming the agriculture sector into a modern and dynamic commercial sector. The availability and range of insurance products being developed by the insurance industry aim to provide multiple benefits to the farmers including enhanced access to financing, stability in farm income as well as improved risk management practices and farming technologies.

**Moving Forward**

The key emphasis of the FSMP is to move towards a more diversified and balanced financial system with strong institutional framework, comprehensive market infrastructure, world-class best practices and conducive regulatory environment. As the financial system transitions into Phase 2 of the FSMP, the thrust of initiatives in 2005 will be two-pronged – to continue the efforts to strengthen the institutional development of domestic financial institutions to be well-positioned in a more liberalised and deregulated environment; and to review the current policies and regulatory framework in order to level the playing field between the various market players. Equally important is for institutions to be able to adapt, adjust and respond to changing economic conditions in particular to support new areas of growth. Having robust financial institutions that are able to withstand any potential shocks and have the agility and adaptability to embrace future challenges are key in ensuring long-term sustainability in a more competitive environment as well as the preservation of financial stability.

**Financial Services Liberalisation Measures Since 2000**

| Year | |
|---|---|
| | **Banking Sector** |
| 2000 | • The maximum total credit facilities that could be obtained by non-resident controlled companies (NRCCs) from foreign-owned banking institutions in Malaysia was increased from 40% to 50% in December 2000.<br>• Licensed Offshore Banks in the Labuan International Offshore Financial Centre (Labuan Offshore Banks) would be allowed to invest in ringgit assets/instruments in Malaysia for their own accounts, though not on behalf of their clients.<br>• Licensed commercial banks, including the foreign-owned banks, and Bank Islam Malaysia Berhad in Malaysia (licensed banks) were allowed to extend in aggregate an intra-day overdraft facility of not exceeding RM200 million and an overnight facility of not exceeding RM10 million to non-resident stockbroking companies and non-resident global custodian banks to finance funding gaps due to inadvertent delay in relation to settlement for trade on the KLSE. In addition, they can also enter into short-term currency swap and/or outright forward contracts to cover for purchase of shares on the KLSE. |
| | **Non-banking financial sector (excluding insurance)** |
| | • The maximum foreign equity limits in a stockbroking company and a financial leasing company were increased to 49% from 30% effective 1 July 2000. |
| | **Banking Sector** |
| 2001 | • Foreign-owned banking institutions were allowed to set up communicative websites from 1 January 2001.<br>• Banking institutions (including the foreign-owned banks) in Malaysia were allowed to extend credit facilities in ringgit to finance the purchase and/or construction of one immovable property for non-residents who participate in the Silver Hair Programme implemented by the Immigration Department of Malaysia.<br>• Financial institutions (including the foreign-owned banks) were allowed to extend up to three credit facilities in ringgit to non-residents to finance the purchase or construction of any property in Malaysia (excluding for the purchase of land), subject to their own internal credit assessment guidelines.<br>• Banking institutions (including the foreign-owned banks) in Malaysia were allowed to effect transfers involving External Accounts and another External Account and/or Resident Account of different account holders by way of:<br>(a) Automated Teller Machine transfer up to RM5,000 per person/company, per day, per bank for any purpose;<br>(b) Internet-bank transfers up to RM5,000 per person/company, per day, per bank for any purpose; and/or<br>(c) Cheques up to RM5,000 per cheque for any purpose. |
| | **Insurance sector** |
| | • All insurers with the requisite minimum risk management and security systems in place were allowed to offer the full range of life and general insurance products through the internet with effect from April 2001. |
| | **Banking Sector** |
| 2002 | • Foreign-owned banking institutions were allowed to offer transactional internet banking from 1 January 2002. |

| | |
|---|---|
| | • Internal credit lines used solely to facilitate drawing against uncleared cheques, granted by licensed banks (including the foreign-owned banks) to NRCCs, were excluded from the computation of the NRCC's total domestic credit facilities. Licensed banks were also permitted to allow NRCCs to overdraw their current accounts for amounts of up to RM500,000 per account for a period not exceeding 2 working days.<br>• Banking institutions (including the foreign-owned banks) in Malaysia were allowed to extend additional ringgit credit facilities to any non-resident up to an aggregate of RM5 million per non-resident to finance projects undertaken in Malaysia. Prior to this, credit facilities in ringgit to a non-resident, for purposes other than purchases of three immovable properties or a vehicle, were limited to RM200,000.<br>**Insurance sector**<br>• The areas in which insurers may employ expatriates were expanded to include, in addition to the fields of specialised underwriting, actuarial and information technology previously provided for, other areas involving product research and development, risk management and investment. |
| 2003 | **Banking Sector**<br>• Licensed banks (including the foreign-owned banks) in Malaysia were allowed to extend overdraft facilities in ringgit not exceeding RM500,000 in aggregate to a non-resident customer, provided such overdraft facilities are covered by fixed deposits placed by the non-resident customer with the licensed banks in Malaysia. These overdraft facilities were in addition to all ringgit credit facilities allowed to be extended freely by banking institutions since 21 November 2002.<br>• The 50% limit on the maximum total credit facilities that could be obtained by NRCCs from foreign-owned banking institutions in Malaysia was removed on 1 April 2003.<br>• The overnight limit for foreign currency account (FCA) to retain receipts arising from export of goods (export receipts) for Approved Operational Headquarters (OHQ) was increased to US$70 million from US$10 million. The maximum overnight limit on export FCA of other resident exporters was also raised to US$70 million.<br>• Residents may invest in investment products that are linked to foreign currency denominated derivatives that are offered by licensed banks (including the foreign-owned banks) in Malaysia. The foreign currency funds used for the investment that are utilised from the residents' FCA will be earmarked and computed as part of the aggregate overnight balances of the FCA of the residents.<br>• Allow up to three new Islamic banking licences to qualified foreign players.<br>**Insurance sector**<br>• Effective 17 April 2003, foreign-owned insurers with foreign shareholding not exceeding 51% were allowed to open not more than two branch offices in one year. |
| 2004 | **Banking Sector**<br>• To enhance cash flow management for supporting value chain expansion in Malaysia, licensed banks (including foreign-owned banks) can retain higher amount of foreign currency funds for residents in FCA:<br>- Up to a maximum of US$100 million (previously US$70 million) of export receipts.<br>- Any amount of non-export receipts for residents with domestic borrowing (previously need approval).<br>- Up to US$150,000 for education/employment purpose (previously US$100,000).<br>• Labuan Offshore Banks are allowed to maintain FCA for residents:<br>- Up to US$0.5 million of non-export receipts for residents without domestic borrowing (previously need approval). |

- Up to US$150,000 for education/employment purpose (previously US$100,000).
- Any amount overseas foreign currency funds for resident individuals.

- To enhance access to ringgit funds for business requirements in Malaysia, the various limits for banking institutions lending to non-residents in ringgit have been consolidated to one single aggregate limit of RM10 million for use in Malaysia for any purpose (excluding stockbroking company, custodian bank and correspondent bank).
- The extension of property loans in ringgit by residents, including licensed banks, to non-residents now includes the purchase of land (previously not allowed).
- Licensed banks are allowed to extend an aggregate overnight overdraft facility of RM200 million (increased from RM10 million) to a non-resident stockbroking company or a non-resident custodian bank to facilitate settlement for purchase of shares listed on the KLSE.
- Resident individuals employed or staying abroad with foreign currency funds sourced from abroad are allowed to invest in any foreign currency assets, including those offered by licensed banks, approved licensed merchant banks and Labuan Offshore Banks.
- Multilateral Development Bank and foreign multinational corporation issuers of ringgit-denominated bonds in Malaysia may enter into forward foreign exchange contracts with onshore licensed banks to hedge their currency risks arising from the issuance of the ringgit denominated bonds. Non-resident investors subscribing to these issues can also hedge their foreign exchange risks.

## SUPERVISION OF THE BANKING SYSTEM

The supervisory activities throughout 2004 continued to be directed at the promotion of a sound and robust financial system as part of the preservation of financial stability. These objectives were achieved through allocation of on-site supervisory resources to areas of high risk, continuous monitoring of the banking institutions, adoption of pre-emptive measures and enforcement of prudential regulatory standards. The responsibilities of Bank supervisors have also expanded in recent years to include several development financial institutions and payment system operators which have been placed under the supervision of Bank Negara Malaysia. The Bank is also involved in providing technical assistance to other domestic supervisory agencies as well as international bodies.

**The supervisory objectives were achieved through allocation of resources to areas of high risk, continuous monitoring of the banking institutions, adoption of pre-emptive measures and enforcement of prudential regulatory standards.**

The supervisory activities, which include on-site examinations and off-site supervision, are based on a rigorous risk based supervisory framework and emphasise vigilant monitoring of the financial condition and operating soundness of banking institutions. The risk-based supervisory framework provides a structured and forward-looking approach to assess a banking institution's risk profile and risk management systems. With this forward-looking methodology, supervisors are able to allocate resources optimally in supervising the institutions, focusing on the risk areas.

The financial and operating conditions of the banking institutions are assessed using the CAMELS rating framework. The respective banking institutions are assigned a composite rating, ranging from strong (best rated) to very unsatisfactory (poorly rated), and supported by a rating for each of the six components of the CAMELS rating framework, namely capital adequacy, asset quality, management capability, earnings performance, liquidity position and sensitivity to market risk. The rating covers both quantitative and qualitative aspects of the financial and operating condition of the banking institution. Implicit in the rating is the adequacy of a banking institution's risk management systems and practices vis-à-vis its risk profile. During 2004, it was observed that the financial performance and risk management capabilities of most banking institutions had improved as evidenced by the improvement in their ratings.

The on-site supervision of banking institutions was complemented with rigorous off-site surveillance functions. The off-site surveillance of the financial condition of banking institutions was conducted through a review of regular reports and financial information submitted by the banking institutions. This mechanism enables early detection of emerging problems so that pre-emptive corrective actions can be taken. A fraud surveillance system has also been put in place to monitor incidences of fraud in the banking system. This enabled identification of new modus operandi of frauds that was highlighted to the banking institutions so as to prevent further occurrences and losses in the banking system. The respective banking institutions are also subjected to continuous monitoring of their resilience to economic shocks under stressed conditions. In conjunction with this, banking institutions are required to submit to the Bank the results of their stress tests on a quarterly basis. The stress test incorporates a set of minimum parameters prescribed by the Bank while allowing the banking institution the flexibility to adopt its own assumptions for certain parameters.

As part of the supervisory activities, the Bank evaluates the performance of directors and the various board committees established in the banking institutions, in line with the increasing attention accorded to the assessment of corporate governance practices of the banking institutions. In this respect, it was observed that the board and senior management of banking institutions are becoming increasingly responsive to risk management issues and this has contributed significantly to the creation of a strong risk management culture across the banking industry. There has also been more active involvement of directors and senior management of banking institutions, particularly amongst the independent directors who are more aware of their responsibilities and having a more active role in guiding the institutions. This bodes well for the banking industry as they are able to provide further perspective and direction regarding the level of risk exposures and strategies for the banking institutions. The Bank continues to place emphasis on the importance of embedding strong corporate governance culture in all aspects of a banking institution's operations. In line with the expectations under the Financial Sector Masterplan, the roles and functions performed by the board members either individually or collectively towards enhancing their organisation's capacities, capabilities and competitiveness are continuously assessed and evaluated.

The emphasis on risk management in banking institutions in recent years has also resulted in the development of a more vibrant and dynamic banking sector. With greater risk management capabilities, banking institutions have the capacity to offer new and more complex value-added products and services to a wider market segment, hence enhancing capacity to improve productivity. The growing utilisation of complex and exotic financial instruments either as a risk management or profit-enhancing tool have necessitated greater supervisory attention in the area of risk management, particularly in the identification and measurement of risks. A significant number of banking institutions have invested in sophisticated trading and risk management systems as well as strengthening their middle-office and compliance functions. Correspondingly, the supervisors have also enhanced their capabilities to assess risk measurement models used by banking institutions. In this connection, the supervisors validate the banking institutions' market risk models to ensure that the practices being adopted are in line with best practices. With effect from September 2004, banking institutions are required to implement, on a trial basis, the new Market Risk Capital Adequacy Framework (MRCF). In order to ensure the smooth implementation of the MRCF upon its full compliance from the second quarter of 2005, the Bank has also reviewed the banking institutions' trading book policy statements and MRCF monthly submissions.

As part of the Bank's efforts to ensure that the banking system is not being used as a conduit for money-laundering activities, supervisory resources are also channelled towards reviewing the adequacy of anti-money laundering and anti-terrorist financing measures established by the banking institutions. Over the years, there has been an increasing level of awareness among banking institutions on the importance of establishing a strong institutional framework to combat money laundering and the financing of terrorism. Together, the Bank and the banking industry have instituted the necessary measures to deter and detect undesirable money laundering activities, which can undermine the integrity of the banking system.

In line with the standards stipulated in the Basel Committee's Core Principles of Effective Banking Supervision, the normal on-site examination cycle for each banking institution, including Islamic banks and development financial institutions is once in every 18 months. However, more frequent examinations are carried out if a banking institution warrants closer supervision. These examinations cover local and overseas branches, bank holding companies and related companies of banking institutions. The examinations of bank holding companies and other related companies of banking institutions are an integral part of the consolidated supervision process undertaken by the Bank. This process enables the Bank supervisors to assess the ability of the bank holding company to act as a source of financial support to the banking institution within the group and to assess whether other risk-taking activities within the banking group may pose a financial and contagion risk to the banking institution. The planning and monitoring of the performance of the Bank's on-site examinations are certified under the MS ISO 9001:2000 Quality Management System.

In line with the importance of the role of the board in the corporate governance of the banking institution, Bank supervisors have more frequent interactions with members of the board and senior management of banking institutions. This assists Bank supervisors to keep abreast with issues confronting the banking institution, its business strategies, risk profile and risk management capabilities and, at the same time, communicating supervisory concerns on the banking institution to the senior management. This two-way communication with senior management is useful for Bank supervisors to have a thorough understanding of the banking institution, identifying emerging risks more efficiently and effectively, hence instituting corrective measures in a prompt manner.

Supervisory issues arising from on-site examinations are communicated to the senior management and board of directors of the banking institutions in addition to the recommended courses of action. Banking institutions are required to respond to the proposed corrective actions and update the supervisors on the status of their implementation. In cases where the supervisory issues are considered significant and require speedy corrective actions, banking institutions are subjected to the Informal Enforcement Action Framework (IEAF). With the implementation of IEAF since September 2002, significant supervisory issues are closely monitored by the Bank supervisors and greater commitment from the board and senior management is being obtained towards their resolution in a prompt and systematic manner.

With the rapid and diversified development of technology in the banking environment in recent years, the banking institutions are required to be more effective in managing the related information systems (IS) risks in order to improve the safety and soundness of the IS environment in these institutions. The Bank has undertaken several measures to enhance the overall IS governance as well as to promote IS best practices. These include on-site examination, off-site monitoring, issuance of guidelines on the management of the IS environment and improving the standards of IS supervision by benchmarking against other proven IS auditing standards.

In addition to on-site IS examination of banking institutions, the Bank also conducted examinations on the payment system operators under the Payment Systems Act 2003. The examination process includes an appraisal of the capability of the institution in managing the IS risks and where applicable, payment systems risks as well as on the overall management of the payment system operator, and subsequently highlighting areas of concerns related to IS initiatives, security and controls, and system performance. Over the years, the overall IS risk management framework in most banking institutions had improved considerably, given the increased awareness and commitment by the management of the institutions.

For better assessment of the banking institutions' IS environment and to ascertain the soundness of their IS operations, the Bank has enhanced the quality of its IS supervision function by implementing a new methodology for on-site examination, PRISM (Information Systems Risk Assessment). This methodology provides a more balanced appraisal of the IS environment in the banking institutions by linking the IS practices and risks to the business requirements and processes. The Bank is also developing a system to enhance the off-site monitoring function by implementing a database of information on the development and usage of technology by the banking institutions. The system would be able to provide an early warning mechanism on potential systemic risks as well as to provide benchmarking of core processes across the banking industry and promote best practices in IS risk management.

An area that has been accorded supervisory importance is the outsourcing arrangements of banking institutions. This is due to the increasing trend in outsourcing of some of the banking institutions' back-office processes, such as payment processing, call centre and IS infrastructure services to third-party service providers. The Bank reviews the outsourcing arrangements between the banking institutions and the third-party service providers as well as conducts examinations on the third-party service providers to ensure that all aspects of the outsourcing are managed effectively. Ultimately, the customers of the banking institutions must be adequately protected while benefiting from the more efficient services provided by the banking institutions.

In order to remain effective in today's fast evolving financial markets, Bank supervisors need to build up expertise quickly in order to be able to provide value add to the banking institutions. For this purpose, several specialised groups of Bank supervisors had been developed to focus on specific areas, which are critical in performing the Bank's supervisory functions.

In meeting the supervisory responsibilities expected of the supervisors specifically under Pillar 2 of the new Basel capital accord, various capacity building initiatives are being undertaken to equip supervisors with the necessary knowledge and skills. In addition to knowledge acquisition, supervisory processes are being reviewed and enhanced to facilitate the assessment of a bank's capital management and processes.

Globalisation and market liberalisation under the Financial Sector Masterplan will see the emergence of new and significant players. The formation of bigger banking entities arising from the merger of the commercial banks and finance companies within each banking group, emergence of new foreign incorporated Islamic banks, increasing complexity of operations arising from the greater regional presence, cross-selling activities within entities in the same banking group and outsourcing of banking institutions operations will necessitate the Bank to continuously set new benchmarks for its supervisory approaches and activities. Efforts will continue to be taken to ensure that the supervisors are equipped with the necessary skills and capacity to manage these challenges.

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

**Overview**

Malaysia continued to develop and enhance its national AML/CFT regime by strengthening its AML/CFT legislative framework as well as by improving domestic and international co-operation, and upgrading the capacity of law enforcement personnel in these important areas. Bank Negara Malaysia, as the lead agency for the National Co-ordination Committee to Counter Money Laundering (NCC) that co-coordinates the implementation and enforcement of the Anti-Money Laundering and Anti-Terrorism Financing Act 2001 (AMLA) and AML/CFT measures, is committed in ensuring that Malaysia's financial system is sound, robust and free from abuse.

During the year, Bank Negara Malaysia extended the AMLA regulatory net to new reporting institutions and invoked other reporting obligations under Part IV of the AMLA to existing reporting institutions. More importantly, extensive AML/CFT briefings, training and awareness sessions were conducted throughout the country for the law enforcement personnel and the respective regulatory authorities in the public sector as well as various categories of new reporting institutions in the private sector.

**Enhancing the Role of the NCC**

The NCC continued to ensure that the national AML/CFT regime remained up to date and relevant to the evolving threats of money laundering and terrorism financing. Domestic co-operation was further strengthened by regular meetings of the NCC members during the year to develop, among others, AML/CFT policies, and to coordinate the effective implementation of the AML/CFT measures, based on internationally accepted standards as contained in the Financial Action Task Force on Money Laundering's (FATF) Forty Recommendations on Money Laundering and Nine Special Recommendations on Terrorism Financing. The FATF, which is an inter-governmental body established by the G-7 Summit in Paris in 1989, develops and promotes policies to combat money laundering and terrorism financing. During the year, the NCC continued to ensure that the developments in the national AML/CFT regime are consistent with the FATF's Recommendations.

The NCC's role in the national AML/CFT regime is further strengthened by changes in its composition. The NCC now comprises senior level representation from the various enforcement agencies. The Ministry of Domestic Trade and Consumer Affair's Enforcement Division, which is responsible for enforcing the Optical Discs Act 2000 and Copyright Act 1987, was included as a new member of the NCC. During the year, the National Narcotics Agency ceased to be a member as matters relating to the enforcement of the Dangerous Drugs Act 1952 is under the purview of the Royal Malaysian Police, which is one of the founding members of the NCC.

**Enhancing AML/CFT Legislative Framework**

Instead of a new anti-terrorism financing statute, Malaysia amended five pieces of legislation namely, the AMLA, the Penal Code, the Subordinate Courts Act 1948, the Courts of Judicature Act 1964 and the Criminal Procedure Code to enable Malaysia to accede to the following two international conventions on terrorism:

- The International Convention for the Suppression of the Financing of Terrorism adopted by the General Assembly of the United Nations on 9 December 1999 and comply with the United Nations Security Council Resolutions on counter-terrorism measures, in particular Security Council Resolution 1373 (2001) of 28 September 2001; and
- The International Convention against the Taking of Hostages adopted by the General Assembly of the United Nations.

The Anti-Money Laundering (Amendment) Act 2003 and the Penal Code (Amendment) Act 2003 were *gazetted* as law on 25 December 2003. The Penal Code (Amendment) Act 2003, among others, extended the application of the Penal Code to extra-territorial offences under the new Chapter VIA, which deals with, among others, the suppression of the financing of terrorist acts, and added on additional grounds for extra-territorial criminal jurisdiction to be sought. The Subordinate Courts (Amendment) Act 2004 and the Courts of Judicature (Amendment) Act 2004 were *gazetted* as law on 23 December 2004. The amendments, among others, extended the extra-territorial criminal jurisdiction of the High Court to offences under the new Chapter VIA of the Penal Code. The consequential amendments to the Criminal Procedure Code on police powers in relation to terrorism offences would be tabled in Parliament after deliberation by the Select Committee of the Lower House of Parliament.

The Anti-Money Laundering (Amendment) Act 2003, among others, extended the reporting of suspicious transactions to Bank Negara Malaysia to cover the reporting of suspected terrorism financing activities. This new law also extended the AMLA mechanism for tracing, freezing, seizing, forfeiting and confiscating assets to include assets used for the financing of terrorist acts. The new Part VIA of the AMLA empowers the Minister of Internal Security to deem any entity as a terrorist, whose property could then be seized and forfeited to the Federal Government.

**AMLA Regulatory Net**

***Extension to New Reporting Institutions***

The AMLA requires a reporting institution to report to Bank Negara Malaysia any transaction where the identity of the person involved, the transaction itself or any other circumstances concerning the transaction gives the reporting institution reason to suspect that it involves proceeds of an unlawful activity. The statutory requirement to report suspicious transactions has been invoked incrementally on conventional, Islamic and offshore entities since the commencement of the AMLA on 15 January 2002. During the year, the AMLA regulatory net was extended to the stockbrokers and futures brokers with effect from 31 March 2004 and to the lawyers, accountants and company secretaries with effect from 30 September 2004. Lawyers and accountants are required to report to the Bank any suspicious transaction identified in the course of carrying out the following types of business activities for their clients:

(i) buying and selling of immovable property;
(ii) managing 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.

Company secretaries are required to report to Bank Negara Malaysia any suspicious transaction identified in the course of carrying out the following types of business activities for their clients:

(i) acting as a formation agent of legal entities;
(ii) acting as (or arranging for another person to act as) a director or secretary of a company, a partner of a partnership, or a similar position in relation to other legal entities;
(iii) providing a registered office, business address or accommodation, correspondence or administrative address for a company, a partnership or any other legal entities or arrangement;
(iv) acting as (or arranging for another person to act as) a trustee of an expressed trust; or
(v) acting as (or arranging for another person to act as) a nominee shareholder for another person.

The extension of the AMLA regulatory net to cover lawyers, accountants and company secretaries is a significant milestone in the national AML/CFT regime. Money laundering schemes have become more complex as countries endeavour to implement comprehensive AML/CFT measures in the financial sector to detect and deter money laundering, terrorism financing and other transnational crime, thereby forcing criminals to turn to these professionals to assist them in accessing the financial system. The timely invocation of the AMLA reporting obligations on these professionals during the year further denied criminals indirect access to the financial system through the professional 'gatekeepers' who could structure complicated financial transactions with the view to hide tainted proceeds.

***Increasing Reporting Obligations***

The AMLA reporting obligations are invoked gradually on the reporting institutions to provide sufficient time for them to implement and discharge their AMLA reporting obligations. The statutory requirement to report suspicious transactions to Bank Negara Malaysia was initially invoked on Lembaga Tabung Haji, Bank Kerjasama Rakyat Malaysia Berhad and Bank Simpanan Nasional on 15 January 2003. In order to facilitate such reporting to Bank Negara Malaysia, any obligation as to the secrecy or other restriction on the disclosure of information imposed by written law or otherwise on these institutions were overridden and their officers reporting suspicious transactions in good faith to Bank Negara Malaysia were provided immunity from civil, criminal and disciplinary proceedings. During 2004, the remaining reporting obligations under Part IV of the AMLA, where relevant, were invoked on Lembaga Tabung Haji, Bank Kerjasama Rakyat Malaysia Berhad and Bank Simpanan Nasional with effect from 31 March 2004. These reporting obligations include retention of records for a period of six years, conducting customer due diligence, as well as establishing internal reporting and compliance programmes that are designed to reduce their vulnerability to misuse by criminals.

***Increasing Predicate Offences***

In 2004, the number of money laundering predicate offences in the Second Schedule to the AMLA was increased from 150 to 168 serious crimes from 24 pieces of legislation. The inclusion of the new money laundering predicate offences in the AMLA would enable Bank Negara Malaysia to track the financial trail of these offences and share the financial intelligence with the relevant enforcement agencies.

***Enhancing AML/CFT Compliance***

During the year, Bank Negara Malaysia developed a comprehensive AML/CFT Compliance Handbook as a reference guide to assist reporting institutions in discharging their obligations under the AMLA. The Handbook contains various documents and literature on the national AML/CFT initiatives pertaining to specific industries, including industry specific regulatory and compliance guidelines, international standards and recommendations as well as circulars and core compliance standards. The CD-ROM copy of the Handbook was distributed during the year to the conventional, Islamic and offshore reporting institutions and the various trade associations. Reporting institutions could refer to the Handbook for assistance in establishing, among others, suspicious transactions reporting mechanisms, record-keeping, customer due-diligence, compliance and on-going training of employees.

**Domestic Co-operation**

***Awareness Programme***

The AML/CFT awareness programme was conducted nationwide through a series of briefings for the various categories of new reporting institutions as well as the respective regulatory authorities. The objectives of the briefing sessions were to educate the reporting institutions on their obligations and responsibilities under the AMLA and to establish their working relationship with the Financial Intelligence Unit (FIU) in Bank Negara Malaysia. In addition to the AMLA briefings, Bank Negara Malaysia organised training courses and workshops to upgrade the knowledge and skills of the various law enforcement personnel involved in the fight against money laundering and terrorism financing. During the year, the following training sessions were conducted:

- Briefing on the AML/CFT measures to members of the Malaysian Bar Council in January 2004;
- Briefing on the AMLA invocation and reporting obligations to the capital market intermediaries in March 2004;
- Briefing on the AMLA to Heads and Senior Officers of the Enforcement Division of the Ministry of Domestic Trade and Consumer Affairs in April 2004;
- Seminar on the AML/CFT measures to the Sabah Law Association in May 2004;
- Briefing on the AMLA invocation and reporting obligations were conducted at 18 locations for lawyers, accountants and company secretaries from July – September 2004; and
- Briefing on the AMLA to senior officials of the Companies Commission of Malaysia on 5 November 2004 in connection with the invocation of the AMLA reporting obligation on company secretaries.

Combating the crimes of money laundering and terrorism financing is essential to the integrity of the financial systems. The training sessions were effective platforms to raise concerns and exchange ideas on best practices and on the practical implementation of the AML/CFT measures. Arising from these training sessions, which raised the reporting institutions' level of compliance with international standards, the national AML/CFT regime is now better supported by the contribution of the financial and non-financial reporting institutions that hold critical information on transactions that may hide criminal schemes.

***AMLA Investigation Reference Guide***

As part of the efforts to document the AMLA investigation processes, a Working Group on the AMLA Investigation Reference Guide, comprising members from the relevant agencies in the NCC drafted a set of required tasks to assist investigators in carrying out investigation in relation to money laundering and terrorist financing offences under the AMLA. The successful formulation of the AMLA Investigation Reference Guide is the result of co-operation among experienced domestic law enforcement personnel, who were unstinting in sharing their knowledge and skills in conducting investigations into financial crimes. After the NCC has adopted the AMLA Investigation Reference Guide in the coming year, it would be distributed to the relevant law enforcement agencies to facilitate investigations into any breaches of the AMLA provisions.

***Sub-Committee for Information Sharing***

The NCC set up a Sub-Committee for Information Sharing during the year for better analysis and sharing of information gathered from suspicious transactions reports (STRs) and for better use of financial intelligence. This Sub-Committee provides a formal mechanism where intelligence developed by Bank Negara Malaysia based on information obtained from the STRs could kick-start investigations into suspected money laundering offences, terrorism financing and other serious crimes.

**International Co-operation**

As Malaysia is a member of the Asia/Pacific Group on Money Laundering (APG) Technical Assistance Donor and Provider Group, Bank Negara Malaysia provided technical assistance to the National Bank of Cambodia in drafting the relevant AML/CFT Guidelines for banking institutions in Cambodia. In addition, Bank Negara Malaysia will continue to participate in the AML/CFT mutual evaluation exercises undertaken by various jurisdictions that are members of the APG. Collaborative efforts are also enhanced through the signing of Memorandums of Understanding on the sharing of financial information with various jurisdictions.

**Capacity Building**

***Training Initiatives***

Capacity building continued to be the focus of Bank Negara Malaysia with emphasis on financial investigation techniques in order to upgrade the expertise of law enforcement personnel. Experts from both domestic and foreign law enforcement agencies shared their knowledge and expertise at various training workshops during the year. The participating agencies included the Inland Revenue Board and the Attorney-General's Chambers of Malaysia, the National Criminal Intelligence Service and the National Terrorist Financial Investigation Unit of the United Kingdom, the Immigration and Customs Enforcement Division of the United States' Department of Homeland Security, and the United Nations Office of Drugs and Crime. During the year, Bank Negara Malaysia organised and participated in the following training programmes:

(i) The Money Laundering and Terrorism Financing Seminar, Kuala Lumpur, March 2004;
(ii) The AMLA Enforcement Workshop, Kuala Lumpur, September 2004;
(iii) The Computer Forensic Introduction Workshop, Kuala Lumpur, November 2004; and
(iv) The AMLA Net Worth Analysis Workshop, Kuala Lumpur, November - December 2004.

**Internal Enabling Initiatives**

***Financial Intelligence System Phase I (FINS)***

As the competent authority under the AMLA, Bank Negara Malaysia continued to receive STRs, which have improved in terms of quality and quantity during the year. For the purpose of facilitating the reporting of suspicious transactions by financial institutions, Bank Negara Malaysia developed FINS to assist the financial institutions in their online submission of STRs. FINS went live in May 2004 and enabled the financial institutions to submit STRs from the convenience of the compliance officers' work-stations in a high speed and secured web environment. The basic analysis tool in FINS automatically analyses the STRs received and thereby enables Bank Negara Malaysia's financial analysts to expedite their identification and review of the financial linkages between the dubious transactions.

***Increase of Staff in the Financial Intelligence Unit (FIU)***

In view of the expanding AMLA regulatory net and the additional responsibility of tracking the financing of terrorism, Bank Negara Malaysia increased the staff strength of the FIU from 18 to 24 with the creation of more high level posts in the department. In order to facilitate the effective implementation and enforcement of the AMLA, two new sections, namely the Compliance Section and the Investigation Support Section, were created during the year. The Compliance Section oversees the financial and non-financial reporting institutions' compliance with the AMLA obligations, while the Investigation Support Section helps the relevant law enforcement agencies with financial intelligence for their AMLA related investigations.

**Challenges Ahead**

Bank Negara Malaysia will continue to extend the AMLA regulatory net to other classes of reporting institutions such as trust companies, operators of forecast numbers and other gaming outlets, fund and asset management companies, unit trust companies, real estate agents, jewellers, dealers in precious metals and stones and antique dealers. The money laundering trends and typologies as well as international AML/CFT standards will determine the timing of the invocation of the AMLA obligations on any of these non-financial entities.  In addition, the AMLA obligations will only be invoked after the requisite briefing sessions to, and consultations with, the respective industries and sufficient time is granted for the target reporting institutions to fully understand and prepare for their statutory obligations.

Another essential mechanism to ensure effective implementation of AMLA is to establish an informal AMLA enforcement framework for swift regulatory action against any reporting institution for its failure to comply with the AMLA reporting obligations. Such an informal enforcement framework would systematically enumerate corrective and pre-emptive actions against any errant reporting institution before its non-compliance deteriorates to a stage where it becomes the weakest link in the national AML/CFT regime and is abused by criminals to launder their tainted funds.

## PERFORMANCE OF THE BANKING SYSTEM

### Overview

The banking system remained resilient throughout 2004, with positive developments recorded in all key financial soundness indicators. With non-performing loans (NPLs) continuing to trend downwards and profitability improving, capital ratios were sustained at high levels throughout the year, providing the banking system with sufficient buffer to absorb any unexpected shocks. The sound financial position of banking institutions, together with sustained strong economic performance, low interest rate environment, and favourable household and business sentiments, provided the main impetus for strong expansion in the financing activities. The main highlights of the performance of key indicators of the banking system were:

- High capital adequacy ratios despite several capital rationalisation exercises and strong expansion in risk-weighted assets;
- Higher profitability with improved returns on equity and average assets;
- Net interest margin remained narrow as competition continued to exert pressure in the lending market;
- NPLs continued to trend downwards to its lowest level since the Asian financial crisis, driven mainly by sustained recoveries and reclassifications, and lower incidences of new NPLs;
- Lending activities of the banking institutions remained robust, supportive of the increased demand from the households and businesses; and
- Exposure to market risks remained within prudential levels.

### Profitability

Supported by favourable economic and financial market conditions, the banking system recorded preliminary unaudited pre-tax profits of RM11.8 billion for the calendar year 2004, 16.1% higher than the preceding year. This was attained on account of improved gross operating profits, higher net gains from securities trading and investment activities, as well as increase in dividend income from non-banking entities. The strong financial performance resulted in higher returns on average assets and equity of 1.4% and 16.6% respectively, whilst pre-tax profits per employee rose to RM127,827 in 2004 from RM110,526 in the previous year.

The banking system posted gross operating profits of RM12.6 billion for the year, an increase of 3.3% over the level recorded in 2003. The improved performance was driven by higher net income from interest- and fee-related activities, which offset the increase in staff cost and overheads. Reflecting strong competition in the loan market, income from loan and financing activities recorded a marginal growth of RM0.3 billion or 1.1%. The boost in net income from interest-related activities was driven by strong increases in interest income from net interbank activities (+RM0.8 billion or 96.6%), bulk of which was due to the liquidity operations of Bank Negara Malaysia to absorb excess liquidity, as well as investment securities (+RM0.6 billion or 23.9%). By type of institutions, net interest income of the commercial banks increased by 13.8%, while that of the finance companies declined by 14.6%, partly reflecting the technical adjustment following the mergers of five finance companies into the commercial banks. Meanwhile, the merchant banks registered a decline in their net interest income of 3.7% during the year given their continued focus on fee-based activities.

As competition kept lending rates low, the commercial banks continued to diversify into a broader range of non-lending fee-related activities to cater to more affluent consumers. Income from fee-based activities for commercial banks and finance companies as a group increased by 18.1% to RM4 billion in 2004. This was contributed mainly by income derived from private banking activities, including cross-selling of unit trust and bancassurance products, and payment-related activities such as remittances. The ratio of fee-based income to operating income of commercial banks and finance companies as a group stood at 17.2% in 2004 compared with 15.6% in the previous year.

Fee-based income of the merchant banks posted a strong growth of 7% to RM350 million, attributed primarily to higher income generated from portfolio management, share placement and loan syndication activities. Fees derived from portfolio management activities recorded a marked increase of 124.7% to amount to RM37.8 million. Although accounting for only 10.8% of total fee-based income of merchant banks, the substantial growth reflected increased awareness and growing acceptance of wealth management products in generating better returns in the prevailing low interest rate environment. The increase in other fee income of 76.3% to RM54 million was driven primarily by several large placements of corporate shares during the year.

The ratio of cost to income rose slightly to 48.8% following increases in both staff cost and overheads. The larger expenses on personnel was reflective of the higher remuneration packages offered to retain

**Table 5.2**
**Banking System[1]: Income and Expenditure**

| | 2003 | 2004*p* | Annual change | |
|---|---|---|---|---|
| | For the calendar year | | | |
| | RM million | | | % |
| Interest income net of interest-in-suspense | 38,123 | 40,612 | 2,489 | 6.5 |
| *(Interest-in-suspense)* | *4,793* | *3,812* | *-981* | *-20.5* |
| Less: Interest expense | 18,943 | 20,385 | 1,442 | 7.6 |
| Net interest income | 19,180 | 20,227 | 1,047 | 5.5 |
| Add: Fee-based income | 3,741 | 4,377 | 636 | 17.0 |
| Less: Staff cost | 5,095 | 5,683 | 588 | 11.5 |
| Overheads | 5,625 | 6,316 | 691 | 12.3 |
| Gross operating profit | 12,201 | 12,605 | 404 | 3.3 |
| Less: Loan loss and other provisions | 4,155 | 4,493 | 338 | 8.1 |
| Gross operating profit after provisions | 8,046 | 8,112 | 66 | 0.8 |
| Add: Other income | 2,131 | 3,699 | 1,568 | 73.6 |
| Pre-tax profit | 10,177 | 11,811 | 1,634 | 16.1 |
| Of which: | | | | |
| Commercial banks | 6,728 | 8,094 | 1,366 | 20.3 |
| Finance companies | 2,644 | 2,739 | 95 | 3.6 |
| Merchant banks | 685 | 866 | 181 | 26.4 |
| Islamic banks | 120 | 111 | -9 | -7.5 |
| Return on assets (%) | 1.3 | 1.4 | | |
| Return on equity (%) | 15.3 | 16.6 | | |
| Cost to income[2] (%) | 46.8 | 48.8 | | |

[1] Includes Islamic banks.
[2] 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.

expertise in light of competition in the market and higher number of staff. With greater emphasis accorded to marketing and promotional activities, a total of 17.2% of overheads incurred for the year was for marketing expenditure compared with 14.3% in 2003.

Despite improving asset quality, total loan loss provisions rose by 5.4% as banking institutions set aside higher allocations for general provision, which increased by RM0.4 billion following expansion in the loan base, and specific provision, which was RM0.1 billion higher as several banking institutions adopted stricter provisioning and classification policies for non-performing loans to further strengthen their balance sheets. The higher provisions were partially mitigated by an increase of RM0.2 billion in recoveries.

### Interest Margin

Interest margin continued to narrow during the year as competition in the loan market continued to exert downward pressure on lending rates, particularly in the retail and SME lending segments. Consequently, interest margin net of expenses and loan loss provisions for the year declined by 21 basis points to 0.38 percentage points.

Gross interest margin (difference between interest income and interest expense, expressed as a percentage of interest-related assets) of the commercial banks and finance companies as a group, declined by 13 basis points to 2.66 percentage points on account of higher interest expense. Interest income remained almost unchanged at 4.78% despite the generally lower lending rates as the loan base expanded. The reduction in lending rates was most apparent in the housing market, where the average first year lending rates fell by as much as 93 basis points to 3.08% per annum in December 2004, with a smaller quantum of decline in the remaining periods to maturity. In addition, average lending rates on new business loans have also remained competitive at 5.64% per annum, whilst that of the SMEs was at 6.20% per annum. With liquidity remaining ample, deposit rates were maintained at low levels. Nonetheless, interest expense as percentage of interest-related assets increased by 13 basis points to 2.12% as the banking system experienced a strong increase in total deposits of 13%.

The commercial banks and finance companies as a group also incurred higher staff-related and overhead expenses largely attributed to better remuneration packages and higher marketing expenses. Expressed as a percentage of interest-related assets, staff cost and overheads totalled 1.54%. Meanwhile, loan loss provisions as a percentage of interest-related assets for the year rose slightly to 0.74% compared with 0.67% in the previous year reflecting the adoption of more prudent strategies in dealing with irrecoverable NPLs.

**Table 5.3**
**Weighted Average Lending Rates for New Loans Approved During the Month**

| | Commercial banks | | Finance companies | |
|---|---|---|---|---|
| | Average for December (% per annum) | | | |
| | 2003 | 2004 | 2003 | 2004 |
| Business loans | 5.72 | 5.64 | 7.18 | 8.06 |
| *of which: SMEs* | *6.30* | *6.20* | *7.17* | *8.04* |
| Household loans[1] | 4.32 | 4.34 | 6.49 | 6.32 |
| *of which:* | | | | |
| *Purchase of residential properties* | *4.01* | *3.08* | *4.09* | *3.13* |
| *Purchase of passenger cars* | *n.a.* | *6.53* | *6.59* | *6.37* |

[1] Excludes credit card loans.
n.a. Not applicable.

## Lending Activity

Lending activities of the banking system remained robust in 2004. The positive sentiments in the household and business sectors, coupled with the conducive interest rate environment, provided an impetus for stronger demand for loans from the private sector during the year. As the main mobiliser of funds in the economy, the banking sector was able to support the increasing lending requirements arising from growth in household consumption and business activities given their strengthened position. The introduction of the New Interest Rate Framework in 2004 also provided greater flexibility for banking institutions to price their financial products more efficiently and effectively, thereby enhancing their ability to structure and customise their banking products to suit the needs of the customers.

**The banking sector was able to support the increasing lending requirements arising from growth in household consumption and business activities given their strengthened position.**

The robust demand for loans was evidenced by the strong growth in loan applications in 2004. During the year, the banking system received loan applications amounting to RM273.3 billion, which was 20.1% higher than the previous year. The average loan approval rate remained strong at 63.5%, with new loans approved growing by 13.6% to RM173.6 billion in 2004. Therefore, the monthly average of new loans approved in 2004 of RM14.5 billion was higher compared to the monthly average of RM12.7 billion recorded in the preceding year. Loan disbursements also expanded by 10.6% to RM488.2 billion during the year, reflecting the higher financing requirements from the private sector to fund their activities. As disbursements surpassed repayments, total outstanding loans rose strongly at an annual rate of 8.5% in 2004. Total holdings of private debt securities (PDS) by the banking institutions declined by 2.7% in 2004. As a result, total financing by the banking sector to support economic activities increased by 7.7% as at end-2004.

**Table 5.4**
**Banking System[1]: Financing Activities**

| | For the year | | Annual growth (%) |
|---|---|---|---|
| | 2003 | 2004 | |
| | RM billion | | |
| Loan approvals | 152.8 | 173.6 | 13.6 |
| Loan disbursements | 441.6 | 488.2 | 10.6 |
| Loan repayments | 430.4 | 461.6 | 7.2 |
| | As at end- | | Annual growth (%) |
| | 2003 | 2004 | |
| | RM billion | | |
| Outstanding loans | 473.8 | 514.0 | 8.5 |
| Total banking system financing[2] | 508.0 | 547.2 | 7.7 |
| Total financing for the economy[3] | 618.4 | 674.0 | 9.0 |

[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.

### *Lending to households*

Reflecting improved household income and consumer sentiment, the pace of private consumption increased during the year, and the banking system continued to channel a significant portion of their financing to this sector. As at end-2004, loans to the household sector represented the largest proportion of loans in the banking sector, accounting for 51.4% of total outstanding loans. In total, outstanding loans to the household sector expanded by 14.4% to RM264.4 billion as at end-2004. Loan applications received from households expanded by 22.1% to RM120.2 billion in 2004, of which 72.2% were approved during the year. Total loan approvals to this sector grew by 20.5% to RM86.8 billion, whilst loan disbursements recorded a corresponding increase of 13.8% to RM130.3 billion in 2004. Despite the high disbursements, unutilised loans within this sector grew by 14.7% to RM67.8 billion as at end-2004. As in the previous years, lending activities within this sector were concentrated in mortgage financing, financing for the purchase of passenger cars and credit cards. The strong growth in loans to this sector was supported mainly by the competitive financing packages offered by banking institutions and the promotional campaigns carried out by the private sector to boost demand.

Within the portfolio of loans to the household sector, the highest proportion of loans was channelled towards the acquisition of residential properties, amounting to RM130.3 billion or 49.3% of total household loans. In line with the Government's effort to promote home ownership, the demand for housing loans continued to remain buoyant to cater for the large supply of mid-range residential properties launched during the year. In 2004, the banking system received RM52.4 billion worth of applications for the purchase of residential properties, 11.7% higher than the preceding year. Loan approvals for the purchase of residential properties rose by 18.8% to RM35.7 billion in 2004, whilst loan disbursements grew by 9.1% to RM38.8 billion. Borrowers were able to benefit from lower average lending rates for these loans which ranged from 3.08% to 3.73% per annum for the commercial banks and 3.07% to 5.08% per annum for the finance companies. As a result, total outstanding loans for the purchase of residential properties grew at an annual rate of between 14.2% to 16.2% throughout the year. Although the level of exposure of the banking institutions to the residential sector has increased more than twofold since 1998, banking institutions are better able to manage the risk arising from these lending activities given their enhanced risk management standards. Banking institutions have also been able to leverage on the Central Credit Reference Information System to determine the credit profile of borrowers, thereby facilitating their credit assessment process.

Loans for the purchase of passenger cars accounted for the second largest proportion of loans to the household sector. As at end-2004, loans to this sector comprised 27.2% of total household loans, recording an increase of 17.2% from RM61.3 billion as at end-2003 to RM71.9 billion as at end-2004. The strong consumer demand for motor vehicles was attributed mainly to renewed interest in demand following the revision of duties on passenger cars with effect from 1 January 2004, a number of new launches of mid-range passenger cars and the promotional activities undertaken by car companies to expand their sales. Loan applications for the purchase of passenger cars grew by 27.4% to RM40.6 billion from RM31.8 billion in 2003. Loan approvals to this sector increased by 17.2% to RM30.4 billion in 2004, whilst loan disbursements remained high at RM29.1 billion in 2004 compared with RM24.5 billion in 2003.

Reflecting the strong demand for consumption loans, outstanding credit card loans also recorded an increase of 16.3% in 2004. Loan approvals for credit cards soared by 26.6% to RM11.7 billion in 2004, whilst utilisation of credit card lines was high, accounting for 32.4% of the total credit lines extended to cardholders. The increase in utilisation is in tandem with the higher number of cards in circulation, which grew by 28.6% to more than 6.6 million cards as at end-2004. Disbursements to this sector also rose by 19.1% to RM36.3 billion in 2004, compared with RM30.5 billion in 2003. Efforts by banking institutions to promote credit cards as a mode of payment were complemented by sound risk management standards to ensure that the risk arising from more aggressive lending to this sector is manageable.

***Lending to businesses***

The improvement in corporate profitability, favourable financing conditions and improved external sector performance in 2004 were strong drivers in encouraging larger private investments in new projects and corporate expansion. Reflecting this, demand for new financing by businesses was higher in 2004. Loan applications received from businesses increased by 20% in 2004, a turnaround from the decline of 7.7% in 2003. The increase was driven by higher applications received from the manufacturing, construction and the wholesale and retail trade sectors, amounting to RM76.2 billion in 2004.

In tandem with higher loan applications, new loans approved to businesses increased by 9.8% to RM84.9 billion, accounting for 48.9% of total new loans approved by the banking system. Nearly 51% or RM43.2 billion of new loans approved to businesses were channelled to the construction, manufacturing and the wholesale and retail trade sectors. In terms of disbursements, 68.7% of total disbursements by the banking system were channelled to the business sector. Loan disbursements to businesses grew by 10.5% to RM335.3 billion in 2004, of which 60.8% were channelled to the manufacturing and the wholesale and retail trade sectors. As disbursements were relatively higher compared with repayments of RM319.8 billion, total outstanding loans to the business sector expanded by 2.6% to RM219.2 billion as at end-2004.

Small and medium enterprises (SMEs) continued to receive strong support from the banking sector. Loans to SMEs accounted for 40.3% of outstanding loans to businesses. Loan approvals were high and accounted for 58.4% of total applications received, whilst loan rejections remained low, constituting 19.1% of total applications received. In 2004, new loans approved increased by 21.9% to RM31.6 billion, to more than 92,000 SMEs. On a monthly average basis, the level of loan approvals amounting to RM2.6 billion per month in 2004 was higher compared to the level achieved in 2003 of RM2.2 billion per month. Concurrently, loan disbursements to SMEs also expanded strongly by 15.3% to RM100.4 billion. Consequently, outstanding loans to SMEs expanded by 7.7% in 2004.

In terms of loans to SMEs by sectors, about 59.3% of outstanding loans to SMEs were channelled to the manufacturing, construction and the wholesale and retail trade sectors. In line with the Government's call to promote businesses involved in business process outsourcing and information technology, total outstanding loans to SMEs involved in the business services sector grew by 27.8% on a monthly average basis in 2004. SME loans to the agriculture, forestry and fishing sectors also recorded strong growth of 24.2% to RM4 billion as at end-2004. With the establishment of the National SME Development Council in August 2004 and the initiatives in the pipeline to strengthen the capacities and competitiveness of the SMEs, access to financing for SMEs will be further enhanced.

In view of the positive response to the special funds, Bank Negara Malaysia further increased the allocation of funds to the Fund for Small and Medium Industries 2 and the New Entrepreneurs Fund 2 by RM2.5 billion and RM850 million respectively during the year. With this, a total of RM8.9 billion has been set aside under the five special funds managed by Bank Negara Malaysia to finance priority sectors. As at end-2004, the outstanding loans in these special funds amounted to RM5.1 billion. Meanwhile, the Special Relief Guarantee Facility which was launched in May 2003 to assist businesses affected by the SARS outbreak was eventually closed in July 2004, following the quick containment of the outbreak and the recovery of the businesses that were affected.

***Financing through the bond market***

The bond market continued to be an important channel for corporations to source funds to meet their financing requirements. In tandem with the buoyant economic performance, the issuance of PDS was sustained at a high level following issuances of debt securities by a few large corporations during the year. In 2004, funds amounting to RM28 billion were raised in the bond market, mainly by the utilities and construction sectors. As a result, outstanding PDS in the market rose by 10.7% to RM160.1 billion as at end-2004. Total financing channelled to the economy, which included lending by banking institutions expanded by 9% to RM674 billion as at end-2004.

**Asset Quality**

Reflecting the strong economic performance underpinned by buoyant business activities and strong consumption, non-performing loans (NPLs) of the banking system declined further in 2004. The net NPL ratio as at end-2004 was at its lowest level since the Asian financial crisis in 1998. Recoveries and reclassifications to performing accounts, supported by lower new NPLs during the year contributed to the large decline in NPLs.

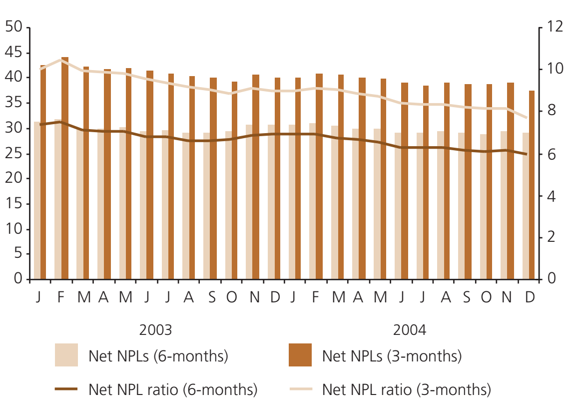
## The net NPL ratio as at end-2004 was at its lowest level since the Asian financial crisis in 1998.

Net NPLs based on the 3-month classification declined by 6.3% to RM37.5 billion as at end-2004. Coupled with the high growth in loan base of 8.5%, the net NPL ratio of the banking sector improved by 1.3 percentage points to 7.6% as at end-2004 (end-2003: 8.9%). Similarly, net NPLs based on the 6-month classification declined by 5.8% to RM29 billion, to account for 5.9% of net loans as at end-2004. The loan loss coverage ratios as at end-2004 strengthened to 53.9% and 59% on a 3-month and 6-month basis respectively. Including the value of collateral, the coverage ratios improved further to 165.3% and 171.8% respectively.

The favourable economic environment increased the capacity of borrowers to service their loans. Better loan repayment capabilities translated into lower classification of loans as new NPLs. During the year, new NPLs amounted to RM23.9 billion, representing a decline of 5% or RM1.3 billion. Recoveries and reclassifications of NPLs, albeit lower by 2.2%, remained strong at RM22.4 billion in 2004. A number of banking institutions capitalised on their strong performance to write-off legacy loans that were deemed uncollectible. Total write-offs during the year were high at RM8.7 billion.

As at end-2004, three CDRC cases had yet to be implemented, with total debts amounting to RM2.4 billion. The other 45 debt restructuring cases with total debts of RM50.1 billion have been successfully implemented in view of the favourable market conditions. The completion of the debt

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



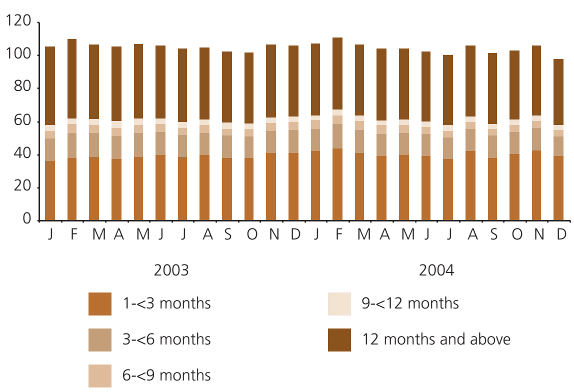

[1] Includes Islamic banks.

**Table 5.5**
**Banking System: Non-performing Loans and Loan Loss Provisions**

| | As at end- | | | |
|---|---|---|---|---|
| | 2003 | | 2004 | |
| | Classification | | | |
| | 3-month | 6-month | 3-month | 6-month |
| | RM million | | | |
| **Banking system** | | | | |
| Non-performing loans | 65,773.8 | 54,797.5 | 60,431.2 | 50,301.7 |
| Interest-in-suspense | 9,344.7 | 8,961.6 | 8,480.5 | 8,101.8 |
| Specific provisions | 16,416.4 | 15,070.2 | 14,473.0 | 13,222.3 |
| General provisions | 9,216.7 | 8,166.2 | 9,643.9 | 8,347.2 |
| Net NPL ratio (%)[1] | 8.9 | 6.8 | 7.6 | 5.9 |
| Total provisions/NPL (%) | 53.2 | 58.8 | 53.9 | 59.0 |
| **Commercial banks** | | | | |
| Non-performing loans | 44,541.6 | 37,562.2 | 46,214.2 | 38,869.3 |
| Interest-in-suspense | 6,201.2 | 6,027.5 | 6,373.1 | 6,093.9 |
| Specific provisions | 11,763.1 | 10,870.5 | 11,460.3 | 10,373.8 |
| General provisions | 6,895.7 | 5,844.6 | 8,414.7 | 7,117.9 |
| Net NPL ratio (%)[1] | 8.1 | 6.3 | 6.8 | 5.3 |
| Total provisions/NPL (%) | 55.8 | 60.5 | 56.8 | 60.7 |
| **Finance companies** | | | | |
| Non-performing loans | 16,025.5 | 12,841.2 | 9,495.5 | 7,423.7 |
| Interest-in-suspense | 2,504.0 | 2,313.6 | 1,491.2 | 1,412.5 |
| Specific provisions | 3,616.5 | 3,205.7 | 2,058.8 | 1,927.2 |
| General provisions | 1,905.6 | 1,906.1 | 829.5 | 829.5 |
| Net NPL ratio (%)[1] | 9.8 | 7.2 | 11.3 | 7.7 |
| Total provisions/NPL (%) | 50.1 | 57.8 | 46.1 | 56.2 |
| **Merchant banks** | | | | |
| Non-performing loans | 3,204.5 | 2,818.6 | 2,568.8 | 2,340.0 |
| Interest-in-suspense | 452.6 | 442.3 | 400.8 | 391.3 |
| Specific provisions | 603.2 | 588.5 | 496.3 | 497.3 |
| General provisions | 240.7 | 240.9 | 235.8 | 235.9 |
| Net NPL ratio (%)[1] | 21.5 | 17.9 | 19.4 | 16.8 |
| Total provisions/NPL (%) | 40.5 | 45.1 | 44.1 | 48.1 |
| **Islamic banks** | | | | |
| Non-performing loans | 2,002.3 | 1,575.6 | 2,152.7 | 1,668.7 |
| Interest-in-suspense | 186.9 | 178.2 | 215.3 | 204.1 |
| Specific provisions | 433.7 | 405.5 | 457.7 | 424.0 |
| General provisions | 174.7 | 174.7 | 163.9 | 163.9 |
| Net NPL ratio (%)[1] | 15.0 | 10.8 | 13.7 | 9.6 |
| Total provisions/NPL (%) | 39.7 | 48.1 | 38.9 | 47.5 |

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

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




[1] Includes Islamic banks.

restructuring process has strengthened the corporations and placed them in a better position to drive economic activities.

Total loans that were in arrears by more than one month declined by 6.5% or RM3.2 billion in 2004. As a percentage of total outstanding loans in arrears, the proportion of arrears in buckets of more than one month declined from 61.1% as at end-2003 to 54.7% as at end-2004. Therefore, loans in arrears by more than one month accounted for 8.9% of total loans as at end-2004 (end-2003: 10.3%).

The improvement in NPLs for the business sector has been broad-based during the year. The improved profitability position of the corporate sector, driven mainly by stronger private consumption and external

**Table 5.6**
**Banking System[1]: Non-performing Loans by Sector**

| | As at end- | | | | |
|---|---|---|---|---|---|
| | NPL by sector | | Change | As percentage of total loans to the sector | |
| | 2003 | 2004 | 2003/2004 | 2003 | 2004 |
| | RM million | | % | | |
| **Business enterprises** | **39,699.2** | **34,597.4** | **-12.9** | **16.3** | **13.6** |
| ***of which SME loans*** | ***11,923.3*** | ***10,569.7*** | ***-11.4*** | ***14.5*** | ***12.0*** |
| **Households** | **17,388.1** | **18,041.5** | **3.8** | **7.9** | **7.2** |
| **Others** | **1,184.2** | **1,086.9** | **-8.2** | **11.0** | **10.8** |
| ***Total*** | ***58,271.5*** | ***53,725.7*** | ***-7.8*** | ***12.3*** | ***10.5*** |
| Agriculture, hunting, forestry and fishing | 781.2 | 678.6 | -13.1 | 7.4 | 6.2 |
| Mining and quarrying | 147.9 | 89.4 | -39.5 | 13.5 | 9.0 |
| Manufacturing | 10,001.4 | 8,615.8 | -13.9 | 16.4 | 13.7 |
| Electricity, gas and water supply | 1,444.4 | 1,299.5 | -10.0 | 28.5 | 25.0 |
| Wholesale and retail trade, restaurants and hotels | 4,633.6 | 4,340.4 | -6.3 | 11.8 | 10.0 |
| *Wholesale trade* | *1,758.2* | *1,623.2* | *-7.7* | *8.0* | *6.4* |
| *Retail trade* | *1,428.1* | *1,250.5* | *-12.4* | *11.7* | *9.5* |
| *Restaurants and hotels* | *1,447.3* | *1,466.6* | *1.3* | *28.9* | *30.4* |
| Broad property sector | 26,641.0 | 26,029.4 | -2.3 | 14.1 | 12.5 |
| *Construction* | *8,178.4* | *7,246.7* | *-11.4* | *27.7* | *23.6* |
| *Purchase of residential property* | *10,122.4* | *11,292.5* | *11.6* | *8.7* | *8.5* |
| *Purchase of non-residential property* | *4,803.9* | *4,347.4* | *-9.5* | *16.7* | *14.0* |
| *Real estate* | *3,536.3* | *3,142.9* | *-11.1* | *25.5* | *22.9* |
| Transport, storage and communication | 1,188.0 | 722.2 | -39.2 | 11.1 | 7.2 |
| Finance, insurance and business services | 2,356.2 | 1,876.4 | -20.4 | 8.1 | 6.1 |
| Consumption credit | 2,641.4 | 2,549.5 | -3.5 | 9.5 | 8.0 |
| *Personal use* | *2,014.3* | *1,848.9* | *-8.2* | *13.3* | *10.7* |
| *Credit cards* | *578.6* | *663.9* | *14.7* | *4.7* | *4.7* |
| *Purchase of consumer durable goods* | *48.5* | *36.8* | *-24.2* | *13.0* | *11.7* |
| Purchase of securities | 3,750.0 | 2,894.3 | -22.8 | 18.9 | 14.9 |
| Purchase of transport vehicles[2] | 2,749.2 | 2,752.4 | 0.1 | 4.2 | 3.7 |
| Community, social and personal services | 752.7 | 791.0 | 5.1 | 15.2 | 15.5 |

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

sector performance, led to stronger repayments and declining NPLs in the business sector throughout the year. NPLs to the business sector declined by 12.9% or RM5.1 billion, to account for 13.6% of total business loans as at end-2004 (end-2003: 16.3%). The improvement was largest for NPLs of the manufacturing sector, which registered a decline of 13.9% or RM1.4 billion as at end-2004. Although the share of NPLs for this sector remained the largest among all business sectors, accounting for 24.9% of total business NPLs, the NPLs for this sector is expected to decline further with continued growth in the manufacturing sector. NPLs for the construction sector also declined by RM0.9 billion to RM7.2 billion in 2004 due mainly to write-offs of large accounts during the end of the year.

In line with the improvement in NPLs for the business sector, NPLs of the SMEs in almost all economic sectors also declined in 2004. NPLs of SMEs recorded an improvement of 11.4% to RM10.6 billion as at end-2004, to account for 12% of total loans of SMEs. In terms of share of SME NPLs to total business NPLs, they accounted for 30.6% of the total NPLs for the business sector. At the sectoral level, NPLs of SMEs were highest in the manufacturing, construction and the wholesale and retail trade sectors, accounting for 58.7% of total NPLs of SMEs. Reflecting the strong performance in the manufacturing sector, NPLs for this sector registered the largest improvement of RM0.4 billion to RM2.7 billion as at end-2004. NPLs for the transport, storage and communication sector also declined by 43.9% or RM0.2 billion due largely to write-offs. NPLs for the real estate sector improved by 21.2% to RM0.7 billion while NPLs for the construction sector declined by 7.6% to RM1.9 billion as at end-2004.

Gross NPLs for the household sector declined to account for 7.2% of total outstanding household loans as at December 2004 (end-2003: 7.9%). Despite the growth in household NPLs by 3.8% to RM18 billion as at end-2004, the magnitude remained small vis-à-vis the stronger growth in household loans of 14.4% during the year. Within the household sector, NPLs for the purchase of residential properties were the largest contributor to household

NPLs, accounting for 62.6% of total household NPLs as at end-2004. NPLs for residential properties grew by 11.6% or RM1.2 billion during the year. Nevertheless, its NPL ratio remained manageable at 8.5% as at end-2004, given the higher rate of increase in loans for residential properties of between 14.2% to 16.2% in 2004. NPLs for credit cards remained small at 4.7% of total credit card loans, whilst the NPL ratio for the purchase of transport vehicles declined to 3.7% as at end-2004 (end-2003: 4.2%). Given the improvements in the performance of the stock market, NPLs for the purchase of securities recorded a large decline of 22.8% or RM0.9 billion as at end-2004, to account for 14.9% of total loans to this sector. While there have been concerns about the risk of over-indebtedness of the household sector, such risk is minimised due to the ability of the banking institutions to access comprehensive credit information of borrowers from the Central Credit Reference Information System and the various risk management infrastructure put in place to strengthen credit risk management standards in banking institutions.

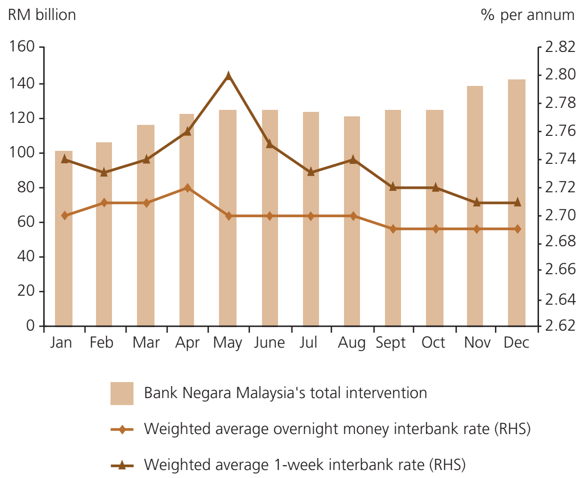
As economic performance is expected to remain buoyant in 2005, NPLs in the banking system are expected to improve further. Strong performance of the corporate sector, supported by continued robust private consumption, will strengthen NPL recoveries and reduce the possibility of new NPLs. Against this backdrop, banking institutions are expected to undertake more aggressive measures to deal with their legacy NPLs, especially in cases where recovery prospects are limited even after taking into account the recoverability of the collateral. In tandem with these efforts, banking institutions are also expected to continuously strengthen their risk management infrastructure in preparation for the implementation of Basel II requirements. With a more sound and robust risk management infrastructure in place and a healthier quality of asset portfolios, banking institutions would continue to be in a strong position to support the lending requirements of the growing economy.

**Liquidity Management**

The sustained large current account surplus of the balance of payments in 2004 led to a further increase in international reserves from RM170.5 billion as at end-2003 to RM253.5 billion as at end-2004. This contributed to high liquidity in the banking system during the year. The resultant excess liquidity in the banking system was mopped up under the liquidity operations conducted by Bank Negara Malaysia to maintain the overnight interbank rate within the 25 basis points around the overnight policy rate of 2.7% per annum. As a result, market intervention in the form of interbank borrowings and issuance of Bank Negara Bills and Negotiable Notes remained high throughout the year, with additional mopping up of liquidity through repo activities undertaken during the last quarter of 2004. By end-2004, Bank Negara Malaysia had mopped up RM142.6 billion of excess liquidity from the banking system as compared with RM95.4 billion as at end-2003. Liquidity management conducted by Bank Negara Malaysia in 2004 has ensured that interest rates remained stable throughout the year. The weighted average overnight interbank rate ranged from 2.69% to 2.72% per annum while the weighted average one week interbank rate ranged from 2.71% to 2.80% per annum.

In relation to the liquidity management by banking institutions, the banking system as a whole had sufficient liquidity to meet any unexpected withdrawals for a period of up to one month. The projected

**Graph 5.3**
**Liquidity in the Banking System[1] in 2004**




[1] Includes Islamic banks.

**Table 5.7**
**Banking System: Liquidity Projection as at 31 December 2004**

| | Cumulative mismatch (RM billion) | | Buffer as % of total deposits | |
|---|---|---|---|---|
| | 1 wk. | 1 mth. | 1 wk. | 1 mth. |
| Commercial banks | 64.9 | 99.9 | 14.5 | 22.4 |
| Finance companies | 4.2 | 4.7 | 10.7 | 12.0 |
| Merchant banks | 6.7 | 9.4 | 39.7 | 56.0 |
| Islamic banks | 4.0 | 5.7 | 20.4 | 28.9 |
| **Banking system** | **79.7** | **119.7** | **15.3** | **22.9** |

cumulative liquidity surplus of the banking system as at end-2004 was RM79.7 billion to meet demands of up to one week and RM119.7 billion to meet demands of up to one month. Commercial banks, finance companies, merchant banks and Islamic banks recorded projected surpluses in the one-month bucket amounting to 22.4%, 12%, 56% and 28.9% of their total deposit base respectively.

**Interest Rate Risk**

Exposure of the banking system to interest rate risk (inclusive of price risk of Islamic type exposures) is assessed using the duration-weighted net position (DWP) approach. In 2004, the DWP approach was further refined to better reflect the economic value changes of interest rate sensitive positions, taking into account their cash flow payment structures. Applying the refined DWP approach, the level of interest rate risk in the banking system in 2004 remained manageable. Expressed as a percentage of capital base, the banking system's DWP increased marginally to 5% as at end-2004.

A significant portion of the banking system's interest rate risk was concentrated in the more than three years maturity bucket due principally to an increase of 22% in fixed rate loans with remaining maturities of over three years. This increase reflects primarily hire-purchase receivables and Islamic loans that rose by RM5 billion and RM7 billion respectively during the year.

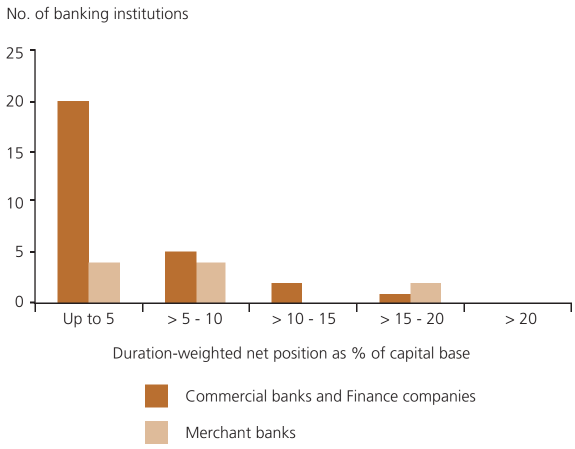
A key measure introduced to address the banking system's interest rate risk associated with fixed rate loans, was the amendment to the Hire-Purchase Act 1967, which was passed by the Parliament in 2004. The amendment allows banking institutions to price their hire-purchase loans based on a variable rate basis. Furthermore, the increased use of Islamic variable rate financing under the concept of *bai' bithaman ajil* (deferred payment sale) which was introduced in 2003, has allowed banking institutions to mitigate their exposures to fixed rate products typical of Islamic financing. Another significant measure allowing the interest rate risk associated with the funding and lending structures of stand-alone finance companies to be better managed was the amendment of the Banking and Financial Institutions Act 1989 to facilitate the merger of the commercial bank and the finance company within a banking

**Table 5.8**
**Banking System[1]: 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- | | | | | |
| | 2003[2] | 2004 | 2003 | 2004 | 2003 | 2004 |
| Commercial banks and Finance companies | -2,898 | -3,398 | -4.4 | -4.7 | -1.0 | -1.0 |
| Merchant banks | -475 | -397 | -10.2 | -8.2 | -3.8 | -4.1 |
| Banking system[1] | -3,373 | -3,795 | -4.8 | -5.0 | -1.1 | -1.1 |

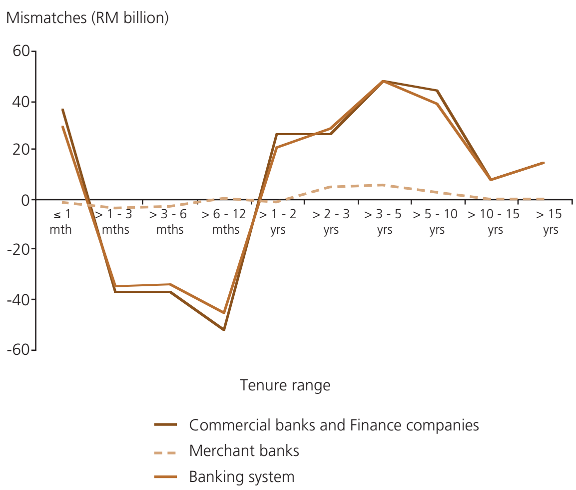
[1] Excludes Islamic banks but includes price risk of Islamic type exposures.
[2] Figures have been adjusted with the application of the refined DWP approach.
Note: Total may not add-up due to rounding.

**Graph 5.4**
**Banking System[1]: Distribution of Duration-weighted Net Position as a Percentage of Capital Base as at 31 December 2004**




[1] Excludes Islamic banks but includes price risk of Islamic type exposures.

**Graph 5.5**
**Banking System[1]: Net Interest Rate Position Mismatches as at 31 December 2004**



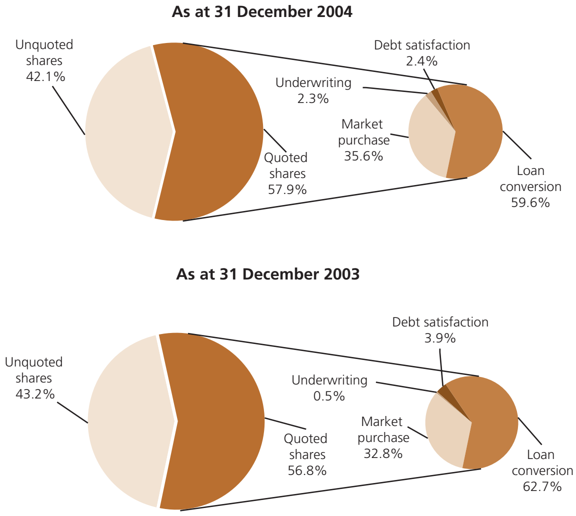

[1] Excludes Islamic banks but includes price risk of Islamic type exposures.

**Table 5.9**
**Banking System[1]: Impact of Trading Book Interest Rate Risk on Capital Strength as at 31 December 2004**

| | RM million | | Total interest rate risk/Capital base (%) | |
|---|---|---|---|---|
| | Interest rate risk | | | |
| | 2003 | 2004 | 2003 | 2004 |
| Commercial banks and Finance companies | 1,007 | 994 | 1.6 | 1.3 |
| Merchant banks | 644 | 504 | 14.3 | 10.5 |
| Banking system[1] | 1,651 | 1,498 | 2.4 | 1.9 |

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

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




[1] Includes Islamic banks.

group. However, given that it was only recently implemented, the full benefits of the merger, in terms of the potential reduction in interest rate risk within the banking system is yet to be fully realised.

With the mergers, some of which were implemented during 2004, the analysis of interest rate risk of the commercial banks and finance companies was based on their combined statistics. As a group, their DWP recorded an increase of 17% to RM3.4 billion as at end-2004. The rise in DWP of the commercial banks and finance companies as a group, was attributed to a significant increase in fixed rate loans with remaining maturity of more than three years. The merchant banks, however, recorded a decline of 16% in their DWP in 2004, following a contraction in their holding of long-term debt securities with remaining maturities of more than three years.

In September 2004, consistent with the Basel Committee on Banking Supervision (BCBS)'s recommendation, Bank Negara Malaysia issued the Market Risk Capital Adequacy framework for implementation. The framework requires market risk to be incorporated into the capital adequacy framework. For the banking system, the major source of market risk in the trading book is interest rate risk. In 2004, interest rate risk declined by 9% to RM1.5 billion or 1.9% of capital base. The reduction in interest rate risk was due primarily to banking institutions taking advantage of the improved bond market in 2004 by reducing their bond holdings.

### Equity Risk

The overall exposure of the banking system to equity risk remained insignificant, with equity investments representing only 0.4% of the banking system's total assets as at end-2004. Equity investments by banking institutions fell by 9.9%, from RM3.4 billion as at end-2003 to RM3.1 billion as at end-2004. Banking institutions took advantage of the improved stock market performance in the first and last quarter of 2004 to sell down the shares acquired from debt restructuring activities in previous years.

During the year, the banking system's investments in quoted shares fell by 8.1% to RM1.8 billion as at end-2004 from RM1.9 billion as at end-2003. Of the overall decline in investment in quoted shares, the holding of quoted shares arising from the conversion of loans into equity declined by RM153.7 million or 12.7% while shares purchased directly from the

**Graph 5.7**
**Banking System: Distribution by Equity as a Percentage of Capital Base as at 31 December 2004**

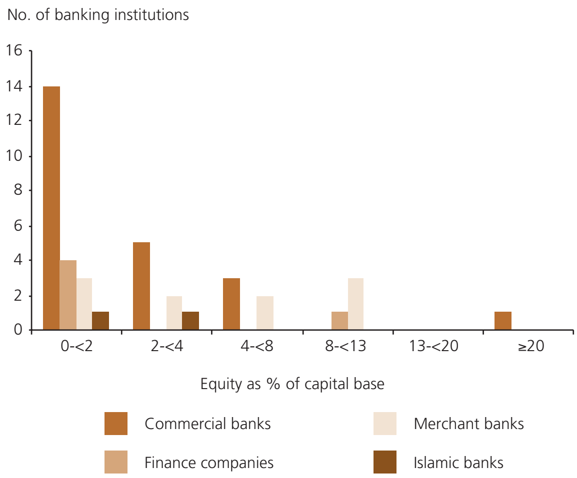


**Table 5.10**
**Banking System: Equity Exposure**

| | Equity[1] holdings (RM million) | | Equity[1]/ Capital base (%) | | Potential equity[1] loss/ Capital base (%) | |
|---|---|---|---|---|---|---|
| | As at end- | | | | | |
| | 2003 | 2004 | 2003 | 2004 | 2003 | 2004 |
| Commercial banks | 1,071.6 | 1,067.0 | 2.0 | 1.6 | 0.1 | 0.1 |
| Finance companies | 427.8 | 357.2 | 3.7 | 6.7 | 0.3 | 0.5 |
| Merchant banks | 402.3 | 320.8 | 8.6 | 6.7 | 0.7 | 0.5 |
| Islamic banks | 35.2 | 34.8 | 2.2 | 1.8 | 0.2 | 0.1 |
| Banking system | 1,936.9 | 1,779.7 | 2.7 | 2.3 | 0.2 | 0.2 |

[1] Amount of investment in quoted shares.

market registered a decrease of RM1.9 million or 0.3% during the year. Similarly, restructuring activities during the year that involved a major conversion of unquoted shares into bonds had resulted in a decrease in total investments in unquoted shares of the banking system by 12.3% to RM1.3 billion as at end-2004 from RM1.5 billion as at end-2003.

Within the banking system, the decline in equity holdings in 2004 was reflected across the different categories of banking institutions. The merchant banks as a group, recorded the highest percentage decline of 17.4% despite an increase in shares held as a result of underwriting. This was followed by the finance companies (-15.4%), commercial banks (-6.5%) and Islamic banks (-4.9%). Despite the relatively significant percentage decline in equity holdings of the merchant banks and finance companies in 2004, as a group, they had a relatively higher ratio of quoted shares to capital base at 6.7%. The commercial banks and the Islamic banks' holdings of quoted shares to capital base were only 1.6% and 1.8% respectively. In terms of individual banking institution, most banking institutions had less than 2% of their capital base exposed to equity risk.

Based on a 10-day volatility of the Kuala Lumpur Composite Index in 2004, the potential maximum loss in equity value for the banking system as a whole was slightly lower at 7.7% as at end-2004 compared to 7.9% as at end-2003. This represented merely 0.2% of the capital base of the banking system.

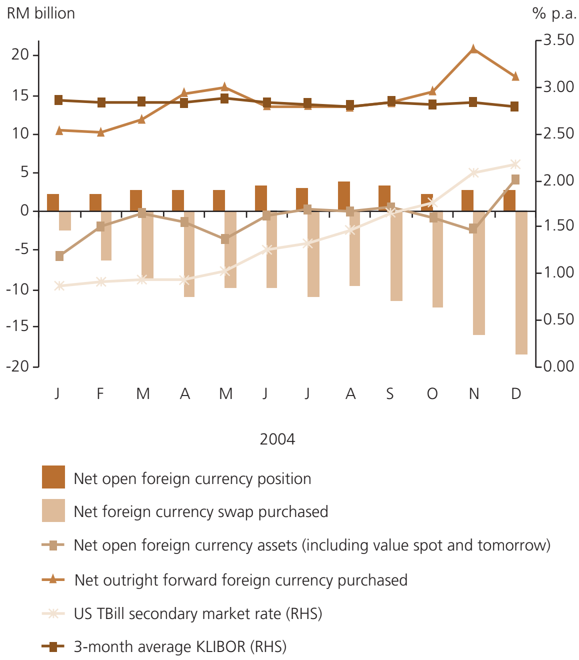
**Table 5.11**
**Banking System: Foreign Currency Exposure**

| | NOP (RM million) | | NOP/Capital base (%) | |
|---|---|---|---|---|
| | As at end- | | | |
| | 2003 | 2004 | 2003 | 2004 |
| Commercial banks | 2,622 | 2,928 | 4.9 | 4.5 |
| Merchant banks | 50 | 48 | 1.1 | 1.0 |
| Islamic banks | 35 | 34 | 2.1 | 1.7 |
| Banking system | 2,707 | 3,010 | 4.5 | 4.2 |

**Foreign Exchange Risk**

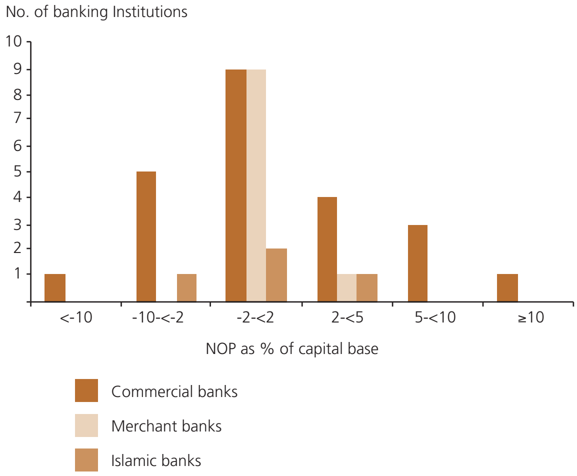
The significant increase in the foreign currency assets of the banking system in 2004 was attributed to the continued repatriation of export earnings and inflows of foreign funds for portfolio and direct investment. However, the foreign currency risk undertaken by the banking institutions remained within prudential levels, as the banking system's net open position (NOP) as a percentage of capital base registered a decline from 4.5% as at end-2003 to 4.2% as at end-2004.

**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 2004**




To manage their long foreign currency positions, banking institutions placed out the funds in the foreign currency interbank money market, resulting in an increase in interbank foreign currency placements from RM17 billion as at end-2003 to RM34 billion as at end-2004. This was complemented by an increase of RM4.4 billion or 41% in foreign currency loans extended in 2004. Foreign currency liabilities also trended up as banking institutions engaged in currency swaps to hedge their foreign currency forward purchases.

Although the forward premiums in the foreign currency forward market narrowed considerably from 55 basis points to 12 basis points, there was strong demand from exporters to sell foreign currency forward contracts in 2004. As a result, banking institutions' foreign currency forward contracts purchased from domestic non-bank entities rose from RM17 billion as at end-2003 to RM34 billion as at end-2004. The strong demand from exporters to sell foreign currency forward contracts may be attributed to their need to hedge their foreign currency exposures in an environment of increasing exports, which rose by 24% during the year, and heightened speculation by the market that the ringgit would be revalued upwards against the US dollar. This contributed to the overall increase in foreign currency forward contracts purchased by banking institutions from RM21 billion as at end-2003 to RM38 billion as at end-2004. As a result of managing the significant increase in foreign currency forward contracts purchased, foreign currency swaps payable rose by RM27 billion to RM51.8 billion.

The banking system is expected to remain a net foreign exchange forward purchaser in an environment with the interest rate differential between the US dollar and ringgit remaining positive.

### Capital Strength

The banking system remained well-capitalised, with risk-weighted capital ratio (RWCR) and core capital ratio sustained above 13% and 10% respectively throughout the year. The capital base increased by RM6.6 billion to RM78.1 billion as at end-2004. The major contributor to the higher capital base was capital raising exercises by several banking institutions that amounted to RM4.2 billion, of which RM3.3 billion was raised through the issuance of US dollar-denominated subordinated debt papers. Audited profits contributed another RM1 billion. Meanwhile, the risk-weighted assets of the banking system grew by RM47.6 billion or 9.2% to RM566.6 billion as at end-2004 due to higher financing activities. Overall, the RWCR of the banking system remained at 13.8% as at end-2004.

**Table 5.12**
**Banking System: Constituents of Capital**

| | As at end- | | Annual change | |
|---|---|---|---|---|
| | 2003 | 2004 | | |
| | RM million | | RM million | (%) |
| Tier-1 capital | 62,727.3 | 61,669.1 | -1,058.2 | -1.7 |
| Tier-2 capital | 19,410.6 | 23,734.1 | 4,323.5 | 22.3 |
| Total capital | 82,137.9 | 85,403.2 | 3,265.3 | 4.0 |
| *Less:* | | | | |
| Investment in subsidiaries and holdings of other banking institutions' capital | 10,604.9 | 7,296.3 | -3,308.6 | -31.2 |
| Capital base | 71,533.0 | 78,106.9 | 6,573.9 | 9.2 |
| Risk assets: | | | | |
| 0% | 177,443.2 | 210,372.2 | 32,929.0 | 18.6 |
| 10% | 17,256.3 | 14,669.8 | -2,586.5 | -15.0 |
| 20% | 120,995.7 | 121,059.9 | 64.2 | 0.1 |
| 50% | 120,545.1 | 136,405.0 | 15,859.9 | 13.2 |
| 100% | 432,769.7 | 472,700.3 | 39,930.6 | 9.2 |
| Total risk-weighted assets | 518,967.0 | 566,581.8 | 47,614.8 | 9.2 |
| Risk-weighted capital ratio (%) | | | | |
| **Banking system** | **13.8** | **13.8** | **0.0** | |
| Commercial banks | 14.1 | 13.9 | -0.2 | |
| Finance companies | 11.6 | 10.2 | -1.4 | |
| Merchant banks | 19.2 | 21.9 | 2.7 | |
| Islamic banks | 11.7 | 12.5 | 0.8 | |

Note: Total may not add-up due to rounding.

Tier-1 capital of the banking system declined marginally due to rationalisation of capital arising from mergers between commercial banks and finance companies (Bafin mergers). This, together with a higher increase in risk-weighted assets, resulted in the core capital ratio declining marginally to 10.8% as at end-2004 (end-2003: 11.1%). Meanwhile, total Tier-2 capital increased significantly due to capital raising exercises by several banking institutions. As a result, total capital increased by 4% and, together with a lower capital deduction for investment in subsidiaries following completion of the Bafin mergers, this caused the capital base to increase by 9.2%.

The RWCR of commercial banks declined marginally to 13.9% as at end-2004, as the increase in risk-weighted assets outpaced the expansion of capital base following lower capital deduction for investment in subsidiaries and issuance of subordinated debt papers. The RWCR of the finance companies declined to 10.2% due to the exclusion of the capital base of the five finance companies that had merged with the commercial banks. The RWCR of the merchant banks increased to 21.9% due mainly to the reduction in risk-weighted assets caused by a decline in the loan base as the merchant banks wind-down their loan activities to focus on investment banking and fee-based activities.

Total risk-weighted assets of the banking system increased by 9.2% to RM566.6 billion as at end-2004, in tandem with higher loan growth during the year. The increase in the 0% category was due mainly to Bank Negara Malaysia's liquidity operations, whilst continued expansion in mortgage financing and lending to the private sector contributed to higher growth in the 50% and 100% categories respectively.

With strong level of capitalisation, the banking system is well positioned to meet the demands for financing to support economic growth and any unexpected shocks in 2005.