MANAGING RISKS TO FINANCIAL STABILITY

Financial stability remained intact

Financial stability was sustained despite persistent uncertainties and a challenging external environment. Well-capitalised financial institutions and orderly functioning of the financial markets continued to provide support for financial intermediation activities in the domestic economy. Financial markets continued to demonstrate the capacity to withstand external shocks and intermediate higher financial flows and volatility against the backdrop of further escalation of sovereign risk concerns in the euro area.

During the quarter, several key initiatives were introduced by the Bank. The Financial Sector Blueprint 2011-2020 was released on 21 December 2011. Themed "Strengthening Our Future", the Blueprint charts the future direction and initiatives to develop the financial sector to best serve the economy and to facilitate the economic growth and transformation over the next ten years. The Blueprint is expected to facilitate the creation of a world-class financial system that would enable the country to transition towards a high value-added and high-income economy. To achieve this objective, efforts will be focused on the following nine key areas: effective intermediation for a high value-added and high-income economy; developing deep and dynamic financial markets; financial inclusion for greater shared prosperity; strengthening regional and international financial integration; internationalisation of Islamic finance; regulatory and supervisory regime to safeguard the stability of the financial system; electronic payments for greater economic efficiency; empowering consumers; and talent development to support a more dynamic financial sector.

Empowering and safeguarding consumers remained an important agenda for the Bank. In November 2011, the Bank introduced the Guidelines on Responsible Financing to promote prudent, responsible and transparent retail financing practices. The guidelines complement other prudential measures introduced by the Bank that aim to create a sustainable retail credit market for consumers. Similar guidelines were also issued by Suruhanjaya Koperasi Malaysia to be observed by cooperatives involved in financing activities.

The Money Services Business Act 2011 came into force on 1 December 2011. It aims to support the development of a more dynamic, competitive and professional money services business industry, while strengthening safeguards against money laundering, terrorist financing and illegal activities. It provides a more integrated regulatory framework for the conduct of money changing, remittance and wholesale currency businesses, and strengthened provisions for the effective surveillance and oversight of the money services business industry.

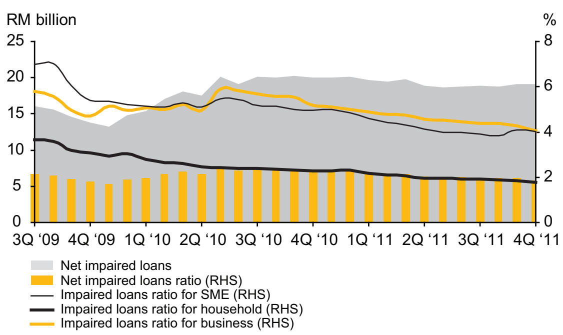
Overall risks to financial stability were contained. The credit risk outlook of the banking system remained stable against the backdrop of strong economic fundamentals and institutional soundness and resilience. Asset quality of the banking system improved with total impaired loans ratio at 1.8% (3Q 11: 2.0%) of net loans and loans-in-arrears (for duration of one to less than three months) at 2.6% (3Q 11: 2.8%) of gross loans.

In the household segment, growth in financing for the purchase of residential properties extended by the banking system moderated marginally to 3.2% (3Q 11: 3.3%). Nonetheless, the moderation was outpaced by higher credit card balances and personal financing during the quarter, resulting in a higher growth in total household debt outstanding (4Q 11: 3.3%; 3Q 11: 2.9%). Overall, total impaired loans for household financing remained unchanged at 1.8% during the quarter (3Q 11: 1.9%).

The domestic banking system continued to support business expansions. Credit to the business sector grew by 3.6% (3Q 11: 2.5%). The risk of delinquency, as measured by the expected default frequency, for businesses moderated further to 0.68% (3Q 11: 0.79%), supported by the sustained debt servicing capacity of businesses. Repayment-to-disbursement ratio moderated slightly to 84% (3Q 11: 92%) due to higher loan disbursement during the quarter. Total impaired loans of the business sector improved to account for 4.1% of gross business loans (3Q 11: 4.4%).

The domestic financial markets continued to remain orderly and exhibited strong capacity to intermediate the volatile flows despite heightened investor risk aversion over the escalation of sovereign risk concerns in the Euro area. The bid-ask spreads and turnover ratios in the debt and equity markets remained close to historical averages of normal times. The impact of the increased volatility in the financial market on the risk exposures of the Malaysian financial institutions remained manageable. The banking system's exposures to equity risk remained well contained at 0.9% of capital base (3Q 11: 0.7%), while the insurance sector's exposures to equity risk went up slightly to 6.9% (3Q 11: 6.6%) of capital base. Interest rate risk exposures remained stable at 4.9% of capital base for the banking system while that of the insurance sector accounted for 3.8% of capital base (3Q 11: 3.4%).

Banking System: Loan quality

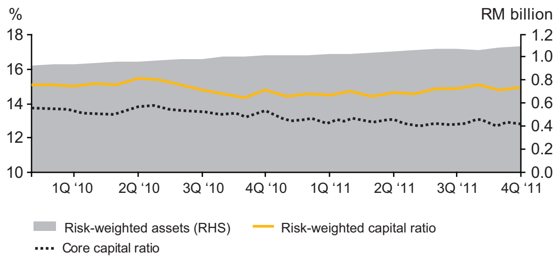


Source: Bank Negara Malaysia

The financial sector exhibited resilience against challenging environment

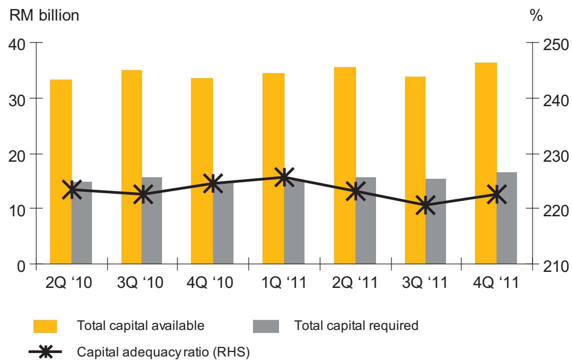
The level of capitalisation of the financial sector remained sound. The core capital ratio and risk-weighted capital ratio of the banking system remained firm at 12.9% (3Q 11: 12.6%) and 14.9% (3Q 11: 14.8%) respectively. Of significance, 86.8% of total capital is of high quality Tier-1 capital, comprising paid-up capital and reserves. Capital in excess of the minimum 8% regulatory requirement remained high at RM71.4 billion. The banking system is therefore well positioned to withstand any unexpected losses under potential adverse financial and economic conditions. Similarly, the insurance sector also maintained a sound capital adequacy ratio of 222.5% (3Q 11: 220.7%) and excess capital buffer of RM20.1 billion.

Banking System: Capitalisation



Source: Bank Negara Malaysia

Insurance Sector: Capitalisation



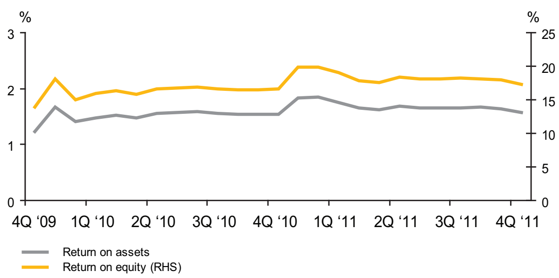
Source: Bank Negara Malaysia

The banking sector continued to record sustained profitability. Pre-tax profit of the banking system stood at RM5.9 billion (3Q 11: RM6.7 billion). The higher income from financing activities and lower funding costs were partly offset by increased in overhead and staff costs and higher provisions for impaired loans (net of recoveries) by one banking institution as part of its balance sheet strengthening exercise.

The life insurance and family takaful businesses recorded higher excess of income over outgo of RM4.3 billion (3Q 11: RM1.3 billion) due primarily to sustained business underwriting as well as gains arising from improved market valuations of investments in the capital market.

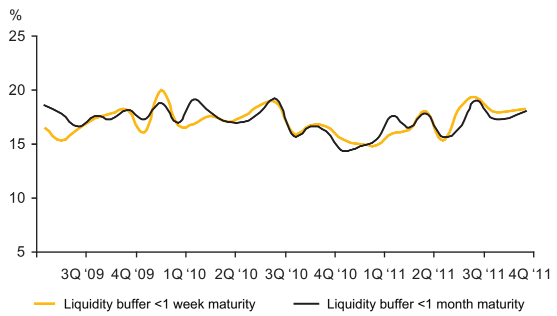
Meanwhile, the general insurers and general takaful operators registered an underwriting loss of RM142.9 million (3Q 11: underwriting profit of RM181.7 million) due mainly to higher provisions on reinsurers' exposures to natural disasters including the recent floods in Thailand. As a result, operating profit was lower at RM234.3 million (3Q 11: RM441.7 million). The 'motor act' business continued to pose a drag on profitability with a higher claims ratio of 300% (3Q 11: 289.2%).

Banking System: Profitability



Source: Bank Negara Malaysia

Banking System: Liquidity Buffer to Total Deposit Ratio



Source: Bank Negara Malaysia

The resilience of the banking system is also reinforced by ample liquidity in the financial system. Overall liquidity buffers stood at 18% of total deposits for liquidity needs maturing within one month, well above prudent levels to meet demands for withdrawals and liquidity obligations.

Insurance and Takaful Sector: Indicators

	2010		2011		
	4Q	Year	3Q	4Q	Year
	RM million				
Life insurance & family takaful Excess of income over outgo	3,233.5	14,095.5	1,315.0	4,314.5	12,641.7
General insurance & general takaful Operating profit	563.7	2,144.4	441.7	234.3	1,787.1
	%				
Claims ratio (as at end position)	62.1		62.5	65.8	

Source: Bank Negara Malaysia