

Risk developments and assessment of financial stability in 2011

Financial stability continued to be sustained throughout 2011, providing an environment conducive to economic growth in Malaysia despite the uncertain global growth prospects and heightened risks emanating from the advanced economies. While global financial conditions have come under renewed stress particularly in the last quarter of 2011, the Malaysian financial sector remains strong, and the impact of unfolding developments in the external environment on financial institutions in Malaysia has been modest owing to the significantly strengthened financials and capacity to manage risks. This has enabled financial intermediation to continue functioning effectively. Domestic financial market conditions have also remained orderly.

After a continued upward trend since 2009, household debt grew at a more moderate pace as the range of measures introduced earlier by the Bank began to take effect. Malaysian households in general remain financially sound, with strong financial buffers to service debt obligations and cushion against income shocks. The debt servicing capacity of households continue to be supported by favourable employment conditions and rising incomes, with loans in arrears continuing to trend downwards and the impaired loan ratio at its lowest since 2000. While lower-income borrowers residing in urban centres are facing difficulties in managing their financial obligations, with higher leverage positions and a limited capacity to save, this segment of borrowers continue to account for a relatively small share of banking system loans. The continued observance of sound underwriting practices by banks, reinforced by the pre-emptive measures undertaken by the Government and the Bank to address emerging strains among the more vulnerable segments of the household sector, further contain the build-up of excessive risks in the household sector. This is also addressed by the Bank's close supervision of the lending practices of individual banking institutions, and the availability of debt resolution mechanisms that are already in place to provide assistance to borrowers in financial difficulty.

Renewed turbulence in global financial markets driven by events in the euro area and in the US led to a surge in short-term portfolio flows during the year, although these flows were effectively and efficiently intermediated. Orderly conditions were preserved in Malaysia without disruptive effects on the domestic financial markets, with market volatility levels significantly lower than those observed at the height of the global financial crisis in 2008, and in other regional markets. Malaysian banking institutions were also less affected by the volatile conditions in offshore wholesale markets, given local institutions' stable funding structures which are supported mainly by domestic savings and deposits. Banks have also not taken on excessive risks, with risk-taking behaviour observed among banks continuing to remain within prudent levels despite the ample liquidity conditions and divergence in market prices between emerging and advanced economies.

With limited exposures to counterparties in affected euro economies, the impact of any further escalation of the sovereign debt and banking crisis in the euro area on Malaysian financial institutions is well contained. The transmission of risks through the Malaysian operations of European banks also remains controlled as these are carried out by separately-capitalised subsidiaries which are supervised by the Bank. The contagion risks from the cross-border operations of Malaysian banking groups are also low as these operations are backed by sound capital and funding positions, with manageable credit exposures.

For the year as a whole, the banking sector continued to sustain healthy capitalisation levels and profitability on account of higher interest/financing income, lower impairment charges and higher fee-based income. The aggregate risk-weighted capital ratio and core capital ratio for the banking system stood at 15.1% and 13.2% respectively, well above the current regulatory minimum as well as the more stringent standards under Basel III. The insurance and takaful sectors experienced lower profitability due to lower investment returns as a result of the volatile market conditions, and higher claims and benefits paid. The impact on the capitalisation level of the industry was, however, not material with the capital adequacy ratio declining only

marginally and sustained at a strong level of 222.5%. Stress tests conducted by the Bank, which assume adverse scenarios of domestic economic contraction, further affirm the resilience of Malaysian financial institutions.

Risks to domestic financial stability in 2012 are expected to continue to be driven mainly by external developments, particularly in the euro area, with key risks remaining largely unchanged. Risk aversion and volatility in the global financial markets are likely to remain elevated given the uncertainty surrounding the recovery of the global economy and progress towards strengthening the global financial system. Domestically, developments in the level and profile of household debt will continue to be closely monitored, while measures already taken should continue to improve the resilience of the household sector.

Development of the financial sector

With strong fundamentals of the financial sector well entrenched, priorities in the financial sector development in 2011 were focused on reinforcing Malaysia's long-term growth potential by strengthening the capacity of the sector in intermediating funds for new growth areas and enhancing Malaysia's regional and international financial linkages, with appropriate safeguards to preserve financial stability. The strategies to achieve this have been set out under the Financial Sector Blueprint (the Blueprint) which was released by the Bank in December 2011. The Blueprint charts the future direction of the Malaysian financial system in the next 10 years and builds on the achievements of the first Financial Sector Masterplan to position the financial sector to assume an enhanced role in supporting Malaysia's transformation towards becoming a high value-added, high-income economy.

The market structure of the financial industry continued to strengthen during the year with the emergence of stronger and more competitive banking groups and insurers as a result of mergers and acquisitions. The Competition Act 2010, which came into effect on 1 January 2012, further reinforces the competitive environment in the financial sector and complements the Bank's efforts to enhance consumer protection in Malaysia. In the insurance sector, a comprehensive solution to the long-standing challenges affecting the ability of insurers to provide compulsory motor liability insurance protection on a sustainable basis was achieved with the introduction of a

new motor cover framework that will address pricing distortions and inefficiencies in the claims settlement process. Gradual adjustments to the premium levels commenced in January 2012 and will be phased in over a four-year period.

Throughout the year, the financial system continued to perform its intermediation function efficiently to support the diverse needs of the economy, as evidenced by the positive loan growth in the business and household sectors. Significant strides were also made to streamline the loan application processes for small and medium enterprises (SMEs) and enhance credit assessment procedures for the green technology industry, to improve the prospect of obtaining financing in these sectors. Focus was thus placed on enhancing the supporting infrastructure and institutional arrangements to meet the needs of SMEs, increasing capacity to support new growth areas and innovative industries, and developing a robust pension framework.

Continued efforts were made to deepen and broaden the financial markets. The debt securities market continues to assume an increasingly important role in meeting the financing needs of Malaysian businesses, with stronger demand observed for more innovative Islamic financial products and services. Danajamin as a financial guarantee insurer continues to provide vital support for Malaysian corporations to access the bond market, particularly for longer-term financing. To promote the legal certainty of financial market contracts, specifically derivatives and repurchase agreements, the Bank will be proposing legislative amendments to provisions in the Central Bank of Malaysia Act 2009 this year to provide further certainty with respect to the operations of financial market contracts and to allow financial institutions to determine exposures to counterparties in Malaysia under such contracts on a fully net basis.

Financial inclusion remains a key priority of the Bank. Financing to micro-entrepreneurs continued to increase both by value and number of accounts. All 144 districts in Malaysia now have access to essential financial services provided through physical branches, mobile banking units of banks and development financial institutions (DFIs), or under shared banking services arrangements with Pos Malaysia Berhad. A comprehensive agent banking framework will be developed to further widen access to financial services at the

sub-district level. While Malaysia already has one of the highest levels of financial inclusion, efforts have also been focused on promoting the more effective use of financial services. This can be achieved through the better understanding of the financial requirements and behaviour of different target groups, including the underserved, with the provision of more targeted education programmes, and by addressing the specific challenges faced by low- to middle-income households in urban centres. The launch of the Bank's MobileLINK unit during the year will also enable the Bank to further expand its information and consumer support services to consumers in semi-urban and non-urban areas.

Malaysia's financial integration within the region and with other parts of the world gained considerable momentum, with the progressive liberalisation of the domestic financial system and the continued growth in the overseas operations of Malaysian financial institutions. Efforts to strengthen Malaysia's interlinkages are pursued in a mutually advantageous manner with the broader aim of enhancing the growth potential of the region and promoting regional financial stability. Arising from the 2009 liberalisation measures, three new locally-incorporated foreign banks, one new International Islamic Bank and two new joint-venture family takaful operators commenced operations in 2011.

Efforts to promote deeper financial integration within the Asian region resulted in several advancements which include: (i) the establishment of the ASEAN Infrastructure Fund where nine ASEAN countries, including Malaysia, have pooled resources for infrastructure development in the ASEAN region; (ii) the endorsement of a high-level framework by the central banks of ASEAN countries to reinforce cross-border coordination and cooperation in the financial sector; and (iii) the establishment of reciprocal bilateral arrangements among central banks in the region to promote more efficient cross-border liquidity management and the provision of liquidity support in periods of stress.

Malaysia continued to evolve as an international Islamic financial centre, with robust growth recorded in Islamic banking assets, takaful contributions and the volume of foreign currency business. Malaysia retained its leading position in the global sukuk market, with an increasing amount of outstanding USD-denominated sukuk. The year also saw some landmark innovations in

Islamic financial market instruments, including the issuance of the well-received Wakala Global Sukuk, the first 10-year sovereign USD sukuk in the world, and the world's first renminbi sukuk issued out of Malaysia. These achievements were accompanied by infrastructural developments that will further enhance the transparency, liquidity and pricing efficiency of Islamic financial products. The planned issuance of the first short-term sukuk by the International Islamic Liquidity Management Corporation (IILM) by mid-2012 will also contribute towards the more efficient intermediation of cross-border flows and supporting global liquidity needs. The development of talent in Islamic finance was also further advanced with the increased numbers of qualified Chartered Islamic Finance Professionals and the introduction of a comprehensive training roadmap by the Islamic Banking and Finance Institute Malaysia (IBFIM).

Malaysian financial consumers have also become more engaged in financial matters, supported by sustained awareness and education programmes, and improved disclosures on financial products and services. More consumers are using various channels provided by the Bank and the industry to seek financial information, advice and redress. A study by the Organisation of Economic Co-operation and Development (OECD) showed that financial literacy levels in Malaysia are comparable to those in developed economies. During the year, substantial progress was made in efforts to build a strong foundation for financial capability at an early age. This was done in close collaboration with the Ministry of Education to embed financial education within the revised school curriculum which will be introduced from 2014.

Significant efforts also continued to be directed towards supporting the development of high quality talent for the financial sector, across all levels of an institution, from entry to leadership positions. Institutions established by the Bank to spearhead these efforts, including the Financial Sector Talent Enrichment Programme (FSTEP), the Asian Institute of Finance (AIF) and the Iclif Leadership and Governance Centre, continued actively during the year to enhance and expand their programme offerings to meet the new requirements of the rapidly-changing financial sector. These institutions have also significantly strengthened their internal capabilities, including in research and through the addition of new faculty, in order to better deliver their training mandates.

Regulatory and supervisory framework

In 2011, the Bank continued to reinforce and advance further the core tenets of regulation and supervision, building on earlier work undertaken to strengthen the legislative framework and improve risk management, governance and business conduct practices.

The implementation of global regulatory reforms was a key priority of the regulatory and supervisory framework during the year. In December 2011, the Bank released details of the implementation of Basel III in Malaysia which is aimed at further strengthening capital and liquidity standards for banking institutions. The reform package will be implemented in phases, beginning 2013 until 2019, in line with the globally-agreed levels and implementation timelines. This will allow banking institutions to gradually adjust to the new requirements, thus mitigating any adverse impact on credit intermediation. For the insurance industry, changes were made to the Bank's Risk-Based Capital Framework (the RBC framework) to converge the valuation rules underpinning the determination of regulatory capital with the Financial Reporting Standards. The Bank will continue to review the RBC framework to further improve the alignment of capital with risk and support a more consistent approach to capital standards for financial groups in line with international standards. A new risk-based capital framework for takaful operators was introduced for consultation and is now being finalised, taking into account feedback received from the industry. The proposed new capital framework will take into account the objectives of prudential and Shariah principles.

A focus on promoting sound risk management practices remained central to the Bank's regulatory and supervisory priorities with enhancements of prudential standards in a number of aspects on risk management. This included proposals issued to strengthen standards on risk governance which address requirements for financial institutions to observe sound practices in defining the risk appetite for the institution, and implementing effective controls (including appropriate incentive systems) over risk-taking activities. The control of counterparty risks was also strengthened with proposed enhancements to existing regulatory limits on exposures to single counterparties. With competition in the retail lending space remaining intense and signs of continued pressure on loan pricing, new guidelines on sound pricing practices

for retail loans/financing were also issued as a pre-emptive measure to ensure that banks' pricing practices are appropriately supervised by their board and management, and broadly aligned with their risk and capital management strategies. During the year, corporate governance standards for DFIs were strengthened to promote more robust assessments of the fitness and propriety of appointments to the board and management, consistent with standards already adopted for other financial institutions.

The Bank continued to strengthen the consumer protection framework and market conduct practices of financial institutions by promoting more responsible financing practices, enhancing the transparency and disclosure of financial products and elevating the quality and efficiency of financial services. The Guidelines on Responsible Financing was issued to promote more consistent practices across the industry in the assessments of customers' creditworthiness and their ability to service debt obligations. In the Islamic banking sector, the Guidelines on Late Payment Charges was issued to promote more prudent financial discipline among borrowers, with clearly-established parameters for the imposition of penalties (*gharamah*) and compensation charges (*ta'widh*) on delinquent customers. The Bank also devoted significant attention to addressing mis-selling practices by financial institutions. Financial institutions that were found to have been involved in such practices were compounded, ordered to provide restitution to affected customers and required to strengthen internal oversight arrangements over the product origination, approval, sales and complaints handling process.

To reduce the scope for the regulated financial sector to be used for illegal purposes and to maintain the integrity of, and public confidence in the financial system, efforts were intensified to ensure an effective legal framework and adequate systems and processes within financial institutions to promptly detect and prevent illegal activities. The enactment of the Money Services Business Act 2011 which came into force on 1 December 2011 provides for the strengthened regulatory and supervisory oversight of money changing and remittance services business. The Bank also actively supported closer international cooperation with relevant authorities to facilitate information sharing and cross-border financial crime investigations. With the growing

expansion of domestic financial institutions across borders and increased presence of foreign financial institutions operating in Malaysia, more structured approaches to supervisory cooperation with other supervisory authorities have been put in place. This includes supervisory colleges for regionally-active Malaysian financial groups and foreign institutions operating in Malaysia, which provide a platform for sharing supervisory assessments and the coordination of supervisory activities. On the domestic front, the Bank also continued to coordinate its supervisory and surveillance activities with the Securities Commission and the Malaysia Deposit Insurance Corporation (Perbadanan Insurans Deposit Malaysia, PIDM) and has started a process to further enhance the existing cooperation arrangements with these agencies.

Payment and settlement systems

The payment and settlement systems in Malaysia remained resilient and supportive of the growth of the financial system and the economy. The Bank's oversight activities were directed at ensuring the continued reliability of the major interbank clearing and settlement systems, and improving the security of widely-used payment instruments, thus maintaining public confidence in these systems. The Real-time Electronic Transfer of Funds and Securities System (RENTAS) achieved 100% systems availability, with improvements noted in market efficiency and liquidity management by RENTAS participants. The Bank also continued to collaborate with the industry and enforcement agencies to avert potential incidents of fraud, promote enhanced business practices to better protect consumers against new methods of perpetrating fraud, and educate the public on fraud prevention. Losses due to fraud in retail payments remained negligible in 2011.

The Bank continued to take steps to promote compliance by RENTAS with the relevant principles and recommendations issued by the Bank for International Settlements and the International Organisation of Securities, while also elevating its capability to support cross-border payments and settlements with the provision of an onshore multi-currency funds and securities settlement facility and custodian services for foreign securities denominated in any currency.

In promoting the migration to electronic payments (e-payments), the Bank's efforts were focused on improving the accessibility, speed, certainty and convenience of payment services. A key milestone was the completion of a multi-bank and mobile network neutral infrastructure that would enable access to mobile banking and payment services from any location at any time, under the brand label 'MyMobile'. The Bank's wholly-owned subsidiary, Malaysian Electronic Clearing Corporation Sdn. Bhd. (MyClear), also acquired the major retail payment systems from MEPS in September 2011 to rationalise overlapping e-payment infrastructures and introduce a pricing structure that would further encourage the adoption of e-payments. There was also encouraging progress in the adoption of e-payments by priority sectors such as the Government and financial institutions, with firm commitments to and achievements noted in the migration of internal payments to electronic channels. In the capital market, plans have been formulated to further extend the adoption of e-payments to include initial public offering refunds, subscriptions and redemptions of unit trusts, and subscriptions of rights issues beginning in 2012. Moving forward, the Bank will continue to focus on promoting e-payments as the preferred medium for economic transactions in Malaysia, through the initiatives outlined in the Blueprint.