Executive Summary

Risk developments and assessment of financial stability in 2018

Domestic financial stability continued to be preserved in 2018. Global developments, including the pace of monetary policy normalisation in some advanced economies, escalating global trade tensions and geopolitical risks, as well as volatility in crude oil prices drove investor behaviour. Domestically, policy uncertainties following the 14th General Election (GE14) also weighed heavily on investor sentiment. Amid these developments, domestic financial market conditions remained orderly, supported by strong local institutional investors, including financial institutions. Prudent risk management by financial institutions and limited risks from the external borrowings of Malaysian corporates also contributed to contain market risk exposures at manageable levels.

The banking system and the insurance and takaful sector remained resilient, supported by healthy profits and strong capital and liquidity buffers. Improvements in asset quality continued to be observed. Liquidity and funding conditions also remained conducive for financial intermediation activities. These factors continue to underpin sustained public confidence in the Malaysian financial system.

Household debt remained elevated although it has expanded at a slower pace in recent periods and more in line with income growth. Debt repayments continued to be supported by income and employment growth. At the aggregate level, households also maintained healthy financial buffers. Lower income households, however, remain vulnerable, although their share of household debt has continued to decline over the years following the implementation of responsible lending standards. While the overall quality of household debt remained sound with low aggregate impairment and delinquency ratios, some households are showing signs of difficulty in servicing their debt. This is mainly evident among lower income borrowers with personal financing, and borrowers with larger housing loans (i.e. above RM500,000) and who are more dependent on variable income sources. Given these developments, existing macroprudential measures remain relevant in strengthening household resilience.

In the property market, growth in house prices continued to ease amid weaker demand for higher-priced properties which remain unaffordable for most buyers and less exuberant activity in the housing market in recent years. This is contributing to adjustments in housing supply towards more affordable segments. Affordability constraints have continued to increase the stock of unsold housing units. However, risks of a disorderly correction in the housing market is not expected. With firm housing demand (especially by owner-occupiers) continuing to outstrip new supply in the foreseeable future, coupled with measures by the Government in coordination with the private sector to better align housing demand and supply, the outlook for the housing market is expected to gradually improve. In the non-residential property segment, risks remain of a further deterioration in oversupply conditions with the large incoming supply of office and retail space. However, this poses minimal direct risks to financial stability, given the low exposures of banks to riskier segments of the housing and commercial property markets. Additionally, the Bank's sensitivity analysis indicates that banks' capital buffers are sufficient to withstand a broad price correction in the domestic property market, including its potential spillovers to the other economic sectors.

Businesses recorded a slight deterioration in financial performance, amid supply disruptions in the commodities sector, a relatively weaker ringgit and uncertainties surrounding GE14. However, their overall debt servicing capacity and liquidity positions remained healthy and above prudent thresholds. Firms in the oil and gas-related, real estate and construction sectors continued to face headwinds, but this will not have a significant impact on domestic financial stability. Factors supporting the lower risk profile of corporate external borrowings – namely the substantial share of borrowings which are of a longer-term duration, hedged against currency risks, and represented by intercompany loans and trade credits – further limit risks to broader financial stability.

The Bank's multi-year solvency stress tests on banks and insurers continue to affirm the resilience of banks and insurers under simulated scenarios of severe macroeconomic and financial strains. Banks' and insurers' capital positions remained above the regulatory minimum throughout the stress periods. In 2019, risks to domestic financial stability are assessed to remain broadly stable across the different sectors and risk areas. The Bank continues to maintain close vigilance over the pace and level of debt accumulation and risk taking behaviour to prevent a build-up of vulnerabilities that could expose the financial system to future risks.

Development of the financial sector

Financing by the banking sector remained supportive of economic activity in 2018, with total outstanding financing growing faster by 5.6%, driven mainly by household financing. Business sector financing also recorded a stronger growth of 5.4%. Financing to small and medium enterprises (SMEs) accounted for half of total outstanding financing to businesses, with RM65.5 billion in loans approved to over 108,700 SME accounts in 2018. Ongoing initiatives to address financing barriers that still exist among pockets of SMEs remain an important priority. Among them include improvements in documentation requirements, capacity building support for SMEs in the area of financial management and new approaches to credit assessments that leverage on technology and big data. The implementation of an online financing aggregator platform ("imSME"), operated by the Credit Guarantee Corporation, has helped reduce search costs and expand financing sources to meet the increasingly diverse financing needs of SMEs. At a broader level, initiatives being pursued to facilitate the use of moveable property as collateral, a more holistic approach to the development of alternative finance and measures to encourage businesses to formalise, are needed to further enhance access to financing for SMEs, particularly in new growth and innovative areas.

The Fintech Regulatory Sandbox (Sandbox) continued to serve an important role in enabling the Bank to ensure that regulation remains responsive to financial innovation. During the year, the Bank introduced specialised thematic tracks to the Sandbox (Specialised Sandbox) to allow for a more targeted and efficient testing approach for high-impact innovations. Further progress was also made in facilitating Open Application Programme Interface (API) adoption in the financial services sector to encourage healthy competition and improve the quality and efficiency of financial services. While the focus to date has mainly been on facilitating access through Open APIs to publicly available and product-related data, further work will be undertaken on secure methods for allowing third-party access to a broader scope of financial information, with the customers' consent. This will be accompanied by a careful assessment of the risks and safeguards necessary to protect consumers and the integrity of financial services.

As part of its mandate to promote an inclusive financial system, the Bank also partnered with the United Nations Capital Development Fund (UNCDF) and the Malaysia Digital Economy Corporation (MDEC) to launch the Digital Innovation Hub and Inclusive Financial Accelerator Program. These initiatives aim to support greater use of technology by service providers in offering inclusive financial solutions. Work continues to progress in strengthening the capacity of development financial institutions (DFIs) to effectively contribute to economic growth and social development. A key development during the year was the implementation of an enhanced performance measurement framework to provide better capture and integrate the developmental impact and financial performance of DFIs. In parallel, the Bank is also engaging with the Government to review the DFI landscape to take into account developments in the financial system and changes in Malaysia's economic structure and priorities. This seeks to provide a sharper focus in the mandates of DFIs while optimising performance and synergies.

Access to financial services in Malaysia remains high, with financial access points available in sub-districts across the nation providing almost full accessibility to financial services. Latest indicators of financial inclusion also showed an improved take up of financial products and greater usage of digital channels to conduct financial transactions. These developments further contribute to greater financial inclusion which is concerned not only with access, but also the responsible use of financial services in a way that improves financial well-being.

The Malaysian insurance and takaful sector recorded an increase in total premiums and contributions of 4.9% while total assets correspondingly grew by 3.2%. However, measures of insurance and takaful penetration were little changed reflecting the uneven protection coverage of the Malaysian population, with lower income segments of the population remaining largely without insurance and takaful protection. In this regard, efforts continue to be intensified to support the development of affordable insurance and takaful products, including those offered under *Perlindungan Tenang*. This is further complemented by the implementation of the national B40 protection scheme which aims to help the bottom 40% household income group understand and experience insurance and takaful, and eventually support them to secure protection over the longer term from the insurance and takaful market.

The phased liberalisation of motor and fire tariffs entered its third year, with insurance companies and takaful operators adopting further differentiation in pricing based on an expanded set of risk rating factors. Greater pricing flexibility also led to the introduction of over 200 new motor and fire insurance and takaful products by insurers and takaful operators during the year to meet different risk protection needs. As important are stronger pricing incentives that are being introduced to encourage safer driving and safer vehicles. This should lead to improvements in overall claims experience and more sustainable premium rates over time.

The implementation of the Life Insurance and Family Takaful (LIFE) Framework progressed further with the expansion of products available through direct distribution channels, the gradual removal of limits on operational costs to encourage a more competitive and diverse insurance and takaful market, and the implementation of the Balanced Scorecard Framework for agents which is delivering better consumer outcomes. In efforts to maintain affordable insurance coverage, a Medical Cost Containment Taskforce was also established by the industry to study the drivers of medical claims inflation and potential cost containment measures.

The Islamic finance sector continued to chart positive growth in 2018, with Shariah-compliant financing from Islamic banks growing by 10.5% to account for a higher share of 36.6% of total banking sector financing. Total takaful net contributions similarly expanded by 15.9% with an increased market share of 16.6% of total premiums and contributions. The implementation of value-based intermediation (VBI) strategies by Islamic banks gained further momentum with industry-led initiatives that included the finalisation of the VBI Strategy Paper, sharing of VBI banking practices and development of implementation tools to support the operationalisation of VBI. Moving forward, the Bank is increasing its focus on the role of mainstream finance in supporting the transition to a sustainable economy, and understanding the impact of environmental and social risks on institutional resilience and financial stability more broadly. To this end, the Bank became a member of the Network for Greening the Financial System comprising central banks and supervisors engaged in the development of research and sound regulatory and supervisory practices in managing climate and environmental risks.

In the money services business (MSB) sector, the increased offering and use of digital MSB services continued to accelerate the migration of remittances to formal channels, while reducing the cost of transactions for consumers. Regulatory changes introduced to allow qualified remittance service providers to conduct electronic Know-Your-Customer (eKYC) when onboarding new individual customers have further reduced costs and improved access in locations where remittance service providers do not have a physical presence. During the year, three electronic remittance service providers were approved to conduct eKYC. In addition, the Project Greenback 2.0 was implemented in a second champion city, Kota Kinabalu as part of continuing efforts to educate the public, particularly the migrant communities and SMEs, on the use of authorised MSB services and e-remittance solutions, and reduce remittance costs through increased transparency and access to information.

Measures continued to be taken to develop the onshore foreign exchange market to bolster its resilience to shocks. These included greater flexibility accorded to fund managers to dynamically manage their foreign exchange risk and hedge their positions. In 2018, the Bank announced further changes to its foreign exchange administration policies aimed at improving operational efficiencies and facilitating risk management by businesses and financial institutions. Measures were also taken to provide greater transparency on beneficial ownership in the debt securities market and establish a framework for the operation of electronic trading platforms.

Regulatory and supervisory framework

The Bank's regulatory and supervisory activities in 2018 continued to focus on preserving the resilience of the financial system against emerging risks in a more challenging environment. This was supported by a sustained focus on strengthening risk management practices in the banking and insurance and takaful sectors, particularly in response to risks associated with the rapid pace of technological change and increasing reliance on third-party arrangements. A stronger focus on culture in the Bank's regulatory and supervisory approach also reflects efforts by the Bank to drive behaviour that is consistent with the responsible management of financial institutions and society's expectations.

In the first half of 2019, the Bank will issue proposals on enhanced regulatory requirements and policy measures for domestic systemically important banking institutions (D-SIBs) to reduce the probability and impact of their distress or disorderly failure on the financial system and the economy. This will include requiring D-SIBs to hold additional capital buffers in the form of Common Equity Tier 1. The Bank also completed a review of technology risk management standards to ensure that new and emerging dimensions of risk are managed appropriately, in particular from increased exposures to cyber threats and compromised access to confidential data.

Following extensive engagements with the industry and further progress towards the implementation of recovery plans for financial institutions, the Bank finalised revised standards on the management of outsourcing risks. The standards have sought to balance the benefits of outsourcing in increasing efficiency and supporting the management of risks across financial groups, with the potential costs of over-reliance on third parties, reduced supervisory oversight and added complexity to business operations and their recovery. The Bank is also undertaking a holistic review of the existing regulatory framework for DFIs to reflect the roles and specific mandates of DFIs, and ensure that prudential standards remain appropriate to the risk profiles of individual DFIs. This envisages greater differentiation at an individual institution level, while ensuring that market distortions are minimised. As part of the review, the Bank plans to consult on proposed revisions to 10 core prudential standards applicable to DFIs over the coming year.

In the insurance and takaful sector, the Bank concluded revisions to standards on the conduct of investment-linked (IL) business, as part of the Life Insurance and Family Takaful Framework to support the long-term development of the insurance and takaful industry. The revisions aim to ensure that the rapid growth of IL business is supported by responsible practices that are consistent with the fair treatment of policy owners and takaful participants. The Bank also published proposed revisions to the Takaful Operational Framework to accord recognition to a wider range of Shariah instruments within takaful business in line with advancements in the development of Shariah standards.

Malaysia's continuous efforts to preserve the integrity of the financial system and combat money laundering and terrorism financing (ML/TF) risks resulted in the upgrading of Malaysia's technical compliance ratings of its Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) framework by the Financial Action Task Force. The National Coordination Committee to Counter Money Laundering also endorsed the results of the National Risk Assessment which assessed the threat levels for serious crimes that pose ML risks, and vulnerabilities of financial and non-financial sectors to ML/TF risks. Guided by the outcomes of the NRA, the National AML/CFT Strategic Plan will be reviewed in 2019 to incorporate strategies to address identified gaps and vulnerabilities. This will include enhancements to existing legal and regulatory frameworks to combat financial crimes and the reallocation of resources towards areas posing higher risks.

Measures also continued to be taken during the year to mitigate risks from the abuse of cash for criminal activities. Effective 1 January 2019, the Bank reduced the cash transaction reporting threshold from RM50,000 to RM25,000 to facilitate enhanced monitoring of suspicious transaction patterns. The Bank is also considering other measures, such as a limit on high-value cash transactions, to address the use of cash to store, move and disburse proceeds from illicit activities. In addition, the on-going review of the Money Services Business Act 2011, currently under public consultation, will further strengthen the ability to crack down on illegal money services business activities which have also been a means for criminal actors to move illicit cash proceeds.

Effective and timely enforcement actions by the Bank continue to serve as a credible deterrent against non-compliances with applicable laws and regulations. As earlier announced, beginning from 2019, details of individual enforcement actions are now published on the Bank's website.

Market conduct and consumer empowerment

Risks to financial consumers from the elevated level of household debt remained a key focus of the Bank's regulation and supervision of market conduct in 2018. In particular, the Bank took specific measures to ensure that banking institutions act fairly when repricing loans after a borrower fails to make repayments on time, and do more to help individuals pay off their credit card debt faster to avoid higher financing charges and persistent debt traps. Banking institutions were also required to revise terms and conditions in housing loan and financing contracts that were found to be unfair to consumers or unnecessarily complex.

These measures were a subset of a broader initiative by the Bank to establish a set of overarching standards on the fair treatment of financial consumers by financial service providers (FSPs). The standards which were issued for consultation during the year, address expectations of FSPs to align their internal governance, conduct and operations with fair consumer outcomes. This includes establishing reward and remuneration systems that are consistent with the fair treatment of financial consumers, ensuring fair contract terms, providing clear and concise product information and offering advice or recommendations that are appropriate to a customer's needs and financial circumstances. Improvements in FSPs' conduct towards consumers continue to be reinforced through supervisory and enforcement actions by the Bank. In 2018, such actions were taken against 51 FSPs for non-compliances with financial conduct rules and regulations.

Financial education remained a key focus of the Bank to empower and protect financial consumers. The Bank continued to work closely with its partners in the Financial Education Network (FEN) to expand the reach and coverage of financial education initiatives. Based on the results of a follow up assessment on Malaysia's Financial Literacy and Capability (MYFLIC) Index (which measures the level of knowledge, behaviour and attitudes of Malaysian consumers on financial matters) conducted during the year, the level of financial knowledge among Malaysians remains generally low. This in turn has an important influence on financial attitudes which leave a significant proportion of Malaysians ill-prepared to deal with unexpected expenditures and life events, including retirement. These findings will be used to inform priorities and targeted interventions under the national strategy for financial education that is being finalised by the FEN.

Payment and settlement systems

The payment and settlement systems remained resilient and operated without any major disruptions throughout the year. Focus continued to be centred on enhancing the cyber and operational resilience of the large value payment system infrastructure (RENTAS), both within the Bank's own environment and that of Payments Network Malaysia Sdn. Bhd. (PayNet) and participants of RENTAS. The Bank achieved full compliance with all mandatory and advisory Society for Worldwide Interbank Financial Telecommunication (SWIFT) security controls, which was affirmed through an independent external review of the Bank's compliance. The Bank and financial institutions are also increasingly deploying effective control measures in an 'assumed breached' environment to complement existing defences against cyberattacks.

In the retail payments area, retail electronic payments continued to record strong double-digit growth. Given the corresponding demand for immediate payments and the increasing net debit exposures in real-time retail payment systems, financial institutions have been required to improve the monitoring and management of their intraday liquidity positions and exposures. While payment fraud losses remained low, measures continued to be undertaken by financial institutions to strengthen safeguards against fraud attempts. Alongside ongoing measures to educate consumers on payments security, strengthened procedures and controls for the registration and change of mobile phone numbers used by customers to receive Transaction Authorisation Codes (TAC) were implemented by financial institutions to further protect customers against social engineering fraud.

During the year, further progress was made in the migration to e-payments. The volume of cheques reduced by more than half from 204.9 million in 2011 to 101.4 million in 2018. While cash usage remains prevalent in Malaysia for retail transactions, the ratio of cash-in-circulation to Gross Domestic Product (CIC/GDP) also started to demonstrate a declining trend. The expansion of e-payment acceptance points among retail merchants, coupled with the migration of payment cards to support PIN and contactless functionalities contributed to the increased use of payment cards. In particular, debit card transactions grew strongly by 51.5% to 245.7 million transactions in 2018 (2017: 162.2 million).

The adoption of credit transfer services has continued to gain traction. This was largely driven by the substantial growth in the usage of Instant Transfer, following the fee waiver for transactions of RM5,000 and below for individuals and SMEs. Mobile payments have also gained momentum in displacing cash for low value transactions, with total mobile payment transactions recording a significant increase to 23.7 million transactions in 2018 (2017: 1.2 million). This was supported by an expanded network of merchants that accept mobile payments. With the growing presence of non-banks in the mobile payment segment, the Bank implemented the Interoperable Credit Transfer Framework (ICTF) to enable interoperability between banks and non-banks via a shared payment infrastructure. This aims to preserve competition and innovation in the payment market, while optimising positive network effects that are critical to benefit users of different payment services.