2012

EXECUTIVE SUMMARY

Risk Developments and Assessment of Financial Stability in 2012

Domestic financial stability remained intact throughout 2012, providing a supportive environment for continued growth of the Malaysian economy. The Malaysian financial system continued to demonstrate a high degree of resilience amid persistent uncertainties in several of the advanced economies and weaker global growth. This was supported by strong and well-capitalised financial institutions, orderly conditions in the domestic financial markets and ample liquidity, thus ensuring that financial intermediation continued to function efficiently to support domestic economic activity. Despite increased competition prevailing in the retail lending segment and a more buoyant property market, financial institutions have generally maintained sound underwriting and risk management standards. Overall confidence in the domestic financial system also remained firmly intact. The assessment of Malaysia under the Financial Sector Assessment Program conducted by the International Monetary Fund and World Bank in 2012 further reaffirmed the strength of the Malaysian financial sector, noting in particular its resilience to macroeconomic and financial stresses, and the high level of compliance of the domestic regulatory and supervisory frameworks, deposit insurance system and the financial market infrastructure with international standards.

Credit quality also remained sound. The financial condition of businesses has been healthy and generally improving, while income growth and stable employment prospects generally have continued to support the debt servicing capacity of households. Earlier precautionary measures undertaken to promote the resilience of households and sustainability of the property market have had a positive effect, although other developments have exerted additional pressures on the financial positions of households and on property prices. Overall growth in household lending was slower for the second consecutive year, with indicators in the banking sector continuing to support the sound credit quality of household financing by the banking system. Bank lending practices remain sound, and were further strengthened following the implementation of the Guidelines on Responsible Financing during the year. Non-bank financial institutions are, however, expanding their financing activities to the household sector. Equally prudent practices therefore need to be adopted to ensure that increases in the financial vulnerabilities of households will be avoided.

In the property market, pre-emptive macroprudential and fiscal measures undertaken have had a moderating effect on investment activities involving the purchase of residential property. However, overall house prices have continued to increase at a strong pace. Macroeconomic, rather than financial factors are mainly driving this trend as the supply of houses remains insufficient to meet genuine demand for new homes. Measures already being taken by the Government to increase the supply of affordable houses, along with additional fiscal measures, are aimed at mitigating such further price increases. Also important is for the supply of new commercial and retail spaces to be staggered and phased to avoid oversupply in the short term. Risks to financial stability from these developments, however, remain well-contained, mainly on account of continued discipline in lending standards and further improvements in the risk management practices of banks. Exposures of financial institutions to the non-residential property segment are also low.

Exposures of Malaysian financial institutions to counterparties in Europe remained low and were further reduced for exposures to the European countries that are most affected by the euro area crisis. Global reinsurance conditions have also improved considerably, reducing the risks associated with foreign reinsurance placements. Malaysia remains well placed to cope with the effects of potential deleveraging activities by European financial institutions, with the domestic institutions and other foreign banks in Malaysia in a position to replace any lost capacity. While Malaysian banks have continued to expand their regional operations, this has been at a relatively moderate pace and is commensurate with the greater capacity of the banks to manage risks on a group-wide basis.

Financial institutions continued to record strong capital positions and financial performance which improved the ability of banks to meet new capital requirements under Basel III that are being phased in from 2013. Profit performance has continued to be driven by core lending and insurance activities and not from higher risk-taking in trading and treasury activities. In addition to continued discipline in lending, financial institutions have taken measures to manage exposures to market risk, insurance risk and displaced commercial risks. These strategies have further improved their resilience to a range of economic and market shocks.

The external environment is expected to remain challenging in 2013. The key risk to the Malaysian financial sector continues to stem from the general weakness in the external economic conditions which is transmitted through the trade channel. The more favourable domestic and regional economic and financial outlook is expected to provide some support against this risk. The Malaysian financial sector is well placed to cope with such adverse external developments given the strong financial buffers of financial institutions, comprehensive institutional arrangements in place for responding to system-wide risks, and most importantly, the sound and continuous improvements in credit, market and operational risk management practices of banks. Liquidity and funding conditions in 2013 are also expected to remain supportive of the domestic intermediation by financial institutions in Malaysia. The business expansion and lending activities of non-bank financial institutions, the high leverage of the lower-income households and developments in the property market are areas that will continue to be closely monitored by the Bank.

Development of the Financial Sector

Development initiatives in 2012 continued to focus on further enhancing the critical role of the financial sector in harnessing Malaysia's long-term growth potential. An important part of this involved promoting sound conditions for the intermediation of funds to new growth areas and strengthening Malaysia's interlinkages with regional and international economies as outlined in the Financial Sector Blueprint 2011-2020. The enactment of the new Financial Services Act 2013 (FSA) and Islamic Financial Services Act 2013 (IFSA) supports and strengthens the preconditions for these efforts.

During the year, investment banks gained greater scale and capacity through mergers and acquisitions to tap growth opportunities in the region, while the general insurance industry consolidated further, significantly improving the viability and competitiveness of smaller insurers in the industry. The implementation of the first phase of the new motor cover framework proceeded smoothly to bring the industry closer to sustainable pricing levels for motor insurance, while broader reforms to improve the efficiency of claims settlement processes and to control claims costs have started to produce results. With the development of a comprehensive regulatory and supervisory framework for the insurance industry and a more competitive insurance market achieved over the years, another important structural adjustment that will be pursued in the insurance sector relates to the review of existing cost controls that are applied to both life and general insurers. This is intended to allow market forces to work more effectively to encourage innovation and further develop alternative distribution channels for insurance, while also providing stronger incentives to develop the capacity of agents. The first phase of this review was implemented in January 2013.

Financing to small and medium enterprises (SMEs) continued to register strong growth. Lending indicators showed greater access to financing for SMEs, both in terms of an increase in the number of SMEs that have benefitted from the various financing facilities provided for SMEs, as well as in the higher average value of financing approved. More flexible financing products for micro-enterprises were also introduced by the financial industry which would allow more micro-enterprises to be eligible for financing. Financial institutions have continued to maintain a strong focus on the SME sector, with several banks continuing to raise the financing targets for SMEs and investing resources to enhance the capacity to further grow their SME financing portfolio. Financing for green technology ventures has similarly grown with improving prospects as a result of additional funding capacity provided by the Government, and further progress achieved to develop the credit assessment and risk management capabilities of banks in this area. Development financial institutions (DFIs) continued to have an important role in supporting the growth and development of strategic economic sectors. Financing by DFIs under the purview of the Bank recorded strong growth for the year and their risk profiles improved further. During the year, measures were advanced to improve the transparency of the performance of DFIs against their mandates and to provide greater clarity on the risk-sharing arrangements between the DFIs and the Government.

The debt securities market remained an important source of funding for corporations, with a larger share of financing by businesses being met through the debt market compared with the banking system for more than a decade now since 2002. Malaysia continues to have the largest debt securities market in Southeast Asia and remains among only two countries in the region with a significant private debt securities market that is almost as large as the public debt securities market. The increased capital allocation by the Government to Danajamin Nasional Berhad will further enhance the capacity of Danajamin in improving cost-efficient access to the bond market for issuers seeking to raise longer-term funding. In the money market, the Bank continued to introduce new products to facilitate more efficient liquidity management by Islamic financial institutions. As concerns increased globally over rate-rigging practices in relation to financial market benchmark rates, the Bank and the financial industry took additional measures to preserve the credibility of key domestic benchmark rates and reinforce the confidence of market participants in the use of these rates. In efforts to further deepen the foreign exchange market, an immediate focus has been to improve the access to, and availability of a broader range of hedging instruments. To this end, the foreign exchange administration rules were further liberalised to encourage greater innovation in foreign exchange product offerings and demand for more efficient foreign currency management solutions.

Measures of financial inclusion showed improvement in terms of access to deposit accounts, while access to financing accounts remained at high levels. The work done by the Bank to develop a Financial Inclusion Index showed that Malaysians generally used financial services in a responsible manner and were reasonably satisfied with the financial products and services provided, but that there was scope to further improve convenient access to financial services. During the year, two key initiatives to improve access to financial services were the implementation of the agent banking framework and the MyMobile platform. This is expected to have a significant impact on widening the reach of financial services in Malaysia.

Domestic banking groups continued to extend their regional footprint, with overseas operations in 21 countries, from 19 previously. Efforts to deepen regional financial integration also gained further momentum under the ASEAN Financial Integration Framework. ASEAN member countries are in the final stages of launching a banking sector integration framework that will support a more dynamic and meaningful role by qualified ASEAN banks in the region. The launch of a pilot platform for the cross-border investment and settlement of debt securities under a joint initiative by the Bank, the Hong Kong Monetary Authority and Euroclear Bank will enable investors and market intermediaries to access bond markets in Malaysia and Hong Kong more efficiently, in turn contributing to the further deepening of the Asian bond markets. The commitment to develop well-functioning bond markets in the region was strengthened further with the agreement by ASEAN+3 member countries to adopt a new roadmap pursuant to the Asian Bond Market Initiative.

The central focus on promoting regional financial stability remains important to the regional integration agenda. In this regard, the preparedness of the region to respond to crises has been further strengthened, following enhancements effected to the Chiang Mai Initiative Multilateralisation Agreement and continuing work to strengthen existing communication protocols and institutional arrangements for crisis management and resolution within the grouping of the Executives' Meeting of East Asia Pacific Central Banks (EMEAP). Given the important bearing that global regulatory developments have on the domestic financial sector, the Bank continued to contribute actively to regional and international forums focusing on financial regulatory developments. This is important to forward concerns, in particular from emerging economies, so that due consideration would be given to these issues in the international policy making process.

The Islamic financial sector continued its growth trajectory, with robust growth recorded in Islamic banking assets, takaful assets, sukuk and foreign currency business. Malaysia remains a key centre for sukuk issuances globally. The foundations and institutional arrangements for the orderly growth of Islamic finance continued to be strengthened, notably in supporting effective end-to-end Shariah governance and compliance. Malaysia has taken significant steps forward to put in place a contract-based regulatory framework for the Islamic financial sector which aligns legal and regulatory principles with Shariah precepts, and will serve as a useful benchmark for evolving a more comprehensive regulatory framework that will promote greater legal and operational certainty in Islamic finance. This has been complemented by continued innovations in the sukuk market, a strong focus on research and ongoing efforts to develop a deep pool of talent to meet the growing needs of the Islamic financial industry.

The various institutions and programmes that support the talent development agenda, including the Financial Sector Talent Enrichment Programme, the Asian Institute of Finance, the International Centre for Education in Islamic Finance, the Iclif Leadership and Governance Centre and other financial industry training institutes, have continued to expand their programme offerings in efforts to bridge talent gaps in the financial industry. These institutions have also built strong reputations that have enabled them to train more professionals for the industry, and forge strategic alliances that will further enhance their capacity. During the year, the Finance Accreditation Agency was established to provide independent accreditation of learning programmes and qualifications for the financial services industry. The aim is to support high-quality financial services training through the accreditation process and to provide a structure for the mutual recognition of professional learning and experience in financial services. Moving forward, a Financial Sector Talent Council will be established to provide strategic direction and develop coordinated strategies for talent development in the financial sector.

Regulatory and Supervisory Framework

The regulatory and supervisory framework in Malaysia will be placed on a substantially stronger footing with the enactment of the FSA and IFSA. The new laws significantly strengthen the foundations for a regulatory and supervisory framework that is effective, transparent and which contributes to an efficient financial system that is resilient to future stresses. The Bank's regulatory priorities continued to be guided by a domestic focus on further raising the standards in governance and risk management practices in keeping with the growing scale and complexity of activities of financial institutions in and outside Malaysia. This included strengthening and updating prudential rules in line with international regulatory reforms.

The domestic implementation of the Basel III global regulatory reform package has moved forward with the publication of final rules that will significantly raise the level and quality of banks' regulatory capital. The new requirements are being phased in from January 2013 to December 2018 in line with globally determined timelines. Malaysian banking institutions are in a strong starting position to meet the higher standards, and the extended transition period allows ample room for banks to gradually build up the required buffers. Projections by the banking institutions suggest that any impact on the costs and functioning of domestic financial intermediation will be minimal compared to the benefits from the substantially stronger capital buffers that reduce the probability and costs of bank failures to the economy. Changes made early this year to the global liquidity standards under Basel III which will come into effect in 2015 in general are more reflective of the characteristics of funding markets in Malaysia and are expected to support a smooth domestic transition to the new standards. The Bank also issued the final Risk-Based Capital Framework for Takaful Operators (RBCT) to significantly strengthen the prudential framework for takaful operators to be on par with the standards applicable to the insurance industry. Full compliance with the RBCT will take effect from 1 January 2014.

The Bank further strengthened requirements on effective risk governance that must be observed by all financial institutions. These address the role of the board, senior management and other control functions to ensure strong risk management systems in financial institutions, and require that incentive and remuneration structures are aligned with prudent risk-taking. Strong risk governance will be particularly important to support effective risk management on a group-wide basis for some of Malaysia's largest financial groups which have material operations in more than one regulated sector, or significant overseas operations. The prudential framework for managing exposures to single counterparties has also been enhanced to ensure that risk concentrations continue to be prudently managed by banks in an environment that is more interconnected. Under the FSA and IFSA, the Bank will be able to provide an appropriate level of oversight over financial holding companies to ensure that the activities of financial groups do not pose undue risks to the safety and soundness of financial institutions. This will include setting prudential standards for financial holding companies, conducting ongoing supervision on a consolidated basis and requiring corrective actions by financial holding companies to address identified risks. The Bank expects to publish its proposals on the scope of consolidated supervision that will be applied on financial groups, in the second half of 2013.

The Bank's supervision and enforcement activities which were aimed at preventing the financial sector from being used for illegal activities were also intensified in 2012. As a result of the re-licensing exercise undertaken for the money services business industry, the financial and operational capacity of licensed money changers and remittance service providers has improved substantially, along with more effective controls implemented by these entities against risks associated with financial crime. In total, the number of entities in the money services business industry declined to 515 from 839 in December 2011 following the re-licensing initiative. At the broader system level, the Bank continued to be actively involved in driving anti-money laundering initiatives in collaboration with other law enforcement agencies, working mainly through enhanced arrangements under the National Coordination Committee to Counter Money Laundering. During the year, the legal framework for countering the financing of terrorist activities was further strengthened to include an expanded scope of predicate offences. The enforcement capacity of law enforcement agencies has also increased. Work has commenced to further review the existing anti-money laundering and counter financing of terrorism (AML/CFT) framework to take into account revised international standards issued in February 2012 by the Financial Action Task Force.

To ensure effective oversight over the financial system as regional and international linkages continue to expand and deepen, the Bank further strengthened its cooperation arrangements with other central banks and supervisory authorities. Domestic arrangements for cooperation between the Bank and other authorities in Malaysia which contribute to financial stability, notably the Malaysia Deposit Insurance Corporation and Securities Commission Malaysia, have also been further enhanced.

Market Conduct and Consumer Empowerment

The Bank's oversight activities in the area of market conduct continued to focus on managing risks to consumers arising from the search for higher yields, the accumulation of higher debt by low-income households, and the promotion of more complex products in the market, including products which involve greater risks that are borne by consumers. In managing these risks, the Bank's priorities in 2012 has been on strengthening the legal framework through the FSA and IFSA for the oversight of market conduct, implementing an enhanced market conduct supervisory framework, increasing the scrutiny of insurance intermediaries and empowering consumers through targeted financial education programmes.

Generally, the Bank has observed further improvements in the attention accorded by financial service providers to market conduct issues, largely in response to supervisory engagements, but also as a result of a greater focus on consumer welfare in the business and growth strategies of financial service providers. In particular, banks have strengthened internal processes for assessing affordability to ensure that households are borrowing within their means. Disclosures made in the sales and marketing materials of financial service providers have been more balanced in presenting risks and returns, and the use of plain language has been extended to a wider range of financial contracts. The level of compliance with fair principles relating to fees and charges imposed by banks has also improved, along with strengthened security measures to prevent online fraud. During the year, the Bank strengthened existing requirements on product advice in the life insurance and family takaful sectors and imposed requirements on all Islamic banks to grant *ibra'* (rebates) to customers upon the early settlement of financing contracts. As part of its role in providing a credible deterrent against unfair practices, the Bank took supervisory and enforcement actions against unfair practices, including mis-selling, that were identified through the supervisory and surveillance activities.

The Bank continued to strengthen its efforts to stem the growth of illegal financial schemes and scams. In addition to the investigation of illegal schemes involving breaches of laws administered by the Bank, significant resources have been directed at generating wide publicity on the dangers of illegal schemes and educating consumers to be more vigilant. During the year, a White Collar Crime Taskforce was established to coordinate joint enforcement actions between law enforcement agencies. In another collaborative effort, an inter-agency platform will be established to conduct a comprehensive review of the gaps in the existing regulatory regime for credit providers, with the view to develop a comprehensive consumer credit law that will provide a more cohesive legal framework for regulating consumer credit activities in Malaysia.

The Bank continued in 2012 to advance financial capability and education initiatives to empower Malaysians to build, manage and protect their personal wealth. An immediate focus has been to promote financial capability skills from an early age through the school curriculum and to roll out financial capability programmes based on life event models for adults. The integration of financial education into the school curriculum has progressed well and is on track to be implemented progressively from 2014 for primary schools and 2017 for secondary schools. The focus for adult financial education continued to be directed at education for the young adult population and low-income households given their propensity to borrow and lower financial buffers. Further progress was also made to develop a Financial Education Assessment Framework that measures the financial literacy level of consumers to identify priority areas for financial education interventions and to assess the effectiveness of existing financial education initiatives. To further enhance institutional arrangements for consumer redress, work is in progress to transform the Financial Mediation Bureau into a financial ombudsman scheme with legal backing to deal with a wider scope of disputes and the ability to determine a range of remedies for consumers that have been unfairly treated.

Payment and Settlement Systems

The payment and settlement systems in Malaysia remained resilient and operated reliably without any major disruptions. With the enactment of the FSA, the Bank's powers in respect of payment systems have been rationalised and strengthened further to ensure effective oversight of payment systems and payment instruments. To ensure that the Real-Time Electronic Transfer of Funds and Securities System (RENTAS) continues to meet high international standards, several enhancements to the operations, systems and risk mitigation measures were implemented during the year. This included the Liquidity Optimiser Settlement Facility (LOSF), strengthened policies for accessing the Bank's intraday credit facility, enhancements to the rules and procedures of RENTAS, and the operationalisation of a third-level backup facility. Greater focus was also directed at ensuring the operational reliability of major retail payment systems operated by Malaysian Electronic Clearing Corporation Sdn. Bhd. (MyClear) and Malaysian Electronic Payment System Sdn. Bhd. (MEPS). In addition, measures were undertaken during the year to strengthen the security standards for payment instruments. As a result, losses due to retail payments fraud remained negligible in 2012.

Further progress was achieved during the year towards encouraging the wider use of electronic payments (e-payments), with a marked increase observed in the adoption of e-payments in the recent two years. Efforts were intensified to expand access and improve the functionalities of payment services. To complement these efforts and incentivise the adoption of more efficient e-payment modes, pricing reforms will be undertaken to address existing price distortions between paper-based payments and e-payments and allow the pricing of payment services to better reflect the cost of production. The implementation of the pricing framework will be carefully coordinated with enhancements to the e-payment infrastructure to ensure wide access and convenience, while providing sufficient time for the public and businesses to adjust to e-payment alternatives that are more cost-effective. The Bank also continues to work closely with key sectors of the economy to encourage the use of e-payments. This includes the public sector, the financial sector, participants in the capital markets and the transportation sector. At the regional level, the ASEAN Working Committee on Payment and Settlement Systems continued to drive enhancements to cross-border payment services between ASEAN countries. Engagements with the Asian Payment Network and the ASEAN Exchanges are being pursued to expand cross-border retail payment linkages and facilitate settlements for capital market transactions conducted via ASEAN trading links.