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

Moving Forward

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

Banking Measures Introduced in 2005

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

Enhancing Safety and Soundness of the Banking System

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

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

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

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

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

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

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

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

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

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

Promoting Competition and Efficiency within the Banking Sector

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

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

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

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

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

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

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

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

❏ ***Guidelines on Investment Banks***

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

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

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

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

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

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

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

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

Enhancing Consumer Protection

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

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

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

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

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

PERFORMANCE OF THE BANKING SYSTEM

Overview

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

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

Profitability

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