



GOVERNOR'S STATEMENT

The year 2014 was characterised by volatility in the international financial markets amid a less optimistic outlook for global growth, prospects of divergent policies by major monetary authorities and sharply lower oil prices. Along with the other economies in the region, the Malaysian financial system was affected by the consequent shifts in global liquidity following the reassessment of risks by investors in the current environment. These shifts in liquidity have however been increasingly accompanied by a greater differentiation across countries.

The Malaysian financial system has remained resilient in the face of these developments, underpinned by strong financial intermediaries and the efficient functioning of the intermediation process. This has in turn supported private sector economic activity. The more developed domestic financial markets and the large domestic institutional investor base have also provided a source of stability to the financial markets during the periods of heightened volatility. Orderly conditions have therefore continued to be preserved in these markets. Despite some elevation in interbank and retail funding costs towards the conclusion of the year, in part reflecting adjustments by banks to the impending new liquidity standards, there continues to be ample liquidity in the banking system. Results of the Bank's stress tests under extreme assumptions of credit and funding shocks affirm the high level of resilience of the banking system. During the year, the risks in the household and property sectors have also receded, following the earlier macroprudential and fiscal measures.

Looking ahead, the management of financial system stability will focus on a number of challenges arising from the implications of the changing global and domestic economic conditions on the financial system, and on the adjustments to the broad regulatory reforms. This is to ensure that they do not create disorderly effects on the financial intermediation process. The reduction of the complexity of the international standards and the improvements to their coherence will certainly facilitate their more effective implementation. In implementing the planned changes to the core standards, the Bank will consider their appropriate application in the domestic context. Additionally, attention will also be focussed on ensuring that arrangements safeguarding financial stability will continue to adequately take into account the changing nature of financial intermediation, including the now more significant role of capital markets and non-bank financial institutions, in addition to the increased cross-border financial activities.

The Bank has therefore continued to maintain a high degree of vigilance that has involved a more intrusive supervisory oversight on the financial institutions. Particular focus is given to ensuring that bank lending and provisioning standards remain sound. Key regulatory reforms, notably those related to the Basel III reform package, are also proceeding at a measured pace with close observation of their impact during the transition period. During the year, important steps were taken to strengthen the regulation and supervision of financial groups to improve the risk assessments and to mitigate the effects of regulatory arbitrage that can arise from different prudential standards that are being applied across the financial sector.


The Bank will also continue to regularly review the risk metrics used in the supervision of financial groups and for monitoring risks to financial stability, to capture the new sources of contagion risk and the channels for their transmission. The Bank's risk assessments and stress tests, that is elaborated in this Report, have expanded considerably in scope. The Bank has also broadened the surveillance of the non-bank intermediation activities. Our strengthened financial legislation has enhanced the ability of the Bank to address identified risks arising from such intermediation activities that is outside the formally regulated financial system. This has been particularly important in mitigating the build-up of financial imbalances in the household and property sectors. Considerable work also continues to be directed at strengthening the operational frameworks, including their governance, for managing these risks and towards improving inter-agency coordination in safeguarding financial stability.

An important consideration for financial stability has been the growing regional and international linkages of the financial system through the growing overseas presence of domestic financial institutions and the evolving payment and settlement arrangements that facilitate the trade and investment flows. Such strengthened interlinkages will contribute towards enhancing the region's growth potential and facilitating the more efficient mobilisation and allocation of funds across the region. The international characteristics of Malaysia's sukuk market and the participation of non-residents in the domestic capital markets more broadly, have also strengthened the diversity and the internationalisation of our financial markets. Progress within ASEAN on the development of an integrated capital market and the imminent implementation of the ASEAN Banking Integration Framework will reinforce this interconnectivity. The Bank continues to actively expand its cooperation arrangements on financial stability with other central banks and supervisory authorities in different parts of the world. These arrangements, extending to 16 regional and international economies to date, cover a broad range of areas, including supervision, financial stability risk assessments and monitoring, and crisis management. Also important has been the continuing efforts to identify and remove impediments to information flows that are necessary to support cross-border supervision and risk management.

The Bank continues to pursue a number of important structural reforms in the financial system. These generally have two main objectives: to enhance the efficiency and capacity of the financial system in meeting the needs of the economy, and to reinforce sound incentives for prudent risk taking while having regard to the changing dynamics in the financial system. In the coming years, major reforms in the insurance sector will shift into sharp focus as the Bank continues to carefully balance the objective of evolving a more competitive environment that is reinforced with financial prudence and adequate consumer protection. In the banking sector, the implementation of the new reference rate framework for the pricing of retail financial products will enhance the transmission of monetary policy, while improving pricing discipline and transparency to consumers. The introduction of Islamic investment accounts, supported by an integrated Investment Account Platform, will also significantly expand opportunities for the financing of new and innovative businesses. In the payment card industry, reforms will be introduced this year to address incentive distortions and promote the wider use and acceptance of cost-efficient and competitive payment instruments.

Given the important global developments in the international financial stability agenda, the Bank remains an active participant in the various international fora. During the course of the year, the Bank was admitted as an observer on the Basel Committee on Banking Supervision and Financial Action Task Force, both of which will provide a strategic opportunity for the Bank to highlight the emerging market perspectives on the key developments shaping the financial landscape. It also affirms Malaysia's commitment towards embracing international standards that are inclusive. In addition, Malaysia became the host of the headquarters for the Alliance for Financial Inclusion (AFI) and a World Bank Group Office, both located at the Bank's Sasana Kijang. The AFI in particular reflects the global recognition of Malaysia's long-standing commitment to the global and domestic advancement of financial inclusion.

Going forward, the Bank's financial stability agenda will continue to maintain a strong focus on enhancing the conditions for long term resilience and stability that will support the sustained growth of the Malaysian economy.



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Governor
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