



GOVERNOR'S STATEMENT

The domestic financial system remained resilient in 2013 with significant progress achieved on a number of important fronts to strengthen the conditions for financial stability. As an open economy, Malaysia experienced significant two-way capital flows following the continued volatility in the international financial markets. The effects have however been relatively modest reflecting a far more resilient domestic financial system. The orderly conditions in the domestic financial markets was supported by the deeper and more developed domestic financial markets which was further reinforced by the presence of a large number of strong domestic institutional investors. Financial institutions in Malaysia also continue to demonstrate a high degree of resilience during the year.

Among the significant developments during the year were several legislative, structural and institutional enhancements in the financial sector. This included the coming into force of the Financial Services Act 2013 and Islamic Financial Services Act 2013 in June which, together with the Central Bank of Malaysia Act 2009, takes the legislative framework for financial stability in Malaysia to a new frontier. This reflects and anticipates a financial system that is more dynamic, more interconnected and inclusive but also more complex. The legislation significantly strengthens the Bank's capacity to maintain financial stability in this changing environment and in many ways, places Malaysia at the forefront of financial stability frameworks.

This strengthened capacity has enabled the Bank to respond to the potential build up of financial imbalances in an environment in which credit has continued to expand at a relatively strong pace in particular to the household sector, while asset prices experienced upward pressures. The Bank expanded the use of macroprudential instruments including to the non-bank sector to secure stable conditions in the credit and asset markets, in addition to maintaining a strong supervisory focus on the lending and provisioning practices of the banking institutions. Maintaining confidence in the financial system has also involved protecting the system from abuse. Actions against financial crime – both preventive and enforcement actions – continued to be pursued to safeguard the integrity of the financial system. This included the steps taken to review and strengthen the Anti-Money Laundering and Anti-Terrorism Financing Act 2001 (AMLATFA), while the enforcement actions have also been more effective including with stronger domestic and international cooperation.

Prudential standards have also continued to be raised, most notably with the implementation of the Basel III reform package beginning from January 2013. At the same time, the greater maturity of the financial sector has allowed the Bank to pursue important reforms to further reduce pricing distortions, including in the motor and life insurance industries, and in respect of payment instruments. Progress has also been made in the plans to replace the base lending rate framework with a new reference rate framework that is more relevant and reflective of conditions in the funding markets. These developments reinforce the progress in evolving a greater degree of market orientation in financial services that would in turn, contribute to the efficient and effective overall functioning of the financial sector. Finally investment in talent development for the industry has remained a key priority. The efforts have culminated in three further strategic initiatives - the establishment of the National Talent Council, the Finance Accreditation Agency and the Financial Services Professional Board, which is being led by the industry, to raise the bar in the financial services industry.

On the regional front, Asia as a whole has continued to become more cohesive. Regional financial integration has gained further traction during the year with the ASEAN Banking Integration Framework now in its final stages. Regional surveillance and research activities have also continued to support assessments on the risks and vulnerabilities in the region. The adoption during the year of a regional crisis management and resolution framework that establishes agreed protocols and commitments to enhance cooperation between central banks during crises, further consolidates the region's progress in building strong foundations for regional stability and growth.

An area of focus during the year has been the management of risks to domestic financial stability that have revolved around the accumulation of household debt and the developments in the property market. Following the series of macro and micro-prudential measures that were implemented during the year, the pace of growth of household debt has been slower. The more modest growth trend is expected to continue although debt levels to GDP are likely remain elevated in the near term. The broader structural measures currently being pursued by the Government to increase the supply of affordable homes and the development of the public transportation system will contribute towards reducing the amount of debt by households as homes become more affordable and as the reliance on public transportation increases. While the risk profile of new household lending remains sound, reinforced by further improvements in lending standards and an intensification of financial education programs, the Bank will continue to monitor closely the potential risks associated with the high household indebtedness.

Developments in the property sector has also warranted close attention during the year. Speculative activity in the property market, while not widespread, has occurred with the progressive lowering of entry costs for prospective investors through attractive home packages offered by property developers and the low borrowing costs. The Bank has therefore increased its scrutiny of the valuation and provisioning practices of financial institutions to ensure that lending decisions based on inflated valuations are not fuelling price increases and that loan loss buffers are adequate over the life cycle of the loan. This has been reinforced by measures by the Government to curb speculative activity, including improving the transparency in property prices in addition to the coordination of the supply measures. The National Housing Council represents an

important development to monitor and manage these measures in a coordinated manner. Also important will be the careful management and sequencing of the incoming supply of commercial office and retail space in the period ahead.

As the financial sector has an important role in supporting the financial management of businesses and households, efforts in coming year will be intensified to further widen access to financial services, increase the efficiency of financial intermediation and further develop the financing ecosystem. These include enhancements to the Development Financial Institutions Act 2002 to strengthen the performance of development financial institutions (DFIs) to better achieve their development mandates and to the agent banking framework to ensure broad-based and safe access to formal financial services. As financial inclusion is not just about access, but about equipping consumers to effectively use financial services, efforts will continue to further improve the financial literacy of Malaysian households and businesses, in particular, the small and medium size enterprises. A national financial education network will be established to drive and coordinate the financial education priorities.

In the payments area, the implementation of pricing reforms is expected to accelerate the migration by households and businesses to electronic means of payments. This will be reinforced by initiatives to further diversify and increase the efficiency of e-payment channels, making it more accessible and affordable, and providing opportunities for small businesses in particular to improve their business processes and reduce the costs of business.

For Malaysia to develop as a world's Islamic finance marketplace, more will be done to further deepen the Islamic financial markets in particular for extended maturity structures and for multicurrency sukuk issuance. The year also witnessed the inaugural issuance of the short-term sukuk by the International Islamic Liquidity Management Corporation (IILM) which represents an important and significant global breakthrough. This provides Islamic financial institutions including those in Malaysia, with a unique and dedicated instrument to manage their liquidity requirements for preserving financial stability. Islamic finance also continues to have a key role in microfinancing and microtakaful solutions, and in creating new opportunities for micro enterprises in Malaysia. Finally, through the work on the development of Shariah contract standards and a strengthened regulatory framework for the management of Islamic investment accounts, it will contribute providing an enabling environment responsible innovations and hence safeguarding financial stability.

Among the key regulatory and supervisory priorities for the Bank in the year ahead is the implementation of new arrangements for the prudential oversight of financial groups, and continuing to raise the bar on corporate governance and risk management practices in the financial services industry. As part of efforts to strengthen the resilience of the domestic financial system to systemic shocks, the Bank will also commence work on the development of a framework for identifying and strengthening the regulatory and supervisory regime for financial institutions that are systemically significant to the domestic financial system. This will include requirements for such institutions to maintain strong financial buffers, develop credible

recovery plans to restore financial viability in the event of severe stress, and including the support strategies by the relevant authorities to achieve an orderly resolution where necessary.

In pursuing these priorities, the Bank will continue to build on successful collaborative arrangements with other domestic and international authorities. During the year the Bank entered into formal arrangements with the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) specifically to strengthen regional crisis management and resolution. Additionally, given the changing nature and growing interdependencies within the financial services sector, evolving effective inter-agency coordination has been strengthened further as an important part of the agenda for preserving financial stability and promoting the development of a financial system that contributes towards economic sustainability.

A handwritten signature in black ink, appearing to read "Zeti Akhtar Aziz". The signature is fluid and cursive, with the first name "Zeti" being more prominent and the last name "Aziz" following in a similar style.

Zeti Akhtar Aziz
Governor
19 March 2014