

2012

## DEVELOPMENT OF THE FINANCIAL SECTOR

- 61 Enhancing Market Structure
  - 62 *Box Article: Foreign Banks in Emerging Economies: Malaysia's Perspective*
- 67 Ensuring Effective and Efficient Intermediation of Funds
- 69 Developing Deep and Vibrant Financial Markets
- 71 Promoting an Inclusive Financial System
  - 73 *Box Article: Agent Banking: Advancing Malaysia's Financial Inclusion Agenda*
- 76 Enhancing Regional and International Financial Linkages
- 78 Internationalising Islamic Finance: Evolving an International Islamic Finance Marketplace
  - 80 *Box Article: Contract-Based Regulatory Framework for Islamic Finance*
- 83 Talent Development in the Financial Sector



## DEVELOPMENT OF THE FINANCIAL SECTOR

During the year, the Bank forged ahead with medium- to longer-term initiatives to develop and strengthen the financial sector in facilitating and catalysing Malaysia's transition towards becoming a high value-added, high-income economy. Along with ongoing enhancements to the regulatory and supervisory framework, a key focus of the Bank's development initiatives has been on promoting sound conditions for the intermediation of funds to new growth areas and strengthening interlinkages with regional and international economies as outlined in the Financial Sector Blueprint 2011-2020. The new Financial Services Act 2013 (FSA) and Islamic Financial Services Act 2013 (IFSA) are critical to these efforts. Firstly, the legislation better supports effective regulation and supervision in anticipation of a more sophisticated and expanding financial system.

---

The Bank's development initiatives focused on promoting sound conditions for the intermediation of funds to new growth areas and strengthening interlinkages with regional and international economies

---

Secondly, it maintains a clear focus on risk and fair conduct towards consumers while allowing for differentiation between financial institutions. This, in turn, supports healthy competition and productive innovation in the financial sector. Thirdly, as the financial sector becomes more open and interconnected with the regional and global financial system, it ensures that financial sector activities will continue to support and positively contribute to the Malaysian economy. Finally, it improves regulatory efficiency by reducing unnecessary regulatory costs, while ensuring that the necessary safeguards for a sound financial system are preserved.

## ENHANCING MARKET STRUCTURE

Merger and acquisition activities in the banking and insurance sectors continued to be pursued in 2012, as a more competitive environment provided the impetus and opportunities for financial institutions to gain greater scale and capacity. This resulted in some consolidation within the investment banking sector, strengthening in particular those belonging to the domestic banking groups, in anticipation of growth opportunities especially in capital market activities in the region. The total number of investment banks in Malaysia reduced from 15 to 12 as at end-2012, comprising eight bank-backed investment banks and four stand-alone investment banks. Domestic banking groups remain dominant in the banking sector, with a stable combined market share of total banking system assets (73.3%) and deposits (73.8%), affording continued support for the development of the domestic financial system and financial inclusion. The Malaysian banking sector also has a sizeable presence of foreign banks, which has contributed to a more efficient and competitive market while enhancing the breadth and depth of the financial sector. In 2012, two new foreign commercial banks commenced operations in Malaysia, increasing the total number of foreign commercial banks operating in Malaysia to 19.

Further progress was also achieved in reducing the high level of fragmentation within the general insurance industry. During the year, six more merger and acquisition schemes were completed, bringing the number of composite and general insurers down from 33 in 2008 to 23 as at end-2012. The 10 smallest general insurers now account for 25.7% of total gross premiums in the general insurance industry, from only 13.6% in 2008, substantially improving the viability and competitiveness of these institutions. The liberalisation of the foreign equity participation limit in insurance companies to 70% since 2009 has also enhanced prospects for insurers to forge value-adding joint ventures with foreign financial institutions. During the year, approval was granted to six new foreign financial institutions to negotiate for acquisitions of equity interests in

### Foreign Banks in Emerging Economies: Malaysia's Perspective

In the recent two decades, the financial sectors of many countries have become more internationalised, driven by the forces of global economic integration, new technology and increased financial sector liberalisation. This trend is more pronounced in the emerging economies where foreign bank representation in the banking systems has increased from 18% to 36% between 1995 and 2009, compared to an increase of only 19% to 24% for OECD<sup>1</sup> countries over the corresponding period. The number of banks from the emerging economies that have expanded beyond domestic borders has also increased from 147 in 1995 to 279 in 2009<sup>2</sup>. The internationalisation of finance has brought about benefits by enabling greater cross-border trade and investments, facilitating more efficient mobilisation of funds as well as creating new business and employment opportunities.

Nevertheless, there continues to be a plurality of views regarding the impact of foreign bank presence in the emerging economies. While potentially contributing to financial sector development and growth through fostering increased efficiency, market discipline, access to credit, as well as more sophisticated products and services, the preference of some foreign banks to operate only in high-value, high-return customer segments have reduced the overall benefits of liberalisation. In particular, the lower-end segments would be excluded from enjoying the same access as other segments to the products and services that are being offered by such foreign banks. Excessive competition could also encourage unhealthy practices in price competition and risky lending behaviour, thus affecting the soundness of banks and increasing the risks to financial stability.

Views also differ on the impact of foreign bank participation on the stability of the domestic financial system. Research on financial crises has found that emerging countries with less developed deposit insurance systems showed evidence of reduced cross-border 'flight to quality', with depositors shifting funds to the foreign-owned banks with a local presence, instead of repatriating funds out of the country. However, there are also views that the presence of foreign banks amplifies the effects of a domestic financial crisis. Observations show that foreign banks without a strong deposit base in the host economy tend to reduce lending more than their local counterparts during periods of stress, thus exacerbating the impact of a domestic financial crisis.

The recent Global Financial Crisis also exposed new sources of risks arising from a more internationalised financial system. One channel of risk transmission that has potentially adverse implications for the host economy is deleveraging activities by foreign banks in response to losses and the contraction of lending activity in their home economies. The increased interconnectedness of emerging markets with the global economy from trade and financial linkages has amplified the speed and scale of the transmission of external shocks, thus posing a significant challenge for countries in managing and mitigating cross-border contagion risks, especially where domestic financial markets are less developed. These developments hence reinforce the importance of having clear accountabilities and cooperation mechanisms among home and host regulatory authorities in overseeing the operations of foreign banks, especially on information sharing, supervision and surveillance, institutional failure resolutions and burden sharing. This would contribute towards bridging the differences in approaches and practices of home and host regulators, which would facilitate speedier and more effective management of cross-border contagion risks.

#### Considerations for Foreign Bank Participation: Malaysia's Perspective

Taking these views together, a key question that requires careful consideration by the emerging economies in developing policies on foreign bank participation is the extent of net benefits accruing to the local economy. A key objective of the Bank in this regard has been to minimise the risks, while allowing maximum benefits to be gained from financial sector liberalisation and ensuring that the

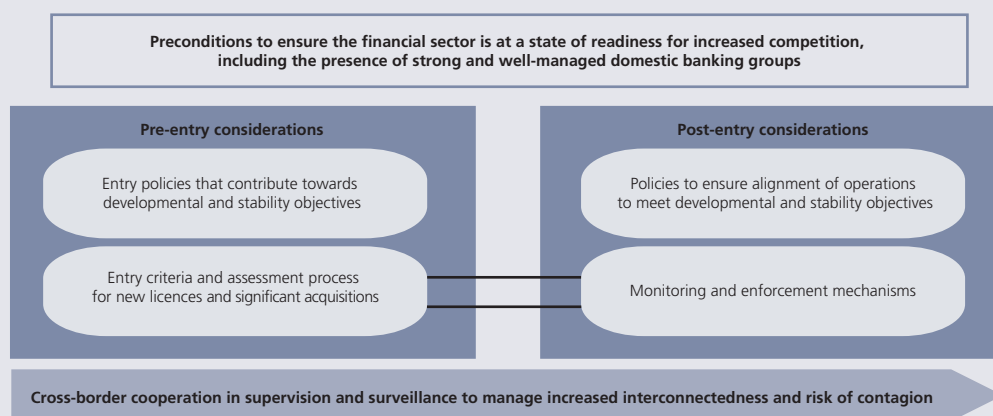
---

<sup>1,2</sup> Classens, K. and van Horen, N. (2012) 'Foreign Banks: Trends, Impact and Financial Stability', IMF Working Paper, International Monetary Fund.

growth of the financial sector as a whole is commensurate with real economic growth. This entails consideration on both stability as well as developmental objectives. The remainder of this article will discuss Malaysia's experience and policy considerations in liberalising the financial sector. This is summarised in Diagram 1.

**Diagram 1**

### Key Policy Areas in Financial Sector Liberalisation in Malaysia



The Malaysian financial system has long been home to foreign-owned banking institutions, with foreign banks being pioneers in the development of the Malaysian financial system more than a hundred years ago. The oldest bank in Malaysia was a foreign bank that was established to meet the financial requirements of the early European traders. Other major foreign banks followed suit as the strong prospects for growth in trade drew keen interest in establishing presence in Malaysia. Since then, foreign banks have become key players with a significant contribution to the Malaysian economy. Today, foreign banks account for approximately 27% of market share in the assets of the banking sector. Several foreign banks with a sizeable presence in Malaysia have also acknowledged Malaysia's growth potential and connectivity with other economies, and have positioned Malaysia as a priority market within the Asia-Pacific region.

Malaysia has always adopted an approach towards liberalisation that takes into consideration the capacity and readiness of the financial sector to benefit from it, while promoting orderly growth and development of the financial sector in a liberalised environment. Greater foreign participation has been sequenced and managed following the establishment of the necessary preconditions (Diagram 2), as articulated in the Financial Sector Masterplan 2001-2010. Central to this approach is a continued presence of strong and well-managed domestic banking groups and a comprehensive financial safety net. In this regard, efforts to strengthen the resilience and competitiveness of domestic financial institutions have led to the emergence of strong Malaysian-owned banking institutions, with significantly improved performance indicators over the years (Table 1).

A key expectation from increased liberalisation is that strong and well-managed foreign banks will contribute to the orderly growth and development of the Malaysian financial sector. The new Financial Services Act 2013 and Islamic Financial Services Act 2013 further elaborate and provide greater transparency on the criteria for market entry by codifying the key expectations on the prudential soundness and quality of the value propositions put forward by prospective entrants (Diagram 3). These considerations are common across many countries that have liberalised and open financial systems, including developed economies.

Diagram 2

## Preconditions to Financial Sector Liberalisation in Malaysia

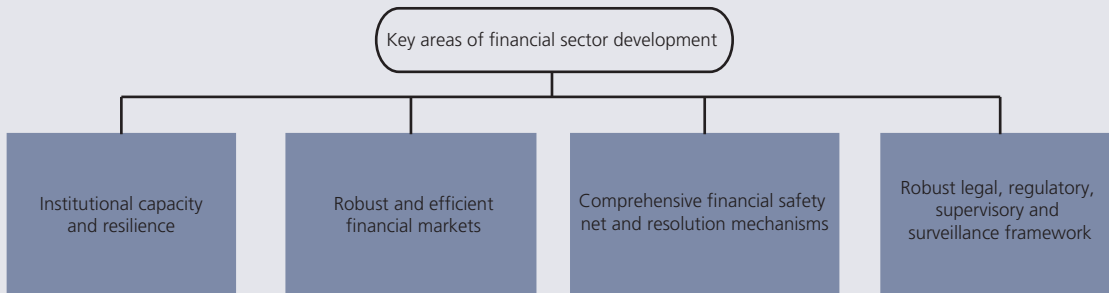


Table 1

## Improved Performance Indicators by Domestic Commercial Banks

	2000		2010		2012	
	Domestic	Foreign	Domestic	Foreign	Domestic	Foreign
<b>Capitalisation</b>						
Risk-Weighted Capital Ratio (%)	11.7	14.0	14.2	14.6	15.0	16.1
<b>Asset quality</b>						
Net Impaired Loans Ratio (%)	9.2	5.7	2.6	1.2	1.5	1.2
<b>Profitability</b>						
Return on Assets (%)	1.1	2.1	1.6	1.6	1.7	1.5
Return on Equity (%)	13.3	26.4	16.7	19.6	17.4	17.7

Note: Beginning January 2010, loans are reported based on Financial Reporting Standard (FRS) 139. The adoption of FRS 139 requirement is based on the financial year of the banks

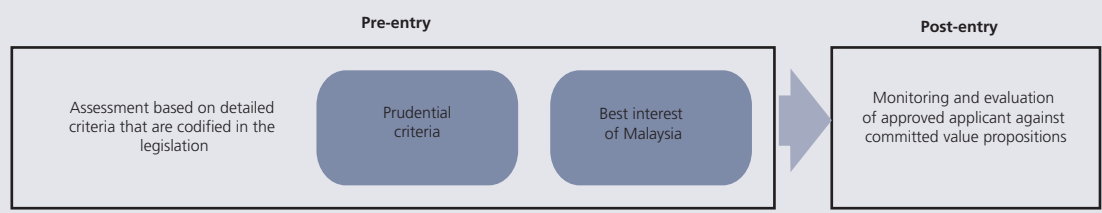
Source: Bank Negara Malaysia

Another key requirement for foreign commercial banks, which equally applies to domestic banks, is to locally incorporate in Malaysia. This is to provide a greater degree of protection to Malaysians through having a permanent commitment of capital that safeguards the sustainability and continuity of the domestic operations, and having a dedicated board of directors with accountabilities and fiduciary duties that are specific to the local entity. Throughout the Global Financial Crisis, the operations of the locally-incorporated foreign banks in Malaysia have remained resilient, with high capitalisation levels, sustained credit quality and positive levels of profitability.

Foreign banks have been accorded operational flexibilities to expand their network through electronic channels, agent banking and the establishment of a further number of physical branches. This has enabled the foreign banks to have an important role in the financial intermediation process and contribute to the functioning and growth of the economy. Moving forward, similar to domestic banks, foreign banks will be allowed to expand their branches more freely, while maintaining a balanced distribution of branch locations by all banks to support the needs of the underserved areas. This would be implemented with measures to further accelerate the development of alternative delivery channels which would promote greater convenience and efficiency in the provision of financial services to consumers.

**Diagram 3**

**Assessment and Evaluation of New Licences and Significant Shareholders**



**Prudential criteria:**

- Character and integrity of applicant or reputation for operating with good governance and integrity standards;
- Soundness and feasibility of applicant's business plans;
- Nature and sufficiency of the financial resources of the applicant;
- Business record and experience of the applicant;
- Transparency and supervisability of the applicant's group structure;
- Whether the institution will be operated by persons with suitable competence and experience; and
- Whether the business is detrimental to public interest.

**Best interest of Malaysia criteria:**

- The effect of the investment on the level and nature of economic activity in Malaysia;
- The contribution towards enhancing international trade and investment linkages between Malaysia and other countries;
- The effect of the investment on the stability of the financial system; and
- The degree and significance of participation of Malaysians in the financial sector. This includes the continued presence of strong and well-managed domestic banking groups that continue to mobilise more than 50% of resident deposits.

In view of enhanced foreign participation in the financial sector, the pace of cross-border cooperation in surveillance and supervision has intensified over the last few years. Malaysia proactively collaborates with home country supervisory authorities to ensure that pre-emptive actions can be taken to preserve financial stability in the event of an imminent shock. This includes developing arrangements for information exchange and supervisory cooperation through memoranda of understanding, as well as participating in supervisory colleges relating to these internationally-active banks. These efforts are consistent with the broad principles recommended by the Financial Stability Board on cross-border cooperation in the management of financial crises.

existing insurance companies. The participation of well-established and strong foreign financial institutions in the domestic insurance market will contribute towards elevating the performance and capacity of existing insurers through the transfer of expertise and enhanced financial resources.

In the life insurance sector, an important outcome of a more competitive market with a broad representation of diverse institutions is the introduction of an expanded product range for individuals to better plan and obtain financial security for their retirement, education and health requirements. With economic progress and changes in the demographic structure in Malaysia, financial solutions for retirement have become increasingly important to meet the demands of the maturing population. Hence, a sustainable pension system for retirement is important to promote a sufficient standard of living in retirement. To spur the growth of the pension business, the Government granted an 8% tax exemption on investment income in a deferred annuity fund to life insurers and takaful operators. This complements the existing 10-year tax relief of RM3,000 on voluntary contributions to insurance and takaful annuities. Collectively, these tax incentives are expected to translate into lower insurance premiums for the benefit of policyholders.

---

### The first phase of the new motor cover framework was implemented with only a small financial impact on consumers

---

In the general insurance industry, the first phase of the new motor cover framework was implemented in January 2012 as planned. This involved the first tranche of adjustments to the premium tariff to more closely reflect underwriting risks. Although the previous review was conducted in 1978, the commitment is for gradual adjustments. Third party policy premiums for the majority of motorcycles and private cars were adjusted by between RM2 to RM4 and RM6 to RM34, respectively per annum, thus having only a small financial impact on consumers. While the adjustments remain substantially short of adequate pricing levels that are commensurate

with the loss experience arising from motor bodily injury claims against insurers, this first review represents a significant step in the transition towards a market-based pricing framework by 2016.

The Bank has been clear from the onset that premium adjustments alone are inadequate to address the considerable challenges confronting the motor insurance industry. To provide the necessary conditions for the sustainable provision of motor cover over the longer term, the new motor cover framework therefore has equal emphasis on measures aimed at improving the efficiency of claims settlement processes and controlling claims costs. This entailed close coordination with multiple Government agencies, the insurance industry, the legal fraternity, and consumer and transport associations which was facilitated through a joint working committee chaired by the Bank. The Committee has facilitated the following initiatives:

- Reducing the interest rates used for judgment awards from 8% per annum to not more than 5% per annum;
- Promoting wider use of court mediation for dispute settlements;
- Strengthening collaboration between Government hospitals and insurers to improve the quality and authenticity of medical reports submitted to insurers for claims purposes; and
- Improving the turnaround times for producing police and medical reports through more transparent commitments to standard timelines.

The early impact of these initiatives were observed in the shorter time taken for insurers to pay motor bodily injury claims, which improved by up to three months from the date that a claim is filed with complete documentation. Plans to establish a 24-hour nationwide toll-free call centre to provide immediate roadside assistance to road accident victims will also provide useful aid to consumers, while further expediting claims settlements and reducing claims fraud in the event of a road accident. The call centre will be operational in the first half of 2013.

Plans to review regulatory requirements applicable to the cost structures for life insurance and family takaful businesses which are subject to the Guidelines to Control the Operating Costs of Life Insurance and Family Takaful Businesses (including investment-linked business) were taken forward during the year. The Guidelines were first

introduced in the 1990s with the aim of instilling greater financial discipline among insurers while promoting higher efficiency levels. Over the years, the Guidelines have had an important role in containing the operating costs of insurers and delivering better value to policyholders. The expense ratio in the life insurance industry (as measured by total expense incurred against earned premium income) improved significantly from 44% in 1995 to 27.5% in 2011. This was achieved while ensuring that incentive structures for agents, which are also regulated under the Guidelines, worked to support the objectives of increasing insurance penetration in Malaysia and encouraging the professional development of agents. In this recent decade, the insurance penetration rate (as measured by the ratio of the total number of life insurance and family takaful policies to the working population) has increased from 40% in 2002 to 67% in 2012, while the average annual income of a full-time insurance agent has increased from RM65,000 to RM91,000. The number of full-time agents has also increased in proportion to the total number of agents, from 23% in 2002 to 39% in 2012.

A more comprehensive regulatory and supervisory framework is now in place for the insurance industry, which includes substantially strengthened policies for the sound financial management of insurers (such as risk-based capital requirements) and the protection of policyholders (in particular, specific requirements to provide suitable advice to consumers and ensure that policyholders' reasonable expectations under policies sold to them are met). A more competitive insurance market has also evolved with wider distribution options including bancassurance, and improved disclosures that provide consumers with a better understanding on the products in the market. Taken together, these developments provide the conditions for the Bank to review the Guidelines, with the view of allowing market forces to work more effectively to encourage innovation and the further development of alternative distribution channels, while also providing stronger incentives for the agency force to upgrade itself to better serve policyholders as the financial needs of Malaysians evolve. The first phase of the review was implemented on 1 January 2013 and involved a revision to existing limits on agency benefit schemes and agency financing facilities to attract and retain the best talent. This is being followed by a review of the cost controls, including agency commission structures and

payment of agency-related expenses, together with measures to minimise market dislocations and preserve value to policyholders.

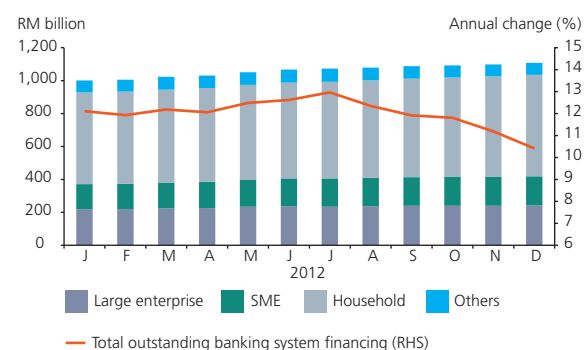
## ENSURING EFFECTIVE AND EFFICIENT INTERMEDIATION OF FUNDS

Despite a more challenging economic environment in 2012, financial intermediation activities continued to be well-supported by the financial sector. Total outstanding banking sector financing increased by 10.4% to RM1,108 billion as at end-2012, while the approval-to-application ratio for the year remained stable at 50.9%.

Financing by banking institutions and development financial institutions (DFIs) to small and medium enterprises (SMEs) increased by 14.3% to account for 40.5% or RM189 billion of total business financing with approval rates remaining stable above 83%. In addition, SMEs continued to benefit from existing special funds under the Bank, which provide financial assistance to SMEs, namely the Fund for Food, Bumiputera Entrepreneur Project Fund-i, Fund for Small and Medium Industries 2, New Entrepreneurs Fund 2, and the Micro Enterprise Fund. As at end-2012, total financing approved under these funds amounted to RM22.6 billion benefitting over 54,000 SMEs. In April 2012, the Islamic financial industry introduced a new RM2 billion Shariah-compliant SME Financing Scheme with support from the Government. Under the Scheme, the Government provides a subsidy of 2% on the profit rate for financing provided by Islamic banks to SMEs for a period of up to five years. With the participation of 13 Islamic banks in the Scheme, SMEs now have broader access to a

Chart 2.1

### Outstanding Banking System Financing



Source: Bank Negara Malaysia

Shariah-compliant alternative for financing. As at end-2012, financing amounting to RM65 million has been approved under the Scheme for SMEs in the various economic sectors. Financial institutions have continued to maintain a strong focus on the SME sector in their financing activities with several banks continuing to progressively raise financing targets for SMEs and investing resources to enhance capacity to further grow their SME financing portfolio. In addition, banks have established dedicated SME units to enhance their reach and services to SMEs. Lending indicators for SMEs also showed an increase in the average value of financing approved for SMEs from RM570,000 to RM600,000. Combined with the various capacity building measures for SMEs taken by the SME Corporation Malaysia and SME associations, these developments continue to significantly improve the financing prospects for Malaysian SMEs.

The financial sector continued to mobilise funds to support the financing needs of micro-enterprises, which constitute over 75% of businesses in Malaysia. Through the *Pembiayaan Mikro* scheme that was launched in 2006, total financing amounting to RM870.3 million was channelled to more than 68,000 microfinance accounts. During the year, the financial industry also introduced more flexible microfinancing products, which cater to the irregular or seasonal cash flow streams typically experienced by micro-enterprises, which had previously prevented such enterprises from qualifying for financing. This flexibility enables the prompt drawdown of financing in times of need, with higher loan ceilings for borrowers that demonstrate responsible credit behaviour.

Access to financing for green technology initiatives continued to improve. As at end-2012, 78 companies had successfully secured funding amounting to RM1.1 billion from the Government's Green Technology Financing Scheme, up from RM0.6 billion as at end-2011. The fund's capacity of RM1.5 billion will be further boosted by an additional RM2 billion allocated by the Government for the Scheme under the Budget 2013. This will be complemented by the planned roll-out in 2013 of specialised training programmes on credit assessments for green technology financing projects by the Institute of Bankers Malaysia (Institut Bank-Bank Malaysia, IBBM), in collaboration with the Bank and the Malaysian Green Technology Corporation. A more pronounced focus on training represents an important strategy

to overcome the lack of familiarity and relevant expertise within financial institutions to accurately identify, measure and manage the risks associated with green technology projects, which has been a key impediment to greater access to financing for green technology initiatives. Further visibility among banking institutions for green technology financing opportunities was also promoted through the Green Technology Financing Bankers' Conference jointly organised by the Bank and IBBM in October 2012. Banking institutions committed during the Conference to several measures to further enhance access to financing for green technology ventures. These include:

- Programmes by the industry to raise awareness on the importance of green technology solutions among businesses and the general public;
- Improving the quality of data on green technology financing performance reported to the Bank, which will help track the involvement of financial institutions in green technology financing; and
- Increasing investments in human capital development programmes to build expertise among bankers and develop higher education courses to develop a pool of experts in green technology financing.

---

Going forward, the development and sustainability of a vibrant and dynamic green technology and clean energy ecosystem extends beyond financing initiatives and necessitates a holistic strategy by the Government and other key stakeholders

---

Going forward, the development and sustainability of a vibrant and dynamic green technology and clean energy ecosystem extends beyond financing initiatives and necessitates a holistic strategy by the Government and other key stakeholders. This includes, for example, the realignment of fossil fuel subsidies to support a more rapid transition towards green technology by strengthening incentives for higher private sector investment in green technology.

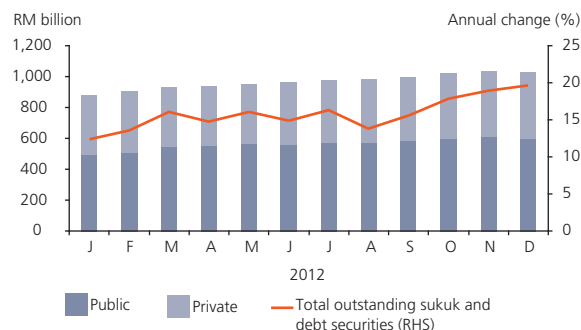
DFIs continued to have an important role in supporting the growth and development of strategic economic sectors, including agriculture, infrastructure, SMEs, as well as export-oriented, capital-intensive and high-technology industries. In 2012, financing by DFIs under the purview of the Bank registered a strong growth of 10.1% to RM111.1 billion as at end-2012, driven mainly by financing to the business services, construction, utility and agriculture sectors. The risk profiles of DFIs improved further, as evidenced by a decrease in the gross impaired loans ratio to 6.3% (2011: 7.3%). Their capital position remained sound, with the risk-weighted capital adequacy ratio at 22.7% as at end-2012 (2011: 23.3%). In December 2012, the Bank strengthened requirements on financial reporting and disclosures by DFIs to improve the transparency of the performance of DFIs against their mandates, and provide greater clarity on the risk-sharing arrangements between DFIs and the Government. These are contained in the Guidelines on Financial Reporting Requirements issued to DFIs, which require DFIs to publish (i) information on their mandate, strategic objectives, action plans and key performance indicators; (ii) the performance of schemes managed by the DFIs; and (iii) the future outlook for the strategic sectors supported by the DFI, including its broad strategies to grow in these sectors. These initiatives are important to ensure that the performance of DFIs is continuously strengthened to enable them to meet their mandates.

## DEVELOPING DEEP AND VIBRANT FINANCIAL MARKETS

The debt securities market continued to be an important source of funding for corporations, breaching RM1 trillion (or 110% of GDP) in 2012 in terms of total outstanding value of debt securities issued. Total financing through the corporate debt securities and sukuk markets increased further during the year, extending the trend which has seen a larger share of financing by businesses being met through the debt market compared with the banking system since 2002. The debt securities market now accounts for 61% of total outstanding corporate financing (2011: 58.3%). Malaysia also has the largest debt securities market in the Southeast Asian region and remains among only two countries in Southeast Asia with a significant private debt securities market that is almost as large as the public debt market.

Chart 2.2

### Outstanding Sukuk and Debt Securities



Source: Bank Negara Malaysia

Chart 2.3

### Sukuk and Debt Securities Issuance (Public and Private)

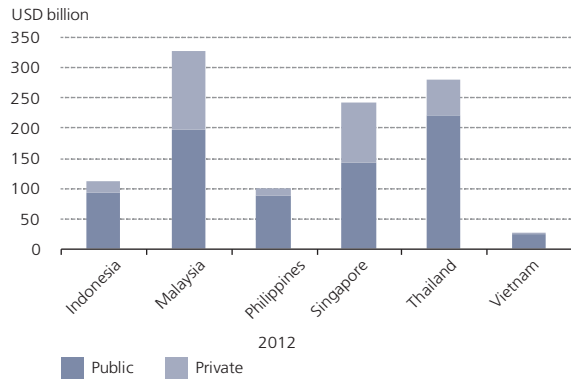


Source: Bank Negara Malaysia

During the year, Danajamin Nasional Berhad, Malaysia's only financial guarantee insurer, approved RM2.8 billion in guarantees for bond and sukuk issuances. This increased the total guarantees approved to date to RM10.1 billion as at end-2012. Of these, RM4.9 billion in bonds and sukuk have been issued (2011: RM3.2 billion). Although general risk aversion has subsided since the time of Danajamin's establishment in 2009, Danajamin continues to have an important role in enhancing access to the bond market for issuers seeking to raise longer-term funds at reasonable cost. Credit enhancements provided by Danajamin continued to benefit issuers from diverse economic sectors, including the construction, property, plantation, oil and gas, and manufacturing sectors, with sizeable bond issuances typically exceeding RM100 million. Danajamin's co-guarantee

Chart 2.4

### ASEAN Outstanding Local Currency Debt Securities Market



Source: Asian Bonds Online

and syndicated guarantee arrangements with commercial banks, introduced since 2011, saw further collaborations pursued with banking institutions during the year on four new schemes. Such arrangements have enabled commercial banks to participate in larger bond issuances with longer maturities.

Danajamin has continued to invest heavily in strengthening its risk management capabilities, with a particular focus on capital and liquidity management policies and processes, to support its role and ensure its continued ability to meet guarantee obligations. Danajamin's guarantee exposures are also subject to prudential capital and liquidity requirements imposed by the Bank. To further enhance Danajamin's capacity in supporting the genuine needs of businesses, particularly in priority economic sectors, for efficient access to funding from the capital market, the Government has allocated an additional RM400 million to boost Danajamin's capital over the next two years.

In the money market, the Bank continued to introduce new products to facilitate more efficient liquidity management by Islamic financial institutions. Malaysia has a deep and vibrant Islamic money market, with 16 approved Islamic financial institutions participating in the interbank market and an annual trading volume exceeding RM1 trillion. In May 2012, the Bank launched another new Islamic monetary instrument, the Collateralised *Murabahah*. This low credit-risk financial instrument combines *murabahah* financing transactions with sukuk as the pledged asset, enabling interbank

transactions to be conducted on a collateralised basis. The instrument can also be pledged to the Bank for liquidity support. To date, the Bank has signed Collateralised *Murabahah* agreements with 11 Islamic banks.

As probes by financial regulators into rate-rigging practices escalated in key financial centres across the world, the Bank took steps to further strengthen expectations on the internal oversight processes within banking institutions to prevent the manipulation of rate submissions in the setting of financial market benchmark rates. In Malaysia, concerns over the potential for rate manipulation in the domestic financial markets are largely mitigated by the clear roles and responsibilities imposed on approved Kuala Lumpur Interbank Offered Rate (KLIBOR) contributors appointed by the Bank. The Bank also has in place stringent internal processes in the selection of contributors and has the authority to remove a contributor that does not perform its obligations. Further, rates submitted by the contributors are closely monitored by the Bank.

### The Bank strengthened expectations on the internal oversight processes to prevent the manipulation of rate submissions in the setting of financial market benchmark rates

These existing practices were further enhanced through self-policing initiatives introduced by the Financial Markets Association Malaysia (Persatuan Pasaran Kewangan Malaysia, PPKM), which among others, require rate contributors to provide credible two-way bid and offer prices which are deal-able among the contributors. In December 2012, the Bank issued additional requirements for the KLIBOR setting process, which included more specific expectations on the roles and responsibilities of the board of directors and senior management of financial institutions as well as internal control requirements. Collectively, these measures serve to preserve the credibility of KLIBOR as a key domestic benchmark rate, and reinforce the confidence of market participants in its use. In addition, in determining the USD/MYR rate,

all licensed onshore banks are now required to use only the domestic rate as reference for pricing of foreign exchange contracts involving the ringgit. Existing parameters in determining the fixing process set by PPKM have also been enhanced to further promote the quality and integrity of the fixing process, and to ensure that it is reflective of the prevailing market conditions.

As part of the broader review of the financial sector legislation which was completed during the year, amendments were made to the Central Bank of Malaysia Act 2009 and the new provisions were incorporated in the FSA and IFSA. These provisions aim to preserve the contractual rights and obligations of the counterparties under close-out netting and collateral arrangements in situations where the Bank is able to exercise specific powers accorded to it to undertake orderly resolutions of financial institutions. This substantially removes uncertainties surrounding the enforceability of close-out netting arrangements in financial market contracts, which is important both for the efficient functioning of the financial markets and in enhancing the capacity of Malaysian financial institutions to more effectively manage risks through the use of such contracts. With the changes to the legislation, the International Swaps and Derivatives Association (ISDA) has opined that prior to insolvency interventions, the exercise of close-out netting rights under the ISDA Master Agreement would generally be enforceable against a Malaysian-incorporated counterparty, but identified a few remaining areas under other legislations which would need to be addressed by the authorities concerned to secure Malaysia's status as a netting-friendly jurisdiction.

---

As a result of wide-ranging initiatives pursued to deepen the foreign exchange market, it has grown six-fold over the 2001 to 2010 period

---

Over the recent years, wide-ranging initiatives have been pursued to deepen the foreign exchange market, starting with a focus on increasing business efficiency for trade and financing activities, to meet the needs of the real sector and on facilitating direct investment

abroad. As a result of these initiatives, the foreign exchange market has grown six-fold, representing an average annual growth rate of 20.4%, over the 2001 to 2010 period. The average daily turnover of the foreign exchange market was USD10.8 billion in 2012 (2011: USD9.6 billion), accounting for 3.6% of GDP, reflecting the continued expansion of regional and international trade, the sustained onshore investments by non-residents and the venturing of Malaysian corporations abroad.

The priority moving forward is to develop greater access to, and availability of a broader range of hedging instruments to meet the financing needs of Malaysians as cross-border trade and investment linkages intensify further. Currently, the Malaysian foreign exchange market is largely dominated by spot transactions, which form 70% of total foreign exchange volume in 2012, while swaps and forwards comprise 23% and 7%, respectively.

Towards this end, further liberalisation measures were announced in 2012, including flexibilities allowing (i) licensed onshore banks to trade foreign currencies against another foreign currency with a resident; (ii) licensed onshore banks to offer ringgit-denominated interest rate derivatives to non-bank non-resident customers; and (iii) residents to convert existing ringgit or foreign currency debt obligations into a debt obligation of another foreign currency. These measures are expected to encourage greater innovation in foreign exchange product offerings and demand for efficient foreign currency management solutions.

## PROMOTING AN INCLUSIVE FINANCIAL SYSTEM

Malaysia continued to advance the financial inclusion agenda with some notable developments in 2012. The number of deposit accounts per 10,000 adults increased during the year to 30,735 (2011: 30,355) deposit accounts. Meanwhile, financing accounts per 10,000 adults were lower but remained high at 8,337 (2011: 8,949).

In November 2012, the Bank shared its work on the development of a Financial Inclusion Index at the Workshop on Financial Inclusion Indicators, jointly organised with the Irving Fisher Committee on Central Bank Statistics, which operates under the Bank for International Settlements. The Index measures financial inclusion levels based on four

dimensions that are (i) convenient accessibility; (ii) take-up rate; (iii) responsible usage; and (iv) satisfaction level. Its main purpose is to provide policymakers with a tool for assessing the impact of financial inclusion initiatives in the short and medium term. It also facilitates the comparison of financial inclusion levels between different segments of the population, thereby focusing efforts to increase financial inclusion in a way that achieves an even progress across the country. The composite index for Malaysia as a whole was 0.77 out of a total score of 1, where 1 reflects full inclusion. Results of the component measures of the Index indicated that while Malaysians generally use financial services in a responsible way and are reasonably satisfied with the products and services provided, there remains substantial scope to further improve convenient

access to financial services and correspondingly, the take-up rate of financial products and services. Composite measures of the Index will continue to be refined with ongoing improvements in capturing data that increases the informational value of the Index in supporting the Bank's strategic and policy priorities in the area of financial inclusion.

Two initiatives that were implemented during the year to improve access and which are expected to have a significant impact on widening the reach of financial services were the roll-out of agent banking channels and Malaysia's mobile banking and payment platform, MyMobile. Further information on the agent banking channel and the MyMobile platform is provided in the box article 'Agent Banking: Advancing Malaysia's Financial Inclusion Agenda', and in Chapter 5, respectively.

### The Financial Inclusion Index

- An index of financial inclusion was developed by the Bank to measure the progress and impact of policies to achieve greater financial inclusion in Malaysia.
- The Index encompasses four financial inclusion dimensions of equal weight which comprise eight main indicators of financial inclusion.
- Higher values indicate better performance while dimensions with lower values require further policy improvements.

Table 1

#### The Four Dimensions and Eight Main Indicators of the Index

Dimension	Indicators	Equally weighted Sub-indices	Equally weighted Index
Convenient Accessibility	% of sub-districts with a population of 2,000 or more with at least one access point	0.64	0.77
	% of population living in sub-districts with at least one access point		
Take-up Rate	% of adult population with deposit accounts	0.7	
	% of adult population with financing accounts		
	% of adult population with life insurance/takaful policies		
Responsible Usage	% of customers with active deposits	0.98	
	% of customers with performing financing accounts		
Satisfaction Level	% of customers who are satisfied with overall financial services	0.76	
			0-1.00

Source: Bank Negara Malaysia

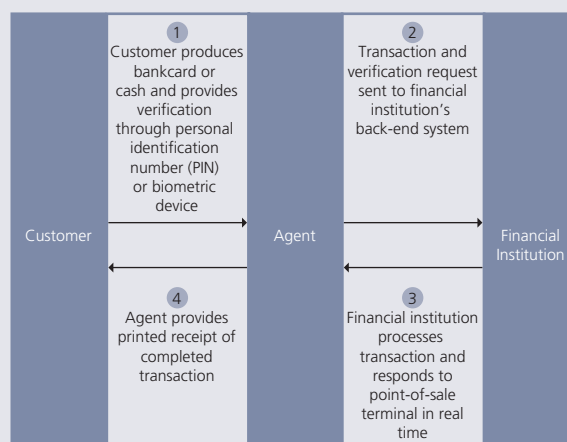
## Agent Banking: Advancing Malaysia's Financial Inclusion Agenda

Over this recent decade, Malaysia has made significant strides in pursuing the financial inclusion agenda. The articulation of the Bank's primary function to promote a sound, progressive and inclusive financial sector in the Central Bank of Malaysia Act 2009 further reinforced the Bank's strategic focus on driving financial inclusion policies. To date, 92% of the total adult population has formal savings accounts<sup>1</sup> and all 144 districts in Malaysia are served by at least one financial access point<sup>2</sup>. Malaysia is also highly ranked in several of the international financial inclusion rankings<sup>3</sup>.

As one of the key initiatives under the Financial Sector Blueprint 2011-2020, the introduction of agent banking by the Bank in 2012 will further contribute to the financial inclusion agenda by enhancing accessibility to quality and affordable financial services, particularly in the underserved and remote areas. Agent banking is the provision of banking services by a licensed financial institution to customers through a third-party agent, such as retail outlets and post offices. By substantially lowering the cost of providing banking services, and making it easier for individuals to access banking facilities in an environment they are familiar with, agent banking channels can help bridge commercial and inclusion imperatives, especially for high-volume, low-value accounts. Diagram 1 illustrates the conduct of deposit and withdrawal transactions through an agent bank on a real-time basis.

**Diagram 1**

### Real-Time Deposit and Withdrawal Transactions through an Agent Bank



*Note : For deposit and withdrawal transactions, both agent and customer must have an account with the financial institution*

### Agent Banking Regulatory Framework

Agent banking in Malaysia operates within a regulatory framework that promotes the professional conduct of agents, and safeguards the security and integrity of agent banking transactions. Central to the framework is the proper authorisation and oversight of agent banks by financial institutions, and the provision of adequate information to consumers about how to protect their financial transactions conducted through agent banks. These matters are dealt within the Guidelines on Agent Banking issued by the Bank in 2012 as summarised in Table 1.

<sup>1</sup> Financial Inclusion Demand-Side Survey, Bank Negara Malaysia, 2011.

<sup>2</sup> Financial access points are channels where the basic financial services of deposits and withdrawals can be performed, which include financial institutions' branches, mobile units and agents.

<sup>3</sup> 1st since 2008 for 'Getting Credit' (Doing Business Report, World Bank, 2008-2012); 8th out of 144 countries on 'Ease of Access to Loans' (The Global Competitiveness Report, World Economic Forum, 2012).

Table 1

## Key Features of the Guidelines on Agent Banking

Agent appointment and monitoring process	<ul style="list-style-type: none"> <li>• Only legally-established non-bank entities with fixed business premises can be contractually appointed as agents.</li> <li>• Agents must be financially sound and have the knowledge and competency to conduct banking services on behalf of the financial institutions.</li> <li>• Financial institutions must establish a management oversight mechanism to monitor agent conduct and ensure that associated risks are managed effectively.</li> </ul>
Provision of basic banking services offered	<ul style="list-style-type: none"> <li>• Agents can accept deposits, facilitate withdrawals, perform fund transfers, and facilitate bill payments and financing repayments.</li> <li>• The opening of bank accounts, money-changing services and appraisals of financing applications must continue to be performed only by financial institutions to ensure compliance with 'know-your-customer', customer suitability and responsible financing requirements.</li> </ul>
Safeguards to promote secure transactions	<ul style="list-style-type: none"> <li>• Transactions are conducted on a real-time basis at the agent's business premise.</li> <li>• Financial institutions must have in place robust infrastructure to support agent banking facilities, including a minimum 2-factor authentication system for agent banking transactions.</li> </ul>
Consumer awareness and protection	<ul style="list-style-type: none"> <li>• Details of authorised agents must be published and updated on the financial institution's website.</li> <li>• Financial institutions must implement measures to ensure customers are adequately informed of their rights and responsibilities, which includes mechanisms to verify authorised agents, a dispute resolution and redress mechanism, and efforts to educate customers on agent banking.</li> <li>• The national agent banking logo (Diagram 2) must be prominently displayed together with the financial institution's logo, at the business premise of agents to facilitate easy identification of authorised agents by consumers.</li> </ul>



Diagram 2: National Agent Banking Logo

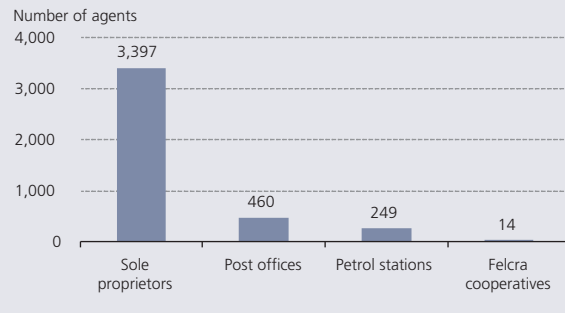
## Impact of Agent Banking

The agent banking initiative has already produced promising results. Three financial institutions, namely Malayan Banking Berhad, RHB Bank Berhad and Bank Simpanan Nasional have a combined agent network of 4,120 agents as at end-December 2012, which includes post offices, petrol stations, retail outlets and telecommunication agents (Chart 1). Bank Simpanan Nasional has announced plans to further expand their agent banking network to 5,000 agents in rural areas nationwide by 2014.

Since its implementation in 2012, a geographical mapping exercise by the Bank found that 75% out of 837 *mukims* (sub-districts) with a population of more than 2,000 have at least one financial access point, a significant increase from only 46% in 2011 (Diagram 3). This is expected to increase further to 90% by the end of 2014. The total number of transactions conducted through agent banks since the introduction of agent banking has exceeded three million, with a total value of more than RM446 million. Compared with branches, financial institutions reported that agent banking channels delivered cost savings in terms of set-up costs of more than 80%, while agents have also benefitted from the increased customer flow to their business premises.

**Chart 1**

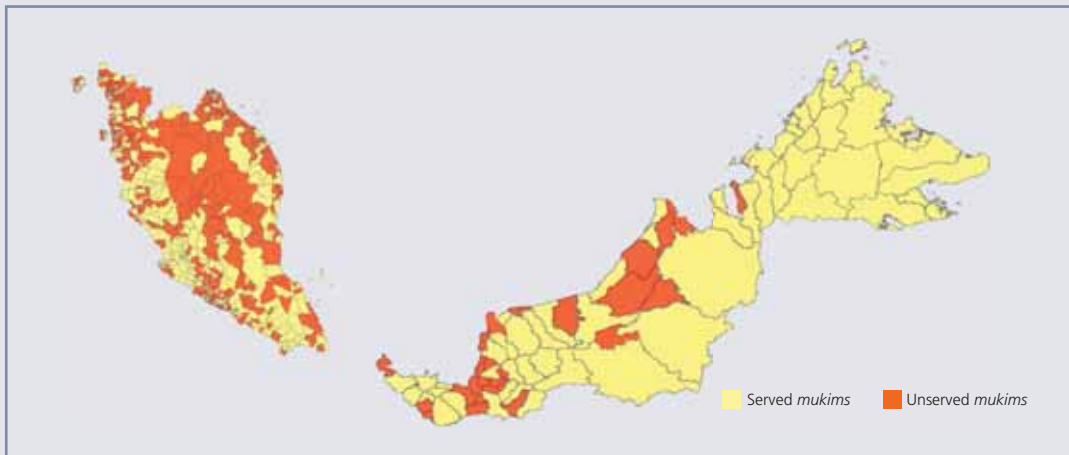
**Agent Banking by Type of Agent**



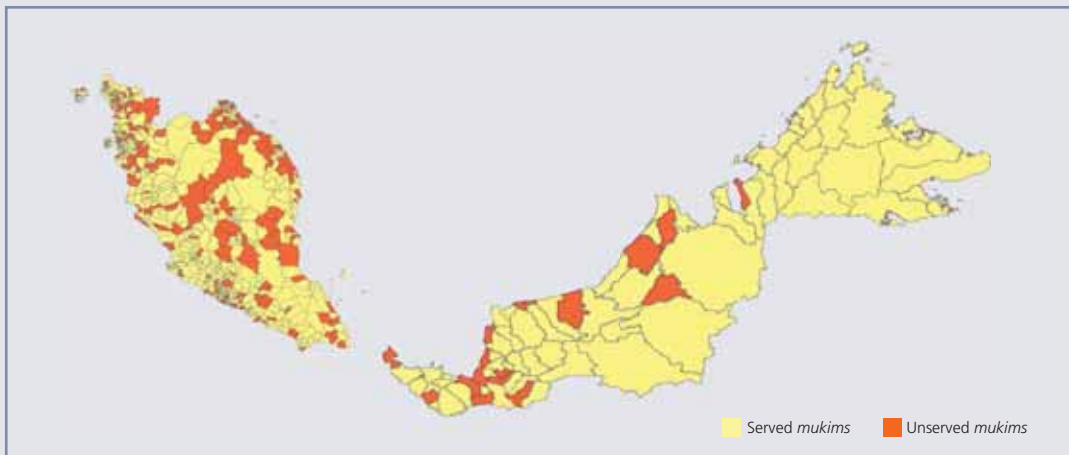
**Diagram 3**

**Access to Basic Financial Services**

Before the introduction of agent banking



After the introduction of agent banking



The Bank will be releasing proposals to further enhance the Basic Banking Services Framework for public consultation. First introduced in 2005, the Framework makes it mandatory for banks and DFIs to offer no-frills savings and current accounts to all Malaysians at minimal or no cost. In these five years, the demand for basic savings and basic current accounts has stabilised at about 15% and 10% of total savings accounts and total current accounts, respectively. The review of the Framework aims to ensure that it continues to meet the general banking needs of retail customers, which includes providing for the increased use of more efficient electronic payment channels. Proposed enhancements include unlimited and free debit card payment transactions with basic deposit accounts, and extending access to all individuals residing in Malaysia including foreigners with valid identification and documents to encourage the use of formal payment channels for making remittances abroad.

Bank Simpanan Nasional, in its role as a specialised financial institution with a specific mandate to promote financial inclusion, facilitated greater access to financing for targeted groups under several schemes that were introduced during the year. This included financial services provided to 1,145 taxi owners and hired-car owners to secure financing to purchase vehicles amounting to a total of RM58.8 million since January 2012. More than 8,000 low-income individuals also received financing amounting to a total of RM38.8 million through the Skim Amanah Rakyat 1Malaysia to purchase Amanah Saham 1Malaysia units to enhance their financial well-being.

The Bank has been accorded the privilege to co-host the Alliance for Financial Inclusion (AFI) annual Global Policy Forum at Sasana Kijang in September 2013. The Forum serves as an arena for high-level representatives from AFI members comprising central banks and ministries of finance, as well as other relevant stakeholders to exchange knowledge and experiences to work together in advancing the financial inclusion agenda. The goal of the AFI network is to accelerate the adoption of innovative financial inclusion policy solutions, with the ultimate aim of making financial services more accessible to the 2.5 billion people who do not have access to the formal financial system. The AFI network's peer-to-peer learning model helps AFI members to share knowledge, and identify and implement effective evidence-based policy solutions in their home countries.

## ENHANCING REGIONAL AND INTERNATIONAL FINANCIAL LINKAGES

Malaysia's interlinkages with regional and international economies have continued to deepen in recent years. In 2012, domestic banking groups extended their footprint in the region, with six of the eight domestic banking groups having overseas operations in 21 countries, from 19 countries previously. Total overseas assets of the domestic banking groups increased by 19% to RM313.8 billion in 2012 (2011: RM264.7 billion), accounting for 19.2% of total assets of these groups (2011: 19%). This, in turn, resulted in a higher contribution of overseas operations to the groups' operating income, which has increased from RM10.3 billion to RM12.8 billion in 2012. The enhanced overseas presence of domestic banking groups is supported by more rigorous oversight by the Bank and closer cooperation with relevant host supervisory authorities to promote more effective supervisory activities and assessments on a group-wide basis across borders.

---

The ASEAN member countries are in the final stages of launching a banking sector integration framework, which will support a more dynamic and meaningful role by qualified ASEAN banks in driving regional financial integration

---

Efforts to deepen financial integration within the Association of Southeast Asian Nations (ASEAN) gained further momentum under the ASEAN Framework Agreement on Services. Following the endorsement of the ASEAN Financial Integration Framework in 2011, the ASEAN member countries are in the final stages of launching a banking sector integration framework, which will support a more dynamic and meaningful role by qualified ASEAN banks in driving regional financial integration. This Framework provides an enabling mechanism for well-managed and capable ASEAN banks to expand and operate in the region, supported by strengthened cross-border regulatory collaboration and cooperation amongst home and host countries to facilitate the effective sharing

of information and supervision of ASEAN banks. Given the differing stages of development of financial sectors in ASEAN member countries, the Framework provides flexibility for member countries to participate based on assessments of mutual benefits to the participating countries, and the ability of their financial sectors and regulatory frameworks to cope with new entrants. Central to this is the existence of key preconditions to support the integration process, which includes having the necessary infrastructure and regulatory framework to ensure that regional financial stability continues to be preserved in a more liberalised environment. The integration process will also be complemented by capacity building initiatives to support the readiness of countries to participate in the Framework.

Regional cooperation in crisis management intensified further with the agreement of the ASEAN+3 member countries (comprising all ASEAN members, the People's Republic of China, Japan and South Korea) to enhance the Chiang Mai Initiative Multilateralisation (CMIM) Agreement to incorporate a crisis prevention facility. The enhancement allows participating countries to tap into the CMIM facility in the event of impending stress to their balance-of-payments or short-term liquidity positions, thus allowing a more pre-emptive response to challenges that could pose risks to financial stability. Prior to the enhancement, the facility was only available when countries were faced with a balance-of-payment or short-term liquidity shock. The CMIM facility was also enlarged from USD120 billion to USD240 billion in May 2012, signalling the region's commitment to strengthen regional frameworks for crisis management to preserve financial stability in the region. Meanwhile, work continued to progress on strengthening 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). An important part of this work includes examining the constraints of current policy toolkits for managing crises across borders and exploring appropriate enhancements or new instruments for supporting regional responses to crises.

Global regulatory developments have an important bearing on the domestic financial sector. Assessments of Malaysia's financial sector are based on standards that are set by international standard-setting bodies. Such standards are

observed in more than 140 countries, including countries whose financial institutions operate in Malaysia, as well as countries in which Malaysian financial institutions have a presence. There are substantial benefits for the seamless operation of cross-border activities and effective cross-border supervision of financial institutions if domestic and international regulatory standards are closely aligned. For these reasons, the Bank continued to contribute actively to regional and international forums, focusing on financial regulatory developments to ensure that Malaysia's interests, and those of emerging economies in the region are given due consideration in the international policy-making process. The Bank co-chairs the Financial Stability Board (FSB) Regional Consultative Group for Asia, one of the six regional consultative groups established by the FSB in 2011, which discusses vulnerabilities affecting financial systems globally, and current and proposed initiatives to promote international financial stability. It also supports the implementation of policy initiatives and global regulatory standards within the region by examining issues that are pertinent to the region in general and emerging markets in particular, and raising important issues to the FSB. The Group met twice during the year, and agreed at its second meeting to form two working groups to examine in greater detail the developments in shadow banking activities in the region and the impact of the policy framework for systemically-important financial institutions on the Asian financial sector. Additionally, the Bank also became the regional coordinator for training initiatives under the International Association of Insurance Supervisors which supports implementation of training and education initiatives aimed at enhancing supervisory capacity and improving cooperation among insurance supervisors in the region.

An important infrastructure arrangement to support regional financial integration was also put in place with the launch of a pilot platform for cross-border investment and settlement of debt securities. The collaborative effort by the Bank, the Hong Kong Monetary Authority and Euroclear Bank marks a key milestone towards achieving a unified bond market within the region by enabling investors and market intermediaries to access the bond markets in Malaysia and Hong Kong more efficiently and effectively. This, in turn, contributes to the deepening of the Asian bond market. Additionally, to support the development of well-functioning bond markets in the region, the ASEAN+3 member countries have agreed to

adopt the New Roadmap+ pursuant to the Asian Bond Markets Initiative, which encapsulates key strategies such as the establishment of a regional settlement intermediary, developing government bond markets and the introduction of guarantee programmes.

As economic and financial integration in the region deepens, the Bank further strengthened its bilateral relationships with other central banks to promote mutually-reinforcing growth and development. The bilateral currency swap agreement between the Bank and the People's Bank of China was renewed for a further term of three years in tandem with the continued growth of Malaysia's trade and investment linkages with the People's Republic of China over the last few years. The RMB/MYR swap fund was also increased from RM40 billion (equivalent to RMB80 billion) to RM90 billion (equivalent to RMB180 billion) to facilitate larger settlements of trade and investment in renminbi. The Bank also signed a memorandum of understanding with the Central Bank of the Republic of Turkey, paving the way for both countries to collaborate strategically in the development of the financial services sector and to enhance economic and financial linkages through bilateral trade and investment.

## INTERNATIONALISING ISLAMIC FINANCE: EVOLVING AN INTERNATIONAL ISLAMIC FINANCE MARKETPLACE

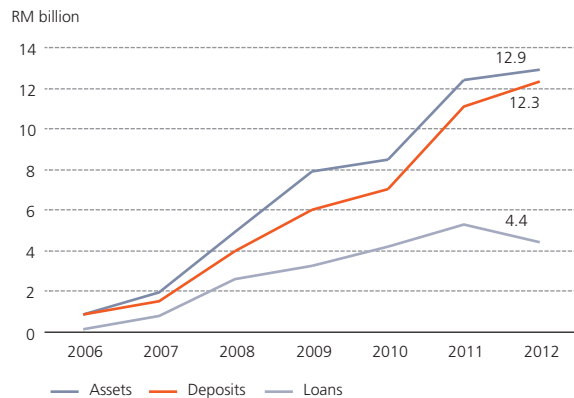
The Islamic banking sector continued its growth trajectory, recording a double-digit growth of 13.8% in total assets, to account for 23.8% of total assets in the overall banking system (including DFIs). As Malaysia's Islamic financial system transitions to become more international in orientation, the volume of foreign currency business, including those conducted by the International Islamic Banks and International Currency Business Units, has increased over the years (Chart 2.5). There are now 16 Islamic banking institutions in Malaysia that operate as separate subsidiaries and 10 Islamic banking operations conducted through windows as at end-2012. In the takaful sector, total assets of takaful funds grew by 12.4% to RM19 billion, while total takaful contributions accounted for 13.6% of total premiums and contributions in the insurance and takaful industry. Despite the challenging global environment, sukuk

issuances in Malaysia remained strong, with a series of notable multi-currency sukuk issuances by multinationals, corporations and multilateral agencies. As a result, Malaysia continued to be a key participant in the global sukuk market, with sukuk issued in Malaysia accounting for 74% of total global sukuk issuances (2011: 71.6%). Malaysia also continues to have one of the largest US dollar-denominated sukuk market globally (Chart 2.6).

Developments during the year further strengthened the foundations and institutional arrangements for the orderly growth of Islamic finance in Malaysia, while supporting the internationalisation of Islamic finance.

Chart 2.5

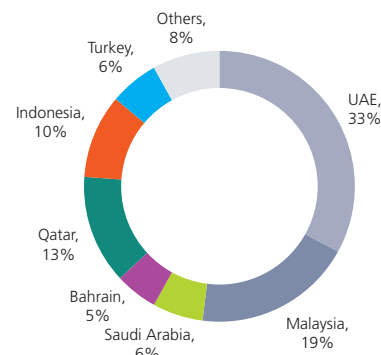
### Islamic Foreign Currency Assets, Loans and Deposits of International Islamic Banks and International Currency Business Units



Source: Bank Negara Malaysia

Chart 2.6

### Total Outstanding US Dollar-denominated Sukuk Globally in 2012



Source: Bloomberg

In a move to strengthen the elements supporting end-to-end Shariah governance and compliance, the IFSA, which also modernises and significantly strengthens the regulatory and supervisory framework for Islamic financial institutions, introduced an important foundation for the evolution of a contract-based regulatory framework for the Islamic financial sector. This is described in the box article 'Contract-Based Regulatory Framework for Islamic Finance'.

---

## Developments during the year further strengthened the foundations and institutional arrangements for the orderly growth of Islamic finance in Malaysia, while supporting the internationalisation of Islamic finance

---

As the pace of internationalisation of Islamic finance gathers stronger momentum, the enforceability of Islamic commercial contracts executed on a cross-border basis becomes increasingly important. Hence, the role of the Kuala Lumpur Regional Centre for Arbitration (KLRC) to adjudicate Islamic finance disputes was enhanced with the development of the 'i-Arbitration Rules' that govern the arbitration of domestic and international disputes in Islamic finance. The Rules, which adopt the United Nations Commission on International Trade Law Arbitration Rules, lend added support to the KLRC as an arbitration centre for the resolution of disputes in international Islamic commercial transactions. In addition to arbitration, a guide was provided on the application of Shariah principles for court proceedings.

A deep and liquid Islamic financial market has continued to develop in Malaysia. During the year, innovations in the sukuk market resulted in several notable issuances, which have further expanded the range of sukuk structures, sizes and maturities. These include a multi-tenured RM500 million sukuk using the *wakalah bil istithmar* structure, Malaysia's first perpetual sukuk issuance amounting to RM2.5 billion and the largest rated sukuk *murabahah* issuance amounting to RM5 billion based on the *tawarruq* arrangement. A sukuk with a programme size

of RM30.6 billion and maturities ranging from five to 27 years was issued to fund one of Malaysia's largest privatisation exercises. The Government also issued *Sukuk Perumahan Kerajaan* amounting to RM4.5 billion to refinance existing housing loans granted to civil servants and to fund new Government housing loans. During the year, the Bank conferred 'Emas' status, which is Malaysia's designation for foreign currency-denominated sukuk originating from Malaysia, to three multi-currency sukuk issuances by a multilateral agency and corporations in Malaysia. The launch of the Bloomberg-AIBIM-Bursa Malaysia Corporate Sukuk Index in September 2012 marked another important advancement in the development of the domestic Islamic financial market, providing a key benchmark for investors of ringgit-denominated Islamic bonds to track and measure the performance of corporate sukuk in Malaysia.

As the international dimension of Islamic finance grows, it is becoming a more significant component of the global financial system and Islamic financial institutions are also increasingly enlarging their international footprint. There is a critical need to catalyse the development of high-quality liquid Shariah-compliant instruments to facilitate more effective and efficient cross-border liquidity management. To meet this need, a collaboration by 10 central banks and the Islamic Development Group established the International Islamic Liquidity Management Corporation (IILM) in Kuala Lumpur in 2010 with a mandate to issue high-quality liquid sukuk for the purposes of facilitating liquidity management in a Shariah-compliant manner. IILM is finalising the rating of its first short-term sukuk programme to facilitate its first issuance.

To support talent development for the Islamic financial system, the International Centre for Education in Islamic Finance (INCEIF), which was established in 2005, continued to build on its strong global reputation as a provider of professional and advanced education in Islamic finance to develop and supply high-calibre talent to meet the needs of the Islamic financial industry. INCEIF has attracted more than 2,000 students since its establishment, including more than 1,800 students pursuing the Chartered Islamic Finance Professionals qualification and 300 students pursuing a Masters or PhD in Islamic finance. Its students hail from 78 countries, bringing important diverse perspectives and dimensions into the learning process for INCEIF students.

## Contract-Based Regulatory Framework for Islamic Finance

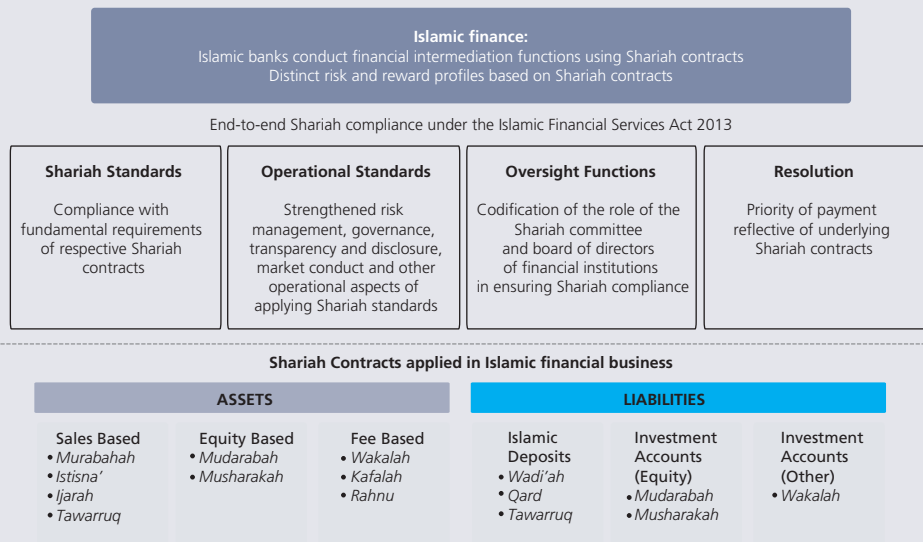
Islamic finance draws its value propositions from the application of a diverse spectrum of Shariah contracts in financial transactions that provide for different risk and return profiles. The strict adherence by Islamic financial institutions to Shariah principles under such distinct contracts preserves the sanctity and validity of Islamic financial transactions. This article highlights the main initiatives undertaken in Malaysia to put in place a comprehensive contract-based regulatory framework for Islamic finance.

### Providing a Strong Legal Foundation

The foundations for end-to-end Shariah governance and compliance for the Islamic finance sector have been further strengthened by the Islamic Financial Services Act 2013 (IFSA). The Act provides the legal premise for a comprehensive regulatory framework for Islamic finance in Malaysia that reflects the specificities of the various types of Shariah financial contracts, and supports the effective application of Islamic contracts in the offering of Islamic financial products and services - from the entering into a contract to the resolution of a failed Islamic financial institution (Diagram 1). This represents a significant step forward in aligning legal and regulatory principles with Shariah precepts, and can serve as a useful benchmark for evolving more comprehensive regulatory frameworks globally that promote greater legal and operational certainty in Islamic finance.

Diagram 1

### Contract-Based Regulatory Framework



In terms of achieving greater alignment with Shariah, three elements of the new legislation are noteworthy:

- **The Act clearly defines the scope of assets and liabilities in Islamic banking business based on the underlying contractual features.** On the liability side, the use of principal-guaranteed Shariah contracts such as *qard*, *wadi'ah* and *tawarruq* in deposit-taking is clearly distinguished from principal non-guaranteed Shariah contracts for investment such as *mudarabah* and *wakalah*. On the asset side, the scope of financing activities similarly draws on the distinctive features of Islamic contracts to include equity and partnership financing contracts such as *musharakah mutanaqisah*, lease-based financing contracts such as *ijarah muntahia bittamleek*, and fee-based activities under *wakalah* contracts.

- **Provisions governing takaful business clearly account for the nature of Shariah contracts that underpin the takaful operational framework.** The new legislation gives legal effect to the segregation of ownership of funds between the takaful participants and the shareholders of a takaful operator in accordance with Shariah. This is reinforced through regulatory requirements that emphasise the fiduciary relationship between takaful operators and takaful participants as stipulated in *mudarabah* or *wakalah* contracts employed in takaful business by requiring takaful funds to be managed on behalf and in the best interests of the takaful participants.
- **The legislation brings the legal framework for the resolution of Islamic financial institutions in line with distinctive elements of the relevant Islamic contracts (Diagram 2).** Assets that are managed by Islamic banks on behalf of investors are legally ring-fenced from the assets of the Islamic banks to reflect the prohibition of any co-mingling of profits and losses attributed to the investment account with other funds. A similar separation is applicable to Islamic windows within licensed commercial banks and investment banks, where Islamic assets and funds are ring-fenced from the conventional banking business. In the event of the resolution of an Islamic financial institution, payments to Islamic depositors are prioritised in a manner that is consistent with the guaranteed nature of contracts employed in Islamic deposit products. Similarly for takaful business, assets of takaful funds and shareholder funds are separated and utilised to meet the respective liabilities in the event of a winding-up of a takaful operator. These obligations differ in priority based on the specific contracts underlying the takaful business model.

### Strengthening the Regulatory Framework

The legislation also contains provisions that enable the Bank to specify regulatory requirements that promote and are consistent with Shariah contract-based operational frameworks. In this regard, the Bank may specify Shariah standards for key Islamic contracts in consultation with the Bank's Shariah Advisory Council. The standards serve to define essential features of the underlying Shariah principles that are adopted by Islamic financial institutions, while enhancing certainty and public confidence in Islamic financial transactions. The Bank issued the Shariah Standard on *Mudarabah* in October 2012, while Shariah standards on *murabahah*, *musharakah*, *ijarah*, *wadi'ah* and *istisna'* are expected to follow in 2013 and 2014.

To support the effective implementation of Shariah standards and ensure compliance by Islamic financial institutions, the Bank also issues guidance or operational standards on Shariah matters. Such guidance and operational standards address sound practice principles and the Bank's expectations for effective risk management, governance, disclosures and appropriate legal and accounting treatments for key Islamic contracts that are necessary to ensure compliance with Shariah under different Islamic contracts. Over the years, the Bank's expectations of the board and management of Islamic financial institutions and their Shariah committees to ensure end-to-end compliance with Shariah have been progressively raised in tandem with the increasing significance of Islamic finance business at the institutional, group and system-wide levels. In 2012, the Guidelines on Financial Reporting for Islamic Banking Institutions were revised to improve the quality of information provided to users of financial statements on the different risk and return profiles and characteristics associated with various Islamic contracts. Enhancements to existing guidance and standards will continue to be developed under a three-year work plan to further strengthen the regulatory framework for application of Shariah contracts.

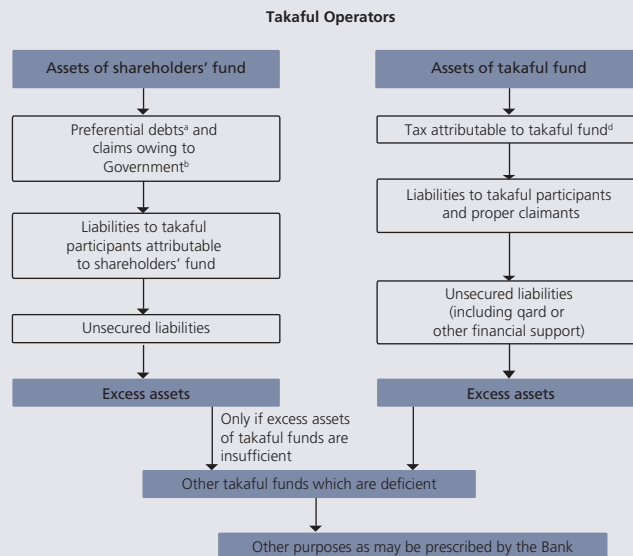
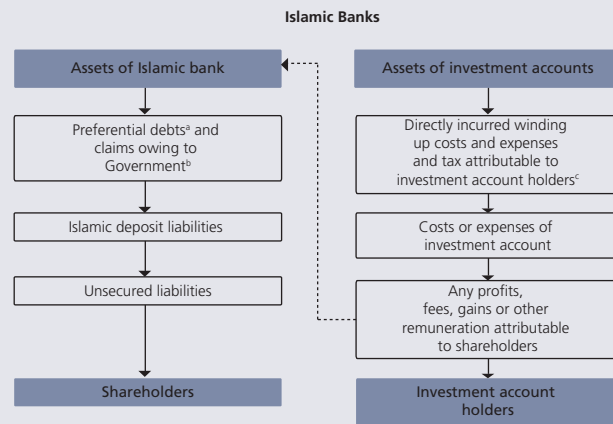
The Bank has wide powers under the law to address non-compliance with Shariah and operational standards. These include the ability to require prompt corrective actions through supervisory intervention as well as a comprehensive penalty framework that provides a credible deterrent.

### Promoting a Cohesive National Infrastructure

Malaysia has also developed a comprehensive legal infrastructure and framework that promotes effective enforceability of Shariah contracts beyond financial services laws and regulations. In 2010, the Law Harmonisation Committee was established with a mandate to undertake objective reviews of other relevant laws, recommend appropriate changes to provide legal recognition to Shariah

Diagram 2

## Priority of Payment Reflective of Underlying Shariah Contracts

<sup>a</sup> Section 292(1) of Companies Act 1965<sup>b</sup> Section 10 of Government Proceedings Act 1956<sup>c</sup> Section 292(1) (a) & (f) of Companies Act 1965<sup>d</sup> Section 292(1) (f) of Companies Act 1965

contractual features, and enhance the legal certainty of financial transactions based on Shariah principles. A current focus of the Committee, working in collaboration with relevant stakeholders, is the development of effective mechanisms to recognise beneficial interests arising from financing under contracts such as *ijarah* and *musharakah mutanaqisah* in the National Land Code 1965 in order to safeguard the interests of contracting parties engaged in Islamic financing. Greater legal certainty is also promoted through the recognition in law of the Bank's Shariah Advisory Council as the reference point for courts and arbitrators on any Shariah matter in relation to Islamic finance business. This has been important to ensure the consistent application of Shariah contractual principles in Islamic financial transactions.

From the taxation perspective, the tax neutrality principle administered by the Tax Neutrality Committee ensures that transactional costs from the application of Shariah contracts in Islamic finance are not structurally higher than conventional financial transactions that produce the same economic impact, thus preserving equivalent tax treatments.

During the year, INCEIF launched its first Executive Master Class programme, which aims to develop leaders in the Islamic finance industry. The programme has attracted more than 300 local and international participants from 36 countries since its launch in September.

To further extend its global reach and contribution to the deepening of a global talent pool for Islamic finance, INCEIF also forged new collaborative arrangements with international partners, including the World Bank, the Islamic Corporation for the Development of the Private Sector (the private sector arm of the Islamic Development Bank Group) and the *Centre Africain D'Etude Supérieure en Gestion* (the training institute of the Central Bank of the West African States). INCEIF also collaborated with BNP Paribas Malaysia Berhad to establish the BNP Paribas-INCEIF Islamic Wealth Management Centre in Malaysia, which is a dedicated research and development centre that aims to catalyse innovation in Islamic wealth management. The Centre is currently undertaking applied research in specialised Islamic wealth management areas focusing on innovative financial solutions to meet the more sophisticated investment demands of the increasingly affluent population, particularly in Asia and the Middle East.

In the area of applied research in Shariah and Islamic finance, the International Shariah Research Academy for Islamic Finance (ISRA) continued to actively engage and support international Islamic bodies, including the International Islamic Fiqh Academy, the Islamic Financial Services Board and the International Islamic Financial Market to promote greater innovation in Islamic

products that comply with Islamic principles and are supported by appropriate governance and risk management structures. Most of the engagements have sought to promote more consistent practices and rules to reduce variances in Shariah standards and interpretation, as part of efforts to achieve greater harmonisation across jurisdictions. ISRA launched the Islamic Financial Knowledge Repository Portal (i-Fikr) in 2012 as a comprehensive database of rulings and *fatwa*, legal and regulatory requirements, articles, books and compendiums on Islamic finance. It is envisaged that i-Fikr will promote greater understanding of Islamic finance principles among industry practitioners, policymakers, researchers and academicians.

## TALENT DEVELOPMENT IN THE FINANCIAL SECTOR

Human capital development initiatives continued to focus on attracting, developing, and retaining talent to build and sustain a highly qualified and competent workforce, which is a key imperative in the development of a dynamic and competitive financial sector. These efforts, which strive to holistically address issues relating to the supply of talent from entry to leadership levels, have been instrumental in bridging the talent gaps in the financial industry.

Since its establishment by the Bank in 2007, the Financial Sector Talent Enrichment Programme (FSTEP), has now become an industry-led initiative, producing more than 1,240 high-calibre and industry-ready individuals for employment in its workforce. FSTEP continues to deliver an

### Survey on Performance of FSTEP Graduates

An independent study was commissioned by the Steering Committee of FSTEP in August 2012 to assess the performance of FSTEP graduates. The study involved a survey of 104 FSTEP graduates (representing 36% of total graduates from three intakes between 2009 and 2012), which covered aspects such as general working attitude, English proficiency, technical knowledge, soft skills, business conduct, teamwork, result orientation and communication, as well as overall satisfaction of employers with FSTEP graduates. Findings from the survey concluded that:

- FSTEP graduates performed distinctly better than other new graduates and met the needs of employers;
- Employers prefer FSTEP graduates to other new directly-recruited graduates;
- FSTEP is effective in preparing entry-level executives for their careers in the financial services industry; and
- Employers are unanimous that they are satisfied with FSTEP graduates.

excellent record of individuals who enrol in FSTEP and are subsequently absorbed into the workforce at a rapid pace. Since 2011, close to 100% of the graduates are employed in the financial services industry with a small proportion of graduates absorbed by other sectors. Improvements continue to be made to the design and delivery of programmes to ensure they remain effective and relevant. Today, FSTEP provides highly-sought exposure to the financial industry and professional competencies required in the workplace to graduates seeking employment in the financial services industry. Further enhancements continue to be made to the programme by leveraging on strategic collaborations with domestic and international bodies, such as CPA Australia Ltd, the Malaysian Insurance Institute (MII) and the Chartered Insurance Institute, to develop mutually-beneficial learning opportunities for participants. With effect from May 2013, FSTEP will be extending its programme to foreign participants working in subsidiaries and associate companies of Malaysian-owned financial institutions operating in the Southeast Asian region. This will provide cross-cultural learning opportunities and support the talent needs of Malaysian financial institutions expanding into the region.

The Iclif Leadership and Governance Centre continued to grow its capacity and capability, strengthening its faculty to support its objectives of developing world-class leaders to helm financial institutions. During the year, a total of 2,802 participants have attended programmes conducted by Iclif, including directors of financial institutions who participated in the Financial Institutions Directors' Education (FIDE) programme. Iclif has also contributed to developing leaders towards facilitating Malaysia's economic transformation process by expanding its reach beyond the financial sector, and providing training to non-financial institutions and multinational corporations. With a strong domestic footprint, Iclif has also expanded into new markets such as Indonesia, Saudi Arabia and Egypt. As part of its thought leadership in the area of leadership and governance, Iclif initiated its first in-house research on the development of an 'Asian Leadership Index', which aims to be a benchmarking tool for countries to assess the quality of their top executive leaders. A sample of 18 countries across the Asian region was selected to participate in this research exercise. The research, expected to be published in 2013, will provide valuable

input to the development and design of future programmes. During the year, Iclif added the 'Business Leadership Programme', provided in collaboration with the University of Michigan's Ross School of Business, to its programme offerings. The Programme covers the critical skills and knowledge gaps relevant to executives advancing into leadership positions to enable them to effectively lead their organisations.

In May 2012, the Asian Institute of Finance (AIF) launched the Microfinance Management Programme designed to enhance the effectiveness and capacity of microfinance providers in supporting the financial services for micro-enterprises. The Programme, developed by AIF's Financial Inclusion Centre, addresses skill gaps that are essential to the effective and responsible delivery of microfinance solutions. Building on this initiative, another flagship programme providing high-level management and leadership training to senior executives in microfinance institutions has been rolled out in February 2013. In 2012, AIF also extended its existing strategic and operational risk management, auditing, as well as governance programmes to Islamic financial institutions. To support these new initiatives, AIF facilitated 54 capacity building projects totalling RM54 million to enhance the capacity of its affiliate training institutions, comprising IBBM, the Islamic Banking and Finance Institute Malaysia, MII and the Securities Industry Development Corporation.

---

A Financial Sector Talent Council will be established in 2013 to provide advisory and strategic direction for talent development in the financial sector which takes into account ongoing and future trends

---

As part of efforts to provide strong incentives for investments by financial institutions in high-quality training for their workforce, and to set clear standards against which training programmes for financial service professionals can be measured, the quality assurance and accreditation division of the AIF was carved out of AIF, and established as a separate entity called the

Finance Accreditation Agency. Its primary role will be to provide accreditation of learning programmes and qualifications for the financial services industry, which will serve as a stamp of quality for financial services training programmes, and facilitate the mutual recognition of professional learning and experience in financial services.

Recognising the importance of having a holistic and comprehensive approach towards human capital development, a Financial Sector Talent Council

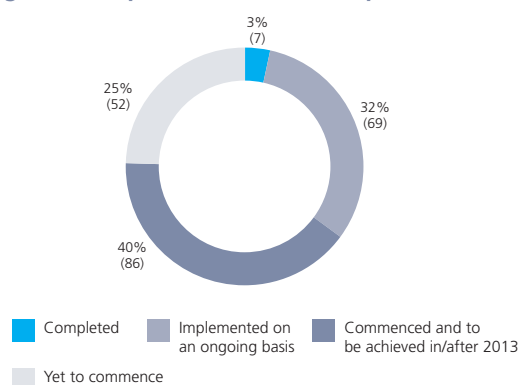
will be established in 2013 to provide advisory and strategic direction for talent development in the financial sector which takes into account ongoing and future trends. The Council will be industry-driven, in collaboration with regulators, Government agencies, academia and training providers. An immediate focus of the Council will be to oversee the identification of the industry's human capital requirements and talent needs, as well as develop coordinated strategies to advance talent development in a cohesive manner.

### Implementation Progress of the Financial Sector Blueprint 2011-2020

Following the launch of the Blueprint in December 2011, the Bank has put in place an internal governance framework within the Bank's business planning process to facilitate monitoring and implementation of the Blueprint initiatives. Under this framework, initiatives will be reviewed periodically in terms of relevance and priority, taking into account its criticality to the vision of the Blueprint, the capacity of key stakeholders in supporting the implementation, as well as the impact of prevailing market conditions on desired outcomes.

Chart 2.7

#### Progress of Implementation of Blueprint Initiatives



Source: Bank Negara Malaysia

In 2012, initiatives under the Blueprint were largely focused on strengthening the foundations for further development of the financial sector. 76 initiatives representing 35% of the total number of initiatives have been completed or are being implemented on an ongoing basis. Of these, the following seven initiatives have been completed:

- 2.2.1 (iii) : Liberalise non-resident participation in the onshore interest rate derivatives market and encourage greater use of interest rate derivatives by market players;
- 2.2.5 (ii) : Permit institutional funds and retail investors to trade in foreign currencies subject to suitable safeguards;
- 2.3.1 (i) : Develop a comprehensive agent banking framework to enable outreach of financial services at lower costs;
- 2.3.2 (i) : Encourage flexible microfinancing products that enable prompt drawdown of financing in times of need and prepayment of financing during good times;

- 3.2.6 (i) : Recognise qualified foreign currency instruments as liquid assets and eligible for use as collateral;
- 4.1.1 : Enactment of a comprehensive legal framework for the Islamic and conventional financial systems; and
- 5.1.1 (vi) : Facilitate higher transaction limits via electronic channels.

The remaining 69 initiatives are being implemented on an ongoing basis in the following areas:

- Promoting effective and efficient intermediation in the financial sector, including supporting the development of a vibrant private pension industry;
- Widening the product range and participation in the foreign exchange market, and money market through the introduction of new instruments, facilitative foreign exchange measures and expanded trading platforms;
- Strengthening the institutional arrangements for the provision of financial services to the underserved in an effective and sustainable manner;
- Supporting initiatives to advance regional financial integration and the regionalisation and internationalisation of qualified Malaysian financial institutions; and
- Developing Malaysia as a reference centre for Islamic financial transactions and to evolve Malaysia as an international Islamic finance marketplace.

Work on 86 other initiatives has commenced and are at various stages of implementation. In 2013, the Bank's focus will be on accelerating the migration to electronic payments, which includes reviewing the pricing structure for payment instruments. To ensure the availability of a deep and sustainable pool of talent for the financial sector, a Financial Sector Talent Council will be established to provide advisory and strategic direction on talent development initiatives in the financial sector. At the same time, efforts will continue to be undertaken to reinforce a sound, transparent and accountable system for effective regulation and supervision. This will entail enhancing the transparency of the suitability criteria for significant controlling interests in financial institutions, and strengthening the supervisory oversight over financial holding companies.