



GOVERNOR'S STATEMENT

Global financial and economic conditions continued to be highly challenging in 2012. While a sustained strength of the global economic recovery has yet to be fully secured, the resolution of the euro area crisis has also remained incomplete. Although international financial market tensions have eased in the recent months, capital flows to emerging economies can be expected to remain volatile.

In this environment, domestic financial stability in Malaysia has continued to be preserved. There have been no disruptions to credit flows and domestic financial markets have remained orderly. Financial institutions in Malaysia are sound with strong capital and liquidity buffers and continuing improvements in asset quality. Weakness in external demand has not impacted the balance sheets of financial institutions, which continue to be well-supported by a diversified lending portfolio and sound underwriting and risk management practices. This has preserved a high level of confidence in the domestic financial sector and its role in facilitating financial intermediation and providing risk protection to Malaysian households and businesses. A positive assessment by the International Monetary Fund and the World Bank under the Financial Sector Assessment Program further affirms the strength of the regulatory and supervisory framework in addressing risks to our financial stability.

The principal risks to domestic financial stability were largely unchanged. Household debt levels have continued to increase in 2012 but at a more moderate pace following the implementation of targeted macroprudential measures by the Bank since 2010. The growth in household borrowings remains broadly in line with rising household incomes, stable employment conditions and expectations of repayment capacity. Banks have also continued to observe prudent lending standards with greater attention to affordability assessments. During the year, the Bank has taken steps to address the growth in lending activities to the household sector from outside the banking sector. Such activities have increased the vulnerability of certain segments of the household sector to income shocks.

Nevertheless, risks to financial stability are well contained with the aggregate measures of household resilience remaining strong. The extension of financial education and debt resolution programmes to households that borrow from non-bank financial institutions is also aimed to promote responsible financial management by households. Equally important are the efforts to ensure prudent and responsible lending practices by institutions operating outside the banking sector, especially under the more competitive conditions.

Developments in the property market have also been a focus of surveillance by the Bank. House prices have continued to increase, reducing home affordability in some locations for Malaysians, particularly those in the lower- to middle-income groups. While house price increases have largely been explained by macroeconomic factors, in the more recent period, investor activity appears to have also had an influence on house prices. The Bank has progressively tightened measures on lending for speculative property purchases, and will continue to monitor the situation closely. To date, there is no evidence that changes in credit policies of banks have been driving house price increases. This mitigates the risks to financial stability, but affordability remains an issue and will need to be addressed through comprehensive measures, including fiscal and supply-side measures. Also important is the management of the incoming supply of commercial property space to preserve stable conditions in the commercial property sector.

In the international financial environment, the global reform agenda to safeguard financial stability has continued to advance forward during the year. While financial institutions in Malaysia have stood up well to the test of the recent crisis, the reforms are a useful benchmark against which the strength and resilience of Malaysian financial institutions can be judged. In a number of areas, including liquidity, the domestic regulatory framework already sets minimum standards for financial institutions in Malaysia which have already been in place for several years. The reforms do however present aspects of the prudential framework that can, and should be further strengthened as the financial system develops and expands in the scope and scale of activities. The implementation of the Basel III regulatory reforms in Malaysia, which commenced in early 2013 will follow the internationally determined timeline. Its implementation will be monitored closely to ensure that the intended benefits of a stronger financial system are delivered while minimising unintended consequences for domestic financial intermediation activities.

A major advancement in the regulatory and supervisory framework for the financial system in Malaysia is the new legislation for the financial sector that has been approved by Parliament in December 2012, and that will come into effect by mid-2013. With the enactment of the Financial Services Act 2013 and Islamic Financial Services Act 2013, Malaysia can have a high degree of confidence in the comprehensive legal framework for the financial sector. Collectively, the financial sector laws including the Central Bank of Malaysia Act 2009 have significantly strengthened the foundations for financial stability in Malaysia. The new legislation provides the Bank with the necessary powers to act effectively in a much more complex financial landscape, while holding the Bank accountable for those actions.

The governance arrangements for financial stability which have been put in place within the Bank have continued to be strengthened. This includes the Financial Stability Committee which has been reinforced by the Joint Policy Committee comprising members of the Monetary Policy Committee and Financial Stability Committee. The Joint Policy Committee has in the recent few years issued several macroprudential measures to ensure developments emanating from the economy and the asset markets would not become a risk to financial stability. The higher degree of integration, both within the financial sector as well as between the financial sector and other parts of the economy has now called for much deeper levels of inter-agency collaboration in promoting financial stability, addressing the risks to consumers and in supporting the development of the financial sector. Towards achieving this, the Bank also entered into arrangements for cooperation and coordination with other domestic authorities during the year to ensure a more complete assessment of the potential risks to financial stability, including that arising from financial intermediation activities from the non-banking sector.

In April 2012, the Bank entered into a Strategic Alliance Agreement with the Malaysia Deposit Insurance Corporation which outlines the roles and responsibilities of the Bank and the Malaysia Deposit Insurance Corporation in the resolution of stressed financial institutions, thus having in place the procedural arrangements for orderly resolutions. In October 2012, the Bank signed a memorandum of understanding with Securities Commission Malaysia to achieve a more effective supervision of financial groups and of banking activities in the capital market, and for monitoring potential systemic risks in the capital market and the broader financial system. During the year, the framework for financial sector regional cooperation was also strengthened further in view of the more pronounced cross-border dimension of financial services. Towards this endeavour, the Bank has during the year worked through supervisory colleges, bilateral engagements with central banks and supervisory authorities, and through regional groupings.

A further area of collaboration is with other law enforcement agencies in the country, in particular, the National Coordination Committee to Counter Money Laundering. This cooperation serves to facilitate inter-agency initiatives, the exchange of information and the coordination of enforcement actions. The legislation for anti-money laundering and anti-terrorism financing was also strengthened further during the year. Cumulatively, this has aimed to counter the use of the financial system for illegal activities and thus, safeguard the integrity of the financial system.

The regulatory framework for Islamic finance also broke new ground during the year, further contributing to the goals of financial stability in the Islamic financial system. The Bank took major steps towards the implementation of a contract-based regulatory framework in Malaysia which will reinforce the principles of Shariah and facilitate reducing the legal and operational risks in the conduct of Islamic financial transactions. The framework is an important foundation for future innovation in Islamic finance and will contribute towards further strengthening confidence in Islamic financial products and services. The contract-based regulatory framework will also contribute towards advancing the goals of financial stability which seek to preserve a financial system that works effectively and efficiently to serve real economic activity.

Financial inclusion remains an important agenda of the Bank with its dimensions having grown in significance. In addition to promoting greater access to financial services by households and small businesses, it has also become more important to ensure those that currently have financial access do not, over time, become financially excluded due to the growing complexity of financial products and services. The introduction of new channels of access, such as through mobile banking and agent banking, also places additional demands on the regulatory framework to provide for the adequate protection of consumers and effective management of operational risks by financial institutions.

The Bank expects to increase the intensity of its financial capability initiatives, working together with its partners, to ensure that the financial system remains inclusive as it becomes more developed. To better understand the impact of these efforts going forward, work has already commenced on the development of a framework for measuring the effectiveness of financial education initiatives in promoting responsible financial behaviour. In addition, the Bank has developed a financial inclusion index which measures accessibility to financial services and its usage.

A key part of modernising the financial system and raising the level of competitiveness of our economy has involved the transformation of the payment landscape. A decade ago, almost half of non-cash payments by volume were made by cheques. Today, e-payment channels account for close to 90% of all non-cash transactions. This trend has gained further traction in the recent two years with the sustained efforts to expand access to e-payment services and the enhancement of the supporting infrastructure and functionalities. In 2012, the Bank has announced the intentions to pursue pricing reforms to accelerate the migration to e-payments. While a new pricing framework for payment transactions will be announced in 2013, a one-year lead time will be given for its implementation. This will allow consumers and businesses to position themselves to effectively adjust to the new pricing arrangements. The reform will remove the current price distortions between e-payments and paper-based payment instruments, and encourage the transition to more cost-effective payment methods.

Looking ahead, the financial sector is well placed to cope with future challenges but continued vigilance is required by the Bank as well as the financial institutions. A continued focus on the development of a sound, progressive and inclusive financial sector, guided by the recommendations of the Financial Sector Blueprint 2011-2020, will also further reinforce the resilience of the financial system and its ability to support and drive Malaysia's transformation to becoming a higher value-added, high-income economy to be achieved in this decade.



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Governor
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