has been very valuable to the Bank in facilitating its efforts to undertake effective consolidated supervision of banking institutions. In this context, Bank Negara Malaysia carried out nine examinations of overseas branches and subsidiaries of domestic banks. The assessment of the financial and general conditions of these entities was discussed with the respective host supervisory agencies to identify any common issues of concern and facilitate their resolution. The Bank also jointly conducted two examinations on offshore subsidiaries of domestic banks with the Labuan Offshore Financial Services Authority (LOFSA).

Bank Negara Malaysia is committed in its role in preserving the safety and soundness of the banking system through effective bank supervision. In the Bank's pursuit towards this objective, efforts will continue to be directed at strengthening our supervisory resources and processes. These efforts include a more intensive training in specialized areas of expertise, developing specialists in core banking operations, closer co-operation with other regulatory and supervisory agencies, and international bodies, as well as automation of work processes to achieve greater efficiency.

Banking Measures Introduced in 2003

Measures implemented in 2003 were aimed primarily at enhancing the efficiency, competitiveness and soundness of the financial sector. Initiatives were also taken to improve access of businesses, in particular the small and medium enterprises (SMEs), to financing. Institutional arrangements to strengthen consumer protection and to increase the awareness of consumers were also introduced.

Measures to Enhance Safety and Soundness

Guidelines on the Establishment of Board Committees, Minimum Qualifications and Training Requirements for Directors and Definition and Responsibilities of Independent Directors
The Guidelines were issued in May 2003 as part of Bank Negara Malaysia's continuous efforts to enhance the corporate governance standards among the licensed institutions. The Guidelines outlined the following:

- The requirement on the establishment of board committees comprising nominating committee, remuneration committee and risk management committee, and the terms of reference for each of the committee. The main objectives of the committees are as follows:
  Nominating Committee
  To provide formal and transparent procedures for the appointment of directors and chief executive officer and assessment of effectiveness of individual directors and board as a whole and performance of chief executive officer and key senior management officers.
  Remuneration Committee
  To provide formal and transparent procedures for developing remuneration policy for directors, chief executive officer and key senior management officers and ensuring that compensation is competitive and consistent with the licensed institution's culture, objectives and strategy.
  Risk Management Committee
  To oversee senior management's activities in managing credit, market, liquidity, operational, legal and other risks and to ensure that the risk management process is in place and functioning effectively.

- To ensure that only qualified individuals are appointed to serve on the boards of licensed institutions, the Guidelines set out the minimum qualifications and continuous learning requirements for the directors.

- Recognising the critical role played by independent directors in corporate governance, the Guidelines also set out the definition of independent directors and their expected roles and responsibilities.

Auditor's Independence and Appointment of External Auditors
A number of corporate scandals overseas, which involved irregularities in accounting practices, issues on auditors' independence and the role of auditors, have raised the concerns of various regulators

worldwide. In this regard, Bank Negara Malaysia issued Guidelines on the Appointment of External Auditor by licensed institutions which cover:

- The imposition of mandatory rotation of engagement partner after a period of 5 years. The engagement partner relinquishing the assignment would not be allowed to resume the role of audit engagement partner for the licensed institution until after a period of 5 years has lapsed;
- Provision of non-audit services by the same audit firm would require the prior approval of the respective licensed institution's Audit Committee; and
- The approval for the re-appointment of external auditors by Bank Negara Malaysia on an annual basis. There should not be any compromise on auditor's independence in the interim period before the 5 years rotation requirement takes effect.

Prudential Standards on Asset-Backed Securitisation

Although significant benefits could be derived from securitisation activities, participation of banking institutions in securitisation activities could potentially increase the overall risk profile of the institutions. In this regard, Bank Negara Malaysia has issued the Prudential Standards on Asset-Backed Securitisation Transactions which outline the general risk management framework as well as specific regulatory treatment relating to asset-backed securitisation transactions undertaken by banking institutions. The Prudential Standards were issued on 10 March 2003.

Credit Card Guidelines

The Guidelines were issued in March 2003 to all credit card issuers. The Guidelines were intended to promote active consumerism and consumers' understanding of credit card usage and protecting their interest as card users.

The Guidelines specify the minimum requirements on credit card operations that need to be complied with by all credit card issuers. Among others, the Guidelines set the following:

- Minimum eligibility criteria on credit card application.
- RM250 limit as the cardholders' liability for unauthorised transactions as a consequence of lost and stolen credit cards.
- Barring of credit card usage for unlawful activities.
- The requirement for credit card issuers to undertake prudent credit assessment and verification of credit worthiness of the card applicants using the Central Credit Reference Information System (CCRIS) and other sources of credit information.

Migration to Chip-based Automated Teller Machine (ATM)

In an effort to enhance the security of payment cards, banking institutions were required to migrate to chip-based payment card technology. The domestic banking institutions were required to fully upgrade their ATM infrastructure to be fully chip-enabled and convert their customers' ATM card to chip-based by end-September 2003, and the locally incorporated foreign banks, by March 2004.

Minimum Security Standards for Cheques

A concept paper on the proposed Guidelines on Minimum Security Standards for Cheques was issued to the banking industry in November 2003. The proposed Guidelines set the minimum standards for security features on cheques, cheque fraud detection facility, security management in cheque printing and consumer advice on best practices.

Accounting Treatment of Handling Fees for Hire Purchase Loans (HPL)

To standardise the accounting treatment of handling fees for HPL across the finance company industry, all handling fees for HPL approved and disbursed after 1 January 2004 by finance companies have to be expensed off in the period they are incurred. For HPL approved and disbursed before

1 January 2004 where the amortisation method had been adopted, finance companies were allowed to continue amortising the outstanding handling fees. Accordingly, in the event of prepayment or the HPL turning non-performing, the balance of the unamortised handling fees would be expensed off.

Recognition of Deferred Tax Assets (DTA) and Treatment of DTA for Risk Weighted Capital Ratio (RWCR) Purposes

In line with MASB 25 which was issued by the Malaysian Accounting Standards Board (MASB), licensed institutions had to account for all DTA in their financial reports. For RWCR purposes, however, such deferred tax income or expense is excluded from the computation of Tier-1 capital and calculation of risk-weighted assets.

Concept Paper on Incorporation of Market Risk into the RWCR Framework

In April 2003, the first concept paper (CP1) on the incorporation of market risk into the RWCR Framework was issued to the industry for comments. CP1 adopted and customised recommendations issued by the Basel Committee on Banking Supervision (BCBS) according to the environment of the local banking industry.

Following a series of discussions with the Market Risk Industry Working Group, the second concept paper (CP2) was issued in January 2004. CP2 incorporated significant changes to CP1, in particular on the following areas:

- Classification of securities in the trading and banking book;
- Holdings of securities resulting from debt/loan restructuring;
- Hedging policy;
- Underwriting positions; and
- Valuation of illiquid papers.

CP2 also aims to gauge the level of readiness for incorporation of the revised market risk framework and assess the quantitative impact of the latest proposal on the financial institutions.

Concept Paper on Consolidated Supervision of Financial Conglomerates

In line with Recommendation 3.26 of the Financial Sector Masterplan (FSMP), Bank Negara Malaysia has developed a framework for the Consolidated Supervision of Financial Conglomerates. This is to ensure that the financial health of financial groups may be adequately assessed and monitored by supervisors on a group-wide basis so as to minimise risks emanating from the financial group that could destabilise the financial system.

A concept paper was issued to the banking industry in December 2003. The proposed framework outlines the underlying regulatory principles of consolidated supervision. Specific recommendations were made in five areas, namely group structures, corporate governance, risk management, intra-group exposures, and reporting requirements.

Implementation of the Anti-Money Laundering Act 2001 (AMLA) Compliance Programme

To combat money laundering activities, banking institutions were required to put in place a comprehensive compliance programme to comply with AMLA. The compliance programme includes an effective transaction monitoring system that is implemented at all operations of banking institutions including the branches and subsidiaries. There should also be regular on-going employee training and regular independent audit.

Measures to Enhance Competition and Efficiency of the Banking Industry

Guidelines on New Product Approval Requirements

The Guidelines were issued in March 2003 as part of the measures to promote Bank Negara Malaysia's regulatory philosophy of "what is not prohibited is allowed" as stated in the FSMP. The main essence of the Guidelines is the replacement of the existing product pre-approval requirements with a simple new product notification and approval process that is expected to promote greater incentive for banking institutions to increase their investment in developing more innovative products. The requirements for greater product transparency and consumers to have access to product information are embodied in the Guidelines.

Investments Linked to Derivatives

Effective 12 May 2003, banking institutions were allowed to offer additional yield enhancing investment products linked to derivatives, other than investments linked to Ringgit denominated interest rate derivatives. Blanket approval was granted to all banking institutions to offer the following additional investment products linked to derivatives:

- Investment products linked to interest rate, commodity, equity and fixed income derivatives, denominated in both Ringgit and foreign currency; and
- Investment products linked to foreign currency derivatives denominated in foreign currency only.

Nevertheless, banking institutions are required to meet the general conditions when offering investment products linked to derivatives and comply with all exchange control rules. However, investment products linked to credit derivatives would still require specific approval from Bank Negara Malaysia.

Amendments to the Central Bank of Malaysia Act 1958 (CBA) and Banking and Financial Institutions Act 1989 (BAFIA)

Both the CBA and BAFIA were amended to incorporate provisions to support the efforts to develop the bond market and to enhance competitiveness and efficiency of the banking industry. The amendments came into force on 1 January 2004 for the CBA and 15 January 2004 for the BAFIA.

The CBA was amended, among others to empower Bank Negara Malaysia to carry out its functions in providing the infrastructure for the Ringgit bond market, including the power to establish and operate systems for the bond market and to make the necessary regulations for the operation of the systems.

The BAFIA was amended to provide for the establishment of a banking and finance company, an entity which will hold two licences, one for banking business and the other for finance company business.

Measures to Improve Access to Financing

Establishment of Bank Negara Malaysia SME Special Unit

As part of the initiatives to enhance access to financing to SMEs, Bank Negara Malaysia established the SME Special Unit in May 2003 to assist SMEs in the following areas:

- To provide information on the various sources of financing for SMEs;
- To facilitate loan application process for SMEs;
- To deal with problems faced by viable SMEs in accessing financing; and
- To provide advisory services on other SMEs financial requirements.

The role of the SME Special Unit will be expanded to include:

- Coordinating, monitoring and evaluating the financing needs of the SMEs;
- Formulating policies and strategies to enhance access to financing by SMEs;
- Establishing and maintaining database on SME financing;
- Enhancing SMEs awareness on various financing sources; and
- Formulating structured training programmes for SMEs.

Additional Allocation for Special Funds for SMEs

As part of efforts to ensure availability of adequate funds at reasonable cost to the SMEs, Bank Negara Malaysia increased the allocation, twice in 2003 for Fund for Small and Medium Industries 2 (FSMI2) and the New Entrepreneurs Fund 2 (NEF2) by RM1,350 million and RM650 million, respectively. Consequently, the total funds available for FSMI2 and NEF2 rose to RM2 billion and RM1.15 billion respectively.

Small Debt Resolution Mechanism

To facilitate the restructuring of non-performing loans (NPLs) of SMEs with on-going businesses and to assist in their financing requirements, Bank Negara Malaysia established a Small Debt Resolution Mechanism in November 2003.

Under the mechanism, an 11-member Small Debt Resolution Committee (SDRC) was established to undertake independent assessment on the viability of the businesses, and propose the loan restructuring and financing requirements of the affected businesses. The SME Special Unit at Bank Negara Malaysia serves as the Secretariat to the committee.

This mechanism is open to SMEs with on-going businesses which have aggregate NPLs of not more than RM3 million with the commercial banks, finance companies, Islamic banks, Bank Pembangunan dan Infrastruktur Malaysia Berhad, and Bank Industri & Teknologi Malaysia Berhad.

As the debt restructuring process may involve the provision of new financing to the businesses, Bank Negara Malaysia established the Rehabilitation Fund for Small Businesses with an allocation of RM800 million. In this regard, eligible businesses may obtain new financing up to RM1.5 million at a financing rate of 5% per annum for a maximum of 5 years.

With the introduction of this new mechanism, the existing restructuring and financing mechanisms under Tabung Pemulihan dan Pembangunan Usahawan, and Tabung Pemulihan Industri Kecil dan Sederhana were discontinued.

Access to Financing by Priority Sectors

As in previous years, Bank Negara Malaysia continued to place due emphasis on lending by the commercial banks and finance companies to the priority sectors, namely the Bumiputra community, SMEs and purchase of low and medium cost houses. Targets set were based on various factors taking into consideration the capacity of the respective institutions.

Establishment of a Special Relief Guarantee Facility for Severe Acute Respiratory Syndrome (SARS) Affected Businesses

As part of the Economic Package announced by the Government in May 2003 to assist businesses affected by the SARS outbreak, Bank Negara Malaysia established the Special Relief Guarantee Facility with an allocation of RM1 billion in the form of guarantee fund provided through the Credit Guarantee Corporation Malaysia Berhad (CGC).

The salient features of the Facility are as follows:

- The Facility is implemented through all commercial banks, Islamic banks, finance companies, Bank Pembangunan dan Infrastruktur Malaysia Berhad and Bank Industri & Teknologi Malaysia Berhad;
- The maximum loan amount allowable under the facility is RM2.5 million for a maximum tenure of 2 years;
- The financing rate is capped at 3.75% p.a for the first year and not more than the 3-month KLIBOR rate plus 1 percentage point for the subsequent year; and
- CGC will guarantee 80% of the loans taken from the implementing institutions.

Financial Relief Provided by Banking Institutions to Borrowers in SARS-affected Industries

In response to the SARS outbreak, banking institutions were also requested to formulate appropriate rescheduling or restructuring schemes to reduce the financial burden of borrowers whose businesses and cash-flows were affected by the SARS. The rescheduling/restructuring programme should be implemented on a pre-emptive manner.

To facilitate this measure, the requirement stipulated in the Guidelines on Classification of Non-Performing Loans and Provisions for Sub-Standard, Doubtful and Bad Debts that requires banking institutions to obtain specific approval from Bank Negara Malaysia to reschedule a performing loan account more than once within a 2-year period, was waived.

Measures Related to Consumerism

BankingInfo

To promote greater financial literacy among the public and enhance public understanding of the roles and functions of the different segments in the financial system, Bank Negara Malaysia launched the Consumer Education Programme (CEP), known as "BankingInfo" in January 2003.

In summary, BankingInfo aims to:

- Disseminate information on features of banking products and services, including the rights and responsibilities of consumers and financial institutions in a clear and simple manner;
- Promote public understanding on the role and functions of the different segments in the financial system;
- Alert consumers on illegal transactions and financial scams;
- Provide information on basic financial management and importance of savings and financial planning; and
- Provide consumers with information on how they can seek redress in the event that they have suffered monetary losses.

To date, 18 booklets have been introduced and are available at all branches of banking institutions. Information on BankingInfo is also available at the Internet website www.bankinginfo.com.my.

Formation of Financial Mediation Bureau (FMB)

In line with Recommendation 3.37 of the FSMP, a concept paper on the Formation of the Financial Mediation Bureau (FMB) with the objective of expanding the current role of both the Banking Mediation and Insurance Mediation Bureaus was issued in April 2003.

The members of FMB will comprise:

- Commercial banks, finance companies, merchant banks, and Islamic banks;
- Development financial institutions regulated under the Development Financial Institutions Act 2002;
- Payment systems operators and issuers of designated payment instrument under the Payment Systems Act 2003; and
- Insurance companies, Takaful operators and Malaysian Nasional Reinsurance Berhad.

The formation of the FMB is expected to facilitate the financial institutions in enhancing their customer service level and would cover a broad range of retail consumer complaints against all financial institutions regulated by Bank Negara Malaysia.