

Transformation of the Financial Sector

The Malaysian financial system and landscape have undergone a major transformation in this recent decade. These changes have included financial and regulatory reforms and financial infrastructure development, thus paving the way for a more robust, diversified and efficient financial sector today. Much of the transformation of the Malaysian financial sector was attributed to significant strides made in the bond market and the significant advancements made in Islamic finance. In addition, the progressive liberalisation and deregulation, industry consolidation and technological advancements have also resulted in new delivery channels, wider range and diversity of products and services, and emergence of new non-traditional players in the domestic financial sector. The maintenance of financial stability under such a dynamic environment has, therefore, become increasingly complex and challenging.

Much of the transformation of the Malaysian financial sector was attributed to significant strides made in the bond market, Islamic finance, progressive liberalisation and deregulation, industry consolidation and technological advancements.

In meeting the challenges, the policy thrust adopted by Bank Negara Malaysia in 2006 continued to be directed towards preserving the stability by supporting and strengthening institutional transformation, promoting an efficient and effective financial infrastructure, facilitating financial market development and promoting a balanced and effective regulatory and supervisory environment that fosters the development of a progressive, dynamic and resilient financial system. Emphasis was also given to further enhance financial inclusion to

ensure access to a wider choice of services to all levels of society.

INSTITUTIONAL TRANSFORMATION

In the continuously evolving financial landscape, the year 2006 saw further progress being made towards rationalising the domestic financial institutions following the completion of several mergers and consolidation among market intermediaries in the banking, insurance and capital market sectors, as well as the commencement of business by new licensees in the Islamic banking and takaful sectors.

The investment bank framework in particular, achieved a significant milestone during the year with almost all of the entities involved completing the transformation process. The framework, which provides for the development of full-fledged investment banks through consolidation and rationalisation between several entities (nine merchant banks, nine stockbroking companies, five discount houses and three universal brokers), saw all of the eligible entities obtaining the necessary approvals to transform into 12 investment banks. Nine financial groups with merchant banks, stockbroking companies and discount houses have completed the legal transformation and commenced operations as investment banks in the first quarter of 2007. Three universal brokers have been incorporated into investment banks while another two universal brokers are still in the process of meeting the necessary pre-requisites. One discount house was issued a merchant banking licence and will complete its transformation into an investment bank within six months. With the creation of investment banks, the discount houses are no longer in the financial landscape.

The emergence of investment banks in the financial landscape has enhanced the capacity and capability of domestic financial institutions to capitalise on business opportunities both locally and within the region and widen the range of financial and advisory activities, hence strengthening their competitive advantage.

Consequently, these developments have further enhanced the potential of the investment banks to contribute towards our economic transformation and to play a pivotal role in the development of a vibrant and dynamic financial system.

The banking and insurance sectors continued to see further consolidation and rationalisation in 2006. The banking sector saw the completion of a merger between two domestic banking groups which consequently reduced the number of domestic banking groups to nine. The insurance sector also witnessed a merger of two general insurers driven by acquisition activity at the shareholder level. As players in the financial sector focus on strengthening their resilience, developing internal capabilities, leveraging on group synergies between different entities and building economies of scale in order to remain competitive, the resulting increase in vibrancy would drive further product innovation, competition, improvement in consumer service levels and ultimately better quality of products.

The entry of new players into the Islamic financial industry is expected to accelerate the pace of industry development and lead to improved business efficiency, product development and service quality that would elevate the domestic Islamic banking and takaful industry to new levels of dynamism.

In the area of Islamic finance, liberalisation of the Islamic financial industry has been brought forward with the issuance of three new Islamic bank licences to foreign Islamic financial institutions from Kuwait, Saudi Arabia and Qatar. This was made possible by the progress made in the development of the Islamic banking sector and strategies aimed at enhancing global linkages. Another important strategic measure undertaken since 2004 was the move by several

conventional banking groups participating in the Islamic banking scheme (IBS) to transform the current 'Islamic window' institutional structure into an 'Islamic subsidiary' (IS). Thus far, seven Islamic banking windows have been transformed into subsidiaries. There are now 11 Islamic banks comprising six Islamic subsidiaries, two domestic Islamic banks and three new foreign Islamic banks.

To enhance the global integration of the takaful industry, four new takaful licences comprising joint ventures between domestic and foreign operators were issued. New licences were also granted to takaful brokers and adjusters. This move is in line with the objective to create an efficient, progressive and comprehensive Islamic financial system and develop takaful as one of the important components of the Malaysian financial system. As at end-2006, there were eight takaful operators including three new takaful operators. Another new takaful operator would commence operations in 2007. In the area of retakaful, Bank Negara Malaysia in 2006 granted approval to two retakaful companies to be established in Malaysia under the Takaful Act 1984.

The entry of the new players into the Islamic financial industry can be expected to contribute towards accelerating the pace of industry development. Healthy competition in the marketplace is expected to lead to greater consumer benefits in terms of improved business efficiency, product development and service quality which in turn would elevate the domestic Islamic banking and takaful industry to new levels of dynamism. The new entrants with their own distinct capabilities, modalities and strengths will not only add further depth and diversity in the growing domestic Islamic banking and takaful industry, but will also be able to tap new markets in the region and the Middle East. With the added diversity of players, it is envisaged that the development of the Islamic banking and takaful sector will gain further momentum with new areas, such as debt capital market, private banking and fund and wealth management, also gaining increased significance.

With the growing maturity of the Malaysian financial system, licensed institutions may now

Table 3.1
Financial Sector: Number of Players

Financial Institutions	1998	2005	2006
Commercial Banks	35	23	22
Finance Companies	31	4	0
Investment Banks/Merchant Banks	12	10	14 ¹
Discount Houses	7	7	0
Islamic Banks	1	6	11 ²
Insurance Companies	58	42	42
Reinsurance Companies	10	7	6 ³
Takaful Operators	2	5 ⁴	8
Development Financial Institutions	14	13 ⁵	13 ⁵

¹ Includes a merchant bank in the midst of transforming into an investment bank and three universal brokers that transformed into investment banks in January 2007

² Includes a foreign Islamic bank that commenced operations in January 2007

³ One licence of a foreign reinsurer was surrendered following a group rationalisation exercise by its parent company abroad

⁴ Includes a takaful operator that commenced operations in January 2006

⁵ Of which six development financial institutions are regulated under the Development Financial Institutions Act 2002 (DFIA)

simultaneously enter into multiple negotiations relating to mergers and acquisitions. Interested parties are given the flexibility to enter into initial talks to acquire or dispose of interest-in-shares of institutions regulated by the Bank.

FINANCIAL INFRASTRUCTURE DEVELOPMENT

Financial infrastructure development is key to supporting active economic activities and provides a strong foundation for future growth.

During the initial years after the Asian financial crisis, the focus of financial infrastructure development was mainly related to strengthening the supporting infrastructure for credit risk management and enhancing the quality of credit assessment. This was apparent with the introduction of supporting systems including the Central Credit Reference Information System (CCRIS) and the accreditation requirement for credit personnel. With the development of the financial sector gaining momentum, the focus shifted to deepening and diversifying the financial markets and, at the same time, promoting consumer education and enhancing the consumer protection framework. Measures to strengthen

the development of the domestic bond market in 2006 included:

- The upgrading of the **Fully Automated System for Issuing/Tendering (FAST)** into a **web-based** application to enhance the effectiveness and coverage of information dissemination and transparency on primary market activities. FAST, operated by Bank Negara Malaysia, is the centralised system to facilitate the issuing and auctioning of Government and corporate debt securities and enables the Bank to conduct liquidity management via repurchase agreements (repo) or money market auctions.
- The issuance of **Commercial Papers (CPs) and Medium Term Notes (MTNs) on a scripless basis** since 15 May 2006 under the Real Time Electronic Transfer of Funds and Securities (RENTAS). Dematerialising the CPs and MTNs facilitates simultaneous book-entry transfer of securities and funds under the delivery-versus-payment principle, thereby eliminating the risks of settlement and non-delivery of securities.
- The **enhancement to the architecture of the Institutional Securities Custodian Program (ISCAP)** which was originally launched in January 2005 to increase secondary market liquidity. The ISCAP enables the Bank to borrow securities and use them as part of its operations via repo and securities lending to release captive holdings of securities by institutional investors and financial institutions.
- The issuance of the **Guidance Notes on Repurchase Agreement Transactions** in July 2006 to align Malaysian rules and regulations with international best practices. Repo transactions are now subject to the Global Master Repurchase Agreement which provides for, amongst others, the absolute transfer of titles, marking-to-market of transactions, use of haircut and margin maintenance, and events of default. This compulsory agreement as well as other stipulations in the Guidance Notes contribute towards maintaining a sound and orderly operation of the repo market by enhancing legal protection and instilling greater confidence among parties to a transaction.
- The introduction of the first **Islamic Derivative Master Agreement (ISDM)** in the world by

Persatuan Pasaran Kewangan Malaysia, with the first transaction using the agreement signed in December 2006. The ISDM was modelled against the International Swap and Derivatives Association (ISDA) agreement and will be endorsed by ISDA in 2007. The legally binding agreement further deepens the Islamic derivatives market by providing an avenue to Islamic investors for enhanced risk management and greater transparency in market dealings.

- The issuance of “**A Guide to Malaysian Government Securities (MGS)**” as part of Bank Negara Malaysia’s efforts to promote foreign investment in MGS. The guidebook provides essential information on the features of MGS and the characteristics of the local bond market, and is also available in the Bond Info Hub website (at <http://bondinfo.bnm.gov.my>).
- Introduction of an **MGS switch auction** aimed at increasing the trading on liquid benchmark MGS in the market in January 2007. The increased amount of these benchmark securities will enhance trading in the secondary market, thus improving the overall liquidity in the Malaysian bond market and providing added flexibility in maintaining regular issuances of MGS.

Measures implemented in 2006 to safeguard of consumer interests included:

- Commencement of operations of the **Credit Counselling and Debt Management Agency (CCDMA)** on 17 April 2006 which provides an avenue for consumers to seek advice on areas relating to credit, financial management and education as well as debt restructuring.
- Publication of new **multi-lingual booklets** under the **BankingInfo and InsurancInfo** programmes.

FINANCIAL MARKET DEVELOPMENT

The Malaysian financial markets play a crucial role in financing the growth of the economy. Previously, the banking sector served as the predominant source of financing for the nation’s economy. This concentration of risk in the

banking sector was evident during the Asian financial crisis, prompting a move towards the diversification of financing sources to the capital market. This resulted in an increase in total private debt securities (PDS) outstanding as a percentage of total financing (PDS outstanding + outstanding loans from banking institutions) from 10.1% in 1998 to 23.9% in 2006. Given its increasingly prominent role in financing the economy, continuous market development is vital to sustain the economy on a steady growth path. The year 2006 saw greater financial market development in the form of measures undertaken to promote an enabling environment for the introduction of new products and entry of new participants.

A tranche of **callable MGS** was issued on 15 December 2006 which allows the Government to better manage its cash flows. Besides improving product diversity, it is envisaged that the introduction of this new product will further develop the Malaysian bond market, especially the primary market for corporate bonds, as callable MGS may serve as a benchmark for private sector issuers to price their own callable PDS.

Bank Negara Monetary Notes (BNMN)

were also introduced in December 2006 to replace the existing Bank Negara Bills and Bank Negara Negotiable Notes for the purpose of managing liquidity in both the conventional and Islamic financial markets. The main objective of BNMN is to promote financial system efficiency in absorbing excess liquidity and thus reducing its undesirable impact in the domestic financial market. The maximum maturity of these issuances has also been lengthened from one year to three years. This is, however, not intended to signal any targeted level of long-term interest rates.

Product diversity in the financial market was enhanced with the **review of the Guidelines on Negotiable Instruments of Deposit (NIDs)**. With effect from 15 June 2006, liberalisation of pricing took place when floating rate NIDs were allowed to be priced against indices other than the Kuala Lumpur Interbank Offer Rate (KLIBOR).

The Guidelines also allowed issuance of NIDs in foreign currency, providing an additional source of foreign currency funding and, thus, deepening the profile of foreign currency depositors. Foreign currency NIDs also provide an investment alternative in the onshore market for domestic investors.

Given the financial market's increasingly prominent role in financing the economy, continuous market development in product diversity, liquidity and innovation are vital to support the economy towards a steady growth path.

The Bank introduced, on 16 February 2006, **Bank Negara Malaysia Sukuk Ijarah** based on the Islamic concept of *ijarah* or 'sale-and-lease-back'. Its issuance is timely in meeting the demand from international market players desiring Islamic financial instruments which are also compatible with principles subscribed to by Middle East Shariah scholars. This additional instrument to manage liquidity in the Islamic Money Market will be issued regularly. It will also serve as the new benchmark for other short to medium-term Islamic bonds. It is part of the ongoing efforts of the Bank to meet the diversified requirements of a global market.

The entry of new players into the Islamic financial industry contributed towards the development of a wide range of new Islamic banking products. A number of new financing products were introduced in the Islamic banking industry using the Shariah contracts of *mudharabah*, *musharakah* and *ijarah* in addition to the traditional *bai' bithaman ajil* (deferred payment sale). These include home financing-i using the concept of *musharakah mutanaqisah* (diminishing partnership), vehicle financing-i using the concept of *ijarah* (leasing) and cash

financing-i using the contract of *tawarruq*. In the takaful sector, there were 30 family takaful products approved by Bank Negara Malaysia during the year, of which 73.3% were investment-linked and mortgage products. 56.7% of the new products were from new takaful operators. The enhanced product diversity augurs well for the growth of the Islamic financial sector.

To promote further efficiency and provide alternatives in their funding operations, development financial institutions (DFIs) are allowed to participate in the interbank market. The **Guidelines on Participation in the Interbank Market by DFIs** was issued in December 2006 detailing the pre-requisites for market participation which include meeting risk management and liquidity requirements. The participation of DFIs in the interbank market will allow them to make direct placement of funds in the market to obtain better prices and to have direct access to money brokers' competitive rates. The DFIs are also allowed to issue and trade NIDs and Islamic Negotiable Instruments (INIs), both of which are instruments capable of enhancing the liquidity and diversification of the DFIs' funding sources.

REGULATORY AND SUPERVISORY INITIATIVES

Bank Negara Malaysia's approach to prudential regulation and supervision has also evolved in response to the changing landscape and maturity of the financial sector. Efforts continue to be made to ensure that the regulatory framework remains relevant and adaptable to the changing environment which would encourage institutions to embrace innovation and technological advancements to improve their competitive edge.

Consequently, the prudential framework has been reviewed to gradually move away from prescriptive regulations and one-size-fits-all approach to a more principle-based regime that is adaptive and conducive to changing market conditions and innovations. At the same time, it enables banking

institutions to react pre-emptively to new risk areas to reinforce the safety and soundness of the financial sector. Greater emphasis and responsibility is placed on financial institutions to manage risks appropriately in line with individual business strategies and within a broad-based prudential framework.

Given the diversity and complexity of products and services, and the various levels of risk management capabilities, the risk profiles of financial institutions can differ quite considerably from one another and hence require varying levels of oversight and supervision by Bank Negara Malaysia. In order for regulation and supervision to be effective and efficient, Bank Negara Malaysia adopts a risk-based approach where supervisory resources are prioritised towards areas that pose significant risks to the stability and soundness of the financial system and individual financial institutions. With the growing maturity of the market and its players' capabilities, this supervisory approach is further reinforced by differentiated regulation and supervision which accords greater flexibility to institutions that have strong risk management and corporate governance practices in place. Initiatives have also been directed towards strengthening conditions for effective market discipline to reinforce prudential regulation and supervision.

Strengthening the Risk Management and Corporate Governance Framework

Implementation of Basel II, Risk-based Capital Framework and Enhancements to Capital Adequacy Standards

For the banking sector, ongoing initiatives were taken to prepare the banking institutions for Basel II which is aimed at promoting better risk management practices, building capacity and enhancing competitiveness of banking institutions by facilitating greater operating flexibility with appropriate prudential safeguards. The implementation of Basel II is expected to result in more efficient capital management by banking institutions through a more risk sensitive mechanism to compute capital

adequacy which accords due recognition of risk mitigation techniques within individual banking institutions. The adoption of the Internal Ratings Based framework under Basel II in the future will also provide for an alternative method of determining capital adequacy based on internal models developed by banking institutions taking into consideration their own risk profiles and business experience.

In 2006, proposed revisions to the market risk component of the capital adequacy framework were issued to the industry for consultation. This was in recognition of the growing complexity of financial activities undertaken by banking institutions and the evolution of best practices in risk management following the adoption of Basel II internationally. The proposal also included the treatment of interest rate risk in the banking book which will be implemented in tandem with Basel II. Preparations are on track towards implementing Basel II from 1 January 2008 for the Standardised Approach for credit risk and the Basic Indicator, Standardised and Alternative Standardised Approaches for operational risk, with the parallel run for these approaches scheduled to commence during the first half of 2007.

Similarly in the insurance sector, the risk-based capital (RBC) framework has been finalised and will be implemented in 2007 on a parallel run for two years with the existing margin of solvency requirements. A two-year parallel run would provide an orderly transition to the new framework, with early adoption in 2008 permitted for insurers that have met supervisory expectations in terms of the requisite financial and risk management capabilities. The RBC framework will align solvency requirements applicable to insurers with their individual risk exposures and profiles. The capital requirements will also facilitate more effective supervisory interventions by providing early warning signals of deterioration in the capital adequacy levels. In addition, the revised requirements for the

valuation of assets and insurance liabilities will provide for a more explicit quantification of prudential buffers (currently hidden within conservative valuation bases) in line with developments internationally to promote more transparent disclosures of an entity's financial position.

In tandem with the intention to implement the Capital Adequacy Standard (CAS) issued by the Islamic Financial Services Board in 2008, significant efforts have also been undertaken by the Islamic banks during the year in the preparation for the implementation of this new capital framework. A gap analysis was conducted as part of the initial assessment to identify the state of readiness of the Islamic banks to meet the requirements stipulated under CAS. Enhancements to information technology and data systems management have been identified as a key operational capability that needs to be strengthened. In the case of Islamic subsidiaries, the implementation strategy will be streamlined with the initiatives undertaken by their parent bank in implementing Basel II. Efforts have also been initiated to develop supervisory guidance for the implementation of CAS in collaboration with the industry. The supervisory guidance is expected to be finalised by the third quarter of 2007. Bank Negara Malaysia will continue to monitor the progress of the action plans and the risk management capabilities of the Islamic banks during the implementation of the new capital framework.

In managing risks, the DFIs also continued to strengthen their risk management infrastructure, including human resource, systems and processes. In particular, efforts have been undertaken to enhance the human resource capability through continuous and structured training, especially on credit processes as well as product development and innovation to meet the financing and developmental needs of the respective targeted sectors. In addition, the Bank imposes regulatory standards on DFIs to adopt good corporate governance practices so as

to ensure that they are better positioned to achieve their mandated roles with greater efficiency and effectiveness. This is supported by the continuous enhancement of risk management systems and internal processes to identify, measure, monitor and control possible risks associated with the conduct of the mandated activities of the DFIs.

Convergence with Developments in Financial Reporting Standards

As financial reports are an important reflection of the performance of financial institutions, it is important that reporting standards meet and reflect the actual condition of financial institutions. The Bank is currently conducting a review of the regulatory financial reporting requirements and valuation standards for both the banking and insurance sector to promote consistency with Financial Reporting Standards (FRS) and convergence with international best practices. Among the areas currently being reviewed are:

- the basis for loan provisioning and classification of non-performing loans of banking institutions to consider parameters for loan impairment tests under FRS 139: Recognition and Measurement of Financial Instruments; and
- the requirement for valuation of investment properties held by life insurers at fair value (from cost or revaluation basis previously).

To ensure the integrity of fair values reported in financial statements, supervisory expectations will be issued on valuation policies and processes that must be in place within the financial institutions to support the implementation of the FRS. In addition to this, prudential filters through capital adjustments and other prudential safeguards will also be implemented where appropriate to ensure regulatory capital reflects the financial soundness of the institution and acts as an effective buffer for risk-taking activities. Bank Negara Malaysia is closely monitoring preparations by financial institutions to

achieve readiness for the adoption of FRS 139, and has engaged Boards of individual financial institutions to ensure proper oversight of preparations and to address any significant implications arising from the implementation of the FRS.

Other Measures

During the year, further measures to enhance and strengthen the risk management capabilities of financial institutions were undertaken as follows:

- emphasis on the importance of **stress testing** as a key risk management tool which enables banking institutions to better understand their risk profiles and take appropriate pre-emptive actions;
- strengthened requirements on the **appointed actuaries** of life insurers;
- requirement to **solicit institutional issuer ratings** from the local rating agencies to enable Islamic financial instruments to be recognised as qualified liquefiable assets; and
- enhancement of the **internal audit function** of the DFIs to promote prudent conduct and strengthened operational procedures.

Investment Flexibility

With the advent of a strengthened prudential framework, enhanced risk management capabilities and stronger governance within financial institutions, greater operational and investment flexibilities have been accorded to financial institutions as Malaysia transitions towards a more deregulated environment. The thrust of the policies is to provide greater flexibility for management of investment portfolios by financial institutions whilst ensuring that adequate safeguards are put in place to preserve financial stability.

The flexibilities granted include:

- relaxation of **capital treatment** for investments in **non-innovative Tier-1 capital instruments** of other financial institutions;
- relaxation of limits on **investment in debt securities** for life insurance and family

takaful funds, and in **foreign assets** in any one jurisdiction; and

- greater flexibility for banking institutions to manage their **equity-related activities and investments**.

Product Flexibility

The investment flexibilities introduced under the various initiatives were complemented by further relaxation for financial institutions to offer new products and services. The regulatory philosophy evolved towards facilitating an environment conducive for innovation, and fostering equitable and efficient competition towards the development of a more diversified, efficient and customer-centric banking sector.

The initiatives undertaken to accord greater product flexibility include:

- facilitating **faster time-to-market** for new investment-linked to derivative (ILD) products and **expanding the type and amount of ILD products** that banking institutions can offer;
- allowing onshore licensed institutions to enter into **repo transactions with a non-resident** provided that the total amount of credit facilities of the non-resident, including the repo transaction, does not exceed RM10 million; and
- flexibility for banking institutions to sell non-performing loans (NPL) and non-performing financing (NPF) to external parties. The first major tender of distressed assets by a large domestic bank to foreign investors was transacted during the year and is expected to be completed in 2007. This augurs well for the development of a secondary market for distressed assets in Malaysia as more banking institutions take this opportunity to strengthen their balance sheets.

Supervisory Framework

Bank Negara Malaysia's approach towards the supervision of financial institutions entailed greater emphasis on the early identification of emerging risks and system-wide issues as well as vigilant monitoring of financial conditions and operating soundness of financial institutions. Continued enhancements were made to the

risk-based supervisory framework to provide a structured and forward-looking approach to assess financial institutions' risk profiles and risk management systems. Supervisors are now able to allocate resources optimally when supervising the institutions, focusing on specific risk areas which are identified to pose greater risk to the safety and soundness of the financial institutions.

The increased complexity in banking activities, emergence of new risk factors and continuous change in the financial landscape has also prompted the establishment of specialised risk units which are the Credit Risk, Market Risk and Operational Risk units. These units which are equipped with specialist skills and subject expertise will provide integral support to the supervisory and regulatory functions of the Bank.

Supervisory activities in 2006 focused on the assessment of the strength and capability of universal brokers and discount houses to ensure that these institutions meet the pre-conditions before assuming the new roles as investment banks. Due diligence exercises were conducted on these institutions to assess financial capacity, level of corporate governance, robustness of risk management, effectiveness of internal audit function and adequacy of information systems. Subsequent exercises were conducted to assess the corrective measures undertaken to address the identified weaknesses in these areas.

The enhanced supervisory framework also called for greater reliance on internal and external auditors. To meet this objective and ensure greater responsibility and accountability on the part of the auditors, Bank Negara Malaysia conducted industry dialogues with both the internal and external auditors of the financial institutions where views on the supervisory expectations of auditors and the new developments and challenges facing the financial industry were exchanged.

The transformation of the domestic financial landscape also involved greater cross-market and cross-industry integration and

consolidation, adding to a blurring of the lines between capital market and banking activities. The regulatory and supervisory framework was therefore enhanced to ensure harmonisation of rules and address areas of regulatory overlaps, gaps and regulatory arbitrage. In this regard, supervisory co-operation between Bank Negara Malaysia and other regulatory agencies, such as the Securities Commission has also been strengthened and enhanced. The Bank and the Securities Commission are finalising a Memorandum of Understanding to coordinate working arrangements, given that investment banks will be subject to co-regulation by both authorities.

Following the establishment of Malaysia Deposit Insurance Corporation (MDIC), a strategic alliance agreement was also executed between Bank Negara Malaysia and MDIC to strengthen areas of regulatory and supervisory co-operation. This alliance has been recognised by the International Association of Deposit Insurers as an excellent model of co-operation between deposit insurers and regulators. In complementing the supervisory functions of the Bank, key frameworks with regard to risk assessment, enterprise risk assessment and monitoring and payout activities were developed, with the differential premium systems framework to be implemented in 2008. MDIC has also issued "Guidelines on Total Insured Deposits" and "Guidelines on Disclosure Requirements for Joint Accounts and Trust Accounts" as well as implemented governance policies which includes a whistle-blowing policy.

FINANCIAL INCLUSION

Promoting greater access to financial services by all segments of society continued to be at the forefront of the Bank's agenda in 2006. Efforts made during the year focused on strengthening the institutional framework and putting in place the necessary measures to further enhance access to financing and also the level of financial literacy.

Leveraging on the complementary role and developmental mandate of the DFIs in supporting

the Government's socio-economic objectives, several strategic initiatives were undertaken to promote greater access to financing for all segments of the economy. In particular, these include the small and medium enterprises (SMEs) and businesses in the priority sectors.

The development of the microfinance industry is crucial in promoting greater financial inclusion, given that almost 80% of the SMEs in Malaysia are micro enterprises.

During the year, the Bank embarked on an important strategy to promote the development of the microfinance industry in Malaysia. This initiative is crucial in promoting greater financial inclusion, given that almost 80% of the SMEs in Malaysia are micro enterprises with less than five full-time workers. The Census of Establishment and Enterprises conducted by the Department of Statistics in 2005 revealed that micro enterprises mainly relied on their own funds, and borrowings from family and friends to meet their financing needs for their businesses. In this respect, a sustainable microfinance industry is important in providing a channel for micro enterprises to obtain financing from the formal financial system.

To ensure that institutional arrangements put in place will be able to provide continuous access to financing for micro enterprises, it is important that the institutions operate in a financially sustainable manner. Thus, the source of funds and the market-based lending rate charges have to be sufficient to cover the funding and operating costs as well as credit risk, whilst generating a reasonable profit margin. Microfinance providers which operate on a sustainable basis need to have an extensive outreach, as opposed to microfinance schemes relying on Government funding which generally have limited capabilities. In this regard, the development of a sustainable and commercially-driven microfinance industry will thus complement the existing Government-sponsored microfinance programmes undertaken by institutions such

as Amanah Ikhtiar Malaysia (AIM) and Yayasan Tabung Ekonomi Kumpulan Usaha Niaga Nasional (TEKUN).

The development of the microfinance industry involves a number of key initiatives. To enhance the role of DFIs as microfinance providers, Bank Simpanan Nasional has been mandated to provide microfinance to micro enterprises and individuals operating a business. Bank Kerjasama Rakyat Malaysia will also provide microfinance to members of co-operatives, while Bank Pertanian Malaysia (Bank Pertanian) will continue to provide microfinance to those micro enterprises involved in activities in the agriculture and agro-based sector.

The involvement of banking institutions also plays a pivotal role in providing microfinance, given their financial capacity and extensive outreach. Bank Negara Malaysia spearheaded a number of initiatives to create awareness amongst banking institutions on successful global practices of sustainable microfinance. Among these initiatives included joint study visits by financial institutions to successful microfinance institutions in India and Indonesia and the development of global case studies on microfinance to serve as reference materials in assisting banking institutions and DFIs to develop their business models.

As a result of the initiatives to promote microfinancing, a number of banking institutions have started to offer loans for micro enterprises. Common features of these include small loans ranging from RM500 to RM50,000 that are provided to individuals and micro enterprises for business purposes at commercial interest rates. The loan tenure is typically short ranging from one month to five years with flexible collateral or security requirements. The time taken to approve such loans is also fast, between five to eleven working days. Some financial institutions also offer repayment incentives in the form of rebates to encourage good repayment practices among the borrowers.

The development of a "Graduation Programme" is another initiative by the Bank to enable micro enterprises to obtain the right type and amount of financing to meet their

requirements as their businesses grow. Through this structured programme, micro enterprises requiring larger funds to finance their business growth are assisted in obtaining such financing from the providers of microfinance and other commercial banks as well as the SME Bank. It is envisaged that the development of a robust and sustainable microfinance industry will provide a complementary alternative for consumers who may not be currently served by the mainstream financial industry.

With the agriculture and agro-based sector having been identified as a key promoted sector under the Ninth Malaysia Plan, Bank Negara Malaysia embarked on a number of initiatives to ensure continuous access to financing for the sector. To realise the Government's vision for the sector to become the third engine of growth, efforts have been undertaken to ensure that adequate funds are available and channelled effectively and efficiently to support businesses in the sector. As a specialised financial institution for the agriculture sector, Bank Pertanian was restructured and strategically positioned to act as the catalyst to facilitate greater access to financing to the agriculture sector and agro-based industries. Bank Pertanian has adopted a comprehensive approach towards paving its new strategic direction whilst putting in place measures to strengthen its financial capacity and capability, accord greater focus on human resource development, and enhance risk management systems and processes. It is envisaged that Bank Pertanian will, post-restructuring, be on a stronger footing to carry out its mandate as the implementing agency to support the agriculture and agro-based sector as an increasingly important growth sector in the economy.

Access to agriculture financing was further enhanced with the establishment of two venture capital funds of RM150 million each for the agriculture sector. The funds, jointly established by Bank Negara Malaysia with two banking groups, are aimed at creating and developing an integrated agricultural business which will generate spillover effects to benefit the entire value chain of the agriculture

sector. Targeting areas of integrated farming and fisheries and biotechnology ventures, these funds are invested at the holding company level which will then be responsible for the development and provision of technical and business support to farmers, breeders and fishermen. The first fund was launched in September 2006 with the other expected to be launched early 2007.

In line with the Government's call to encourage Malaysian companies and enterprises to venture offshore in order to expand markets, efforts continued to be taken to enhance access to financing by these companies. In December 2006, a RM1 billion Overseas Project Fund was established by Bank Negara Malaysia at Export-Import Bank of Malaysia to promote greater access to financing by Malaysian companies undertaking projects overseas. Through the credit guarantee facility introduced in the first phase, Malaysian companies, particularly the SMEs and professional service providers, will have greater access to financing to support business ventures abroad. The co-financing scheme is targeted for introduction at a later stage in 2007.

MALAYSIA INTERNATIONAL ISLAMIC FINANCIAL CENTRE (MIFC)

Against the backdrop of a rapidly growing Islamic financial services industry within the global financial markets, the Malaysian Government launched the initiative known as the Malaysia International Islamic Financial Centre (MIFC) on 14 August 2006. Besides marking the beginning of a new era for the future landscape of Islamic finance in Malaysia, the initiative also aimed at enhancing the competitive advantage that Malaysia has in the area of Islamic finance, having in place a strong and comprehensive Islamic financial system with a robust regulatory regime and well established legal framework.

The envisioned landscape is that MIFC will be a centre for the offering of Islamic financial products and services in international currencies with a large pool of highly skilled Islamic finance expertise. Ongoing efforts are focused to enhance Malaysia's position as a centre of origination, distribution and trading of Islamic capital market and treasury instruments, Islamic fund and wealth management,

international currency Islamic financial services, and takaful and retakaful business. It is also aimed at positioning Malaysia as the gateway for tapping investment opportunities in the rapidly growing Southeast Asian region. To complement this initiative, measures are also intensified towards positioning Malaysia as a centre of excellence in education, training, consultancy and research in Islamic finance.

The envisioned landscape is that MIFC will be a centre for the offering of Islamic financial products and services in international currencies with a large pool of highly skilled and competent Islamic finance expertise.

The MIFC will also strengthen Malaysia's already strong links with the global market place. The initiative plays an important role in accelerating the process of bridging and strengthening the relationship between Islamic financial markets internationally and thereby expanding the investment and trade relations between the Middle East, West Asia and North Africa regions and East Asia. The promotion of capital and cross-border trade flows between the financial communities of these regions are expected to further strengthen the international integration of the domestic Islamic financial system. In addition, this initiative is expected to enhance the performance of the Islamic financial services industry and strengthen its competitive edge in the increasingly integrated global environment.

As part of the efforts to establish an efficient and effective delivery system in the implementation of the MIFC recommendations, the MIFC Executive Committee was set up on 11 August 2006. The Committee is chaired by the Governor of Bank Negara Malaysia with members comprising senior representatives from the relevant Ministries, Government departments and agencies, financial and market regulators,

and industry representatives from the banking and takaful sectors. The Committee is a single coordinating committee that is entrusted with overseeing the implementation of policy recommendations, providing direction as well as reviewing existing policies for the comprehensive and coordinated promotion of MIFC. The secretariat is Bank Negara Malaysia, which acts on behalf of the Committee as a one-stop entity to undertake this task.

Major measures were introduced in 2006 to promote Malaysia as an Islamic banking hub including issuance of new category of licences known as International Islamic Banks (IIB) under the Islamic Banking Act 1983 to qualified foreign and Malaysian financial institutions to conduct business in international currencies. Similarly, new registrations were made under the Takaful Act 1984 to qualified foreign and Malaysian insurance companies to conduct takaful business in international currencies as International Takaful Operator (ITO), and approvals have been given for the establishment of International Currency Business Units (ICBU) by Malaysian Islamic banks and takaful operators. The IIB and ITO establishment can either be a branch or a subsidiary of the parent financial institution. Incentives provided for international currency business include a tax holiday for 10 years under the Income Tax Act 1967 starting from the year of assessment 2007. In addition, approval was granted for Labuan Islamic banking institutions and Islamic divisions of offshore banks and takaful operators to establish operational offices anywhere in Malaysia. Notwithstanding the physical location, the Labuan tax law will continue to be applied to these players. These measures are aimed at creating the necessary critical mass of players that will contribute towards achieving the objectives of the MIFC and creating the business volume for a vibrant Islamic financial centre.

The MIFC initiative was further strengthened with the liberalisation of the foreign exchange administration rules to allow residents and foreign issuers to raise foreign currency-denominated bonds, in particular Islamic bonds in the Malaysian capital market. Foreign issuers that are eligible to take this opportunity include

sovereigns, agencies or national corporations of foreign governments, multilateral development banks, multilateral financial institutions and multinational corporations. This is also part of the continuous efforts to promote the development of the Malaysian bond market, and to enhance Malaysia as a centre of origination, distribution and trading of sukuk. The issuance of foreign currency-denominated bonds will also provide additional flexibility for both residents and foreign investors to diversify their investments into non-ringgit investments in Malaysia. In boosting the cost competitiveness of product offering and structuring of instruments, the Government granted a 10-year stamp duty exemption on instruments executed by entities under the MIFC and instruments relating to ringgit and foreign currency-denominated Islamic securities.

With regard to human talent development, a personal tax relief up to a maximum of RM5,000 per year on study fees was extended to courses in Islamic finance approved by Bank Negara Malaysia or the Securities Commission in local institutions of higher education including at the International Centre for Education in Islamic Finance (INCEIF).

To complement MIFC are the efforts on talent development in Islamic banking and finance. As part of this initiative, INCEIF has signed a Memorandum of Understanding with nine institutions of higher learning, paving the way for closer collaboration with institutions of higher learning to realise the common objective of developing a significant pool of expertise in Islamic finance globally. This collaborative move, aims to establish a network of mutual co-operation and collaboration that would strengthen the efforts between the institutions of higher learning in the areas of curriculum development, research, training, exchange of ideas and information, and resources in Islamic finance. In addition to this, INCEIF has commenced collaborative initiatives with five takaful operators in promoting and undertaking research, development, training and education in Islamic finance. In the international arena, INCEIF has established strategic alliances with the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank, Lembaga Pengembangan Perbankan Indonesia (LPPI) of

Bank Indonesia, National Institute of Banking and Finance (NIBAF) of State Bank of Pakistan and Ceylinco Sussex Business School, Sri Lanka, among others.

In an effort to spur research and development in Islamic finance, INCEIF has granted research grants for ongoing as well as new research projects on a competitive basis covering a broad range of areas ranging from Islamic financing, product innovation, risk management and governance. To date, INCEIF has more than 600 registered students with 26% comprising foreign students from 21 major countries.

Initiatives have also been taken to enhance the pool of talent in the field of Shariah. Towards achieving this objective, the Shariah Scholarship and Research Grant Awards have been provided from the Fund for Shariah Scholars in Islamic Finance which was announced in August 2006.

INTERNATIONAL CO-OPERATION

As the global economy becomes more integrated through increasing intra-regional trade, Bank Negara Malaysia has continued to participate actively in promoting regional and international economic and financial co-operation. Trade agreements constitute a means by which this process can be facilitated via preferential treatments between parties, enabling market access and trade privileges. While such agreements would allow parties to benefit from comparative advantages and potentially reap mutual benefits, they also involve trade-offs that need to be taken into account. Hence, an appropriate balance between the promotion of greater competition, efficiency, trade and investment flows and that of maintaining financial system and socio-economic stability, has to be reached. Ultimately, there needs to be commensurate benefits derived from entering into trade agreements.

Committed towards gradual and progressive liberalisation, promotion of trade facilitation and international co-operation, Bank Negara Malaysia continued to play an active role in the trade negotiations at the bilateral, regional and multilateral levels and had acted as the lead agency

in undertaking negotiations on trade in financial services. Malaysia's approach to financial services negotiations, whether at the bilateral, regional or multilateral levels, is principally based on a net-benefit approach – to dismantle policy impediments in areas where gradual liberalisation is deemed as a necessary means to facilitate the achievement of broader economic objectives and where the overall benefits to the country are meaningful and significant.

Committed towards gradual and progressive liberalisation, promotion of trade facilitation and international co-operation, Bank Negara Malaysia adopts a net-benefit approach to financial services negotiations – to dismantle policy impediments in areas where gradual liberalisation is deemed as a necessary means to facilitate the achievement of broader economic objectives.

On an international level, a forum to share and leverage on expertise and mutual experience of counterparts in various countries is important to assist in developmental efforts towards building a resilient financial sector. In this endeavour, Bank Negara Malaysia participates actively in international meetings, which include amongst others, the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP) Working Group that focuses on three main areas relating to financial stability – banking supervision, financial markets and payment and settlement systems. The participation in the working, technical and high level committees have contributed towards efforts to:

- facilitate the adoption of international standards for banking supervision and financial stability through appreciation of implementation issues from a regional perspective;
- identify supervisory priorities and areas of concern that will have impact on financial stability; and

- improve techniques relating to supervision and surveillance at the national and regional levels. Pertinent areas that are discussed include implementation of Basel II, home-host supervisory issues, International Accounting Standards (IAS) 39 and macroprudential surveillance framework.

OUTLOOK : FUTURE POLICIES

The thrust of policy measures in 2007 will focus on establishing and reinforcing the supporting prudential and legal framework for financial institutions, facilitating the emergence of core domestic players to spearhead the development of the financial sector and enhancing the level of efficiency within the financial system through deregulation and allowing greater operational flexibility. In addition, continued focus will be given in driving the MIFC agenda to further develop the Islamic finance industry and strengthening the role of DFIs and financial market players to contribute towards the economic transformation.

The consolidation process and group rationalisation that took place over the years have resulted in a more vibrant, diversified and resilient financial sector. It has also facilitated the emergence of increasingly complex group structures as financial entities move towards integration to reap the potential benefits of economies of scale as well as to leverage on business and management synergies. The Bank will continue to strengthen prudential regulation and surveillance over diversified financial conglomerates. Policy initiatives will be directed towards establishing a holistic framework for consolidated supervision and ensuring that the activities of financial conglomerates are within appropriate risk levels and do not pose any systemic risk to the financial system. The framework would encompass measures to further strengthen cross-border and cross-sector co-operation and information sharing between Bank Negara Malaysia and other financial regulators and supervisors.

The year 2006 also saw an increasing interest by foreign institutions to have a more meaningful presence in Malaysia by taking up strategic stakes

in domestic financial institutions. One insurance group will strengthen its presence in Malaysia by locally incorporating itself, while two domestic financial groups had received proposals from foreign institutions to participate as shareholders. One foreign financial group also completed its acquisition of a strategic stake in a domestic insurance company during the year. The strategic repositioning of these institutions by co-operating with foreign partners should contribute to further strengthening the capabilities and capacities of the institutions in the areas of technical expertise, innovativeness, reputation and network to further enhance efficiency and competitiveness. Bank Negara Malaysia would continue to play a facilitative role in encouraging the formation of strategic partnerships that aim to bring mutual benefits to the parties involved and the nation generally, whilst preserving financial stability at all times and evolving a financial system that contributes to socio-economic stability.

In terms of the prudential framework, policy initiatives will continue to be focused on establishing and reinforcing the supporting framework for the implementation of Basel II, risk-based capital and risk-based supervision. These measures would include the development of comprehensive risk management standards for all major risk components of banking and insurance operations and the strengthening of supporting infrastructure. Greater responsibility will be accorded to the Boards of financial institutions in ensuring proper oversight of the strategic direction and that internal governance and risk management processes of institutions are firmly in place and effectively implemented. Measures will also be taken to outline preconditions for enhanced market discipline such as improved disclosure requirements, in line with the focus towards greater transparency. This move towards greater market-oriented oversight and discipline aims at providing greater flexibility for financial institutions to innovate and enhance competitiveness in a dynamic operating environment.

The transformation of the financial sector will be further supported by the strengthening of the legal and regulatory framework in 2007. The

review of the legislative framework will reflect the progressive changes in the regulatory and supervisory approach over the years, moving towards minimising regulatory impediments to facilitate a more effective and efficient environment for financial institutions to operate. The revised legal framework will also align existing practices with developments in financial markets, business practices and financial reporting standards as well as increase uniformity with other governing legislation.

Endeavours in consumer awareness and education, which play an indispensable role in the continuous efforts of the Bank to achieve financial inclusion, will be improved upon. These include intensifying promotion of basic banking accounts as a measure to increase access to financial services at minimal costs. Improving product transparency and the professionalism of financial service providers and intermediaries which are becoming increasingly important to boost consumer confidence in the financial system, will also be addressed.

The major policy thrust for DFIs in 2007 will continue to focus on strengthening the regulatory standards to ensure the development of sound and robust DFIs capable of supporting their mandated activities in an effective and efficient manner. Several measures, tailored according to the unique nature and specific roles of the DFIs, will be introduced to further enhance their capacities and capabilities in order to develop strategic sectors of the economy. In addition to offering a wider range of facilities via innovation of products and services, emphasis will be on the provision of value-added advisory, consultancy and technical assistance to the targeted sectors.

The year 2007 will also see a concentration of efforts to achieve the MIFC agenda whilst further strengthening the resilience, capability and capacity of Islamic financial institutions in Malaysia. Recognising the importance of Shariah compliance in the Islamic finance industry, Bank Negara Malaysia will continue in its efforts to enhance the Shariah framework. Among these efforts include formulating standard Shariah

parameters as the main reference in developing Shariah compliant products and instruments, strengthening the supervisory framework over Islamic finance operations and promoting greater innovation and diversity in Islamic financial products and investments. The impending implementation of equity-based contracts would promote the gradual shift from predominantly asset-based financing to equity-based financing. Given the unique risk and rewards profile of these innovative contracts, Bank Negara Malaysia will continue to ensure that adequate measures and prudential safeguards are in place to address the regulatory, Shariah and legal aspects of these contracts.

While Malaysia is unilaterally committed to liberalising the financial sector under the Financial Sector Masterplan, the proliferation of trade agreement negotiations has provided new opportunities and challenges for Malaysia. However, the gradual and progressive financial liberalisation efforts in Malaysia will continue to be

sequenced and implemented accordingly in order to maximise opportunities from the liberalisation process whilst avoiding destabilising effects on the financial sector and overall economy. The process will be accelerated in areas where Malaysia deems liberalisation as a necessary means to facilitate the achievement of economic objectives and national socio-economic policies.

In this era of globalisation, keeping up with the accelerated pace of evolution in the financial sector poses a highly challenging feat in itself. While the developmental efforts have contributed significantly in achieving a vibrant and resilient Malaysian financial sector, the domestic financial sector needs to rise to the challenge to operate and thrive in a more integrated domestic and international market. Bank Negara Malaysia's initiatives thus far and moving forward would hence focus on balancing the various objectives to build an efficient, effective, diversified and resilient financial sector whilst ensuring that financial stability is preserved at all times.

Market Conduct and Consumer Capability

Market confidence is crucial to effective intermediation and the efficient functioning of the financial markets. In today's dynamic environment, given the important link between market confidence and financial stability, considerable effort has been undertaken by the Bank to put in place the appropriate framework and measures that allow the financial services sector to evolve, while at the same time ensuring the safety and soundness of the financial system as well as efficient market and fair practices.

Consumer financial requirements and expectations are changing rapidly in the face of increasing personal wealth, growing sophistication and the demand for differentiated product offerings and value-added services. These trends have not only become important in reinforcing a more competitive environment in the financial services industry but have also spurred significant structural changes in the financial sector with greater diversity of players, more innovative and complex products and services as well as more efficient delivery channels. While these changes have generally been positive and often leading to more varied product offerings, lower costs and better quality to consumers, they also present new challenges to consumers as their financial knowledge may not have kept pace with the dynamic developments in the financial sector. An important aspect of the Bank's regulatory strategy and approach therefore, has been to ensure that the continued growth of the financial sector is underpinned by fair market practices and conduct. Equally important is the need to enhance consumer capability to ensure that consumers are better equipped with information and knowledge necessary to make financial decisions that improve their economic well-being. The establishment of the Consumer and Market Conduct Department marks another milestone in the Bank's ongoing commitment towards according greater focus on elevating consumers' financial literacy levels, promoting sound and fair market practices, as well as putting in place the necessary infrastructure for consumer protection and redress. The mission is therefore to promote greater consumer activism aimed at engendering greater competition and better performance in the financial sector, by:

- formulating and implementing consumer-related market conduct requirements;
- conducting surveillance and initiating remedial or enforcement actions for any breach of market conduct requirements; and
- promoting financial capability of consumers.

Promoting Fair and Equitable Market Practices

Financial service providers and their intermediaries are expected to implement fair consumer practices with policies and systems that focus on the customers' information and other requirements in order to foster continued public confidence in the financial system. In addition to promoting sound business practices, the Bank will also continue to direct efforts towards enhancing market conduct surveillance and take enforcement actions against financial service providers that adopt unfair practices. At the same time, efforts are also focused on promoting self-regulation in the industry through enhancing the roles and effectiveness of the industry associations and their enforcement of the respective codes of good business practice.

Consumers also need to be empowered to take responsibility for their own well-being and thus be given the relevant information on which to base their financial decisions. In this regard, requirements are in place for the banking sector to disclose and make available information on fees and charges imposed on products and services offered to individuals and small and medium

enterprises (SMEs) at all their branches and websites. For the insurance sector, apart from improving transparency in product features and sales practices, disclosure is required for commissions, fees and charges for insurance products with savings and investment features that are sold through banking institutions. In addition, greater disclosure requirements have been introduced for the family takaful business. Except for medical and health takaful products, the allocation of investment profit, surplus or fees to the takaful operators must be disclosed in the proposal form, certificate documents and brochures. Going forward, product disclosure and transparency will be enhanced to ensure that consumers have access to information that accurately represents the features, risks and returns associated with the financial products and services. As part of these efforts, the Bank has reviewed the broad guiding principles on the imposition of fees and charges for conventional and Islamic banking products and services for individuals and SMEs. While committed to a framework of greater market orientation in determining product pricing, fees and rates, the Bank will continue to ensure that cost and cost savings are allocated fairly and equitably between the financial service providers and consumers.

A sound financial system hinges on, amongst others, the resilience of the players and market confidence. In their dealings with consumers, financial service providers are therefore expected to act with due care and diligence as well as seek the pertinent information from customers and assess their financial needs before concluding a contract or giving advice and handling the private information with due care. Life insurers have an obligation to provide more extensive sales illustrations in marketing life policies, while life agents must observe proper advice practices in the sale of life products. In addition, the Bank has tightened regulations on claims settlement practices and strengthened controls over bonus reductions by life insurers. The Code of Good Practice for Life Insurance Business has also been revised to maintain a high standard of professionalism in the design and sale of insurance products, including the requirement for 'truth in selling' with proper disclosure. In line with these developments, the Guidelines on Family Takaful Products were issued to establish the minimum requirements for the introduction of any new family takaful products, including marketing information to prospective participants of family takaful schemes.

It is also important for loss adjusters, insurance brokers, takaful brokers, financial advisers and money brokers to have adequate knowledge and high level of professionalism in their dealings with customers. As they represent an important interface between consumers and financial service providers, their good market conduct is equally essential to promote confidence in the financial system. To raise the benchmark on the quality of financial advice, financial advisers are also being promoted as a new distribution channel for life products and other products such as savings for children's education, retirement planning and investments for the future.

Enhancing Financial Capability of Consumers

In a competitive environment where market discipline and consumer activism drive financial performance, consumers need to be increasingly financially savvy. The presence of more confident and financially astute consumers will promote greater competition and thus market efficiency and innovation. This can however, only be achieved when consumers have access to information on the financial products and services that are being offered and are equipped with sufficient knowledge to understand the risks and obligations involved in order to make informed decisions. Measures have been undertaken by the Bank to promote consumer awareness and knowledge on financial products and services of conventional banks, Islamic banks, insurance companies and takaful operators, as well as electronic payments channels and instruments. The Bank together with the financial industry have implemented the Consumer Education Programme (CEP) as part

of the efforts to increase consumer awareness. A total of 23 articles have been published in the BankingInfo website and 24 articles in the InsuranceInfo website. These articles are also published as information booklets in English, Bahasa Melayu, Mandarin and Tamil. To date, the BankingInfo and InsuranceInfo websites have received significant response. The BankingInfo website has also been enhanced to include comparative information on financial products to facilitate and reduce the cost of information search by consumers.

To enhance the outreach of the CEP, various target groups including school children, housewives, young adults and retirees have been identified and information on a broad range of subjects such as household finance management, savings, use of credit, e-payments, general banking and insurance have been provided. Working collaboratively with the Ministry of Education, more than 7,000 schools nationwide have been adopted by banking institutions to impart to students, the importance of savings and smart money management. In order to achieve the common goal of enhancing financial capability of consumers, the strategic alliances with the Financial Mediation Bureau (FMB), Credit Counselling and Debt Management Agency (CCDMA), Malaysia Deposit Insurance Corporation and the Securities Commission have been strengthened with the establishment of the Financial Education Working Committee. The Committee, chaired by the Bank, aims to foster greater coordination and collaboration amongst its members in enhancing consumer awareness and financial capability.

Strengthening the Enabling Infrastructure

A good dispute resolution process that is simple and easily accessible is an essential element to ensure the fair treatment of consumers. In this regard, conventional and Islamic banks, insurance companies and takaful operators have established their own respective Complaint Units. Going forward, a dedicated Complaint Unit will also be extended to payment systems operators. Intervention is on ensuring that these Complaint Units deal with complaints and claims effectively and fairly through an equitable process, rather than on issues relating to commercial decisions such as pricing of loans and contractual arrangements. The Bank also would not intervene in the cases heard in court or that are pending legal action given that only a court of law can resolve those disputes and award damages that are legally binding on both parties. To ensure that consumers have recourse to an independent, fair and impartial dispute resolution mechanism, the FMB is an alternative redress avenue for consumers of financial service providers under the Bank's purview.

As part of the Bank's efforts to improve access by the public to information relating to our operations and policies, the Laman Informasi Nasihat dan Khidmat (Bank Negara Malaysia LINK) was established, as a one-stop reference for members of the public and the SMEs in matters relating to financial products and services. Since its inception in February 2005, the response to the Bank Negara Malaysia LINK has been overwhelming with more than 40,000 visitors comprising individuals and SMEs that sought information on various issues pertaining to banking, loan related matters, insurance, foreign exchange administration and credit reports. In relation to this, a Contact Centre will be established in May 2007 as an integrated customer information service at the Bank that aims to improve response to queries by increasing access channels for the public to refer financial related matters.

With the robust growth in private consumption, growing consumer affluence and increased access to the financial sector, enhanced capacity to manage finances and debts prudently become essential to preserve the resilience of the household sector. In this regard, the Bank has established the CCDMA in April 2006 to provide an avenue for consumers to obtain advice on matters relating

to debt management. Consumers who are unable to meet their financial obligations arising from unexpected developments or overstretched finances, can seek the advice of CCDMA. The agency also counsels consumers on financial and money management as well as assists, free of charge, in rescheduling or restructuring their housing loans, hire purchase, credit card and personal loans through out-of-court procedures, based on repayment plans and terms that have been agreed upon by both creditors and debtors. In October 2006, CCDMA established regional offices at the Bank's branches in Penang, Johor Bahru, Kuala Terengganu, Kuching and Kota Kinabalu. To date, over the span of less than a year, more than 15,000 customers have sought the services of CCDMA and more than 2,000 customers have received assistance under the Debt Management Programme.

In a move to combat fraud in the financial sector, initiatives have been taken to strengthen collaboration with the industry and law enforcement agencies. The Bank, the financial sector and representatives from the Royal Malaysia Police have established a Joint Steering Committee and a Joint Working Committee to share information and knowledge among the members to identify and mitigate fraud risks in the insurance and takaful sectors. During the year, several training programmes and workshops were held in major cities in Malaysia to facilitate sharing of information on, and increase understanding of, fraud risks among the industry participants. For the banking sector, the Bank works closely with the industry associations with the aim to alert the banking institutions on the trends and new *modus operandi* on frauds and preventive measures that should be taken to minimise the occurrence of frauds. The Bank will also continue to ensure that the financial sector implements appropriate systems and controls in managing fraud risks, and collaborates with law enforcement agencies to combat financial fraud.

Moving Forward

In an environment of rapid transformation of the financial sector, a more principle-based market conduct regime will be adopted. Such a regime however, requires certain preconditions to be in place to provide the supporting infrastructure and incentives that will align market practices with sound principles. Greater emphasis will therefore be accorded towards enhancing governance, integrity and transparency as the foundation for industry players to maintain public confidence and trust. Similar focus will be given to further strengthen the financial capacity of consumers as well as improving the effectiveness of redress mechanisms. This is based on the premise that a progressive financial sector is one where prudential safety and soundness, competition and consumer protection co-exist to effectively serve the interests of the various stakeholders in the financial markets.

The aim is to achieve an appropriate balance between providing an adequate level of protection for consumers while promoting increased competition and innovation in the financial system. The overriding objective is to facilitate a market place where consumers are in a position to choose from a wide range of products and services on the basis of being empowered with pertinent information and knowledge. Fostering a dynamic and progressive financial sector is a shared responsibility of the regulator, the industry, consumers and other stakeholders. In this context, consumers are expected to assume a greater responsibility in managing their finances by understanding their rights and obligations as well as in exercising due care and skill in their selection of products and services. Complementing this, financial service providers are expected to operate in a fair, equitable and transparent manner in providing their financial services to customers.