



GOVERNOR'S STATEMENT

The Malaysian financial system has remained stable and sound in an environment in which risks have increased at a time when significant global and domestic developments continue to affect our financial system. The year also saw the global economy experiencing slower growth than earlier anticipated, with heightened financial market volatility. It has been the financial sector development and reforms implemented during this recent decade, reinforced by the pre-emptive measures introduced since 2006 to address the risks relating to household leverage and rising property prices, that have contained the repercussions. Greater financial inclusion and financial education have also supported the adjustments needed by the households. While the operating conditions will remain challenging for the financial sector in 2016, the sustained strength and resilience of the Malaysian banking and insurance industries will also continue to be supported by sound risk management, and ample liquidity and capital buffers. These factors will firmly support financial intermediation activities and preserve the ability of the financial system to weather these developments.

A further fundamental development in our financial sector with important implications for financial stability has been the comprehensive legislative reforms over the last 15 years, involving the enactment of 12 pieces of legislation for the financial sector. These laws have served as catalysts for further strengthening of regulation, supervision and the institutional frameworks to deal with the new challenges in the management of financial stability. These challenges also include the larger role of non-bank financial intermediation activities in the mobilisation and allocation of funds as a result of financial deepening. The interactions between the financial system and the real economy have correspondingly taken on new and broader dimensions. The financial system has also become more interconnected across borders with the growing global and regional presence of financial institutions and more internationally integrated financial markets. Additionally, the leverage on technology has increased operational dependencies in ways that may directly affect the stability of critical functions performed by banks in Malaysia. Finally, the orderly alignment of the domestic regulatory framework to the extensive global regulatory reform agenda has been managed so that it achieves greater long-term resilience without unintended dislocations.

In responding to these developments, the Bank has also intensified its surveillance, and reviewed and expanded prudential, conduct and integrity standards that are applied to financial institutions. This has been reinforced with extended co-operative frameworks and arrangements with other authorities. Heightened supervision, including that of financial groups, will continue to be of high priority for the Bank going forward. In the current environment, the Bank also accords close attention to signs of cyclical tendencies in bank behaviour. Given the range of measures that have been implemented to promote sound lending, risk-informed pricing and provisioning practices during the period of strong credit growth, such tendencies have now been substantially mitigated.

A further area of focus for the Bank has been the development of a broad and functional toolkit for managing crises, building on domestic and regional crisis management frameworks that are already in place. Going forward, the focus is on recovery and resolution planning to strengthen market discipline and ensure that critical functions will not be imperilled by risks to the financial system.

In relation to this, the development and greater sophistication of the Malaysian financial system has required a fundamental review of the traditional measures of risks to the system. Prompted in part by the episodes of volatility in the funding markets during the year, the Bank has introduced new liquidity metrics (the liquidity coverage ratio and loans-to-funds ratio) to provide a more comprehensive measure of liquidity risks in the banking system. As banks have now increasingly tapped the now more developed capital markets for their funding requirements and with the wider avenues that have been developed for households and businesses to save and invest, broader liquidity measures are now needed to gauge the soundness of bank funding activities. Improving the quality and relevance of publicly available information is aimed at promoting market actions that contribute to financial stability. Measures have also been taken to implement globally consistent standards for funding and liquidity, including their measurement and disclosure.

As the competent authority under the Anti-Money Laundering, Anti-Terrorism Financing and Proceeds of Unlawful Activities Act 2001, the Bank works with other relevant authorities in Malaysia to ensure that safeguards are in place and operating effectively to prevent money laundering and terrorism financing. In this recent two years, this work has been subjected to close international scrutiny under the mutual evaluation of Malaysia's anti-money laundering and counter-terrorist financing (AML/CFT) framework by the Financial Action Task Force (FATF). In September 2015, the FATF published its report on Malaysia which affirmed the high degree of technical compliance with international standards on combating money laundering and terrorism financing. The Bank, in cooperation with other agencies that form the National Coordination Committee to Counter Money Laundering, is fully committed to undertaking additional measures needed to ensure the effective implementation of these standards across all reporting entities whose activities are exposed to risks of financial abuse. Based on the commitment demonstrated by Malaysia's action plan and the continuing progress in efforts to improve its AML/CFT programme, Malaysia was granted full membership of the FATF in February 2016. Our effectiveness in protecting the integrity of the financial system from abuse for criminal and terrorist activities largely depends on the strength of controls implemented by reporting institutions, in particular financial intermediaries, to identify, analyse and report risks that they encounter. This must therefore continue to be a high priority for all our reporting institutions.

Several milestones were also achieved in the area of Islamic finance in 2015. The issuance of Malaysia's first sustainable and responsible investment sukuk and the pilot issuance by the Bank of a new class of money market instruments will further add to the depth and diversity of the Islamic financial markets in Malaysia. Islamic banks in Malaysia also completed a two-year exercise to fully align all existing customer deposit accounts with their underlying Shariah contracts. This will contribute towards the potential for intermediation in the form of investment accounts that directly promotes risk-sharing. At a global level, there has been greater recognition of the significant potential of Islamic finance in addressing the concerns relating to income inequality and overcoming the inherent problems associated with predominantly debt-based financing systems. The Bank continues to support its development through its active participation in the work of the Islamic Financial Services Board which sets global standards for the effective regulation and supervision of Islamic finance to preserve financial stability in the Islamic financial system.

Five years into the strategic roadmap for e-payments that was outlined in our Financial Sector Blueprint, the Bank has largely completed planned work around regulation and market incentives to encourage the wider use of e-payments. While this has enabled important strides towards achieving the e-payment targets set under the Blueprint, much further progress still remains ahead of us. In the coming years, enhancements to key payments infrastructure and extensive outreach will be accelerated for more businesses and agencies of the Government to migrate to e-payments. There also needs to be more traction in the implementation of innovative initiatives by the financial industry to further enhance e-payment convenience and competitive pricing in this environment.

Promoting an inclusive financial system continues to remain an integral part of the Bank's mandate in advancing our financial stability agenda that is also conducive to sustainable growth. Having made significant progress in increasing financial access, with financial services now within the convenient reach of 99% of Malaysians across the nation, the Bank has intensified efforts to encourage the effective use of financial services. In particular, the Bank encourages further innovation with an inclusive focus across the entire spectrum of financial services – including savings, insurance, credit and payments. Given the rising level of household indebtedness, the Bank has also accorded attention to rein in this trend and to provide effective mechanisms to deal with households in financial distress. This will continue to be supported by education programmes and regulations which balance the objectives of financial stability, inclusion and integrity.

While much ground has been covered in the Bank's efforts to promote financial stability, significant work still lies ahead in a task that has become increasingly more complex in its considerations and dimensions. In turn, the regulation and supervision of the financial system by the Bank, in co-operation with other relevant authorities, will continue to evolve at the national, regional and international levels. Equally important in this endeavour, the Bank has continued to strengthen its organisational capability that is now well supported by our strong institutional framework, a high powered workforce and an important network of domestic, regional and international relationships built over the years that will advance this work forward.



Zeti Akhtar Aziz
Governor
23 March 2016

