



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

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Financial Stability and Payment Systems Report 2010

The Financial Stability and Payment Systems Report is an annual publication by Bank Negara Malaysia (the Bank) which highlights the Bank's assessment of risks and challenges faced by the Malaysian financial system and the capacity of the system to sustain its financial intermediation role in the economy. It also reports the developmental initiatives pursued by the Bank to reinforce the roles of the financial services sector in supporting and contributing to economic growth, as well as the regulatory and supervisory measures undertaken by the Bank to ensure continued safety and soundness of financial institutions and promote overall financial and payment systems stability.

Risks developments and assessment of financial stability in 2010

The Malaysian financial system remained stable and supportive of economic growth in 2010 despite the continuing uncertainties and challenges in the operating environment. During the year, financial intermediation remained efficient and broad-based, supported by the orderly functioning of financial market. Strong fundamentals of the domestic financial system, coupled with an ample liquidity environment, have provided the necessary conditions for the orderly exit of the temporary blanket deposit guarantee by the Government on 31 December 2010.

The banking sector remained well-capitalised, reinforced by the high quality of capital, which is predominantly in the form of common equity and reserves. The aggregate risk-weighted capital ratio (RWCR) and core capital ratio (CCR) were 14.8% and 13.0% respectively, well above the current regulatory minimum levels, as well as the higher requirements under Basel III. Profitability of the banking sector improved further in 2010, largely driven by higher net interest income and lower provisioning for impairment. Similarly, the capitalisation of the insurance industry remained strong with a capital adequacy ratio (CAR) of 224.6%. The insurance and takaful sectors also registered stronger financial results which have been backed by sustained

demand for savings and protection products and the improved performance of the equity market. The risk-bearing capacity of the financial system to withstand extreme macroeconomic and financial conditions was reaffirmed by the stress tests carried out on the banking and insurance sectors, at both the aggregate and institutional levels.

The household debt level continued to rise, but remained manageable. This has been supported by the sound financials of the household sector underpinned by income growth, further accumulation of financial assets, favourable employment conditions and a high level of savings. The debt coverage ratio of households (measured as the ratio of financial assets to total debts) was in excess of two times, thus providing households with the flexibility to adjust to changing economic and income conditions while preserving their debt servicing capacity. The strength of the household sector is also evident with the continued improvement in the household delinquency trend. To ensure that developments in the household sector does not become a source of financial instability, pre-emptive and comprehensive measures were introduced during the course of the year. These included targeted financial education programmes, new credit card measures, the targeted implementation of loan-to-value ratios in the residential property financing segment and strengthened requirements for banks to adopt prudent and responsible lending practices.

The increased and more volatile portfolio investments into the Asian region, including Malaysia, has prompted heightened surveillance of risk accumulation in the financial system and asset markets. Despite the magnitude of the portfolio flows, implications to financial stability remained contained as risk-taking behaviours of Malaysian financial institutions, businesses and households did not change materially. Orderly conditions in financial markets were also maintained and the increased volume and movements of such portfolio flows were intermediated through a diverse range of asset classes.

The contagion risks arising from external developments, largely stemming from fiscal and banking developments in Europe and geo-political tensions in the Middle East, has had negligible impact on the financial sector in Malaysia due to the low and mostly indirect exposures of financial institutions to counterparties in these regions. Any potential credit losses in the event of widespread sovereign defaults would therefore be limited. The expansion of Malaysian banking groups in the Asian region in recent years has further deepened financial linkages and while this has increased the potential for cross-border risk transmission, adverse spillovers from overseas operations are assessed to be immaterial. Credit risk to the banking system emanating from overseas operations remained manageable given the strong economic performance of countries in the region. This is further reinforced by the strong balance sheet fundamentals and risk management capacity both at the overseas entity and group levels. In addition, measures have been taken by a number of jurisdictions in the region to curb excessive asset price appreciation.

The Islamic banking system continued to be resilient throughout 2010, supported by high capitalisation, improved asset quality and sustained profitability in an environment of ample liquidity. Prudent administration of the profit equalisation reserves by the Islamic banks has contributed towards the effective management of displaced commercial risk. Islamic banking institutions have also been actively managing re-pricing gap risk that arises from the fixed rate nature of the financing portfolio with Islamic profit rate swaps. In reducing the concentration to fixed rate financing, Islamic banking institutions have increasingly been focusing on variable rate Islamic financing products in the form of *musharakah mutanaqisah* (diminishing partnership) and *ijarah* (leasing).

The payment and settlement systems in Malaysia remained resilient and continued to operate smoothly throughout the year contributing to the stability of the financial system and maintenance of public confidence. The operations of the systemically important payment systems (Real-time Electronic Transfer of Funds and Securities System RENTAS), have remained sound and achieved 99.9% system availability in 2010. Similarly, the major retail payment systems such as those operated by Malaysian Electronic Payment System Sdn. Bhd. (MEPS) and Touch 'n Go Sdn. Bhd. (TnG) did not experience any major disruptions during the year.

Development of the financial sector and payment systems

Policy measures to develop the financial sector continued to support macroeconomic stability and the growth momentum of the economy, while advancing longer-term initiatives to enhance the potential capacity and resilience of the Malaysian financial sector.

The financial safety net was further strengthened in the coming into force of the new Malaysia Deposit Insurance Corporation (PIDM) Act 2011 on 31 December 2010. The new legislation extended and increased the coverage of the deposit insurance system, while according PIDM with a broader range of intervention and resolution tools that can be deployed in the unlikely event of a member institution's failure. A new financial safety net framework for the insurance and takaful sectors has also been introduced with the implementation of the Takaful and Insurance Benefits Protection System (TIPS), which will provide better protection for insurance policyholders and takaful participants.

In the insurance industry, efforts continued to be directed at promoting further improvements in capital and risk management capabilities, and to position the industry to support new and larger demand for insurance and takaful solutions as Malaysia transitions into the new economy. Towards this end, the Bank continued to promote consolidation, particularly in the general insurance industry. Structural enhancements were also taken forward to improve the long-term sustainability of the motor sector. The proposed new motor cover framework sets out to achieve better outcomes for consumers in terms of

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enhanced access to motor insurance at premium rates that are affordable and sustainable over the long term. This will be complemented by improvement measures to the claims settlement process, to ensure fair and timely compensations.

The prompt policy measures undertaken by the Bank in 2008 and 2009 to provide support for business and household sectors in managing their debt obligations during this period, and to ensure continued credit flows to the economy, have enabled financial intermediation to continue smoothly and efficiently. Total outstanding financing to both businesses and households recorded robust growth of 9.4% and 13.4%, respectively. The environment for financing to small and medium enterprises (SMEs) continued to improve with continuous efforts to put in place a comprehensive institutional framework for SMEs. This included the creation of additional platforms for outreach and the provision of support and advisory services to SMEs, as well as collective measures by financial institutions to expedite the approval and disbursement of loans to SMEs. Such initiatives continue to provide essential support for SMEs to advance and transform to become larger and more competitive.

Initiatives to reinforce Malaysia's position as a global hub for Islamic finance continued to be an important agenda for the Bank, focusing in particular on capacity building, infrastructure and talent development. The Bank participated in the establishment of the International Islamic Liquidity Management Corporation (IILM) in October 2010 which would form part of the international Islamic infrastructure to support the liquidity needs of the global Islamic financial system. A high-level Law Harmonisation Committee was also set up during the year to develop recommendations to improve the certainty and enforceability of Shariah contracts in Malaysia. The introduction of more accommodative immigration policies to attract talent into the Islamic finance industry, and the continued advancements by the International Centre for Education in Islamic Finance (INCEIF) in the field of higher education in Islamic finance, have enriched the available pool of talent to support the industry's growth. Four new family takaful licences have also been issued to joint ventures between global and regional players and strong domestic entities, given their strong value propositions which are expected to significantly grow the family takaful industry in Malaysia.

In line with Malaysia's commitment towards gradual liberalisation, five new commercial banking licences were also issued to foreign institutions with new expertise, global networks and strong value propositions to contribute positively to the Malaysian financial system and economy. These institutions are expected to add further diversity to Malaysia's financial system, support new areas of growth and facilitate international trade and investment flows. Existing locally-incorporated foreign banks (LIFBs) were also given greater operational flexibility during the year to establish new branches.

The Bank continued to advance efforts to improve the outreach of financial services nationwide, with plans progressed to establish the presence of financial institutions in the remaining unserved districts in Sabah and Sarawak. Greater flexibility has also been accorded for banking institutions to

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leverage on shared banking service platforms in collaboration with third parties to provide wider access to basic financial services to the public. Access to financing without collateral has seen significant growth since the implementation of the framework for Pembiayaan Mikro in 2006, with total outstanding micro financing amounting to RM776 million as at end-2010. This is further complemented by the 1Malaysia Micro Protection Plan (1MMPP), which is being finalised by the insurance and takaful industry to provide a financial safety net for micro enterprises and individuals. Ongoing efforts by the Bank to empower consumers through financial information, education and assistance were sustained, and further intensified through strategic collaborations with consumer associations to conduct financial literacy programmes for communities and youths in both urban and non-urban areas nationwide.

With the rapid expansion of Malaysian banking groups within the region and Islamic finance becoming an integral part of the global financial system, bilateral relationships and cooperation with central banks from around the region and beyond were strengthened. The framework for bilateral relationships and cooperation with central banks continued to be enhanced with the formalisation of a number of new memorandums of understanding (MoUs), covering a broad range of areas related to cross-border banking supervision, economic integration, capacity building and strategic developments in both conventional and Islamic finance. A key cooperation initiative was the implementation of the Chiang Mai Initiative Multilateralisation Agreement involving a currency swap agreement for all ASEAN countries, People's Republic of China, Japan and Korea to further strengthen regional capacity to deal with risks to financial stability.

National efforts to curb money laundering and terrorism financing activities were enhanced with the implementation of a National Anti-Money Laundering and Counter Financing of Terrorism (AML/CFT) Strategic Plan 2010 – 2012 to deliver high impact outcomes, more optimal resource allocations and improved monitoring of AML/CFT measures. This was supplemented by a comprehensive review of the legal and regulatory regime for the money changing and remittance services industry to elevate and modernise the industry, while further strengthening its defences against illicit activities.

In respect of payments systems, progressive efforts have been undertaken to enhance and modernise RENTAS to achieve greater efficiency and reliability. The Bank further intensified its efforts to achieve greater penetration of electronic payments in targeted sectors. To date, 97% of Government payments have migrated to electronic payment modes. The implementation of electronic share payment and electronic dividend initiatives during the year increased efficiency in the capital market, while providing greater convenience and faster access to funds for investors. Work also progressed to create an open and interoperable mobile banking and payment ecosystem which would promote the wider use of mobile banking and payment channels in the country. Collaborative efforts for the regional integration of payment systems among central banks in the ASEAN region and regional industry players are also intensified to achieve an ASEAN Economic Community by 2015.

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Regulatory and supervisory framework

Given the changing landscape and an increasingly integrated global financial system, the financial stability policy framework adopted by the Bank has sharpened its focus on the complementary roles of microprudential and macroprudential policy framework as well as market conduct regulation and supervision.

The migration of 11 banking institutions to the Internal Ratings-Based (IRB) approach for credit risk and the implementation of the Guideline on Internal Capital Adequacy Assessment Process (ICAAP) - the Pillar 2 component of Basel II - completed Malaysia's transition to Basel II. The Bank's supervisory focus in 2011 will be directed at reviewing and monitoring the progress of banking institutions' Pillar 2 initiatives and evaluating the approaches used by banks to allocate capital to key business risks. In addition, further enhancements were also made to prudential standards on corporate governance to promote more effective assessments of the fitness and propriety of persons in responsible positions within financial institutions.

Global reform initiatives by the Basel Committee on Banking Supervision (BCBS) made significant progress during the year with the release of the new capital and liquidity standards in September 2010. The implementation strategy for the local adoption of the new international standards will be further detailed in 2011, and will involve a careful assessment of the potential impact on the economy, the overall readiness of the financial system and the benefits that will be gained from strengthening the resilience of the financial system to future shocks.

The regulatory framework for the Islamic financial system was further strengthened with the development of a more robust solvency framework, enhanced regulatory framework for the management of takaful funds and Shariah governance standards for Islamic banks and takaful operators, which are aligned with prudential standards issued by the Islamic Financial Services Board. Global initiatives to strengthen the resilience of the Islamic financial system were also taken forward during the year. The Task Force on Islamic Finance and Global Financial Stability published the Islamic Finance and Global Financial Stability Report, which highlighted eight key building blocks for a sound and resilient Islamic financial system in the more challenging global environment. Malaysia is now at an advanced stage in developing these key building blocks as efforts to develop the Islamic financial sector have moved in parallel with the conventional financial system over the recent decade.

Supervisory activities in 2010 remained focused on shoring up financial institutions' capacity to anticipate and respond to emerging risks as well as ensuring that identified vulnerabilities and weaknesses were followed up on and effectively rectified. The focus was directed in particular at promoting more robust stress testing and capital management processes to ensure the continued resilience of financial institutions under a range of economic and financial scenarios. The Bank also heightened its surveillance of market

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conduct practices in view of the more intense competition in the retail segment. Thematic supervisory reviews were also conducted to examine board practices among banking institutions as well as to assess the effectiveness of AML/CFT measures implemented by financial institutions. The outcome of these supervisory activities and reviews has enabled the Bank to respond pre-emptively to the vulnerabilities identified with the appropriate supervisory actions.

Priorities in 2011

Key developmental priorities in 2011 will be focused on the implementation of a new financial sector blueprint, which aims to enhance the capacity and capability of the Malaysian financial sector to serve the needs of a high-value added and high income economy. Among the basic thrusts of the plan are to reinforce the position of Malaysia as a global hub for Islamic financial services, support the holistic review of the pension and social security system given the demographic and social trends in Malaysia and further deepen Malaysia's inter-linkages with regional and international economies through facilitating further growth of cross-border financial transactions.

While Malaysia's financial system is well-placed to preserve financial stability, the Bank will remain vigilant to potential sources of risk arising from external developments. The Bank's macro surveillance and supervisory activities will continue to focus on ensuring prudent and responsible risk-taking behaviours by financial institutions, while maintaining heightened surveillance of the growing activities of non-bank entities to ensure any potential risks to financial stability will be managed at an early stage.

Bank Negara Malaysia
23 March 2011