chapter three

banking sector

Background

The banking sector comprises licensed institutions namely commercial banks, finance companies, merchant banks, discount houses and money brokers which are licensed under the Banking and Financial Institutions Act 1989 (BAFIA) and supervised by BNM.

The banking sector plays an important role as financial intermediary and is a primary source of financing for the domestic economy, accounting for about 70% of the total assets of the financial system as at end-1999.

As at end-2000, there were 31 commercial banks (of which 14 are fully foreign-owned), 19 finance companies, 12 merchant banks and 7 discount houses. Upon completion of the merger programme among domestic banking institutions, the number of domestic banking institutions will be significantly reduced to 10 domestic banking groups consisting of 10 commercial banks, 10 finance companies and 9 merchant banks.

Currently, the domestic banking institutions (excluding the discount houses) control about 75% of banking sector's market share, in terms of total assets and total deposits. Despite the dominance of domestic banking institutions, the 14 fully foreign-owned banking institutions have made a strong presence in the domestic banking sector. The foreign banking institutions as a group has generally been ahead of domestic players in terms of financial performance as reflected by the higher return on equity and return on asset, operational efficiency and product innovation in the domestic market. The incumbent foreign banking institutions have generally operated based on a target market, focused on high value corporate clients as against the mass consumer and corporate customers by the domestic banking institutions. Other factors contributing to the better performance of the incumbent foreign banking institutions include their global network, access to talents and experience in various markets as well as their superior level of information technology. There are therefore significant gaps between foreign and domestic banking institutions, which need to be narrowed to achieve the orderly development of a viable and effective domestic banking sector.

Vision and Objectives

While the financial sector will become increasingly more diversified, the banking sector will continue to be an important source of financing for the domestic economy in the future. The development of the banking system, particularly the domestic banking institutions is therefore vital to facilitate and support the economic growth and transformation process. Primarily, due to their dominant market share, the strength of the domestic banking institutions is an important element of financial stability that contributes to the long-term resilience of the economy. The advantage of having better knowledge of the local market however does not promise long-term competitiveness for domestic banking institutions given the trend towards greater globalisation and liberalisation. The ability of domestic banking institutions to meet the increasingly more complex demands of the changing economy and the retention of their market share will be severely tested as domestic competition intensifies. Therefore, the survival of domestic banking institutions will be dependent on their ability to improve their efficiency and effectiveness in product offering so as to be at par with the world class players. As market forces assume a greater role, domestic banking institutions must be proactive in their strategies in order to compete with global players. Innovation and strategic reengineering will be vital as the process will eventually see domestic banking institutions having to redefine their focus and find their own niches with broad oversight by the regulatory authorities.

The banking industry is also rapidly restructuring and consolidating. Merger and acquisition activities worldwide have intensified over the last few years. New non-traditional players such as supermarkets and telecommunication companies are entering the financial services markets. These new entrants bring large customer base and more innovative delivery channels. Insurance companies, building societies and independent mortgage companies are leveraging on their large captive customer base by cross-selling a wide range of financial products. Virtual marketplaces are also increasing price transparency and pushing margins down. Websites are providing simple, easy-to-access comparisons of the fees, charges, interest rates and investment returns offered by the different providers of financial services. Over time, increased transparency will lead

to lower margins as the best product offers attract a wider range of better-informed customers.

The landscape of the Malaysian banking sector can be expected to evolve and change significantly. Players with strong value proposition will survive and expand while others will eventually exit the market. The aim is for a set of core domestic banking institutions to emerge, out of the competitive process, to become leaders in the financial sector that is able to compete meaningfully with the foreign players.

The presence of foreign banking institutions in Malaysia is currently high, controlling about 25% of banking sector's market share in terms of total assets and total deposits as at end-2000. Moving forward, incumbent foreign banking institutions will be able to operate on a more level playing field with domestic banking institutions as the domestic market is increasingly deregulated. The role played by foreign banking institutions will be assessed in terms of their contribution to the development of the financial industry as well as to the overall economic growth and stability. The introduction of new types of foreign competition, particularly during the advanced stage of development of the financial system, will also be considered with a view to ensuring that the domestic financial system continues to be effective, vibrant and responsive to the requirements of the economy.

Over time, it is expected that the domestic banking groups, through a process of mergers, acquisitions, asset swaps and alliances, will evolve into more differentiated competitors, spurred by increasingly more demanding customers and shareholders. Banking institutions will be competing on cost, to be global and to dominate in certain product segments in Malaysia at the expense of generalist institutions. The key to this is the build-up of capital size and business scale as well as the investment in the requisite ICT infrastructure and human talents.

It is envisaged that the trend towards building meaningful size will be complemented by greater specialisation. Financial institutions are specialising more and more in specific product markets or specific functions along the business chain of traditional services. These institutions develop scale and skills in the particular functions necessary to dominate in the area of focus, reduce costs and increase service quality. As they succeed in one market, these 'specialised institutions' develop other skills and scale necessary to enter new markets and become globally competitive based on strategic approaches by focusing on specific product markets or specific functions along the business chain.

While increasing size is important, this takes time and requires significant resources. Domestic banking institutions are therefore expected to consider the alternative means by which to leapfrog and acquire new skills and experience. Outsourcing and strategic alliances can assist this process. Global trend indicates this has been widespread, and is fast increasing. Banking institutions are increasingly outsourcing and entering into strategic alliances to access the skills they do not possess internally. External access to

technology, which entails high costs, ensures banking institutions access to the latest technology and will reduce replacement costs. The most significant example in the area of outsourcing is the growth of virtual banks that outsource nearly all their functions.

ICT will continue to be a key driver in banking in the future. Successful banking institutions will be the ones that are able to leverage most from the ICT revolution. Greater recognition of ICT as a driver of change among domestic banking institutions will see the rise in investment in ICT. One of the key areas of new technology investment is the development of alternative delivery channels, notably the internet. Internet financial services are already widespread in North America. Hong Kong is leading in Asia (excluding Japan) where internet financial service providers are developing strong value propositions with high participation from banking players, both in the context of wired and wireless internet banking.

Successful banking institutions in the future will be increasingly dependent on intangible assets such as talent. As competition intensifies, the need for domestic banking institutions to attract and retain the best skills and talents will become more urgent. Domestic banking institutions would therefore be expected to strengthen their human resource management.

The regulatory environment will also influence the future landscape of the banking sector. Changes in regulatory philosophies and approaches to be undertaken aim to provide conducive environment for growth and expansion of banking institutions. The key to this is the ability of individual banking institutions to adapt swiftly as well as respond and adjust to new rules.

On the consumer front, a change in mindset will have to be evolved over time. Consumers must take charge of their own finances to engender a competitive environment and lower the cost of capital. In order to achieve this, a proactive education programme has to be implemented for the consumers to be able to make informed financial decisions. Transparency will need to be enhanced, both at the product and institutional levels to promote consumers' awareness of banking and financial products. Similarly, greater flexibility in product pricing that would lead to competitive and differentiated strategies among banking institutions will, eventually benefit genuine customers, in the form of lower costs. The ability of consumers to influence the market to react positively is an important enabler for deregulation within the domestic financial sector.

Recommendations

A **change programme** would be implemented over the next 8-10 years with the objectives of improving efficiency, innovation, flexibility, resilience and dynamism in the banking system. The programme will focus primarily on building the capabilities of domestic banking institutions and increasing the incentive to improve performance. The programme will contain recommendations to be implemented over the period to develop domestic financial infrastructure, strengthen domestic banking institutions, promote financial stability, and meet

the social objectives of Malaysia in an efficient and effective manner which will cause least distortion or disruption to the financial sector. The implementation of the recommendations will observe the following approach and safeguards:

PHASE I

The main objective in the transition is to develop a core set of strong domestic banking institutions. Therefore, initial steps shall focus on measures that seek to strengthen the capability and capacity of domestic banking institutions, create an environment where the best domestic banking institutions emerge, and building and enhancing the financial infrastructure. All the 'building blocks' for creating stronger domestic banking institutions will be implemented early within the first two to four years, along with steps to create the necessary infrastructure for a more market-based consumer protection framework, which is a vital element before moving to the next phase of development. As the consumer protection infrastructure is in place, the framework to foster further competition will be introduced. The result should be the emergence of domestic players that are stronger, more efficient and innovative and increasingly more competitive and resilient.

PHASE II

Following the initial phase in which domestic banking institutions have built greater capacity and capability to compete, the playing field for incumbent foreign players will increasingly be leveled. This will begin with the removal of some of the restrictions on incumbent foreign players to add further competition to the industry, as well as providing wider choices for the consumers. These steps will be implemented gradually depending on the overall ability of the financial system to absorb these changes.

PHASE III

Consider introducing new foreign competition in the third phase of development. Given the intensifying degree of global competition and greater assimilation into the global arena, the banking sector needs to be prepared for greater liberalisation. Introducing new foreign competition would therefore be considered. In addition, there will be expansion of domestic banking institutions to foreign markets. At the same time, the potential 'threat' from new and aggressive non-financial players would also serve as an incentive against complacency and for incumbent players to remain competitive.

I. Enhancing Domestic Capacity

The emphasis here is to develop a core of strong domestic banking institutions that is able to provide the broad range of high quality products and services to the economy and that is efficient and cost-effective; and that has a significant share of domestic banking assets and profits. Broadly, this objective is to be achieved in two steps, that is, building the capabilities of domestic banking institutions through several proactive measures and implementing deregulation measures to increase competition and facilitate the emergence of leaders.

The specific recommendations for building the capabilities of domestic banking institutions are summarised as follows:

- The development of industry-wide benchmarks to drive performance improvement, investment in technology and shareholder understanding of banking institutions;
- Introduce a proactive set of capacity-building measures and solving problems identified based on information generated by the benchmarking process. A series of institutionally sponsored programme of senior management seminars and industry-wide training exercise will also be conducted;
- Enhance credit skills of the banking institutions by introducing proactive credit skill-building measures and monitoring the accreditation programme that will be required for officers involved in credit processing and decisions;
- Strengthen skills in all areas and thereby enhancing the ability of domestic banking institutions to mobilise, attract and retain the highly skilled manpower from Malaysia and overseas;
- Introduce measures to further strengthen corporate governance;
- Encourage the maximisation of economies of scale in cost, revenue and customer relationship through rationalisation and strategic alliances between financial and non-financial institutions;
- Streamline regulation of discount houses and merchant banks to level the playing field;
- Encourage and facilitate mergers between merchant banks and stockbroking companies or discount houses of the same group to create full-fledged investment banks;
- Encourage greater shareholders' activism and promote long-term support for the growth of the banking industry through institutionalised and dispersed ownership of banking institutions and bank holding companies;
- Allow and encourage outsourcing of non-core business activities;
- Encourage the development of alternative delivery channels such as internet banking;
- New licenses will be issued to banking groups with attractive value proposition such as virtual banking;
- Encourage innovation among banking institutions in product offerings whereby the regulatory philosophy of 'what is not forbidden is allowed' will be adopted;
- Remove restrictions on pricing when the necessary infrastructure for consumer protection framework is well in place and there is a conducive environment for competition;
- Enhance market discipline among banking institutions through requirement of independent ratings;

- Encourage competition and participation of banking institutions in the areas currently served by fringe institutions;
- Facilitate the development of a conducive tax regime that encourages prudence and innovation; and
- Facilitate greater coordination and research and development within the financial sector through the merging of existing associations of commercial banks, merchant banks and finance companies into one single association.

Recommendation 3.1:

Develop industry-wide benchmarks to drive performance improvement in domestic banking institutions

Increased domestic competition through deregulation will be a key driver of strategic and operational performance improvement in the domestic banking institutions. An industry-wide benchmarking programme provides a powerful tool for greater strategic focusing, for guiding domestic banking institutions to measure their own performance in ways that will highlight both operational and strategic opportunities and for the implementation of skill building measures.

Benchmarking can be used to drive the banking institutions to understand where and how to compete, and therefore stimulate the desired strategy formulation required to build strong domestic banking institutions. It can also highlight specific areas of operational weaknesses that individual banking institutions need to address, by having the right skills and business targets. The information would also enlighten shareholders on the state of their banking institutions.

To achieve these objectives, the benchmarking process will involve the collection of a broad range of data, which would include:

- **Financial and operating statistics** to be collected based on customer segment and product group and aims at driving banking institutions to understand their relative performance as well as the drivers of performance. This will help banking institutions understand their risk-adjusted returns on capital by product and customer segment, which is a necessary precondition to understanding their competitive strategies;
- **Customer needs analysis and satisfaction surveys** should form part of the process. It is important for banking institutions to do systematic market research to drive customer segment strategies, particularly in retail and small business banking; and
- **Risk management processes** which should be benchmarked against best practice templates.

A working group comprising BNM and the banking industry has been established to identify the relevant indicators and approaches that are appropriate for this process.

Recommendation 3.2:

Improve awareness of best practices and conduct focused training

Resulting from the benchmarking programme, banking institutions should undertake proactive measures to address the gaps that have been identified. Efforts will be taken by BNM, Institut Bank-Bank Malaysia (IBBM) as well as the banking institutions themselves to conduct programmes for senior management. Industry-wide training programmes, including periodic discussion groups would be organised to facilitate this process. While seminars and training programmes are long-term measures to build capabilities, the immediate objective of training programmes is to raise awareness of best practices and should be targeted at those areas necessary to improve the institutions. The immediate core areas that need to be addressed are:

- Credit risk management;
- Consumer marketing (including sales force management);
- Performance management;
- Risk-adjusted profitability analysis and pricing;
- Procurement of operational support system (such as ICT, risk management system and physical branch network); and
- Electronic commerce and banking.

Recommendation 3.3:

Enhance credit skills and monitor the requirement for accreditation of credit officers and managers

Strengthening credit skills require proactive focus in the short term. It has been identified as requiring improvement due to the following observations:

- Few domestic banking institutions use credit scoring for retail and small business lending, leading to over-reliance on collateralised lending, high costs, wide margins and customer dissatisfaction;
- Few banking institutions separate credit assessment from credit origination, leading to an inherent conflict in objectives;
- Few banking institutions conduct explicit customer risk-rating exercises, or price their lending products to cover explicitly estimated expected losses, and even fewer manage and price credit risk based on incremental additions to the risk of their total portfolio; and
- Few banking institutions monitor customer accounts across products, one of the key elements of an effective early warning system, apart from being an effective marketing tool.

In this regard, the necessary structures as well as industry seminars and training programmes to raise awareness of best practices in credit risk management and credit processes would continue to be developed and organised. Minimum standards on credit risk management will also be issued by BNM so as to further improve the credit culture. In addition, the accreditation requirement as required by BNM would need to be closely monitored to ensure its effectiveness.

Recommendation 3.4:

Remove restrictions on salaries and staff mobility in banking industry

People are the most important asset for the development of an efficient and effective banking industry. Successful financial banking institutions all over the world are those that are able to attract the best talent and reward this talent accordingly. In the

case of domestic banking institutions, senior talents are lacking particularly in key areas such as risk management, systems development, and alliance building including outsourcing management.

Domestic banking institutions need to attract the very best people, especially those that have acquired experience in the more developed financial markets. These people can either be Malaysians working abroad or foreigners who have interest to work in Malaysia. In this regard, the wage moratorium (which had since been uplifted), and penalty for staff pinching will be gradually removed.

To further improve staff mobility, banking institutions will be expected to take conscious efforts to establish efficient mechanism for redistribution of staff within the industry and sourcing for new talents. This could be done through, for instance, setting up of a single website for recruitments among the banking institutions.

Similarly, banking institutions, together with BNM and IBBM will design a comprehensive training programme to retrain staff who have been affected by the rationalisation process in order to improve their mobility and hence facilitate their redeployment into other areas in the financial sector where there are new manpower requirements.

To complement these measures, the role of unions will also be harnessed so as to bring about greater awareness and change of mindset among employees with regard to the need for banking institutions to increase productivity, efficiency and effectiveness and become performance based.

Recommendation 3.5:

Uplift restriction on employment of expatriates

The ability of banking institutions to attract best talents should contribute to the transfer of technology. However, despite the more liberal policy on the employment of expatriates in the recent years, there is little evidence of significant improvements and transfer of skills taking place in the banking industry. Given the lack of expertise in specific areas of banking and finance, the need for international talents in specific areas remains. However, it is in the interest of the country over the long term to develop its own pool of domestic skills and best talents. In this way, domestic banking institutions will not only provide job opportunities but reduce their reliance on foreign experts. However, in the immediate term, new talents from competent expatriates should serve to energise the industry. The employment of the expatriates could be made on a contractual basis with more flexible remuneration packages.

Recommendation 3.6:

Set up board committees to further improve corporate governance

The key principles of corporate governance are that members of the Board of Directors (BOD) act as representatives of all the owners (shareholders), and potentially of other stakeholders, in their oversight of executive management actions. This means:

- Ensuring directors are qualified, have the necessary information available to exercise their

responsibilities, can veto management decisions that are not in the interests of their constituents, and are compelled to do so through some level of personal liability; and

- Those shareholders (and, potentially, other stakeholders) have the ability to discipline directors who do not perform up to their expectation.

In order to further enhance corporate governance in the long term, it is proposed that:

- All banking institutions be required to establish the following Board Committees, in addition to the existing required committees i.e. Audit Committee, Credit Committee, Asset and Liability Committee:

  - **Nominating Committee -** Responsible for nomination of directors and committee assignments. This committee should comprise of only non-executive directors. The purpose of a Nominating Committee is to counter-balance the influence of executive directors, in response to legitimate concerns of over powering and dominant stature of some owner-managers, to ensure that appointees are suitably qualified. The Nominating Committee should also be responsible for overseeing the composition of the BOD.

  - **Management Development and Compensation Committee(a compensation committee is already required)** - The primary purpose of this committee is to evaluate the performance of management and ensure that executives are appropriately compensated, given their contribution to the creation of shareholder value.

  - **Risk Management Committee** - Responsible for all risk management policies and processes, including market risk management, credit risk management and operations risk management. This committee is not responsible for taking particular market risk positions or credit decisions. It is, essentially, responsible for reviewing decisions made by the Credit Committee and Asset and Liability Committee when these decisions contravene the policies and guidelines that have been established. This 'division of powers' in regard to risk management is a powerful tool for ensuring disciplined and consistent application of risk management principles.

    The above committees should be chaired by non-executive directors. However, in certain cases, executive directors may also be appointed to chair the above committees subject to conditions to be set by BNM. Regular attendance is required for the Board meetings and Board Committee meetings, as per BNM's Guideline on Duties and Responsibilites of Directors and Appointment of Chief Executives (BNM/GP1). This is to ensure that directors have full knowledge and understanding of their institution or relevant function and bear responsibility for its performance.

- To facilitate the desired level of transparency of performance outcomes to shareholders through provision of summary benchmark data, annual analyst briefings by publicly listed financial

institutions would be mandated immediately after announcement of the Annual Report and the Annual General Meeting. The purpose is to ensure that analysts have the opportunity to understand and educate existing and potential shareholders the drivers of performance as well as the strategic strengths and weaknesses of the individual banking institution.

Recommendation 3.7:

Allow group rationalisation and facilitate the operation of one-stop financial centre

In the pursuit of improving competitiveness, efficiency and effectiveness in the delivery of banking products and services, there has been a global trend for financial institutions to create one-stop financial centres that offer wide ranging facilities to customers. This phenomenon involves the conduct of businesses, traditionally carried out solely by either commercial banks, merchant banks, finance companies or stockbroking companies. The ability to offer customers a broad range of financial services through the same distribution channel will be the key to building stronger customer knowledge and relationships - crucial sources of competitive advantage for banking institutions. Research findings indicate that having such centres enable financial institutions to benefit from both revenue and cost synergies through cross-selling products and consolidating back-office processes and rationalising branch operations.

Thus, in order to increase efficiency and effectiveness of banking institutions in meeting the increasingly more differentiated demands of their customers, a wider scope of operations of one-stop financial centres should be considered over the long term. This could include allowing banking institutions involved in cross-selling to consolidate their balance sheets and operate as a single entity holding multiple licenses, subject to prudential considerations. This will require a review of the present licensing requirement and laws regulating the operations of banking institutions in the country. In the immediate term, there are potential benefits of cross-selling and rationalisation of operations that are already permitted by BNM.

Recommendation 3.8:

Encourage strategic alliances

Equity alliances are one of the possible means for domestic banking institutions to catch up to international standards in terms of skills, technology, culture and scale. Significant benefits stand to be derived for domestic banking institutions from alliances with other banking institutions and non-banking institutions. This includes opening up new growth avenues through access to new markets or skills. Alliances between international financial institutions are widespread and fast increasing. Financial institutions in other countries are making increasing use of mergers and equity alliances for a range of reasons, namely, to access skills and scale, access new customers and delivery channels, cut costs, develop new products and access cutting-edge technology.

Moving forward, alliances will be encouraged either in the form of a joint venture (incorporated or unincorporated), an equity swap, a minority equity stake or a contractual alliance. International alliances

would also be considered subject to the prevailing permissible equity participation level. Competition and innovation among banking institutions will also be encouraged through alliances between bank and non-banking institutions such as telecommunications operators, satellite TV providers, and ICT companies as well as between domestic and foreign banking institutions.

Recommendation 3.9:

Streamline the regulation of discount houses and merchant banks to level the playing field

Leveling the playing field between discount houses and merchant banks would allow fair competition among players in the domestic market. Due to the convergence in the activities of these two players, leveling the playing field will enhance competition and reduce possibility of regulatory arbitrage by players in the same group. The streamlining of regulation would be in the areas of the reserve requirement, risk weightings on assets as well as scope of activities undertaken.

Recommendation 3.10:

Encourage mergers between merchant banks and stockbroking companies or discount houses of the same group to create full-fledged investment banks

The merchant banks should be developed into full-fledged investment banks, so as to be at par with international investment banks and to have the ability to undertake trading and brokerage activities, apart from merely providing advisory services. As such, mergers between merchant banks and discount houses, and between merchant banks and stockbroking companies within the same financial group will be encouraged and facilitated to reduce duplication and improve efficiency.

To facilitate this process, the legal and regulatory framework governing the banking and securities industries would need to be fine-tuned and harmonised. Investment banks would be supervised by both BNM and the Securities Commission (SC). Appropriate regulatory and supervisory mechanisms would be formulated to govern the operations of the investment banks. This is to ensure that there are no regulatory gaps or that there is no excessive regulatory burden for the investment banks arising from the dual regulatory environment.

Recommendation 3.11:

Encourage ownership of banking institutions by institutional investors

Long-term growth of the domestic banking industry depends substantially on the availability of financial and non-financial support from shareholders, in terms of capital for business expansion, skills and experience as well as commitment to pursue business strategies. Hence, it is necessary to ensure that the owners of banking institutions are able to commit their resources for the development of strong banking institutions and a dynamic financial sector. Over the long term, such support could come from institutional investors that have an understanding and strategic interest in developing the financial services industry. Historically, the majority of domestic banking

institutions is either family-owned businesses or controlled by prominent individuals. Hence, the development of these banking institutions largely depends on the capacity of the individuals to inject new capital and provide the necessary resources and expertise. Furthermore, the premium attached to owning a banking license is high, given that no new license has been issued for some time. This has to some extent contributed to the slow consolidation of the banking industry.

Moving forward, greater participation of the institutional investors in the financial sector will be encouraged in order to develop and nurture the much needed shareholders' activism to drive performance improvements among domestic banking institutions. The legal provision of section 46 of the BAFIA which limits the shareholding of a banking institution to not more than 20% for corporations and 10% for individuals, will be strictly enforced such that the ownership structure of domestic banking institutions and their holding companies will improve. A divestment of shares over a reasonable time frame would be introduced to meet this objective.

Recommendation 3.12:

Encourage outsourcing of non-core functions

Outsourcing is a potentially useful tool in assisting banking institutions to neutralise the scale advantage enjoyed by larger institutions, to cut costs, and to focus the banking institutions' attention on developing strong skills in niche areas. It allows institutions to concentrate their resources and energies on developing a set of core competencies. It will also allow the banking institutions to access scale and skill improvements in core areas of their business, as well as enhance the customer service level. Well-developed core competencies provide competitive advantage against existing and future competitors. Focused and well-established relationship will improve the competitive advantage.

In the rapidly changing marketplace and the pace of technological advancements, outsourcing can decrease the risk of investing in outdated technology, shorten upgrade times and potentially create better customer responsiveness. In the current environment of technological change, flexibility is particularly important for the banking institutions.

Areas that can be outsourced by banking institutions on a contractual basis are low-skill processes that are not crucial to the strategic positioning of the institution. These include back-office processes such as data entry, data conversion, transaction processing, payroll functions and certain ICT functions such as coding and technical design. Other ICT processes such as website services, network management and advanced data analysis can also be considered.

There are several alternatives with respect to outsourcing. While using the services of locally based providers could be an attractive option, some banking institutions may want to set up in-house units or pooled arrangements between few banking institutions to obtain scale advantage. Consideration however needs to be made with respect to the sharing of information and the secrecy provision specified in section 97 of BAFIA. Some flexibility however can

be accorded to outsourcing by banking institutions for it to achieve a discernible effect on costs and jobs allocation.

Recommendation 3.13:

Require management of banking institutions to give greater attention to the development of ICT

Given the speed of changes in technology, the large ICT investment by banking institutions, however, does not necessarily guarantee against obsolescence, scalability and flexibility in the future. Therefore, attention at the highest senior management level will be vital to ensure the formulation of appropriate ICT strategies. The investment should aim at allowing maximum flexibility and expandability in the future. The ability to discern trends and developments in ICT and hence, appreciate the potential impact on the institutions is critical. ICT should be regarded as a strategic tool to create value, and not simply an operational tool to enhance work processes. Examples would be in the use of customer relationship management (CRM) tool to analyse customer profiles and behaviours for better marketing and strategic focus and the application of customer-managed relationships (CMR) that allow better understanding of customers' needs. Hence, the ability to contribute to the development of technology within the banking institutions will be part of the core competencies to be expected of senior management in the future.

Recommendation 3.14:

Encourage the development of new delivery channels

Innovative and more efficient delivery channels such as internet and mobile phones will become an increasingly essential part of a modern banking system. It will offer banking institutions significant advantage in customer retention, customer acquisition and service cost reduction. Skills and brands can be developed and promoted through these channels, which have been important for success in other high technology services such as TV/broadband banking. High technology services such as internet banking offers a unique value proposition to consumers and is growing fast globally. The internet improves accessibility to banking products and services, and can be harnessed not just as mere delivery channels but as new business venture through the setting up of virtual banks by banking institutions.

In this regard, banking institutions will be allowed and encouraged to embrace these innovative approaches. At the same time, minimum standards will be imposed to ensure that such innovations do not compromise financial stability and integrity. Thus, its regulatory framework will balance the various trade-offs between efficiency and financial system stability.

Recommendation 3.15:

Adopt 'what is not prohibited is allowed' regulatory philosophy and phase out product pre-approval requirement

The present approach involves pre-approval requirement restriction on activities to be undertaken by banking institutions. Participation and introduction by banking institutions in these new services is subject to the approval requirement.

Although some restrictions are necessary for prudential purposes or consumer protection, the requirement for approval to conduct activities that are not clearly forbidden has been viewed as an impediment to innovation.

The uncertainty among banking institutions as to the regulatory requirements for new approaches to be approved has contributed to the uncertainty and has been a disincentive to innovative ventures. As such, banking institutions have tended to remain with their traditional approaches.

In addition, this has been aggravated by the lack of pressure for banking institutions to improve efficiency and effectiveness in the absence of aggressively demanding customers and shareholders.

A move to the approach of 'what is not prohibited is allowed' should provide more certainty to banking institutions to new and innovative banking activities from regulatory perspective. The adoption of this philosophy however must be complemented with efforts by banking institutions to improve the level of product transparency and consumer education. Banking institutions would be required to increase product transparency and improve access to product information as well as to make available an effective mechanism to address and provide resolution for consumer complaints.

In addition, a more efficient structure involving Banking Mediation Bureau (BMB) as an efficient means to address consumer complaints will need to be implemented.

Recommendation 3.15.1:

Replace product pre-approval requirements with a simple new product notification process

A simpler product notification process will give incentive for investment in new and innovative products. Banking institutions will be encouraged to invest in research and development to develop products that can capitalise on their areas of expertise. The notification process will be sufficient to ensure that regulators are aware of market development on new products. Intervention with corrective actions shall still be possible for cases of improper disclosures to ensure that there is adequate protection for consumers against wrong and misleading information on banking products. BNM will also have the right to recall products that have been introduced by banking institutions which have detrimental effects to the consumers or the stability of the financial system.

Recommendation 3.15.2:

Outline guidelines for all applications for regulatory exemptions

Following the above recommendation, a set of clear guidelines for applications for regulatory exemptions to ensure that banking institutions provide the relevant information would be issued by BNM. This will contribute to reduce the response time for approval of new banking products and give incentive for innovation. The reasons for rejection of products will be communicated to the banking institutions to indicate the nature of the regulatory concerns.

Recommendation 3.16:

Deregulate pricing and rules of association on rates, fees and charges gradually

A key element in driving performance improvement in domestic banking institutions is to increase substantially the competitive intensity in the industry. This will drive the specialisation, focus and agility that will be required to build sustainable competitive advantage for core domestic banking institutions. At the heart of increased competition is the need for market-determined prices.

As the ability of banking institutions to price their product improves over time, the present rule on pricing and imposition of fees and charges on selected products and services would be further liberalised. This would seek to:

- Avoid high lending margins, possibly through tacit agreements not to price below the base lending rates;
- Avoid overpricing to certain customer segments, and credit rationing on others that could possibly happen in an environment where price cap is imposed; and
- Facilitate product bundling for segment-specific bundled products with segment-targeted pricing, which is potentially a key source of competitive advantage for domestic banking institutions when competing with specialised market player.

Price limitations would be removed together with an effective monitoring of price collusion among banking institutions to ensure that collusive behaviour does not emerge. Another precondition would be an effective market-driven consumer protection framework where consumers are able to exercise their rights and have recourse to legal protection to address potential problems.

Recommendation 3.17:

Mandate all banking institutions to be rated

One of the important elements in building capacity of banking institutions is the implementation of measures that aim to exert and improve market discipline. This is particularly important as regulation plays a lesser role in determining market outcomes. Under a more liberalised environment, the activities of banking institutions will be subject to the scrutiny of market players and hence there will be greater demand for transparency. Banking institutions' performance will be measured against a broad spectrum of financial benchmarks that will reveal the key strengths and weaknesses of the banking institutions.

To ensure that banking institutions are consistently aware of the role of market forces in evaluating their performance, measures to enhance market discipline will need to be implemented. Therefore, it is recommended that the banking institutions be rated by at least a local rating agency. The rating should serve to inform consumers and investors the level of risks in the banking institution. A precondition to this is an enhanced level of consumer education and depositors' understanding of financial information. Improvement in the level of transparency and accountability of rating agencies

would also be an important prerequisite for the implementation of this recommendation.

Recommendation 3.18:

Encourage competition and participation of banking institutions in areas currently served by fringe institutions

Fringe institutions include savings institutions, housing credit institutions, leasing companies, factoring companies and credit token companies. Altogether, these institutions account for less than 4% of total assets and less than 5% of total deposits in the financial system. These fringe institutions therefore have limited impact on the efficiency, effectiveness and stability of the overall financial system.

In the long term, banking institutions would be expected to increase their participation in the areas currently served by fringe institutions. While some of the fringe institutions will survive the competition and expand, some of them may be phased out or be taken-over by banking institutions. It is not possible to forecast who the future winners in each market will be. The end game will depend not only on the degree of market orientation of the financial system, the regulatory framework but also on the evolution and transformation of the real sector. The options are open as long as there is a comparative advantage in a competitive market where the institutions operate under the same rules.

As the business focus of fringe institutions becomes broader and riskier, it will be necessary for the regulatory framework to evolve accordingly. For mortgage building societies, for instance, the initial business focus on end-financing, has now been shifting towards financing housing developments. As the risk of the business has increased and in order to promote a level playing field among the financial institutions, it will be necessary for the authorities to exercise a certain form of prudential regulatory control over their activities to ensure that consumer protection and investors' interests are preserved.

Recommendation 3.19:

Facilitate the development of a conducive tax regime

While certain tax exemptions have been granted to drive banking businesses, particularly those involving mergers and acquisitions, certain aspects of the tax framework may need to be reviewed further to provide incentives to encourage financial prudence and innovation. This relates to, in particular, facilitating greater research and development activities, thereby encouraging innovation among banking institutions.

Recommendation 3.20:

Merge the associations of banks, merchant banks and finance companies into a single association

While the financial sector is progressing towards greater consolidation, efforts should be taken by the three respective associations to converge by establishing an association with wider and broader memberships of financial institutions. The current efforts of the three associations can be assimilated and streamlined in the merged association, whereby the scope of work can be more exhaustive and conclusive in dealing with the issues relating to the financial institutions. On training, the synergy obtained through cross memberships can further enhance the skill level and understanding of the staff in the financial institutions. The merged association is hoped to undertake further consumer education programme and develop a close network of professionals with similar prudential behaviour and

identity. A website detailing their products and services, as well as educational materials on current issues could be established.

II. Promoting Financial Stability

Maintenance of stability in the financial sector is one of the core objectives of the FSMP and will remain an important challenge for regulators. Banking institutions should be resilient to systemic and external shocks and be in a position to provide high quality service to consumers throughout the transition process of the implementation of the FSMP. An important aspect of this is the regulatory framework and having a set of risk-adjusted prudential regulation and supervision to ensure safe and sound institutions and the protection of the interest of all stakeholders, as well as the development of an efficient and reliable infrastructure. A careful balance will be made between the need for protection and stability against the need to attain efficiency and competitiveness.

Strong, Risk-Adjusted Prudential Regulation and Supervision

In moving towards a market-based supervisory framework, the regulatory framework would need to be adapted accordingly. Flexibility is vital in order to accommodate the rapid technological advances and avoid stifling innovation. The challenge for the regulator would be to ensure continuous surveillance of market developments and the evaluation of trade-offs between encouraging innovation and maintaining stability. These would include implementing the following measures:

- Strengthen corporate governance and risk management capabilities of banking institutions;
- Continue implementing risk-based supervision with incentives for strong performers and more focused supervisory attention for weak institutions;
- Strengthen consolidated supervision of financial conglomerates;
- Refine capital adequacy risk weightings in response to new market developments and based on the risk profile of loan books;
- Introduce legally binding arrangements for banking institutions to implement examiners' findings;
- Enhance surveillance of the financial sector to provide early warning signals to impending problems; and
- Implement a transparent and clearly structured early warning system and set of prompt corrective measures for weak institutions.

These recommendations are discussed in the following sections. Corporate governance and risk management are already covered in Section I of this chapter.

Recommendation 3.21:

Continue implementing risk-based supervision with more focused supervisory attention for weak institutions

It is recommended that BNM continues to conduct its supervisory function using the risk-based approach where on-site examination will be focused on a few high risk areas. Banking institutions with higher degree of risk would be continuously monitored

and subject to more regular and intense on-site examination. As an added incentive for the banking institutions, the proposed set up of the deposit insurance fund as discussed in Section III of this chapter will require contribution from banking institutions based on a risk-based approach.

Recommendation 3.22:

Refine calculation of risk weightings for the purpose of capital adequacy calculations

A more sophisticated and differentiated treatment of different risk classes shall be developed to take into account the risk profile of loan exposures to different sectors of the economy, besides incorporating the market risk. The aim of this measure is to be able to assess the required capital for the institution, depending on the risk profile of that particular institution. Besides the above, the revised risk-weighted capital adequacy framework places greater reliance on the assessment of credit risk, through internal ratings or use of external ratings to determine risk weights.

Recommendation 3.23:

Implement a system of incremental enforcement actions

Incremental enforcement actions against problem banking institutions shall be developed to implement examiners' findings. These will be divided into informal and formal enforcement actions.

Informal enforcement actions may include board resolutions (declaration by the BOD outlining a plan to deal with identified weaknesses), and memorandum of understanding (MOU), outlining specific actions an institution must take to address and correct identified weaknesses or non-compliances. Unlike board resolutions, the MOU will be drafted by BNM and signed by the members of the board of affected banking institutions. On formal enforcement actions, these will be imposed by BNM on banking institutions, which were found to be operating unsatisfactorily as highlighted by the examiners' findings. This may include a written agreement or capital directives, cease and desist orders, penalties, and prompt corrective actions required for institutions with weak capital positions. The purpose of the formal enforcement actions is to ensure that banking institutions seek remedial actions on the findings raised by the examiners. The formal enforcement actions must have a legal standi. This will therefore require amendments to the BAFIA or specific regulations to be gazetted.

Recommendation 3.24:

Implement a transparent and clearly structured early warning system and set of prompt corrective measures for weak banking institutions

The transparency of intervention process to banking institutions will be an important incentive for banking institutions to avoid adverse publicity and reputation. This is to facilitate enhanced corporate governance among banking institutions. An explicit codification of the trigger points would also result in making the intervention process more consistent and meaningful. The prompt corrective actions will be taken in cases where specific early warning indicators reached identified levels such as declining risk-weighted capital ratio (RWCR) which indicate deterioration in the overall safety and soundness of banking institutions.

However, the transparency of the intervention process will be managed so as to avoid any

destabilising consequences on the individual banking institution. It will be complemented with adequate consumer education programme and institutional transparency, whereby banking institutions are to publish adequate information for the public to make informed decisions.

Recommendation 3.25:

Enhance surveillance of the financial sector through the use of modern technology

Given the increased volatility of the financial markets, the degree of surveillance by regulatory agencies over financial activities and developments in the financial market will need to be enhanced significantly. This would be achieved through the use of modern technology that allows real time information to be collected. Key information on market development will need to be provided in an integrated manner so as to allow better understanding of the impact of such developments on the financial sector as well as the economy. Such information should be presented in the manner that would facilitate analysis and understanding among policy makers as well as to provide the early warning signals for impending problems. A single comprehensive system of real time information on financial markets that allows tracking of sources of risks in the economy should be developed to allow early corrective actions to be taken.

Recommendation 3.26:

Develop comprehensive framework for consolidated supervision of financial conglomerates

The increasingly complex group structure involving financial conglomerates with heterogeneous capital requirement and risk factors and a combination of at least two entities from the banking, insurance or securities industry has called for an enhanced framework for consolidated supervision. This is to ensure that the financial health of the conglomerates can be assessed on group-wide basis, and not just at individual institutions level. Regulation would therefore need to balance between allowing group synergy and efficiency, and ensuring that the activities of the financial conglomerates do not introduce excessive risks to the financial system.

Developing a comprehensive approach towards consolidated supervision would not only require streamlining principles of regulation of the different entities within the group, but also to study the various financial conglomerate structures that may impair effective supervision. This is vital in order to formulate appropriate policies with respect to regulatory principles and the acceptable corporate structures. Here, a clear scope or materiality threshold of supervision on the financial group would be defined. Another aspect would be the assessment of the group-wide methods of supervision such as on the measurement of capital adequacy, risk concentration, intra group transactions as well as adequacy of internal controls and corporate governance. A key requirement for

the implementation of the consolidated supervision is an efficient information sharing and coordination among the different regulatory bodies.

Efficient and Stable Infrastructure

An efficient and stable financial system needs to be built on a solid foundation made up of interconnected financial infrastructure. Four elements of the necessary infrastructure include:

- Deep and liquid **capital markets** allowing institutions to broaden their product offering and manage their risk exposures. Through balance sheet structuring, investment choices for consumers can be diversified, and contribute to macro-level stability (This is covered by the Capital Market Masterplan by the SC);
- Efficient and reliable **payments system** promotes efficiency and inspires consumer confidence in banking institutions and in the wider financial system;
- Use of **electronic trading platforms** in the foreign exchange and money market to improve efficiency and the accessibility level in the market; and
- Strong **consumer protection infrastructure** protects consumers, promoting public confidence in the system (Recommendations in this area will be covered in Section III of this Chapter).

Recommendation 3.27:

Increase efficiency and competition in the payments system

As we move forward, the efficiency of the payments system should be enhanced to support the needs of the financial system. The financial system would require a payments system that is capable to facilitate settlement between various financial players and for various types of instruments in the market. In this regard, a flexible, proactive and effective regulatory framework for the payments system would be adopted by BNM in its oversight of the payments system. The framework would seek to improve the efficiency of the payment-related infrastructure while maintaining the safety and integrity of the payments system. The regulatory framework would provide a holistic view of the payments system and would cover the following areas:

- BNM policy objectives in payments system;
- Scope of regulatory oversight by BNM on payments system;
- Policies on the conventional payment mechanisms (e.g. Automated Teller Machines [ATM], debit, credit and charge cards) as well as payment mechanisms made possible by the advent of internet (e.g. e-money, e-cheques, barter trade exchange);
- Minimum criteria and standards including security standards for service providers to be authorised to provide payment services; and
- Minimum standards to address consumer related issues such as transparency of fees and

charges, privacy of consumer information, as well as consumer education and awareness programmes.

Recommendation 3.28:

Allow market forces to shape developments in the payments system while BNM assumes the role of regulator

As the payments technology and the structure of the financial services industry are changing rapidly, it would be more efficient and effective for the market forces to play a pivotal role in the development of the payments system. Allowing greater competition will increase innovation in payments system, particularly for the retail payments system. By driving competition further and allowing alternative payments system and gateways, greater dynamism and efficiency would be encouraged in the existing payments system providers. Recognising this, BNM will adopt a facilitative rather than a developmental role, especially in the retail payments system. However, BNM would need to ensure that minimum security standards are met when new systems are introduced.

Recommendation 3.29:

Allow incumbent foreign banks to set up shared ATM network

Currently, the foreign banks individually manage a limited number of ATM machines. The presence of an alternative ATM network operated by foreign banks will drive further dynamism in the traditional payment networks and provide an alternative payment channel for the consumers. In the long run, there is a possibility for the domestic ATM operator, Malaysian Electronic Payment System Sdn Bhd (MEPS) to initiate a merger between the two networks to form a single ATM network. While this could be an optimal solution, the decision by MEPS with regards to its future strategies should be based on the business value of the alternatives.

Recommendation 3.30:

Allow use of electronic communication networks and electronic trading platform

The significant growth of the internet has contributed to the increased popularity of electronic communication networks and electronic trading systems. While this could lead to a disintermediation of traditional players, these advancements in technology have enabled the incumbent players to reap greater opportunities and extend their market reach. In this regard, domestic financial institutions and brokers should seek efficiency gains by conducting transactions through electronic means with respect to their operations in the foreign exchange and money market. Regulatory flexibility would be accorded to encourage efficient use of technology for provision of transaction systems that can provide measurable cost savings to the participants.

III. Meeting Socioeconomic Objectives

Another primary objective of the FSMP is meeting the social objectives of Malaysia, particularly with regard to:

- Access to funding by priority sectors in the economy (SMIs, low-cost housing and Bumiputera entrepeneurs);

- Providing advisory services to small borrowers;
- Providing banking services in rural areas;
- Funding of specific industries (agriculture, shipping and infrastructure); and
- Consumer protection.

Access to Funding by Priority Sectors

Priority sectors such as the SMIs are essential sub-sectors of the economy that require financing. While the development of low-cost houses and lending to Bumiputera community seek to raise standards of living and improve the socioeconomic balance, the SMIs contribute more significantly to the economic transformation and growth of the country. Over time, SMIs will be increasingly more significant such that it will become a vital foundation of the economy, hence, bringing larger volume of businesses to banking institutions. Banking institutions need to maintain good long-term relationship and understand the businesses of SMIs.

While it is important to ensure adequate financing to these sub-sectors, such provision of financing should be consistent with the objective of developing an efficient banking sector. The present approach would be reviewed and enhanced as embodied in the following recommendations:

Recommendation 3.31:

Introduce an expanded credit guarantee scheme

Lending to priority sectors by the banking institutions should be implemented through mechanism that has least distortion on the efficient working of the sector (Access to funding to priority sectors from other sources is covered in chapters 6 and 7). Presently, there are three lending targets imposed on the banking institutions, namely lending to SMIs, lending to the Bumiputera community and low-cost houses. While the banking institutions as a group, have always met, the overall lending targets, some banking institutions have had difficulty in meeting the individual lending targets for SMIs during the crisis years.

Overtime, as price deregulation takes place, the lending targets can be gradually replaced with an expanded and more efficient credit guarantee system. Such a framework will ensure that continuous access to financing by these sectors while at the same time avoid homogeneity in bank strategy and the maintenance of duplicated infrastructure, as well as weakening the credit system. The fiscal cost to the Government under this arrangement will be in the form of higher guarantee funds that need to be allocated to the Credit Guarantee Corporation (CGC). The CGC will play a larger role in guaranteeing the priority sectors, especially the SMIs. At the same time, Cagamas would play a role in supporting loans extended to the low-cost houses. Besides introducing more attractive financing schemes, CGC has taken a number of steps recently to improve its operations, including opening of new branches all over the country as well as strengthening its funding structure. This will prepare CGC for the enhanced role in the expanded guarantee scheme.

In the new framework to be introduced, CGC is expected to expedite application and the approval process by the setting up of a portal whereby SMIs can apply for loans with CGC guarantee directly. Under such arrangement, the CGC would then solicit from banking institutions their proposed lending rates and guarantee requirements for the loan. Among the prospective lenders, CGC would select the best offer, which is the one with the lowest price as well as lowest guarantee requirement. The scheme, once fully operational would require full participation from the banking institutions. The size of CGC's funding would therefore be further increased through mandatory contribution from all banking institutions, in amounts equivalent to their directed lending target financing. Prior to the removal of the existing lending targets, the banking system's overall compliance with specified targets will be monitored. The lending targets would be gradually removed when the banking institutions have developed the ability to support these priority sectors, and BNM is assured that these sectors will have continued access to financing.

Recommendation 3.32:

Require provision of advisory services on financial planning and management to SMIs and small borrowers

As SMIs and small borrowers become increasingly important customers of banking institutions, the financial support expected from the banking institutions will need to go beyond mere funding. Recognising the business opportunities in the future, based on the earning potential of some of these enterprises, banking institutions would therefore be expected to establish long-term relationship with these borrowers and dedicate resources for provision of a more comprehensive financial support including advisory services on financial planning and management. This would contribute towards better financial understanding and management among these borrowers.

Recommendation 3.33:

Allow banking institutions to rationalise their branch network and relocate branches, subject to certain conditions

In terms of number of branches in the country to the number of population, certain areas are found to be under-branched, where certain geographic locations in the country are not served by any banking institution while there is a high concentration of banking institutions in the urban areas. There is therefore a need to improve the dispersion of the branches in the country through a branch rationalisation exercise. The rationalisation of branches by banking institutions is also necessary for the banking institutions to achieve the right mix of target market and achieve cost savings.

In order to ensure that all areas are served by a banking institution, it is recommended that all areas currently served by banking institutions are to be continuously served by at least one banking institution. The banking institution would be allowed to rationalise their branches as long as there is one branch of a bank serving the area where the branch is to be closed. In order to be equitable, future branches, particularly in the rural areas should be

undertaken by banking institutions that currently have lower-than-average number of rural branches.

Over the longer term, established banking institutions can form alliances to serve the rural areas and create value proposition through tailored products and delivery channels. The channels of delivery can be provided in the form of alliances with retail outlets or with the post offices, so that the institution does not have to build its own network of branches and can thereby decrease its cost base. The supermarket/post office for example can have one multi-function ATM and one employee with a connected computer to the head office. All credit applications would be sent to a central or regional credit centre and replenishment of cash can be outsourced.

Consumer Protection Infrastructure

A crucial aspect of stability in the financial system relates to its ability to undergo the transition to deregulation and increasing competition without resulting in disruption in the level or reliability of services to consumers. The need to protect consumers from potential unfair practices by banking institutions will continue to be one of the main areas of responsibilities of BNM.

Moving towards a supervised market-driven financial system, BNM would need to be less involved in a 'hands-on' way to regulate and supervise the financial sector, and thereby avoid micro-managing the industry. Nevertheless, as part of its social obligation to the country, BNM will continue to ensure that necessary infrastructure is put in place to protect customers from possibilities of unfair practices by banking institutions. Consumer education and awareness are essential to achieve this objective and to ensure that the level of information and guidance to the public will be enhanced.

Recommendations in this section are aimed at ensuring adequate and effective consumer protection in an increasingly market oriented financial system. The recommendations are made under six headings, namely:

- Initiate an active and structured consumer education programme;
- Increase transparency on the performance of banking institutions and the profile of new products;
- Establish legal redress for consumers;
- Expand the operations of the Banking Mediation Bureau (BMB);
- Introduce anti-trust regulation; and
- Set up a deposit insurance fund.

Recommendation 3.34:

Initiate an active and structured consumer education programme

A crucial element in making the FSMP a success is the development of active consumerism. Active consumerism can only be developed with the public having a strong understanding of the products and services of the banking institutions. In view of this, BNM and the banking institutions would need to undertake a structured consumer education programme to educate consumers on retail products and services. The public needs to be informed of the roles and functions of the financial players and the various types of financial instruments being offered. The programme would be comprehensive involving publishing articles in mainstream media and other publications, roadshows and integrating into the curriculum in schools and institutes of higher learning.

Recommendation 3.35:

Increase product-specific and institutional transparency and move towards full disclosure

Product transparency shall be improved through the implementation of full disclosure requirement for retail financial products. In moving towards a standard full disclosure model for products, the following actions shall be taken:

- Develop clearly defined guidelines for comparable disclosure of all fees, interest rates, yields, and other standard product features. The objective would be to achieve more complete disclosure (i.e. product information) to consumers for all financial products;
- Develop a dictionary of common terms used to describe and compare products;
- Require institutions to test initial marketing and disclosure documents with focus groups to ensure that they are easily understood by a representative sample of the population of Malaysia;
- Standardise disclosure rules in formats consistent with internationally recognised best practices to allow clear and transparent analysis and comparison of product features and associated risks; and
- BNM maintains the right *ex post facto* to require an institution to recall product or material that is deemed misleading and reissue clarifying materials.

With regard to institutional transparency, BNM/GP8 'Guidelines on the Specimen Financial Statements for the Banking Industry' would need to be reviewed to ensure that the guidelines are in line with the developments in accounting standards and to enable depositors and investors to gauge the relative strengths of individual banking institutions.

Recommendation 3.36:

Encourage consumers to pursue formal administrative and legal redress

Formal administrative and legal redress should be taken by consumers if they suffer harm due to purchase of financial products and services. This requires banking institutions to set up their own complaint desks to tackle issues brought to them by their clients. The next course of action for the consumer to take is to bring the matter up to the BMB. The BMB was set up to provide redress for consumers aggrieved with the service taken from banking institutions involving financial loss such as ATM-related matters. In this instance, consumers are encouraged to put up complaints against banking institutions, failing which, legal recourse should be taken under the court of law.

Recommendation 3.37:

Expand the operations of BMB to cover full range of retail banking-related consumer complaints

In order for the BMB to undertake the above recommendation, the operations of BMB would be expanded as part of measures to enhance consumer protection against fraudulent and negligent behaviours by banking institutions and their staff. In order for the BMB to play a greater role, its funding and staffing would need to be increased correspondingly. The BMB would have the power to be an independent mediator in the case of all consumer complaints. The BMB would also assume

the primary role in educating banking consumers of their rights and means of channeling their complaints, and available courses of actions.

Recommendation 3.38:

Implement anti-trust regulation

Anti-trust regulation will be developed to define the process by which abuses are brought to the attention of and to be dealt with by BNM. This will be developed over the long term as banking institutions begin to specialise and gain strength and dominance in specific areas. Such regulation will address monopolistic behaviours and be implemented together with the expanded role of the BMB. BNM would monitor whether there is collusion among banking institutions to fix prices which could be detrimental to the consumers.

Recommendation 3.39:

Establish a deposit insurance fund

During the recent crisis, the Government issued a blanket guarantee on deposits and interbank placements. A 100% guarantee of deposits places a considerable financial burden on the Government, a burden that, to avoid moral hazard, should partly be borne by banking institutions. It is therefore recommended that a deposit insurance fund be established. Contribution into this fund would be risk-adjusted. This will serve two purposes, that, it offsets the moral hazard created by a blanket guarantee or insurance scheme; and it creates an incentive for prudent management in line with the FSMP recommendation to move towards performance-based prudential regulation. The depositors on the other hand should be assured that the fund will protect small deposits.

Approach to Implementation

The above recommendations would be implemented and sequenced so as to minimise disruption and dislocation and to maximise the benefits to be achieved. For this purpose, safeguards will be in place, and the necessary milestones need to be met to move to the next stage of development. It is essential however, that a certain momentum is maintained during the implementation period, but at the same time, ensure that the transition is smooth for consumers and facilitate the objective of building an effective, efficient and resilient banking sector. In this regard, BNM will oversee and manage the implementation with the aim of speeding up the transition where possible. The implementation will be made through a consultative and iterative process, involving the stakeholders, namely the banking institutions and relevant public authorities.

In overseeing the implementation of the recommendations, the following areas will be monitored:

- **Efficiency, effectiveness and resilience of domestic banking institutions**

  This process is to be conducted by assessing the progress of the industry and, within that, progress of domestic banking institutions as a group. The performance of the banking institutions as a group in the assessment will be important in order to determine the speed of transition to be undertaken. Key indicators that will be used to

evaluate the progress include tangible pace of product innovation, critical ratios on cost efficiency, market penetration as well as the magnitude of lending margins which will be indicative of the level of competition in the market. The progress of individual domestic banking institutions will also be continually assessed. The objective of this assessment process is to identify the domestic banking institutions that will potentially emerge as the 'winners' in the future. The assessment of individual banking institutions will involve assessing improvements in innovation, the adoption of best practices especially in the area of risk management, the ability to improve shareholders' value and sound application of business strategies. In addition, key ratios will also be analysed to assess the level of efficiency and resilience of individual banking institutions. Should certain domestic banking institutions lag behind industry standards, radical measures including allowing smaller but high performing banking institutions to take over large but under-performing banking institutions, will be taken to specifically increase the level of efficiency and effectiveness in the domestic banking institutions concerned;

- **Stability**
  A review will be undertaken to decide how fast, and the means by which to move ahead with the specific recommendations made in this report and to determine the pace of its implementation given the broader implications on the industry and macro-economic stability; and

- **Consumer protection and socioeconomic objectives**
  The objective is to promote a more market-oriented consumer protection, and assess the degree of achievement that has been realised and the trade-offs that need to be made as the recommendations are progressively being implemented. The result of this assessment will influence the pace of the transition and the policy option to be pursued.

The desired change intended by the FSMP shall be the result of the combined effort of all relevant parties in the financial sector. While it is motivated by the need to be successful, it would also be tampered with a sense of practicality and reality of the environment.