



GOVERNOR'S STATEMENT

Despite the deterioration in the global economic and financial conditions in 2011, domestic financial stability in Malaysia was preserved. The year saw renewed turbulence in financial markets following the heightened market concerns over the sovereign debt crisis in Europe. In addition, funding pressures and the weakening pace of economic recovery continue to affect the financial sector in the advanced economies. While recent measures taken by European policymakers have improved market conditions, considerable challenges remain ahead to restore and strengthen global financial stability.

While not insulated, the Malaysian financial sector has held up well against these developments. The financial sector is expected to continue to remain resilient going forward and is well positioned to continue the intermediation process without disruption. This is not only due to the limited exposures to sovereigns and institutions in the affected euro area economies, but also due to the strong governance and risk management practices. This has resulted in strong balance sheets, continued profitability, strong asset quality and healthy liquidity positions. While there has been some tightening of wholesale funding conditions, particularly in foreign currency, this has had a modest impact on domestic banks given the stable funding structures and continued ample domestic liquidity. The deeper and more diversified domestic financial markets have also supported orderly conditions despite the stronger two-way capital flows experienced during the year.

Following wide-ranging measures introduced during the year, Malaysia's household debt level relative to GDP has stabilised during the second half of 2011. These measures, including the normalisation of interest rates, the raising of the statutory reserve requirement, and the macroprudential measures and the close supervision by the Bank, have aimed at ensuring that household debt will remain sustainable going forward. These measures have started to take effect, most notably in the moderation of property prices which represents the largest component of household debt. New credit card debt has also moderated and there has been improved discipline among banks in assessing affordability. At the aggregate level, the expansion of household debt continues to be supported by positive underlying conditions which include the favourable labour market conditions, rising incomes, and growth in household financial assets. In addition, a larger proportion of the debt is attributed to households that have the capacity to repay. There are however, early signs emerging that there are pockets of households in the lower-income segments, notably those living in urban areas, that are accumulating debt above levels considered prudent, rendering them more vulnerable to income shocks. To address this, in addition to the macroprudential measures, arrangements for debt restructuring and resolution have been introduced by the Bank for addressing stressed conditions, in particular, for this target group. This is reinforced by financial education programmes for the household.

Although the Malaysian financial sector is in a position of strength with capital and liquidity buffers at their highest levels since the Asian Financial Crisis and underpinned by strengthened risk management capacity and oversight, the Bank will maintain a heightened level of intensity in its risk monitoring, supervision and regulation in the period ahead. An anticipatory approach in managing risks to financial stability aims to pre-empt potential risks to financial stability while at the same time reduce the potential costs to the financial system and the economy. Going forward, three important developments are expected to have bearing on domestic financial stability: (i) the prevailing uncertainty in global economic and financial conditions; (ii) an increased pace of financial innovation by domestic financial institutions; and (iii) the more pronounced regional and international complexion of the Malaysian financial sector.

To a large extent, the important preconditions and supporting framework for financial stability are already for the most part in place in Malaysia, both for the conventional and Islamic financial systems. These include an effective legal and regulatory framework, a strong supervisory system, and comprehensive institutional arrangements to support orderly debt resolutions in the event of an increase in the number of defaults. Also in place is an effective financial safety net which reinforces strong incentives for sound risk management through differential deposit insurance premiums. Financial reporting and disclosure standards which promote market confidence and transparency have also been further strengthened by Malaysia's full convergence with the International Financial Reporting Standards from 2012. These factors cumulatively contribute towards reducing the probability and impact of market and institutional failures.

The highly dynamic domestic, regional and international environment however does not provide any room for complacency. The Bank's efforts going forward remain focused on preserving and strengthening the foundations for financial stability. During this year, substantial work was advanced to further strengthen the core elements of the legal and prudential framework for the financial sector. In 2012, we will be bringing new legislation for the financial sector to Parliament that is more aligned with current regulatory and supervisory approaches, and that supports the supervision of more complex financial undertakings. The Bank has also announced the plans to implement Basel III in Malaysia. Efforts to strengthen regional arrangements for financial stability have also seen significant progress with active engagements through supervisory colleges, initiatives to promote greater harmonisation of regulatory standards and the development of enhanced arrangements for cross-border crisis management and resolution. The Bank also concluded two cross-border collateral arrangements with its counterparts in the region to support more efficient liquidity management by financial institutions with cross-border operations, both during normal and crisis periods. The Bank will this year undergo the Financial Stability Assessment Programme by the International Monetary Fund and the World Bank.

The internationalisation of Islamic finance has intensified during the year despite increased uncertainties in global financial markets. As an international Islamic financial centre, Malaysia has worked to ensure that the growth is firmly supported by a sound prudential framework, and developed financial infrastructure and instruments for managing risk. The Bank will also continue to contribute to the global development of Islamic finance, including strengthening the global financial architecture through its active participation in the Islamic Financial Services Board and the International Islamic Liquidity Management Corporation, for ensuring financial stability in the Islamic financial system and hence its sustainability.

The stability of Malaysia's payment systems has continued to be preserved with no disruptions in the operations of the major payment and settlement systems during the year. The payment systems were further strengthened during the year with enhancements to key payment infrastructure and contingency arrangements, as well as the adoption of new measures to increase payment security by financial institutions. Work also significantly progressed during the year to support cross-border payments and settlements and this will further accelerate the pace of regional financial integration. Moving forward, increasing payment efficiency represents a key priority of the Bank and will entail pricing reforms to encourage the migration to electronic payments along with continuing enhancements to domestic and regional payment infrastructures.

The implementation of recommendations under the Financial Sector Blueprint released by the Bank in December 2011 also aims to further contribute to financial stability in Malaysia. Priority will be accorded to promoting effective financial intermediation in a changing economy, and the development of orderly foreign exchange and money markets - two key dimensions of financial stability for which the Bank is responsible under the Central Bank of Malaysia Act 2009. An important part of these efforts is that the development of the financial sector is accompanied by the development and supply of talent for the sector, and a careful consideration of how regulatory safeguards would need to evolve to ensure that changes in banking and financial landscapes, practices and business models do not increase overall risks to financial stability.



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