

2013

EXECUTIVE SUMMARY



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Risk developments and assessment of financial stability in 2013

Domestic financial stability was well-preserved during the year, providing a conducive environment for the growth of the Malaysian economy. The financial system continued to demonstrate a high degree of resilience amid heightened volatility in the global financial markets and against domestic sources of potential risks. During several episodes of sharp capital flow reversals triggered by shifting global investor sentiment, orderly conditions were preserved, supported by deep domestic financial markets and the presence of a pool of strong domestic institutional investors. Financial institutions remained strong and continued to lend support to the financing and risk management needs of businesses and households throughout these episodes. Institutional resilience was further reinforced by sustained improvements in governance and risk management practices, and restraint in risk-taking in an environment of persistent and ample domestic liquidity. Overall confidence in the Malaysian financial system has also remained firmly intact.

Credit growth to both households and businesses expanded at a slower pace in 2013, reflecting economic factors and various precautionary measures taken to strengthen the resilience of households. The quality of domestic financial institutions' credit exposures remained sound. Aggregate business leverage improved further. Along with stable liquidity positions, this supported the overall debt servicing capacity of businesses despite a higher level of external borrowings. The share of delinquent business loans was correspondingly lower. Businesses with a higher share of external debt have generally maintained strong balance sheets and cash flow positions. This remains crucial for preserving buffers against foreign currency movements and elevated input costs.

Aggregate household borrowings grew at the slowest pace since 2010, mainly driven by the significantly slower growth in personal financing by non-bank financial institutions in response to macroprudential measures implemented in July 2013.

The aggregate balance sheet and debt servicing capacity of households remained intact.

This was supported by favourable employment and income conditions, which also saw households accumulating more financial assets. The combined effects of the incremental measures introduced by the Bank since 2010 to curb excessive household indebtedness continued to be observed, particularly in reducing the vulnerability of lower income households. Although the leverage position of these households has stabilised, the current leverage levels remain high. In general, households appear to be paying more attention to managing their leverage positions, which is important to preserve household resilience.

Risks to financial stability from household lending are assessed to remain well-contained. Household loans from the banking system continued to improve in quality across all loan segments, with delinquencies remaining low and continuing to trend downwards. Housing loans that originated over this decade (since 2004) have continued to perform better in terms of the default experience compared with earlier loans of similar vintage, reflecting the sustained improvements in the lending and risk management practices of banks. Simulations of household stress, including under extreme assumptions, also continued to affirm the strength of the banking system's buffers against potential losses from this sector. These buffers were further strengthened during the year with the requirement for banks to raise the level of provisions and reserves held for collective impairments where they were below a minimum level.

The level of household indebtedness is expected to remain elevated over the next few years as demand for credit is likely to remain strong, particularly from the relatively young, more affluent population settling in urban centres and expanded access to credits. As measures by the Government to increase the supply of affordable housing and improve public transportation, along with the current measures on lending practices take firm hold, the level of household indebtedness is expected to moderate. During this current period, it is particularly important that financial institutions continue to maintain sound

lending discipline and adopt robust affordability assessments in their credit lending practices.

In the domestic property market, house prices remained elevated during the year and an area that warrants continuous close monitoring in view of the effect of higher house prices on overall household debt and the significant exposures of banking institutions to the property market. The upward pressure on house prices continues to be largely explained by structural supply and demand factors, with demand particularly for low- to mid-priced homes likely to continue to outstrip supply in the near to medium term. Speculative purchases in the property market which are financed from bank borrowings have continued to remain subdued, particularly following further measures by the Government to raise the entry costs for short-term speculative purchases, and improve transparency in property prices. The effect of these measures should contribute towards encouraging more realistic valuations. While prices of residential properties continued to increase at a strong pace, risks to household finances and financial stability from any market correction are mitigated by the limited borrowings to finance speculative purchases and the strengthened lending practices of banks. The proportion of loans with lower loan-to-value ratios has also improved and now form bulk of the property loan portfolio, providing larger buffers against potential losses. Risks to financial institutions from the non-residential property segment are at present assessed to be low given the small credit exposures of financial institutions. Nevertheless, there is a need to effectively manage the incoming supply of new commercial properties to allow demand to keep pace with supply.

Domestic financial markets and financial institutions have held up well against the more volatile market conditions during the year. Active risk management by financial institutions have contained market risk exposures despite greater volatility in trading and investment income. The funding and liquidity positions of banks remained sound throughout the year supported by stable domestic savings, healthy liquidity buffers and a continued low reliance on offshore wholesale funding markets. Counterparty risk arising from claims by Malaysian financial institutions on external parties remained manageable, mostly comprising external claims on Asian economies. The share of exposures to counterparties in the United States and Europe remained stable.

Consistent with assessments in previous years, the risks from any potential deleveraging activities by foreign financial institutions remain low and have subsided further since the Global Financial Crisis. Global reinsurance conditions have also improved considerably, reducing the counterparty risks associated with foreign reinsurance placements.

Malaysian financial institutions continued to record strong capitalisation and financial performance. Banking institutions achieved a smooth transition into the first phase of strengthened capital requirements under Basel III which began from January 2013. Overall profitability has been sustained despite the more volatile market conditions. The overseas operations of domestic banking groups also continued to perform reasonably well despite tightening measures in some markets and differences in the intensity of the impact of capital flows across economies in the region. For the Islamic banks, the broadly stable ringgit funding conditions has further eased the pressures in managing displaced commercial risks. While the impact of market developments on the profitability of life insurers and family takaful operators was more pronounced, the insurance industry as a whole remained profitable and continued to maintain capital buffers well above the minimum regulatory requirement. In the general insurance sector, losses from the compulsory motor insurance segment continued to pose a significant drag on overall claims and underwriting performance. The implementation of the New Motor Cover Framework will be critical to restore some equilibrium in this segment of the general insurance sector. Results of updated and multi-year stress tests by the Bank continue to indicate sufficient earnings and capital buffers of banks and insurers to withstand severe scenarios of adverse portfolio flows and contraction in the domestic economy.

Looking ahead, Malaysian financial institutions continue to be well-positioned to manage external risks arising from the unwinding of the unconventional monetary policies in the major advanced economies as prospects for stronger economic recovery improve. Continued volatility is likely to persist in the domestic financial markets as investors adjust to changing expectations for the US monetary policy as well as developments in the euro area and The People's Republic of China. Over the recent period, Malaysian financial institutions have demonstrated resilience during such episodes of heightened volatility and have

continued to strengthen its resilience – notably by preserving strong financial buffers, ensuring that foreign currency funding mismatches remain low and continued prudence in risk-taking. The deep and more efficient domestic financial markets will also continue to provide support for orderly market conditions.

Development of the financial sector

Development initiatives in 2013 continued to focus on enhancing the role of the financial sector to better serve the needs of the economy, guided by the progressive implementation of the strategies and initiatives outlined in the Financial Sector Blueprint 2011-2020 (the Blueprint). The efficient mobilisation and intermediation of funds towards productive investments was further enhanced, in particular, for small and medium enterprises (SMEs) which saw the share of financing from the banking system increased further to 42.1% of total business financing, from 40.5% in 2012. Financing for SMEs continued to be supported by a wider range of products and schemes introduced during the year and further improvements to financing processes. In new growth areas, platforms created for greater engagement between businesses and financial institutions to bridge information gaps had an important role in expanding avenues for innovative businesses to obtain financing.

During the year, the Bank advanced proposed reforms under the Life Insurance and Family Takaful Framework to encourage greater operational efficiency, innovation and a higher level of insurance penetration in Malaysia. The framework outlines wide ranging proposals to increase the flexibility given for life insurers and family takaful operators to manage their operating costs with safeguards to protect the interests of policyholders, further diversify delivery channels, improve disclosures to consumers and drive higher professional standards among intermediaries. In the general insurance sector, the implementation of key initiatives under the New Motor Cover Framework (the Framework) progressed further with the second round of motor insurance premium adjustments taking effect to bring the industry closer to sustainable pricing levels. The Accident Assist Call Centre was also introduced to provide immediate assistance to consumers involved in road accidents and along with the Motor Claims Guide, are expected to contribute to a more efficient claims process and greater control over claims costs. These, together with earlier measures implemented under the

Framework, have contributed to the reduction in the average time taken to settle third party bodily injury claims.

Indicators of financial inclusion continued to improve, with the number of deposit and financing accounts increasing further. The implementation of the Agent Banking Framework was instrumental in achieving nationwide access to basic banking services, with banking institutions and agent banks now present in all districts and Parliamentary constituencies. In addition, the MyMobile platform has also significantly widened access to financial services through mobile networks. At the international level, the Bank co-hosted the 5th Global Policy Forum (GPF) with the Alliance for Financial Inclusion (AFI) which explored policy strategies that optimally balance financial inclusion, financial stability and consumer protection objectives. The GPF concluded with the launch of the Sasana Accord which reinforced commitments made by AFI members, including Malaysia, towards advancing the financial inclusion agenda.

Malaysia's debt securities market remained the largest in Southeast Asia, despite slower corporate fund raising activities during the year as global economic conditions remained challenging. A significant development during the year was the inaugural issuance of RM2.5 billion of 30-year Malaysian Government Securities, further extending the maturity profile of the domestic debt securities market. Enhancements made to the payment and settlements infrastructure in line with international standards have also supported a wider institutional investor base for the Malaysian debt securities market. In facilitating the use of renminbi as an additional currency of settlements, the Bank introduced the Renminbi Liquidity Facility to provide an additional avenue for financial institutions to manage renminbi liquidity. At the same time, the foreign exchange administration rules continued to be liberalised to allow businesses to manage foreign exchange risks more efficiently and to support wider range of financial product offerings that facilitate trade and investments. Work currently in progress to secure the enforceability of netting arrangements, including the development of a netting legislation, will further contribute to the deepening of Malaysia's financial markets.

Efforts to promote deeper financial integration within the Association of Southeast Asian Nations (ASEAN) region made important progress during the year, with the high-level principles of the ASEAN Banking Integration Framework now being at an advance stage of being finalised. This work has proceeded in parallel with initiatives to further strengthen collaboration and coordination between authorities in the region in maintaining financial system stability. Of significance was the endorsement of a regional crisis management and resolution framework by the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) which would support timely information flows and effective coordination in managing developments affecting regional monetary and financial stability. The Bank also extended its cooperation arrangements with foreign central banks and supervisory authorities in the areas of supervision, the development of financial markets, capacity building, Islamic finance and the promotion of local currency trade settlements.

The Islamic finance industry continued its growth trajectory during the year supported by several key initiatives that has further advanced the internationalisation of Islamic finance. The sustained momentum of sukuk issuances in Malaysia has continued which includes issuances made by foreign corporations. The year saw several firsts achieved in Islamic financial innovations. The Government issued the first Government Investment Issue based on the *murabahah* concept, appealing to a wider domestic and international investor base for sovereign sukuk. The Bank also participated in the inaugural issue of the short-term sukuk by the International Islamic Liquidity Management Corporation (IILM) which represents an important breakthrough on a global level in promoting the efficient management of cross-border liquidity to support financial stability in the international Islamic finance system. Continuing its work to promote transparency and consistency of Shariah contract application as well as to catalyse greater mutual respect of Shariah opinions across jurisdictions, the Bank has issued Shariah and operational standards for one Shariah contract while concept papers on eleven other Shariah standards and two operational standards have been published for industry feedback. During the year, the Law Harmonisation Committee, which led a comprehensive review of Malaysian legislation to support Islamic financial transactions, released its report which provides a basis for

relevant government agencies to pursue specific legislative amendments that will improve the certainty and enforceability of Islamic financial contracts in Malaysia. Reflecting the increasing connectivity between Islamic financial institutions in Malaysia with the global financial community, a new global brand identity - "Malaysia: World's Islamic Finance Marketplace" - was also introduced by the Malaysia International Islamic Financial Centre (MIFC), marking yet another phase in the development of Islamic finance in Malaysia.

Talent development continued to be a key priority, with a particular focus on further raising the bar on standards of quality, professionalism and ethics. During the year, the Institute of Bankers Malaysia (Institut Bank-Bank Malaysia, IBBM) commenced a process of transformation to separate and strengthen its roles as a professional body (repositioned as the Asian Institute of Chartered Bankers), and as a premier provider of banking education and training through the Asian Banking School. This will complement the establishment of an industry-led Financial Services Professional Board (FSPB) to promote, advocate and facilitate the development and adoption of professional standards across the different sectors of the financial industry. The Finance Accreditation Agency (FAA) was also officially launched during the year as an independent quality assurance and accreditation body of training programmes. Together with the Iclif Leadership and Governance Centre, the International Centre for Education in Islamic Finance (INCEIF) and the industry training and research bodies in the financial sector, these institutions complete the core components of an institutional framework that has been put in place for the development and enrichment of the financial sector workforce at all levels including leadership. Going forward, key challenges remain in developing a strong talent pipeline and the agility to respond to changes in talent demand and supply. To manage these challenges, a Financial Services Talent Council is in the process of being established with a key role in shaping the direction of talent strategies that will enable the financial industry to respond effectively to the challenges faced.

Regulatory and supervisory framework

The regulatory and supervisory framework continue to have a critical role in safeguarding the stability of the financial system and promoting the orderly development of the financial sector. A large part of the Bank's regulatory priorities during the year were directed at giving full effect

to the Financial Services Act 2013 (FSA) and the Islamic Financial Services Act 2013 (IFSA), which came into force on 30 June 2013. This included strengthening the focus of financial supervision beyond individual financial institutions to take into account group-wide and system-wide risks. Following an extensive review of group structures and the nature and scope of group activities observed in Malaysia, the Bank outlined its intended approach to overseeing financial groups which clarified how the boundaries of a financial group will be drawn for the purpose of prudential regulation and supervision and correspondingly, the scope of regulation and supervision that will apply. This will be followed by the progressive issuance, from 2014, of group-level prudential standards for financial groups on capital adequacy, corporate governance, risk management and liquidity management. To give effect to the clear distinction under the IFSA between 'Islamic deposits' and 'investment accounts', the Bank also published proposals on strengthened oversight and risk management arrangements for the management of investment accounts to uphold compliance with Shariah and provide adequate protection for investors commensurate with the investment risks borne by them. These standards will be finalised in 2014 for effective implementation from June 2015 when the separation between Islamic deposits and investment accounts takes full effect under the law after a two-year transition period.

The domestic implementation of the capital and liquidity components of the Basel III regulatory reform package progressed in line with globally agreed implementation timelines. Accordingly, higher regulatory capital standards came into effect from January 2013. The level and quality of banking institutions' capital positions continued to remain strong under the new rules. Work to calibrate the Liquidity Coverage Ratio for domestic implementation is also well advanced and remains on track for effective implementation in 2015. Data from the observation period suggests that banks will be able to meet strengthened liquidity standards without significant difficulty. In the takaful sector, the industry similarly transitioned smoothly towards the adoption of the Risk-Based Capital Framework for Takaful Operators in January 2014, following a one-year parallel run. This will better support a well-capitalised takaful industry and significantly strengthen incentives for sound risk management by takaful operators. The Bank continued to increase its supervisory

emphasis on the effective implementation of Internal Capital Adequacy Assessment Process (ICAAP) by banks and insurers. There has been clear progress observed in some areas, including in how institutions are more formally integrating risk and capital management strategies. The Bank expects this process to continue to evolve as institutions further refine their approaches to setting internal capital targets and enhance internal arrangements to monitor and credibly maintain internal capital target levels.

The Bank continued to strengthen standards of governance and risk management across the financial sector. Measures were proposed and are being finalised to enhance the stature of appointed actuaries in insurers and takaful operators and strengthen the effectiveness of the control function performed by the actuary, including through a clear separation of the appointed actuary from pricing responsibilities. During the year, the Bank also finalised standards to promote the sound pricing of retail loans and other financing products.

Focus continued to be given to strengthening safeguards against money laundering and terrorism financing (ML/TF) threats. The Bank, together with other agencies under the ambit of the National Coordination Committee to Counter Money Laundering (NCC) proposed several amendments to the Anti-Money Laundering and Anti-Terrorism Financing Act 2001 (AMLATFA). The existing regulatory requirements were also revised to be in line with global standards and to ensure that the anti-money laundering and combating the financing of terrorism (AML/CFT) framework remains relevant and effective in combating ML/TF threats. Further progress has been made in raising the standards of compliance with measures to combat ML/TF in the money services business industry. The Bank also intensified its review of the effectiveness of AML/CFT controls within financial institutions. Practices within financial institutions to address threats of ML/TF are generally well established. However, systems in some institutions can be further enhanced to support the effective ongoing monitoring of customer accounts and transaction patterns, in addition to continued investments in training for frontline employees to perform effective assessments of customer risk profiles. Enforcement and supervisory actions were taken against financial institutions that failed to effectively control ML/TF risks in their operations,

erving to ensure that financial institutions remain alert to ML/TF threats and are taking appropriate measures to protect the integrity of the financial system. The Bank, in some cases acting jointly with other authorities, also brought 1,823 charges against companies and individuals investigated for money laundering and operating illegal schemes and activities.

Market conduct and consumer empowerment

The Bank's market conduct oversight activities in 2013 continued to be directed at monitoring and managing risks to consumers arising from increased competitive pressures in the retail market, a sustained low interest rate environment and corresponding search for higher yields, and the wider use of new delivery channels for financial products and services. In managing these risks, the Bank further strengthened standards on business conduct, increased its supervisory intensity in areas which pose heightened risks to consumers, and worked in close collaboration with relevant stakeholders to address conduct issues.

A review by the Bank of financial institutions' compliance with responsible financing requirements which were introduced in 2012 showed that lending practices of financial service providers (FSPs) have improved. More information is being provided to borrowers on the process for demonstrating affordability and the implications of a potential rise in borrowing costs. Financial institutions are also adopting more realistic assumptions in conducting affordability assessments and have demonstrated greater restraint in marketing financing products to more vulnerable borrowers. The fair treatment of customers remained at the centre of the Bank's market conduct focus. In this respect, the level of compliance with transparency and disclosure requirements in the marketing and advertising materials produced by financial institutions continued to improve during the year, although the provision of quality advice on financial products to customers needs to be further improved. The Bank continued to take firm actions on financial institutions that failed to observe the Bank's guiding principles on fees and charges, resulting in refunds of more than RM13 million to affected customers. Similar actions were taken on unfair tied-selling practices especially where general insurers were

requiring policyholders to purchase personal accident insurance as a condition for, or together with, motor insurance.

The Bank remained vigilant in combating banking fraud and financial scams. Cases of Internet fraud have continued to reduce as a result of banking institutions' ongoing efforts to ensure a secure electronic banking environment. Criminal actions taken against illegal investment schemes, stronger inter-agency collaboration and greater consumer awareness on financial scams and frauds have also contributed to the reduced incidence of frauds and scams during the year.

The Bank continued to devote significant resources to enhancing financial capability through education initiatives. The Bank's ongoing collaboration with the Ministry of Education to integrate financial education into the primary school curriculum made encouraging progress with the progressive incorporation of financial education themes into the school curriculum, beginning from 2014. Building on the successful implementation of the POWER! Programme, the Bank worked with the Credit Counselling and Debt Management Agency (Agensi Kaunseling dan Pengurusan Kredit, AKPK) to further tailor financial education programmes to the specific needs and priorities of consumers at different life stages, focusing initially on targeted programmes for working adults that were delivered at the workplace through public-private sector partnerships. A Financial Education Assessment Framework developed during the year enables the Bank to evaluate the effectiveness of these programmes.

Avenues for consumer redress were further enhanced. To give effect to provisions under the FSA and IFSA for the establishment of a financial ombudsman scheme, work to review the current functions (including the scope of disputes handled), operations and funding arrangements of the Financial Mediation Bureau, and facilitate its transformation into a financial ombudsman scheme, is largely complete. The Bank expects to publish the outcome of this review for public feedback in April 2014. The scope of AKPK's debt management services was further expanded during the year to cover borrowers of credit co-operatives and the Malaysia Building Society

Berhad, in addition to borrowers from financial institutions regulated by the Bank.

Payment and settlement systems

The payment and settlement systems in Malaysia remained resilient and continued to operate reliably to support the financial system and economy. Supervisory activities during the year remained focused on ensuring the efficiency and reliability of the major payment systems. Apart from the Real-time Electronic Transfer of Funds and Securities System (RENTAS) which continued to maintain 100% system availability throughout 2013, this included the major retail payment systems such as the Interbank GIRO, Financial Process Exchange, domestic debit card and the Shared ATM Network systems. As the migration to electronic payment (e-payment) gains further traction, the stability of these systems is critical to support the increasing number and volume of e-payment transactions. In addition, previous measures to strengthen security standards for payment instruments and channels have continued to keep fraud losses at negligible levels.

Further progress was made during the year towards achieving the bold targets set under the Blueprint for the widespread adoption of e-payments in Malaysia. E-payment transactions increased in volume by 18.8% for the year. On a per capita basis, the number of e-payment

transactions was also higher at 65 transactions in 2013, with ongoing initiatives expected to further advance e-payment adoption towards the target of 200 transactions per capita in 2020. While the number of cheque transactions decreased at a faster pace in 2013, the total number of cheques issued remains high and would need to decline at a much faster pace to achieve the targets set under the Blueprint. In a major development to encourage greater adoption of e-payments, the first phase of pricing reforms was implemented during the year to incentivise the use of more cost-effective payment instruments, along with continued measures to further improve the accessibility and convenience of payment services. The Bank continues to work closely with key sectors of the economy, including the public sector, the financial sector and the transportation sector, to encourage the use of e-payments and enhance awareness among businesses and the public on the benefits of e-payments as well as the range of e-payment solutions available. The Bank is also closely monitoring developments which are pointing to a rising trend in interchange fees that could increase costs for businesses and consumers that use payment cards, and will consider an appropriate framework for regulating the process of setting domestic interchange fees that balances the interests of the relevant parties.

