RISK DEVELOPMENTS AND ASSESSMENT OF FINANCIAL STABILITY IN 2011

OVERVIEW

Domestic financial stability was preserved throughout 2011, providing an environment conducive to economic growth in Malaysia even as risks associated with the sovereign debt crisis in Europe and weaker growth in advanced economies increased sharply in the second half of the year. Underpinned by strong fundamentals, the Malaysian financial system continued to demonstrate a high degree of resilience to unfolding developments in the external environment. Financial soundness indicators were sustained at strong levels, including under the assumptions of stressed scenarios, affirming the capacity of Malaysia's financial sector, both at the system and institution levels, to withstand shocks. The continued vigilance over areas of potential risk on the domestic front maintained throughout the year has allowed for the early implementation of wide-ranging measures, including supervisory measures, to be taken by the Bank to address emerging risks. These measures ensured that financial intermediation continued to function efficiently, as reflected by the steady broad-based expansion in financing activities. Domestic financial market conditions have also remained orderly despite the higher degree of volatility, and confidence in the financial system remained firmly intact.

Household debts grew at a more moderate pace as the range of measures introduced earlier by the Bank began to take effect. Overall, the financial position of Malaysian households remained sound. Strong aggregate financial buffers continued to support the ability of households to service debt obligations and provided a cushion against potential shocks. This is further reinforced by steady income growth, favourable employment conditions and a high level of savings. Borrowers in the lower-income categories and residing in urban centres, however, face more challenges in managing their financial obligations. While these groups of borrowers account for a relatively small share of the banking system's total credit exposures, the series of measures undertaken by the Bank, together with the debt resolution mechanisms already in place, will contribute towards alleviating the financial stress faced by these borrowers, thus containing the build-up of risks in the household sector.

External contagion from events in the euro area and in the US saw higher volumes and speed in movements in portfolio flows during the year. These flows were effectively intermediated with domestic financial markets remaining orderly despite the higher observed volatility. Funding conditions for Malaysian financial institutions have remained broadly favourable with limited impact observed from the tightening in global wholesale funding markets given the stable funding structures. Malaysian banks also had limited direct and indirect credit exposures to counterparties in the affected Euro economies, while for insurers, these exposures were with counterparties that had maintained strong financial positions.

> The Malaysian financial system demonstrated continuing high degree of resilience to unfolding external developments. The continued vigilance over areas of potential risk on the domestic front has allowed for the early implementation of wide-ranging measures, including supervisory measures, to be taken by the Bank to address emerging risks

The financial sector continued to sustain healthy capitalisation levels and profitability, although the insurance and takaful industry was more challenged by the volatile market conditions. Financial institutions have thus been able to demonstrate considerable agility in responding to the more challenging financial and operating conditions, particularly in managing the market risk exposures. Malaysian banks are also well placed to meet the more stringent capital requirements under Basel III.

Risks to domestic financial stability in 2012 are expected to continue to be mainly externally driven, with developments in the euro area taking prominence. The key risks stem from the continued uncertainties clouding the prospects for a more entrenched recovery and strengthening of the financial systems in the advanced economies. Given the continued fragility in market sentiment, risk aversion and volatility in the global financial markets are likely to remain elevated. In the domestic environment, the accumulation of household debts will continue to be closely monitored although measures already taken are expected to take a firmer hold, thus ensuring that the overall household finances remain sound.

MANAGING RISKS ARISING FROM HOUSEHOLD INDEBTEDNESS

The credit exposures to the household sector continue to be manageable with some emerging signs of moderation in household borrowing, particularly in the second half of 2011. The financial position and debt servicing capacity of households remain sound at the aggregate level, supported by higher income and favourable employment conditions. Within the household sector though, considerably higher levels of leverage with relatively limited buffers against potential income shocks have been observed for borrowers with a monthly income of RM3,000 and below and living in urban centres. The risk of a more generalised deterioration in the credit quality of loans in the banking system and broader implications for overall financial stability is, however, assessed to be manageable. The concentration of bank exposure to borrowers in this group is relatively low representing less than 13% of total banking system loans. Based on historical experience on the level of impairment and provisioning, any impairment losses to banks are not likely to exceed RM2 billion or less than 8% of pre-tax profits of commercial and Islamic banks. Bank lending to individuals earning more than RM3,000 per month account for about 80% of total loans to households by the banking system. Banks have also continued to maintain prudent underwriting standards, resulting in continued improvements in the quality of household loans. In the event of a temporary income shock affecting the lower-income households, the strong financial position of banks allow for considerable room to facilitate adjustments by the affected borrowers through debt restructuring measures, thus limiting the potential for widespread defaults. This is further supported by the existence of established and well-functioning debt management mechanisms in individual banks and through the Credit Counselling and Debt Management Agency (AKPK). This is reinforced by measures that have been taken to restrain excessive accumulation of debt by the more vulnerable borrowers.

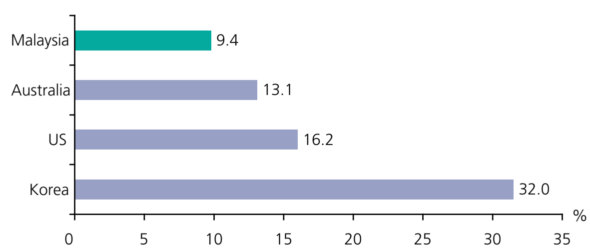
Financial stability implications of household indebtedness in Malaysia remain manageable given the generally sustained strong fundamentals of the majority of households and sound risk management practices of the banking institutions

From a broader macroeconomic perspective, a study by the Bank also revealed that more than half of the variation in consumption is attributed to income (as measured by disposable income), while less than 10% is attributed to credit-related variables. This is further reflected in the proportion of loans for consumption credit as a share of private consumption, which is lower relative to other countries (Chart 1.1). In addition, changes in borrowing costs have had minimal impact on households, as the majority of households is not over-leveraged.

In 2011, household debts increased further, supported by continued income growth. The growth was, however, slower with outstanding household debts expanding by 12.5% for the year (2010: 13.7%) with signs of stabilisation in the

Chart 1.1

Household Sector: Consumption Credit to Private Consumption Ratio by Countries

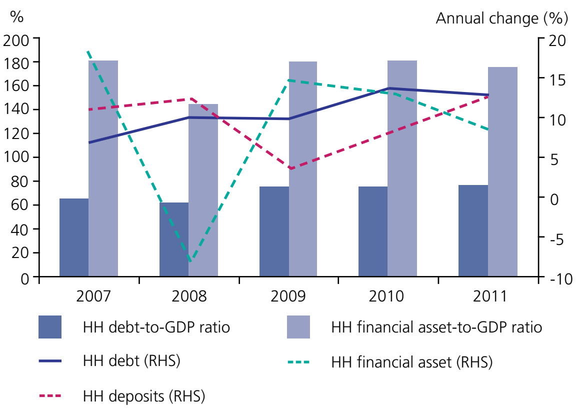


Source: HAVER, National Authorities and internal computation accumulation of household debts relative to gross domestic product (GDP) since the second half of 2011. After a continued upward quarterly trend observed since 2009, the level of household debts as a proportion of GDP has plateaued since June, ending the year at 76.6% (2010: 75.8%) (Chart 1.2).

Household balance sheets generally continue to show strong financial buffers against adverse changes in asset values, interest rates and income levels. The growth in household debts has generally been accompanied by a corresponding expansion in household financial assets. While declines in equity valuations in 2011 had a negative impact on household financial assets which increased at a slower pace of 8.4%

Chart 1.2

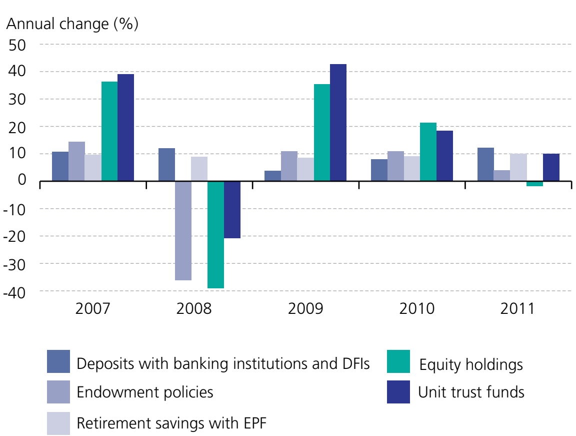
Household Sector: Debts and Financial Assets



Source: Bank Negara Malaysia

Chart 1.3

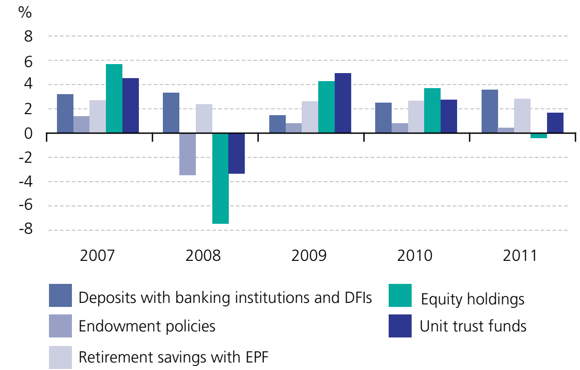
Household Sector: Growth in Financial Assets by Components



Source: Bank Negara Malaysia

Chart 1.4

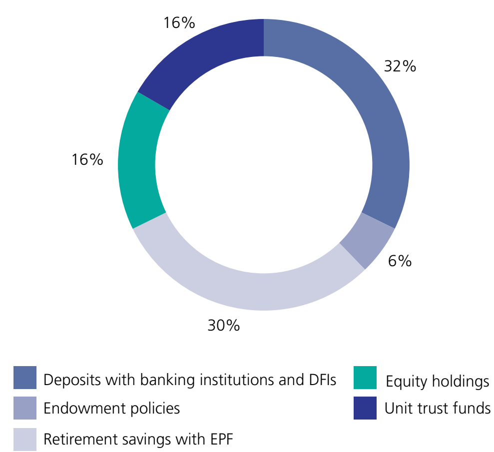
Household Sector: Contribution to Growth of Financial Assets



Source: Bank Negara Malaysia

Chart 1.5

Household Sector: Financial Assets by Composition



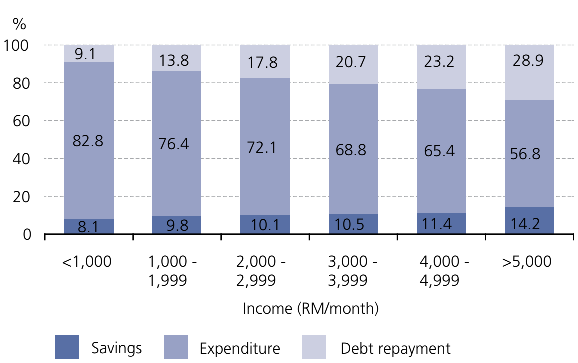
Source: Bank Negara Malaysia

(2010: 12.8%), this was offset by the sustained and stronger growth in household deposits which expanded by 12.2% (2010: 7.9%). This has maintained aggregate household financial buffers at comfortable levels with household financial assets remaining above two times (2011: 2.3 times) of household debts at the end of the year (Chart 1.3, 1.4 and 1.5). Also contributing to the strong financial buffers was the high proportion of liquid and near-liquid assets, including bank deposits, which are available to meet short-term liquidity needs. More than 60% of household financial assets are held in liquid assets, resulting in a liquid asset-to-debt ratio of 1.48 times. About half of these are in deposits placed with banking institutions and development financial institutions.

There are a number of interlinked factors that influence the distribution and level of household debts in Malaysia – the key factors being income level, location and cost of living. By income distribution, a significant proportion (46.5%) of outstanding household debts is attributed to borrowers with a monthly income of above RM5,000 who have comfortable financial buffers and can reasonably afford to meet debt repayments without substantial financial hardship. In contrast, individuals with monthly income of below RM3,000 who reside in major employment centres where the cost of living is significantly higher, spend a larger proportion of their income on basic expenditures such as food, transportation and clothing (Chart 1.6). Given the high dependence on income to sustain consumption, lower-income households, in general, are more susceptible to income shocks and to some extent, price shocks. Outstanding borrowings of individuals in this income group accounted for about 23% of banks' exposures to households or 12.7% of banking system loans, with the majority of borrowers' loan facilities concentrated in vehicle and personal financing. The leverage positions (derived by dividing average outstanding debt by the median annual income for each income group) of borrowers in this group were 4.4-9.6 times of the annual income as compared to 2.3-3.3 times for those in the upper-middle and high-income groups. With lower savings capacity and higher leverage positions, this particular income group is sensitive to income shocks and

Chart 1.6

Household Sector: Savings and Expenditure by Income Group



Source: Department of Statistics, Malaysia and internal computation

interest rate adjustments. Internal estimates by the Bank suggest that in the event of a total loss of income, the accumulated savings of individuals earning below RM3,000 per month would only be sufficient to sustain spending on necessities and debt repayments for a period of up to three months in the absence of any financial assistance. Malaysia's current unemployment rate of 3.1%, which is relatively low compared to 4.5% recorded after the Asian Financial Crisis, reduces the likelihood of this occurring for most households.

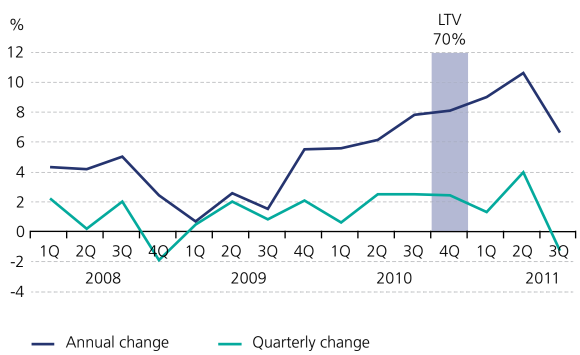
Household borrowings continue to be primarily concentrated in financing for the purchase of residential properties and motor vehicles which accounted for 64% of outstanding household debts. As in previous years, borrowings to finance residential properties have remained the main driver of growth in household debts, increasing at an annual rate of 11% over the recent three years as more individuals became financially qualified to borrow, especially to purchase homes. In 2011, borrowings for the purchase of residential properties slowed only slightly, increasing by 12.7% compared to 12.8% in the previous year. House prices have continued to increase at an annual average of 5.9% on a quarterly basis in the recent three years, compared to the long-run average of 3.9% for the period 2001- 3Q 2011. The bulk of the loans extended for the purchase of residential properties was for those priced above RM250,000.

In 2010, the Bank implemented several measures to mitigate excessive investment and speculative activity in the property market and to contain substantial increases in property prices which resulted in houses becoming less affordable for genuine house buyers. A 70% loan-to-value (LTV) ratio was applied to individual borrowers with more than two housing loans, while capital charges on banks were increased for residential property loans with LTVs exceeding 90%. In December 2011, residential property loans taken by non-individual borrowers were also subjected to an LTV ratio of 60% to make it consistent with the 2010 measure applied to individuals. These measures have started to take effect as the number of borrowers with more than two outstanding housing loan accounts moderated and registered a much lower growth of 2.9% (2010: 14.9%). House price increases as measured by changes in the Malaysian House Price Index slowed to 6.6% in 3Q 2011 (2Q 2011: 10.6%; 2010: 6.7%) (Chart 1.7). In addition, house prices in Kuala Lumpur, Selangor, Johor and Penang have also begun to soften (Chart 1.8). The Malaysian Institute of Economic Research (MIER) Residential Property Index moderated to 120.1 points in 4Q 2011 (2Q 2011: 127.8 points; 1Q 2011: 130 points), reflecting market expectations that residential property prices are returning to more sustainable levels.

Low borrowing costs amid intense competition among lenders have contributed towards reducing the cost of house financing. Financing rates for house purchases have continued to trend downwards with the spreads between average lending rates and average funding costs narrowing from 306 basis points in 2009 to 273 basis points in 2011. This trend raised some concerns over the rigour of banks' pricing methodologies and practices which were borne out by a thematic supervisory review of pricing practices carried out by the Bank during the year.

Chart 1.7

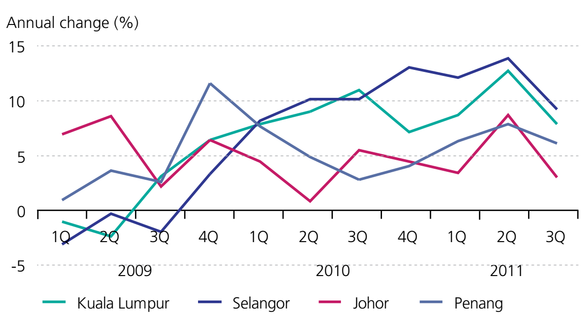
Malaysian House Price Index



Source: National Property Information Centre (NAPIC)

Chart 1.8

Malaysian House Price Index by State



Source: National Property Information Centre (NAPIC)

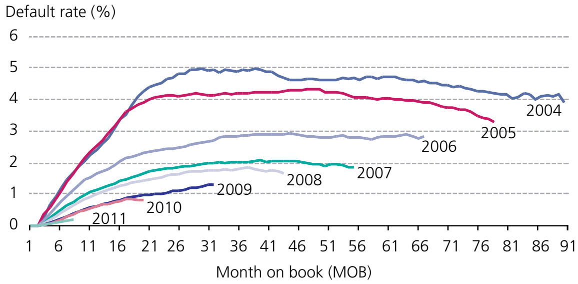
The review, which covered house, automobile and personal financing revealed some prevalent weaknesses. These include less-than-robust assumptions used in the estimation of potential credit losses for pricing purposes. Some banks also relied only on recent low delinquency and loss data that may not sufficiently capture the underlying inherent risks over a complete credit and economic cycle. Another observation was the underestimation of funding costs by a number of banks which assumed a high rate of prepayments and thus, shorter average durations. While repricing risk is currently low given the outlook for growth, these assumptions may not hold over the medium- and long-term. The liquidity premium factored in the pricing methodologies by some banks also assumed that the ample liquidity conditions would continue over an extended period of time.

To a large extent, the observance of sound underwriting practices by banks and strong capital and liquidity buffers have mitigated these risks. Supervisory reviews of banks' lending practices suggest that the most aggressive lending rates are applied only selectively for customers with low risk profiles. Valuations were also more rigorous for loans extended for the purchase of high-end properties in choice locations. Banks generally have put in place robust policies and processes to ensure that independent valuations obtained for such properties are reasonable and sufficiently conservative. These include ensuring that valuations are performed by credible and qualified valuers and periodically cross-checking valuations against recently transacted market prices and internal market analyses. For properties located in choice locations where prices have demonstrated sharp and significant increases, a lower margin of financing not exceeding 80% has been observed among banks to manage any potential price adjustments.

The vintage analysis of the housing loan portfolio for selected large banks affirms the sustained prudence in banks' underwriting practices, with default rates declining steadily since 2004 (Chart 1.9). The amount of impairment for loans extended for the purchase of residential properties correspondingly declined for the fourth consecutive year by 17.9% to account for 2.3% of total residential property loans. Improvements were observed across the board for all property value groups. Loans that are in arrears (more than one to less than three months)

Chart 1.9

Household Sector: Vintage Analysis for Housing Loans



Source: Bank Negara Malaysia

Table 1.1

Household Sector: Loans-in-Arrears for Residential Property Loans by Price (%)

	2008	2009	2010	2011
Up to RM25,000	3.5	4.1	3.4	1.8
Between RM25,000 to RM60,000	4.6	4.7	5.4	4.7
Between RM60,000 to RM100,000	4.0	4.2	4.9	4.3
Between RM100,000 to RM150,000	3.4	3.2	3.8	3.6
Between RM150,000 to RM250,000	2.6	2.4	2.8	2.7
Above RM250,000	1.6	1.3	1.4	1.3
Overall total	2.6	2.3	2.6	2.3

Note: Loans-in-arrears of >1 month to <3 months
Source: Bank Negara Malaysia

Table 1.2

Household Sector: Impaired Loans for Purchase of Residential Properties by Price (%)

	2008	2009	2010	2011
Up to RM25,000	14.3	12.4	5.8	3.5
Between RM25,000 to RM60,000	10.6	8.9	7.7	6.8
Between RM60,000 to RM100,000	9.9	8.2	6.8	5.8
Between RM100,000 to RM150,000	8.3	6.3	5.1	4.1
Between RM150,000 to RM250,000	5.5	4.2	3.3	2.5
Above RM250,000	2.8	2.1	1.5	1.1
Overall total	5.7	4.3	3.2	2.3

Source: Bank Negara Malaysia

Table 1.3

Household Sector: Average Loss Given Default (LGD)

	2010	2011
	%	
Purchase of residential properties	20	19
Purchase of vehicles	49	48
Credit cards	71	65

Source: Bank Negara Malaysia

Table 1.4

Household Sector: Average Probability of Default (PD)

	2010	2011
	(%)	
Purchase of residential properties	3.1	3.1
Purchase of vehicles	3.7	3.2
Credit cards	4.1	3.5

Source: Bank Negara Malaysia

remained low, accounting for only 2.3% of loans for the purchase of residential properties (Table 1.1 and 1.2). The average loss given default (LGD) observed for housing loans was also lower as at end-2011 (Table 1.3), while the average probability of default (PD) remained unchanged (Table 1.4).

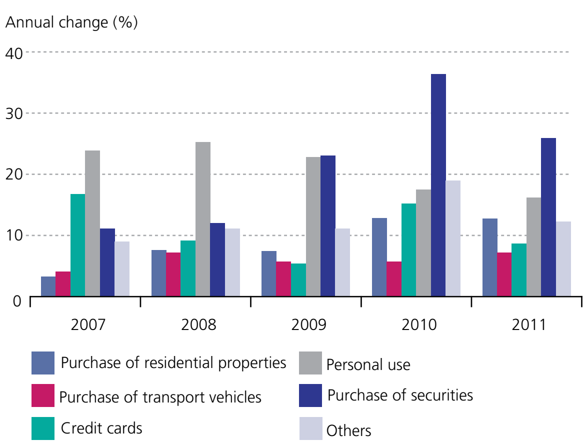
Nevertheless, given the significance of housing debt, which is the single largest credit exposure for both banks (25.5% of total credit extended by the banking system) and households (45.3% of total household debts), it is important to ensure that banks continue to maintain sound pricing and underwriting discipline in lending practices, supported by appropriate risk management and capital allocation strategies to prevent imprudent build-up of risks going forward. The Bank has clearly set out its expectations on practices to be observed by banks for the valuation of properties, followed closely by the issuance of the Concept Paper on Guidelines on Risk-Informed Pricing for Retail Loans/Financing in December 2011 for industry consultation (see Chapter 3). These prudential guidelines issued by the Bank serve to ensure that the expansion of credit does not exacerbate the level of household indebtedness in the country. Moreover, this will continue to be complemented by ongoing supervisory reviews of bank lending to households.

Within other categories of household debts, hire purchase increased at a slower rate of 6% in 2011 (2010: 7.3%) due partly to supply disruptions experienced by car manufacturers and dealers following the natural disasters in Thailand and Japan. New loan applications for the purchase of passenger cars continued to expand at a rate of 6.6%. By income group, the average vehicle loan size typically ranges between 1 to 2.2 times the annual income of those earning up to RM36,000 a year. The government's initiatives to improve the public transportation infrastructure, notably in the Klang Valley, will have a positive impact on the debt burden of the lower-income groups given the fact that vehicle loans account for a sizeable share of their borrowings. Based on the existing debt levels of this group, the leverage position could improve from 4.4-9.6 times of annual income to 3.3-7.4 times if vehicle financing is excluded, without taking into account future increases in income.

The share of unsecured borrowings in the form of personal loans and credit card financing to total household debts has remained stable at 20.2% of outstanding borrowings by households (Chart 1.10, 1.11, 1.12 and 1.13). Growth in personal financing continued to expand at a particularly strong pace, although its share of bank lending to households remains relatively stable at below 10% (2011: 9.1%). The growth was more pronounced among non-bank lenders which registered an increase of 24% in personal financing in 2011. In comparison, personal financing extended by banks increased

Chart 1.10

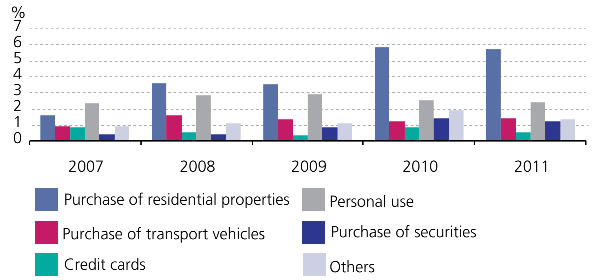
Household Sector: Growth in Debts by Components



Source: Bank Negara Malaysia

Chart 1.11

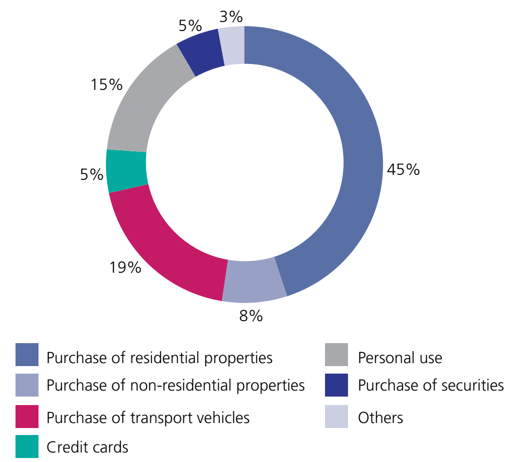
Household Sector: Contribution to Growth of Debts



Source: Bank Negara Malaysia

Chart 1.12

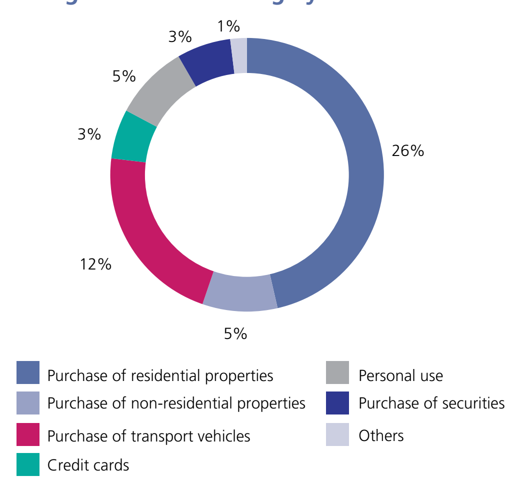
Household Sector: Debts by Composition



Source: Bank Negara Malaysia

Chart 1.13

Banking System: Financing to Households as Percentage of Total Banking System Loans



Source: Bank Negara Malaysia

by 20.6%. Including outstanding credit card balances, banks' unsecured lending to households grew by 15.4% in 2011 to reach RM82.7 billion as at end-2011. This accounted for 8.2% of total banking system loans (2010: 8.1%).

Key providers of personal financing continued to be the non-bank financial institutions such as credit co-operatives, development financial institutions and a building society, which collectively account for about 60% of outstanding personal financing to households. These lenders mainly provide financing to households in the lower- to middle-income categories under automatic salary deduction schemes where repayments are deducted at source. A maximum deduction of 60% of salary (net of taxes, contributions to the Employees Provident Fund and other direct deductions from salary) is applied under these schemes. This has, to a certain degree, helped ensure the affordability of household debts accumulated outside the banking system.

Borrowings for the purchase of securities remained high, a trend observed since 2009. For the recent three years, growth has averaged at 26.7% (2004-2008: 11.1%). This trend has been largely driven by the search for yield combined with the relative strength of the equity market despite increased volatility from higher volumes in capital flows. Financing for the purchase of securities is generally well-collateralised by the underlying securities. Moreover, 83% of such financing were for investments in fixed-priced unit trust funds managed by Amanah Saham Nasional Berhad. Risks from such financing are contained, given the small share of such financing for the purchase of securities in both the total household debts and the banking system's overall exposure to households.

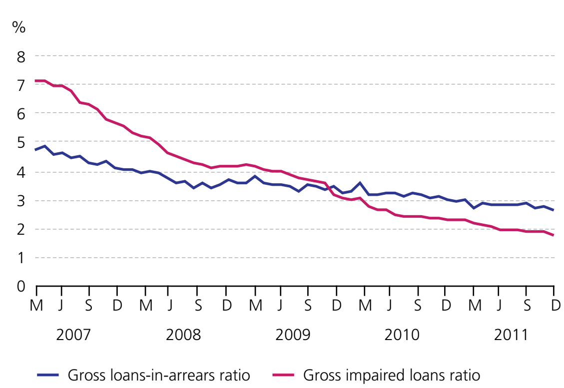
At the aggregate level, households continue to have the ability to meet their debt obligations. Overall debt servicing capacity of households continues to be supported by favourable income and employment conditions. The unemployment rate improved further to 3.1% in 2011 (2010: 3.3%), while a survey by the Bank showed that the average salaries in the private sector continued to grow by 4% in 2011 (2010: 4.5%). Repayment trends for borrowings from the banking system remained positive, with the increase in loan repayments of 12% in 2011 surpassing the rate of loan disbursements of 10.9%. The overall impaired loan ratio for the household sector improved further in 2011 to 1.8% (2010: 2.3%) and is well supported by positive indications of healthy debt servicing ability. The amount of impaired loans declined by 12.6% with decreases across almost all categories of household lending, notably in the financing for the purchase of securities and residential properties, which declined by 25.9% and 17.9% respectively. Loans-in-arrears of more than 1 month to below 3 months were also lower in 2011, moderating further to 2.6% as a proportion of household loans (2010: 3%) (Chart 1.14).

Credit cards were an exception where the amount of impaired loans (net of write-offs) rose in the second half of the year, after declining in the first half (2H 2011: +10.9%, 1H 2011: -5.9%). In addition, balances written off for credit cards increased sharply by 28.5% as compared to 5.1% in 2010. Adjusting for these write-offs, the impairment ratio for credit cards, however, remained unchanged from the previous year at 2.6%, on account of the larger base. The number of credit card holders (excluding defaulters) with revolving balances, that is, those who do not settle the outstanding balances in full, also held steady at 46.4% of total credit card holders (2010: 47.9%). Cash advances remained small at 3.6% of total credit card activities (2010: 4.1%).

While risks to financial stability are limited, as a pre-emptive measure to avert strains arising from credit card debt, the Bank tightened the requirements for credit cards in March 2011 for individuals earning a monthly gross income of RM3,000 and below. Limits were imposed on the number of credit cards and credit limits extended to these individuals so as to commensurate with

Chart 1.14

Household Sector: Delinquencies



Source: Bank Negara Malaysia

their ability to repay debt. Following the measure, the expansion in credit card revolving balances moderated sharply to 11.9% between April to December 2011 (March 2011: 20.3%). Although new applications for credit cards increased to 2.5 million (2010: 2.4 million), the number of cards approved has declined to 1.2 million (2010: 1.3 million), resulting in a lower approval-to-application ratio of 49.1% (2010: 55.1%). While outstanding balances for credit cards have increased further in 2011 (8.7%), part of this was due to the larger volume of retail credit card transactions as more Malaysians use credit cards as a payment instrument. In terms of repayment behaviour, on average, about 30% of credit card holders settle their balances in full, while almost 50% settle at least the minimum payment of 5% of total outstanding balance promptly each month. In terms of amount, about 60% of the total amount spent every month was settled in full in the following month.

For the lower-income household groups which are more vulnerable to potential financial difficulties, institutional arrangements are in place and operating effectively to provide early engagement during periods of financial stress, including through debt counselling, restructuring and consolidation which have helped to contain the probability of default and the extent of the ensuing losses. These arrangements were put in place following the Asian Financial Crisis and include early rehabilitative policies implemented by the banking institutions and AKPK. In 2011, 12,633 borrowers with outstanding borrowings totalling RM1.07 billion were enrolled in AKPK's Debt Management Programme. Since its establishment, AKPK has helped more than 50,000 borrowers with outstanding loans totalling RM4.9 billion to bring their debt under control, thus avoiding financial distress. Compared to the Asian Financial Crisis, banks have also continued to demonstrate a far more proactive role in engaging borrowers who were experiencing financial difficulties, which has contributed to averting wider incidences of defaults.

Bankruptcy cases have also shown a moderating trend in the recent three years, particularly in 2011 where the number of cases increased by 5.8% (19,167 new cases) compared with 11.7% (18,119 new cases) in the preceding year. These new cases account for only 0.3% of the number of bank borrowers.

The government has recognised the significant challenges faced by certain segments of households in an environment of rising costs of living, prompting a series of measures implemented by the government during the year to support lower-income households in coping with these challenges (Table 1.5 and 1.6). Additional measures by the Bank (Table 1.7) include the POWER! Programme and the implementation of the Guidelines on Responsible Financing with the aim of promoting responsible borrowing and financing practices (see Chapter 3). Collectively, these measures serve to ensure that this particular group of lower-income households, and the household sector in general, do not become a source of vulnerability to the financial system and economy in the future.

Efforts to contain excessive indebtedness of households and hence preserve sustainability and fundamentals of the household sector are undertaken in a holistic and collaborative manner by all key stakeholders

While the banking system remains the primary lender to households, accounting for 85% of household borrowings, the increased level of activity by non-bank lenders in recent periods calls for a coordinated response to developments in the household sector. The Bank has accordingly intensified its engagements with Suruhanjaya Koperasi Malaysia and relevant government agencies and divisions as well as directly with other large non-bank lenders to the households. This continued in 2011, with agreement reached on the coordinated adoption of key aspects of affordability assessments under the Bank's Guidelines on Responsible Financing by co-operatives and a building society. In addition, efforts are progressing towards the development of an integrated household database, combining nationwide income and debt data that will support more robust and granular assessments of risks and vulnerabilities in the household sector.

MANAGING CONTAGION FROM EXTERNAL DEVELOPMENTS

External developments which had an impact on the Malaysian financial system mainly stemmed from the renewed turbulence in global financial markets during the year as a result of heightened

Table 1.5

Measures Introduced by the Government

Objectives	Measures
To ensure sustainability of affordable housing	Revamping the Real Property Gains Tax (RPGT) structure to stem speculative activities: Residential properties sold – RPGT rate 0 up to 2 years – 10% More than 2 up to 5 years – 5% More than 5 years – 0%
	Introducing My First Home Scheme and 1Malaysia People's Housing Scheme (PR1MA)
To improve public transportation system	Improving reliability and frequency of public buses
	Integrating public transportation within the city centre
	Enhancing urban public rail transportation over the long-term including: • Launching of Sungai Buloh-Kajang MRT line • Extending the current Kelana Jaya and Ampang LRT lines
To provide financial assistance to targeted household sub-segments	Introducing the SARA 1Malaysia scheme targeted at households earning <RM3,000 per month
	Improving remuneration structure for civil servants and restructuring of annual pension scheme for retired civil servants
	One-off financial assistance e.g. RM500 cash assistance to households with monthly income of less than RM3,000
	School assistance of RM100 for primary and secondary students
	Book vouchers worth RM200 for tertiary students

Residential properties sold	RPGT rate
0 up to 2 years	10%
More than 2 up to 5 years	5%
More than 5 years	0%

Table 1.6

Home Ownership Programmes by the Government

The My First Home Scheme and 1Malaysia People's Housing Scheme (PR1MA) introduced by the government aim to encourage home ownership for the lower- to middle-income groups at affordable prices. To ensure that such schemes do not add excessive debt burdens on these individuals and that the repayment obligation is within the affordable capacity of the individuals, applications for such borrowings will be subjected to the same underwriting standards and credit worthiness assessments as other prospective borrowers of the banks. This is an important consideration to ensure that the household sector, particularly this target group, does not become a source of instability going forward.

My First Home Scheme is targeted at young adults earning less than RM3,000 a month to purchase their first residential property within the price range of RM100,000 to RM220,000 (raised to RM400,000 since January 2012 to facilitate joint borrowings by husband and wife with a combined monthly income of less than RM 6,000). Under this scheme, Cagamas Berhad will provide insurance over the 10% down payment.

1Malaysia Housing Programme Corporation is the sole agency to plan and coordinate PR1MA projects specifically targeted for the middle income group. The agency is responsible to oversee the construction and distribution of houses under the scheme to first-time home buyers earning RM6,000 and below per month. Eligible borrowers will benefit from stamp duty exemption on the loan instruments for the purchase of houses.

Table 1.7

Measures Introduced by the Bank

Objectives	Measures
Macroprudential measures to ensure prudent expansion of credit	Higher risk-weights for personal loans with tenure of >5 years, housing loans with LTV>90%, to heighten banks' resilience over risky portfolios
	Concept Paper on Guidelines on Risk-Informed Pricing for Retail Loans/Financing to ensure pricing of financing products commensurates with risks assumed
To promote responsible behaviour of individuals and financial institutions	POWER! Programme targeted at young working individuals
	Guidelines on Responsible Financing targeted to promote stricter underwriting standards for banks. Similar requirements have been extended to co-operatives and a building society
	Stricter credit card requirements to promote responsible behaviour in the usage of credit cards
To promote sustainable property market and contain speculative behaviours	Maximum LTV ratio for third housing loan and above at 70%, to curb speculative activities in the residential property market
	Imposed LTV of 60% for housing loans by non-individuals to streamline the requirement across all borrowers

concerns over the uncertainties relating to the resolution of the sovereign debt in Europe, and to a lesser degree, the US. This led to dislocations in the funding markets in the form of higher funding costs and a general contraction in market liquidity. These conditions further compounded strains on global banks with significant exposures to the European periphery countries and funding structures that remained extensively reliant on short-term wholesale funding. The capital positions of European banks also came under considerable stress as a result of mounting credit and market losses amid weak economic conditions and elevated volatility in the financial markets, as well as stricter regulatory requirements under Basel III. This in turn raised concerns that deleveraging by European banks would further restrain credit availability and reignite negative feedback loops with the real economy.

The Malaysian financial system weathered the externally-generated volatility and challenges well. This was mainly attributed to the limited exposures to counterparties in Europe and low reliance by Malaysian banks on offshore wholesale funding. The deleveraging activities by European based financial institutions are not expected to have material adverse consequences on domestic financial intermediation and overall stability

Although not immune to these developments, the impact on the Malaysian financial system has been well contained. This was supported by: (i) the orderly intermediation of short-term portfolio flows; (ii) low reliance by Malaysian banks on external funding from offshore wholesale markets; (iii) limited credit exposures of Malaysian financial institutions to counterparties in Europe, including business corporations; (iv) limited impact from deleveraging activities by European banks; and (v) sound capital and funding positions supporting the offshore operations of Malaysian banks.

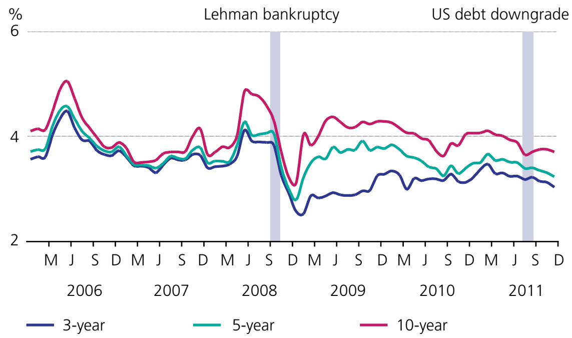
Orderly intermediation of short-term portfolio flows

The search for yield in a global low interest rate environment and heightened risk aversion in the major advanced economies led to a surge in portfolio investment flows into Malaysia during the first half of the year. As a result, portfolio investment registered net inflows of RM56.4 billion, more than double the amount recorded during the corresponding period of the previous year. Intensified uncertainty, particularly in Europe, caused inflows to reverse in the second half of the year. This resulted in net inflows of RM30.3 billion for the year as a whole, mainly concentrated in the public debt securities market. Non-resident holdings of public debt securities correspondingly rose to 29.9% of outstanding public debt securities as at end-2011 (end-2010: 24%), mostly held in the Bank Negara Monetary Notes (BNMN) and Malaysian Government Securities (MGS). Non-resident holdings of equity securities, measured as the proportion of number of shares outstanding, remained relatively stable (end-2011: 17.6%; end-2010: 17.1%). While strong demand for MGS led to some price appreciation, with yields declining at the shorter-end of the maturity spectrum, the deeper and more diversified domestic financial markets supported the smooth intermediation of these short-term capital flows without disruptive effects on the domestic financial markets (Chart 1.15, 1.16 and 1.17). Volatility in the domestic equity market increased to average at 11.6% in the second half of the year (1H 2011: 9%) but remained significantly lower than the levels observed during the height of the Global Financial Crisis in 2008 (20.9%). In comparison to regional peers, the volatility of the FBM KLCI was also considerably lower at about half the volatility level observed regionally (Chart 1.18). While bouts of volatility saw some large domestic institutional investors paring down holdings of equities during the year, this had limited impact on market conditions. As at end-2011, the portfolio investments of pension and provident funds (Chart 1.19) accounted for 11.1% of Bursa Malaysia's market capitalisation and 25.1% of outstanding debt securities (2010: 10.5% and 25.9% respectively).

Malaysian banks have remained prudent with no evidence to suggest significant shifts in risk-taking behaviour or an increased appetite for large

Chart 1.15

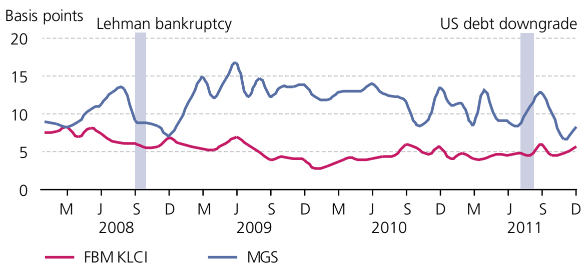
Financial Market: MGS Yields



Source: Bloomberg

Chart 1.16

Financial Market: Average Bid-ask Spreads of Equity and MGS

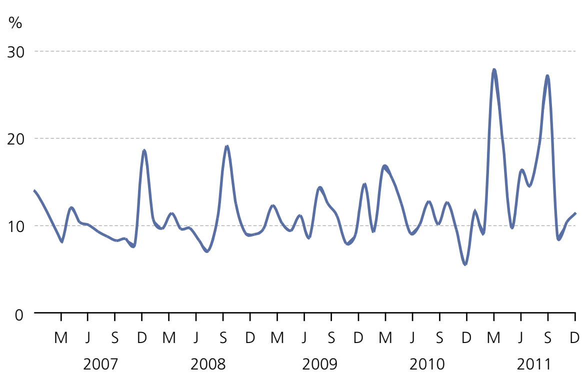


Source: Bloomberg and Reuters

unhedged market risk exposures. Notwithstanding ample liquidity conditions in the domestic market and persistent wide interest rate differentials between emerging and advanced economies,

Chart 1.17

Financial Market: MGS Monthly Turnover Ratio

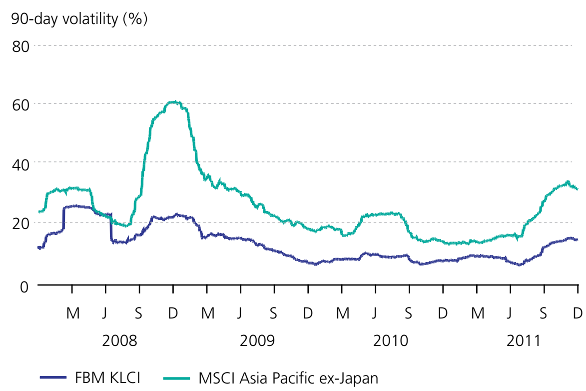


Source: Bank Negara Malaysia and internal computation

banks have not taken on excessive risks. This was reflected in the relatively stable aggregate interest rate exposure of the banking system during the year. Banks remained active in using derivative instruments to hedge and manage interest rate risk, resulting in a higher outstanding notional amount of interest rate derivative contracts, which expanded by 7.4% to RM706.6 billion as at end-2011. The size of basis risk remained manageable as the spreads between MGS and interest rate swap rates progressively converged across all maturities towards the end of 2011. Despite higher volatility in the bond market, the duration-weighted interest rate risk position of banks was unchanged to account for 4.9% of capital base as at end-2011.

Chart 1.18

Financial Market: Domestic Equity Volatility against Regional Benchmark

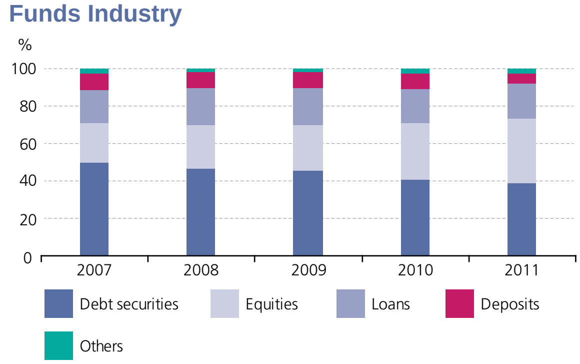


*The MSCI Asia Pacific excluding Japan index is a capitalisation-weighted index that monitors the performance of stocks from the Asia Pacific region excluding Japan

Source: Bloomberg

Chart 1.19

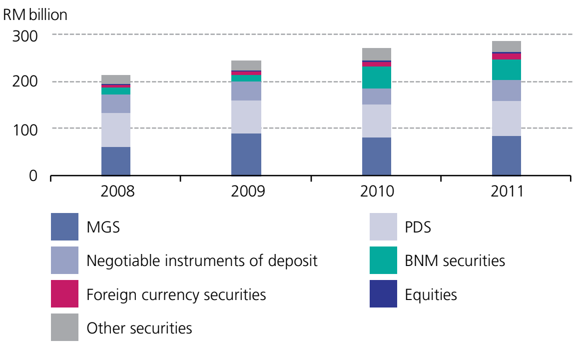
Composition of Assets for Provident and Pension Funds Industry



Source: Bank Negara Malaysia survey

Chart 1.20

Banking System: Composition of Securities Portfolio



Source: Bank Negara Malaysia

Chart 1.21

Banking System: Equity and Interest Rate Risk (as % of Capital Base)

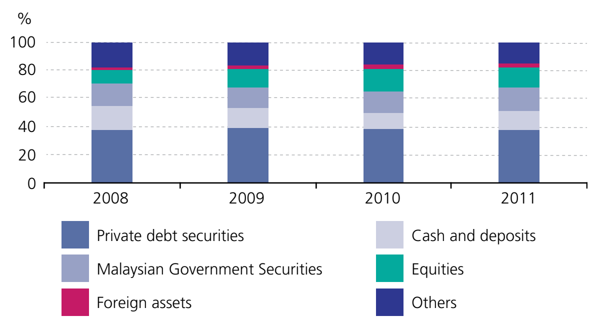
Source: Bank Negara Malaysia

While the trading portfolio of banks grew by 14.4% during the year, on account of higher holdings of assets such as Negotiable Instruments of Deposits (NIDs) and BNM papers, the structural composition of banks' treasury assets in both local and foreign currency denominations remained largely unchanged. Holdings of government and BNM papers continued to dominate the trading book of banks, expanding by 2.3% to account for 53.1% of the banking system securities portfolio (Chart 1.20). Banks' equity holdings declined during the year to account for 0.9% of total capital base as at end-2011 (2010: 1.2% of capital base) (Chart 1.21). The active management of market risk positions enabled banks to post continued net gains from trading activities and investment portfolios which expanded by 30.1% and 44.3% respectively during the year.

In the insurance industry, the composition of insurance fund assets (including takaful business) remained similarly stable with private debt securities (PDS) continuing to form the majority of assets held (end-2011: 37.3%; end-2010: 38.6% of total assets). Market and credit risk exposures arising from holdings of PDS remained manageable with the bulk of PDS (88.1%) held in high-grade papers (rated 'A' and above). Insurers reduced holdings in equities during the year to RM29 billion or 14.7% of assets as at end-2011 (2010: RM30.1 billion or 16.5% of industry assets), in favour of less risky assets such as MGS and fixed deposits which accounted for 17% and 13.6% of the industry's total assets respectively (2010: 15.5% and 11.2% respectively). The rebalancing of investments maintained the market risk exposures of insurers at 12.6% of capital available (2010: 12.5%), with interest rate risk from higher investments in MGS partly offset by lower equity risk exposures. Collectively, equity and interest rate risks formed 84.6% of insurers' total market risk exposures (Chart 1.22 and 1.23).

Chart 1.22

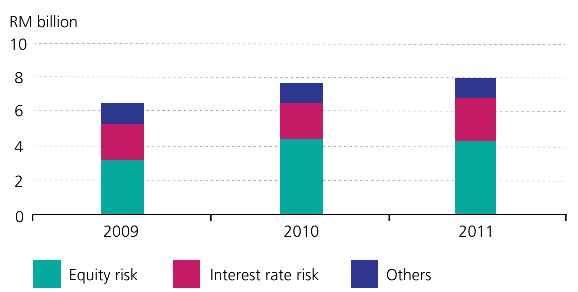
Insurance Sector: Composition of Assets



Source: Bank Negara Malaysia

Chart 1.23

Insurance Sector: Components of Market Risk Exposure



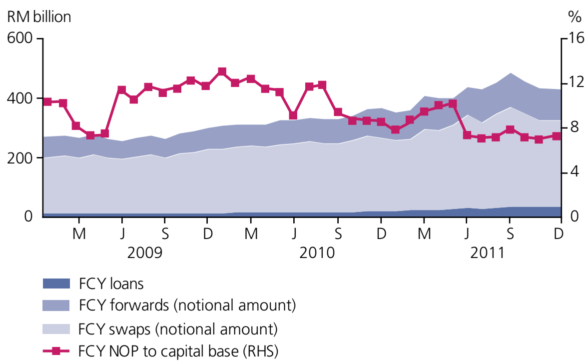
Source: Bank Negara Malaysia

The overall foreign currency net open position (NOP) of the banking system remained manageable at 7.2% of capital base as at end-2011 (end-2010: 8.9%) (Chart 1.24). The open position was primarily attributed to currency swap and forward contracts arising from continued demand by businesses to better manage exchange rate-related risks, interbank transactions, as well as lending in foreign currency (Chart 1.25). Banks were proactive in managing these exposures, particularly given the tighter global US dollar liquidity conditions, resulting in a manageable net US dollar open position of 1.2% of capital base as at end-2011 (2010: 1.7%). Net positions in other major currencies such as the euro, Hong Kong dollar, Singapore dollar and Indonesian rupiah were less than 1% of capital base respectively. A small number of banks that exhibited wider NOP have pared down the foreign currency exposures in the second half of the year in anticipation of more volatile currency movements. Overall liquidity mismatches of the banking system remained manageable, supported by strong liquidity buffers at 18.3% of total customer deposits for maturities of less than one week (Chart 1.26). Banking system liquidity gaps in foreign currency widened temporarily in the fourth quarter, following the reversals of portfolio flows but remained below the peak recorded in 2008. The foreign currency liquidity negative gap for the less-than-one-month maturity bucket continued to narrow to RM8.9 billion as at end-2011 (end-2010: RM13.9 billion) (Chart 1.27). Exposures of the insurance sector to foreign assets remained small at 8.5% of capital base. Foreign investments of insurance funds (excluding funds supporting businesses outside Malaysia) are subject to a prudential limit of 10% of total assets for each individual fund.

The increased volatility in the financial markets has had limited impact on the financial positions of Malaysian businesses. Malaysian corporations with large foreign borrowings benefited from the strengthening of the ringgit in the first seven months of the year through lower debt servicing amounts in ringgit equivalent. Export-led firms, however, were affected by lower ringgit receipts on the weakening of the US dollar, although sustained external demand and firm commodity prices during the year provided support to the businesses in maintaining overall profitability. While external

Chart 1.24

Banking System: Foreign Currency Net Open Position (FCY NOP)

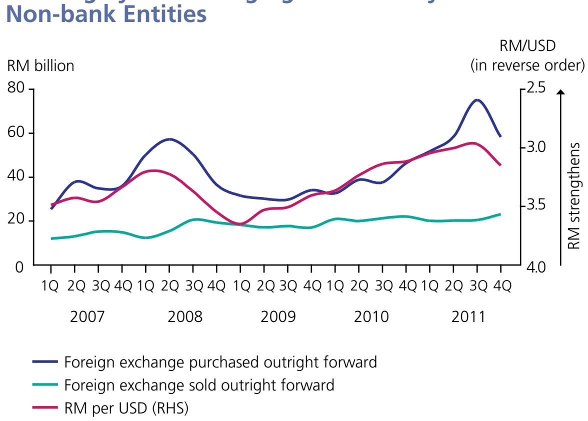


Note: The computation of FCY NOP to capital base is based on Basel II Standardised Approach for Market Risk for foreign exchange risk

Source: Bank Negara Malaysia

Chart 1.25

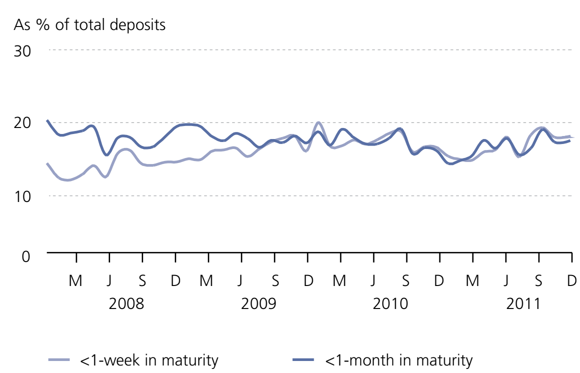
Banking System: Hedging Activities by Domestic Non-bank Entities



Source: Bank Negara Malaysia

Chart 1.26

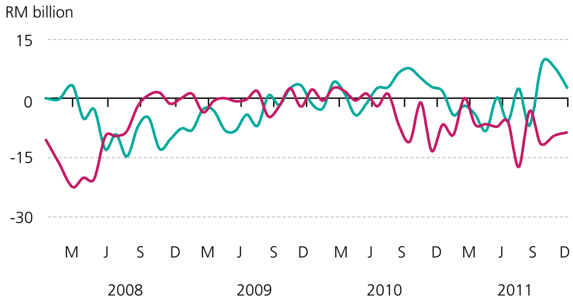
Banking System: Liquidity Buffer



Source: Bank Negara Malaysia

Chart 1.27

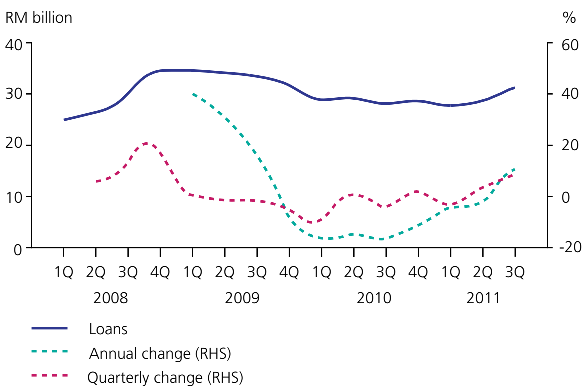
Banking System: Foreign Currency Liquidity Mismatch



Source: Bank Negara Malaysia

Chart 1.28

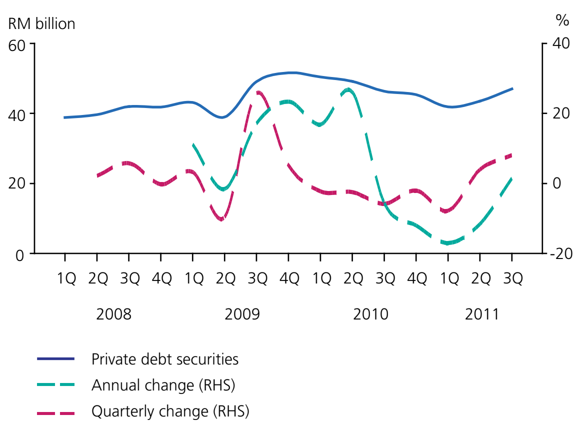
Business Sector: External Loans in USD



Source: Bank Negara Malaysia

Chart 1.29

Business Sector: External Debt Securities in US Dollar



Source: Bank Negara Malaysia

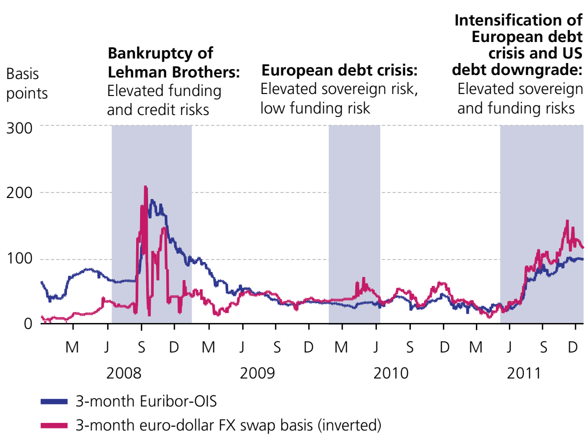
loans of Malaysian corporations increased by 8%, mostly in US dollar borrowings, this did not imply a generalised increase in reliance on borrowings from abroad. The overall external debt position (loans and debt securities) of Malaysian corporations was in fact lower, compared to 2008-2009 (Chart 1.28 and 1.29). Overseas expansion by larger corporations continued to be funded internally through inter-company borrowings or through borrowings from the domestic banking system or the capital market. The exposures of businesses to foreign exchange movements, particularly in the export-oriented industries such as the electronics & electrical (E&E) and palm oil sectors, are also largely hedged. Residual credit exposures of the banking system to export-oriented resource-based industries with unhedged positions remained limited at less than 5% of outstanding business loans.

Limited impact from tighter global US dollar liquidity conditions

While the liquidity strains in the euro zone money markets, to a large extent, affected US dollar funding conditions in most Asian markets (Chart 1.30 and 1.31), the Malaysian banking sector was not significantly impacted. Malaysian banks are less reliant on external funding, including funding from offshore wholesale markets, which accounted for less than 9% of total funding and hence were less exposed to adverse developments in international funding markets (Chart 1.32). The prevalent ringgit deposit-based funding structure among Malaysian banks has been well supported by the continued strong growth in savings and deposits, and ample domestic liquidity. This limits the

Chart 1.30

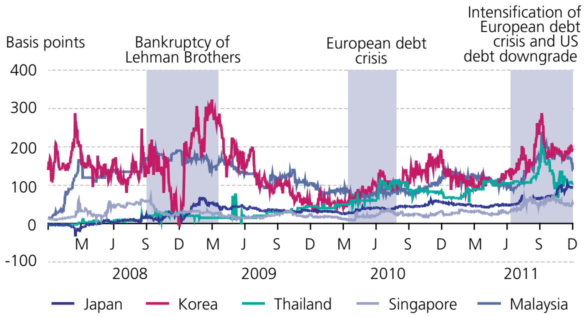
Euro Area Funding and Dollar Liquidity Risks



Source: Bloomberg

Chart 1.31

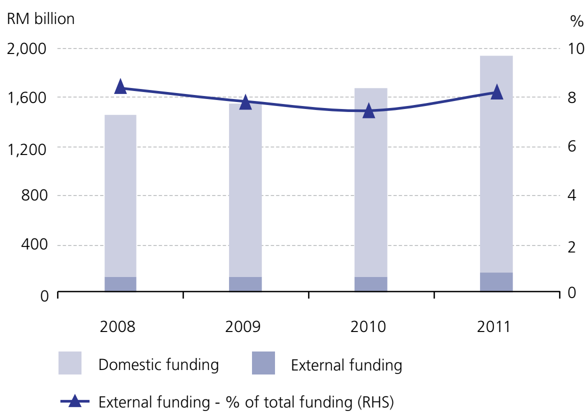
Cross-currency Basis Swap Spread of Selected Asian Countries



Source: Bloomberg

Chart 1.32

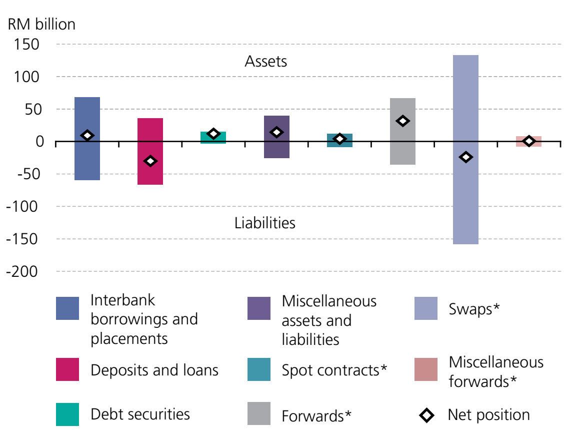
Banking System: External Funding to Total Funding



Source: Bank Negara Malaysia

Chart 1.33

Banking System: Foreign Currency Denominated Assets and Liabilities

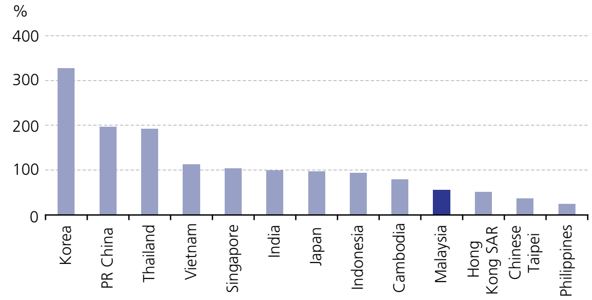


* In notional amount

Source: Bank Negara Malaysia

Chart 1.34

Country Comparison of Banks' Foreign Currency Loan-to-Deposit Ratios



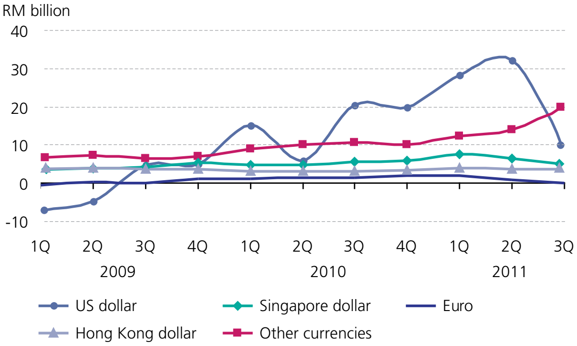
Source: Moody's Investors Service and Bank Negara Malaysia

need for cross-currency funding (borrowing in one currency to fund assets in another currency) from offshore wholesale markets to support credit growth. As a result, the banking system's foreign currency funding gap remained stable and small at RM5.8 billion or 3.5% of capital base (Chart 1.33). In addition, Malaysian banks have not built up excessive cross-border currency or maturity mismatches from its external exposures to non-resident counterparties. While there was increased demand for foreign currency loans by foreign banks and non-bank entities in 2011 (+57.7%), Malaysian banks' non-ringgit loans remained small at 2% of total assets and were well supported by the robust growth (+24%) in foreign currency deposits during the year (Chart 1.34). Furthermore, the foreign claims of the banking system continued to exceed foreign liabilities, reflecting the relatively stable and balanced net external asset positions for exposures denominated in US dollar, Singapore dollar, euro and other foreign currencies (Chart 1.35). Given the limited accumulation of US dollar-denominated investments that were funded by short-term unsecured borrowings, Malaysian banks are less vulnerable to heightened roll-over risks that could arise from further disruptions in the US dollar wholesale funding markets.

Despite this, moderate spillover effects from the tightened US dollar conditions in the euro area were felt in the domestic markets. The general increase in risk aversion and the consequent outflows of foreign funds led to a more cautious attitude among Malaysian banks in the second half of the year to preserve foreign currency funds for their own needs. The resultant tighter onshore US dollar liquidity conditions caused the 5-year USD/RM cross-currency swap rate

Chart 1.35

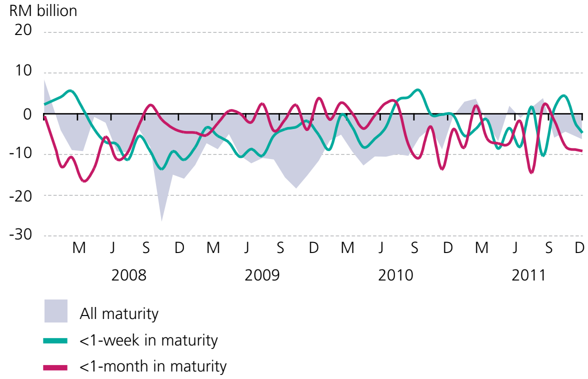
Banking System: Net External Position by Major Foreign Currency



Source: Bank Negara Malaysia

Chart 1.36

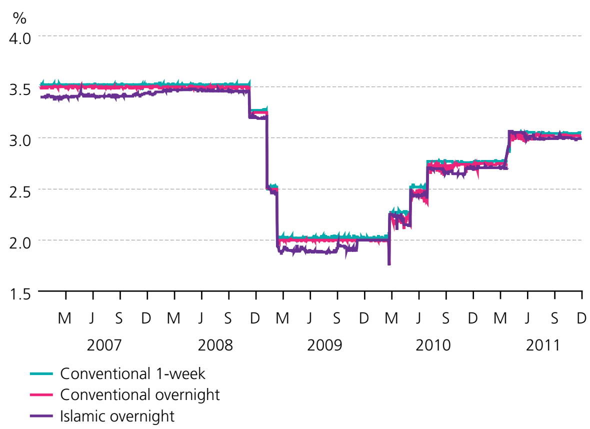
Banking System: US Dollar Liquidity Mismatch



Source: Bank Negara Malaysia

Chart 1.37

Banking System: Conventional and Islamic Interbank Rates



Source: Bank Negara Malaysia

to widen to 240 basis points below KLIBOR, the widest level since 2008 (200 basis points). In response to these developments, banks were more proactive in managing US dollar exposures, including through the centralised liquidity management of US dollar funds within the banking group, the closer monitoring of US dollar maturity mismatches and limiting the accumulation of new longer-term foreign currency assets. Banks with larger exposures also increased their medium-term funding to ensure a more balanced composition of foreign currency funds by maturity. The pre-emptive responses by banks have ensured that the overall US dollar liquidity mismatches in the banking system remained low in comparison with the period prior to the height of the Global Financial Crisis in 2008 (Chart 1.36). The extensive use of the European Central Bank's deposit facility by euro area banks underscored the return of heightened interbank counterparty concerns, pushing the Euribor-OIS spread to its widest level since April 2009. While most European banks operating as branches across the euro area faced more funding pressures due to withdrawals of intra-group financing at the parent level, the locally-incorporated subsidiaries of European banks (LIEBs) operating in Malaysia, which fund their domestic operations primarily through ringgit deposits, continued to operate under ample liquidity conditions. The ringgit interbank rates continued to remain stable across all maturities throughout the year, with little sign of market segmentation or heightened counterparty risk aversion in relation to the LIEBs operating in Malaysia (Chart 1.37).

Enhancements to financial safety nets, both at the domestic and regional levels, have reinforced the banking system's resilience to a potential further deterioration in funding conditions. In addition to the Chiang Mai Initiative Multilateralisation, which is a multilateral currency swap arrangement among ASEAN plus three countries, the establishment of reciprocal cross-border collateral arrangements between the Bank and a number of central banks in the region further expanded avenues for regionally active financial institutions to manage their liquidity needs with greater efficiency across markets. It also serves to alleviate funding shocks that may be propagated from any global scale shortage of foreign currency liquidity. The Bank has also expanded the list of eligible collateral that financial institutions can pledge to obtain ringgit liquidity from the Bank, previously restricted to ringgit-denominated securities only, to include local and foreign currency-denominated securities issued by governments and central banks of the Executives' Meeting of East Asia Pacific Central Banks (EMEAP) member countries, and securities issued by multilateral development banks denominated in US dollar, euro, yen and sterling pound.

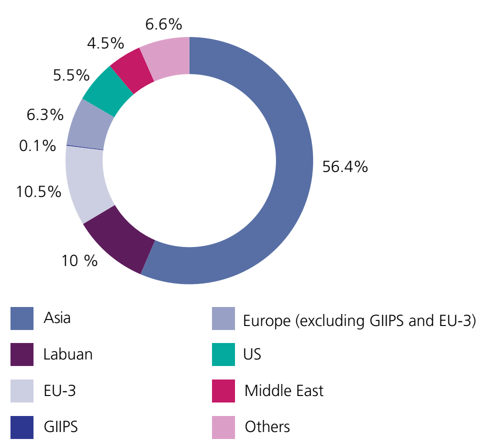
Limited credit risks from external claims of financial institutions and exposures to domestic export-oriented industries with trade relations with European countries

External claims by Malaysian banks on all counterparties domiciled in Greece, Ireland, Italy, Portugal and Spain (GIIPS) remained limited at RM0.2 billion or 0.1% of total external asset exposures (Chart 1.38). Approximately 87% of these claims were in the form of long-term loans to non-bank private entities, while the remainder comprised interbank deposits and nostro account balances with correspondent banks to facilitate currency settlements (Chart 1.39). Assuming a 100% loss given default for all asset exposures to GIIPS, the potential credit loss to Malaysian banks would only amount to 0.1% of capital base. The simulated impact at the individual bank level is similarly small ranging between 0.01% and 1.3% of capital base. Claims on GIIPS originated from offshore banks in Labuan amounted to only RM4 million.

While the escalation of sovereign debt and banking sector concerns has broadened beyond vulnerable peripheral economies, external asset exposures of the Malaysian financial system to other European counterparties were also well contained. Malaysian banking institutions' external claims on the rest of Europe (ex-GIIPS) of RM23 billion accounted for 1.3% of total assets or 16.8% of the banking system's total external assets. Including claims from Labuan banks which amounted to RM4.8 billion, the external asset exposures to Europe (ex-GIIPS) accounted for 15.5% of the combined external assets of onshore and offshore banks. Approximately 63% of such claims were claims on counterparties in Germany, France and the United Kingdom (EU-3) and comprised mainly interbank deposits placements and nostro account balances held by domestic banks and LIEBs (Chart 1.40). The rating downgrades and declines in the market

Chart 1.38

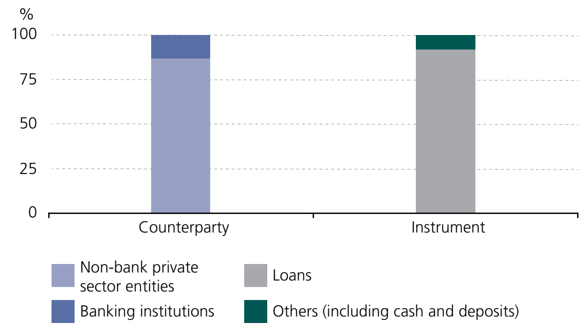
Banking System: Composition of External Claims by Region or Country



Source: Bank Negara Malaysia

Chart 1.39

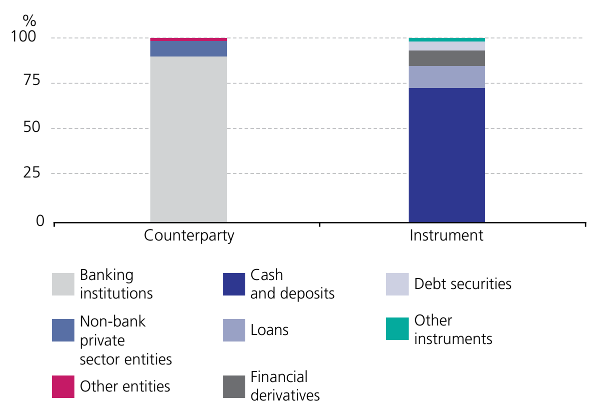
Banking System: Composition of Claims on GIIPS by Counterparty and Instrument



Source: Bank Negara Malaysia

Chart 1.40

Banking System: Composition of External Claims on Europe (excluding GIIPS) by Counterparty and Instrument



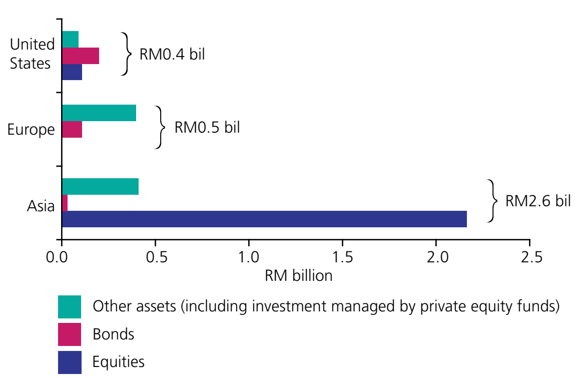
Source: Bank Negara Malaysia

capitalisation of euro area banks during the year had no material impact on Malaysian banks' capital positions as the international ratings of their European counterparties were generally maintained. Other claims arising from derivatives transactions, holdings of money market instruments, debt and equity securities issued by European counterparties (ex-GIIPS) were also largely concentrated with EU-3 banks and remained very small at less than 0.2% of total assets or 2.1% of capital base. In the event of heightened market volatility, the potential trading and valuation losses incurred by Malaysian banks from such exposures would be limited. In addition, credit risk exposures from term loans provided to non-bank private corporations in the euro area (ex-GIIPS) which could be affected by weaker growth prospects for the region amounted to only 1.8% of capital base. Malaysian banks are also less exposed to valuation losses arising from volatile euro currency movements as external claims denominated in the euro continued to decline during the year to account for 1.7% of capital base (end-2010: 3.3% of capital base).

External investments by the Malaysian insurance sector (including takaful business) remained small at RM5.4 billion or 2.6% of total assets or 8.5% of available capital. Almost half of the foreign assets were invested in Asia. Of this amount, external investment exposures to Europe in 2011 amounted to only RM0.5 billion (2010: RM1.2 billion) representing 0.3% of total assets or 0.8% of total capital available (Chart 1.41). These assets were invested mainly in corporate bonds and private equity funds, as insurers pared

Chart 1.41

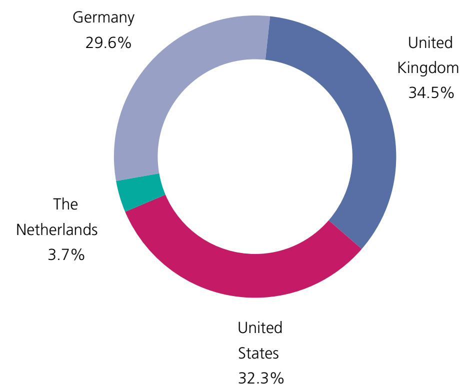
Insurance Sector: External Exposures by Type of Investments



Source: Bank Negara Malaysia

Chart 1.42

Insurance Sector: Investment Exposure to Europe and United States



Source: Bank Negara Malaysia

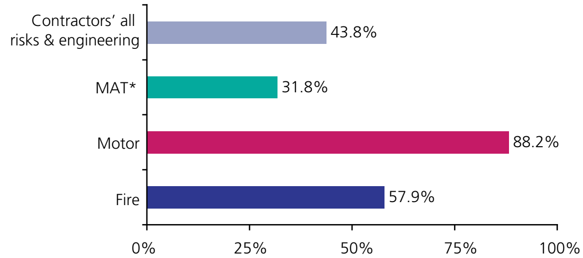
down direct investments in equity markets due to the heightened market volatility during the year. None of these investments was in entities in GIIPS, with RM0.4 billion invested in Germany and the UK (Chart 1.42).

Malaysian insurers reinsure a substantial part of risks underwritten in the global reinsurance market, either directly or through reinsurance placements with Malaysian branches of foreign reinsurers. This is more pronounced for large and specialised risks in the aviation, oil & gas and engineering classes of business, where reinsurance premium ceded amounted to 93.6%, 93.4% and 56.2% of total premiums respectively. In addition to the more challenging investment and operating conditions, global reinsurers, including those in Europe, were impacted by unprecedented losses (estimated at USD107 billion) from more than 250 catastrophic events globally in 2011. The stronger capitalisation of (re)insurers going into 2011 has helped to absorb these losses and maintain support for reinsurance needs globally, although higher reinsurance costs are likely to be experienced going forward (Chart 1.43, 1.44 and 1.45).

Total reinsurance exposures of the general insurance sector to European (re)insurers headquartered outside Malaysia stood at RM945.9 million in 2011 (2010: RM431.5 million), representing about 11.6% of total capital available. The higher exposures were attributed to higher claims incurred for large and specialised business classes. Most of these (re)insurers hail from Germany, France and Switzerland and have continued to maintain sound financial positions

Chart 1.43

Insurance Sector: Retention Ratio by Major Business Classes

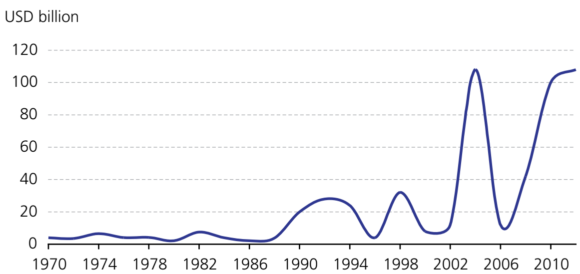


*Marine, aviation & transit

Source: Bank Negara Malaysia

Chart 1.44

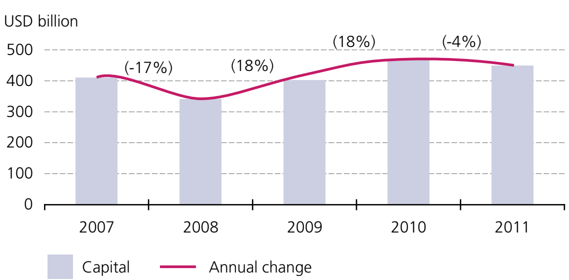
Global Catastrophe Insured Losses



Source: Guy Carpenter

Chart 1.45

Global Reinsurers Capital

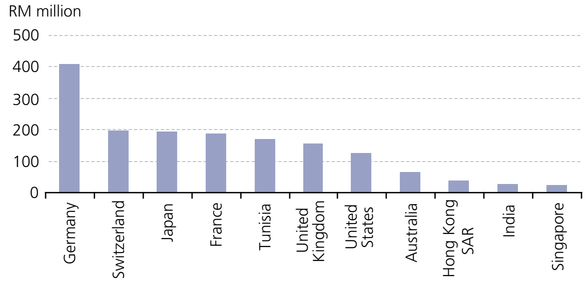


Source: Aon Benfield

and stable ratings. Of this, total exposures to the three European reinsurance branches in Malaysia remained manageable at RM257.2 million in 2011. This accounted for 9.2% of total reinsurance claims outstanding or 2.9% of general insurers' total capital available. Branches of all foreign reinsurers operating in Malaysia which are supervised by the Bank are required to set aside dedicated capital earmarked for the Malaysian operations. These

Chart 1.46

Insurance Sector: Foreign Reinsurance Exposure by Claims Outstanding



Source: Bank Negara Malaysia

branches are well supported by capital buffers, with a combined capital adequacy ratio of more than 277% against risks of the Malaysian branch operations (Chart 1.46).

Increased credit risks of banks and insurers to Malaysian export-oriented industries arising from weaker global economic growth prospects are expected to be mitigated by the continued growth in intra-regional trade and Malaysia's diversified export market base. While Malaysia's exports to the euro area currently account for approximately 10% of Malaysia's gross exports, exposures of financial institutions via loans and PDS holdings to businesses that have trade relations with the European countries accounted for only 1.6% of total outstanding loans and PDS holdings of all financial institutions.

Impact from deleveraging or scaling back of operations by European financial institutions is manageable

Escalating funding strains and capital conservation measures by a number of the major European banks have raised concerns that further deleveraging may adversely affect domestic intermediation activity and economic growth in the region. This could arise from divestments by European banks of US dollar assets in emerging economies, reduced participation in US dollar syndicated financing and withdrawal of US dollar trade financing lines to multinational companies. Since September 2011, a number of major European banks have announced plans to accelerate the disposal of non-core assets and maturing assets as well as scale back low-profitability activities globally (Chart 1.47). In the Bank's assessment, any impact from these developments on domestic financial intermediation will be manageable.

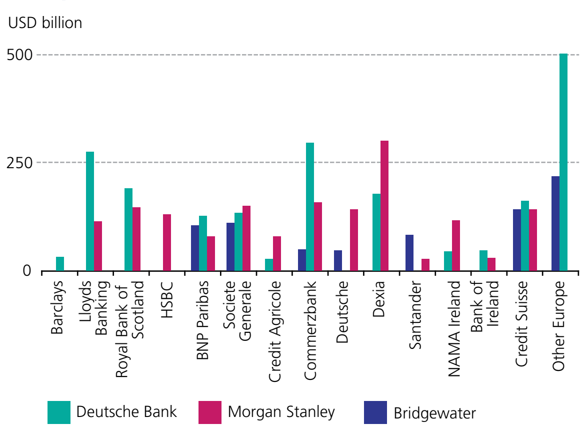
As at the third quarter of 2011, European banks' claims on Malaysia (including Labuan entities) accounted for USD54.3 billion or 19.3% of GDP based on the latest BIS Consolidated Banking Statistics. More than 60% of these consolidated claims, which amounted to USD34 billion or 12.1% of GDP, were in ringgit-denominated claims on Malaysia by European banks' affiliates located outside the home country of incorporation. Such claims reflect the operations in Malaysia which largely comprise: (i) loans to Malaysian entities; (ii) holdings of securities issued by Malaysian entities; (iii) deposits placed with Malaysian financial institutions; (iv) equity/capital investments of foreign banks in Malaysia; and (v) financial contracts e.g. derivatives, guarantees and credit commitments with all Malaysian counterparts (Chart 1.48 and Table 1.8). Excluding UK-based banks, total foreign claims by European banks on Malaysia as reported in the BIS statistics accounted for only USD13.4 billion or 5% of GDP, comparable to most regional peers (Chart 1.49).

The potential impact on Malaysia from deleveraging activities by European banks is significantly lower than implied by the BIS data. This is because the reported European banks' foreign claims on Malaysia include claims of LIEBs operating in Malaysia on all domestic financial institutions, corporations, individuals and public sector entities, which are mostly funded from ringgit-denominated liabilities. Malaysia, like many other jurisdictions in Asia, has a long history of foreign bank presence in the domestic financial system. All foreign banks in Malaysia are locally incorporated subsidiaries with dedicated capital committed to the Malaysian operations as required under the Malaysian banking legislation. There are currently seven LIEBs from the EU-3 countries with a market share of 8.9% of the banking system's total assets as at end-2011. Of these, five are from the UK with a market share of 8.2% of total banking system assets. On aggregate, the claims of LIEBs on Malaysian entities denominated in both ringgit and foreign currencies accounted for approximately USD42 billion or 14.9% of GDP.

The Malaysian operations of LIEBs are funded domestically, with over 80% in the form of local currency deposits, of which 46.9% were in the form of retail deposits. These subsidiaries are well capitalised and are subject to rigorous supervision and regulation by the Bank similar to other domestic-owned banks and other foreign banks. As part of the licensing requirement,

Chart 1.47

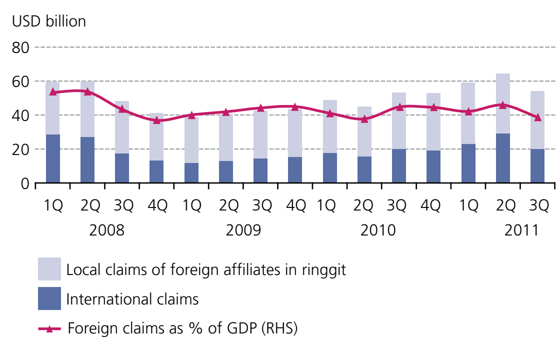
Estimates of Deleveraging Plans by Selected European Banks



Source: Deutsche Bank, Morgan Stanley, Bridgewater and internal computation

Chart 1.48

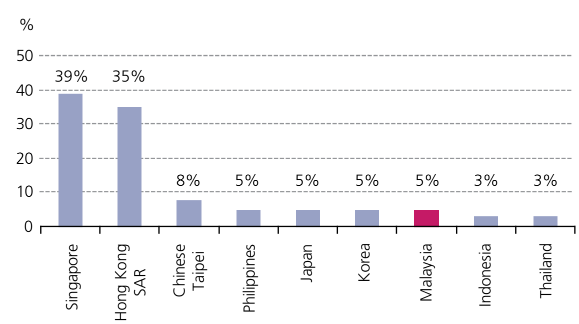
European Banks' Foreign Claims on Malaysia



Source: Bank for International Settlements, Bank Negara Malaysia and internal computation

Chart 1.49

Euro Area (excluding UK) Banks' Foreign Claims over GDP



Note: Euro area banks' foreign claims as at third quarter 2011
2011 GDP estimates by International Monetary Fund (except Malaysia)

Source: Moody's Investors Service and Bank for International Setlements

Table 1.8

European Banks' Claims on Malaysia[1]

	As % of Malaysia GDP	(A) Cross-border claims[2] of European banks on Malaysia	(B) Local claims[3] of foreign affiliates[4] of European banks in foreign currency		(C) Local claims of foreign affiliates of European banks in ringgit	
			Locally-incorporated European banks in Malaysia	Other foreign affiliates	Locally-incorporated European banks in Malaysia	Other foreign affiliates
(i) Foreign claims (A + B + C)	19.3[5]					
(ii) International claims (A + B)	7.2					
(iii) Local claims of foreign affiliates in ringgit (C)	12.1					
(iv) Claims of seven LIEBs	14.9					

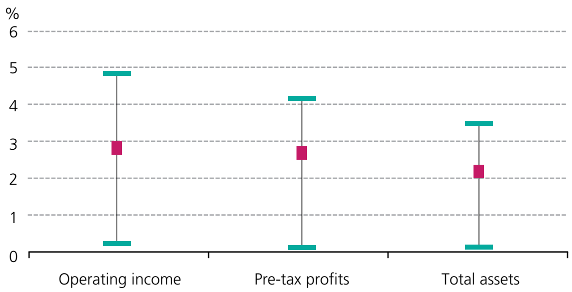
Note: [1] Each claim in row (i) to (iv) refers to the sum of corresponding shaded columns. Claims in row (i) to (iii) are based on BIS Consolidated Banking Statistics. Claims in row (iv) are estimated from the ringgit and foreign currency denominated total outstanding loans, net interbank placement with Bank Negara Malaysia, securities held and capital base of the seven LIEBs
[2] Claims that are granted or extended to non-residents
[3] Claims of reporting banks' foreign affiliates (branches and subsidiaries) on the residents of the host country (country of residence of affiliates)
[4] Foreign affiliates refer to foreign subsidiaries and branches of reporting banks
[5] UK banks' foreign claims on Malaysia based on BIS Statistics accounted for 14.3% of GDP
[6] Consolidated claims of domestic banking groups, i.e. domestic banks with head offices in a given country and their foreign offices (branches and subsidiaries)

Source: BIS Consolidated Banking Statistics[6] (immediate risk basis) and internal computation

all foreign banks are required under the law to hold minimum capital funds of RM300 million for the Malaysian operations. Years of profitable operations in Malaysia have seen these banks build strong capital positions to support the local operations. As at end-2011, the LIEBs have a combined capital base amounting to RM11.5 billion and a risk-weighted capital ratio (RWCR) of 12.9%. Excess capital stood at RM4 billion above the minimum regulatory requirement. Given the strong and consistent financial performance and sustainable returns of the Malaysian operations of the LIEBs, a material scale back of Malaysian operations as a result of deleveraging by European banks is not expected (Chart 1.50 and 1.51). This is supported by data showing that throughout 2011 and to date, the domestic market share of these LIEBs by assets (8.9% of banking system assets), financing (7.2% of total financing by banking system) and deposits accepted (8.7% of total conventional and Islamic banking system deposits) have remained stable. There was also no observed surge in special dividend payments to the parent bank during this period. The requirement for the Bank's prior approval of any repatriation of capital reserves further mitigates future implications from capital conservation measures taken at the parent level. Even in an unlikely event of a wide-scale retreat of European banks from the Malaysian market, domestic intermediation activity would continue to be well supported by other domestic-owned and non-European banks in Malaysia that are well capitalised and have strong liquidity positions to ensure continued access to financing. These banks have a combined excess capital of about RM70 billion and RM132 billion in excess funds placed with the Bank via the interbank market, thus providing ample liquidity in the Malaysian banking system to meet the financing and funding requirements of domestic borrowers.

Chart 1.50

Range of Revenue and Asset Contribution of Five LIEBs to Parent Group



Source: Bank Negara Malaysia

In the insurance sector (including takaful business), European-based insurers accounted for 16% of total assets or 27.6% of total premium of the sector. Thus far, there has been similarly no sign of scaling back of the Malaysian operations by the European-based insurers, also due partly to the subsidiarisation of these entities in Malaysia, as well as the continued strong credit standings of the parent entities, which are mainly headquartered in Switzerland, United Kingdom, the Netherlands and Germany. The domestic-owned insurers and other non-European insurers operating in Malaysia also have strong capital positions with excess capital buffers of RM6.8 billion and the capacity to provide support for domestic risks if a pullback by European insurers were to occur.

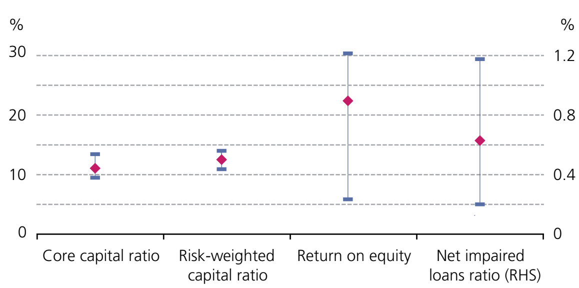
Given the low reliance on external borrowings by Malaysian corporations to fund their activities, any withdrawal of cross-border financing by the European banks is not expected to have a significant impact on the funding needs of resident companies. While some companies borrowed from abroad to fund the overseas operations or to leverage on competitive financing rates, external borrowings by Malaysian corporations from banks domiciled in Europe amounted to only RM1.7 billion, the bulk of which were by European-based manufacturing and aviation companies.

Limited spillovers from cross-border operations

The transmission of risks from the expanded cross-border operations of Malaysian banks is limited on account of several factors. Traditional lending activities continued to be the main contributor to the growth of foreign branches and subsidiaries of domestic banking groups, accounting for 75% of total assets of overseas operations. The bulk of this lending is extended to the corporate and commercial sectors for working capital purposes and through bank guarantees and letters of credit to facilitate international trading activities (Chart 1.52 and 1.53). Retail loans extended are largely secured, mostly for the purchase of residential properties, while unsecured financing accounted for only 16% of the total outstanding loans of overseas operations. The operations of overseas subsidiaries of the Malaysian banks are also largely funded by stable sources of local funding in the relevant markets, including deposits which accounted for more than half of total funding (Chart 1.54). The relatively stable loan-to-deposit ratios combined with improved group-wide risk management systems and practices contribute towards mitigating any

Chart 1.51

Banking System: Range of Key Financial Soundness Indicators of LIEBs

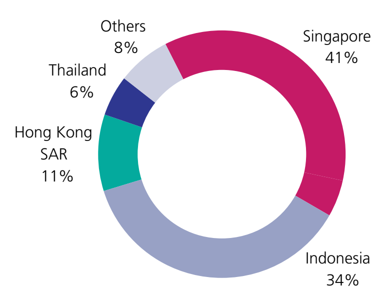


Note: Excludes one newly established LIEB

Source: Bank Negara Malaysia

Chart 1.52

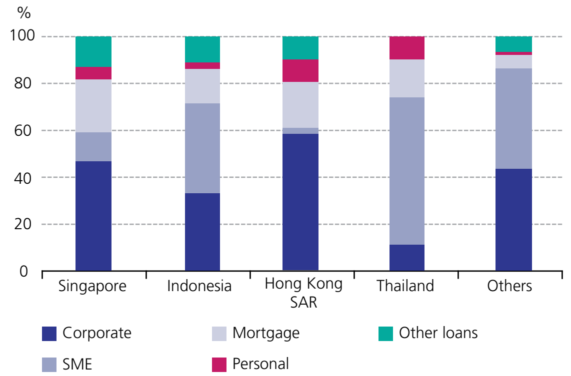
Banking System: Asset Composition of Overseas Operations



Source: Bank Negara Malaysia

Chart 1.53

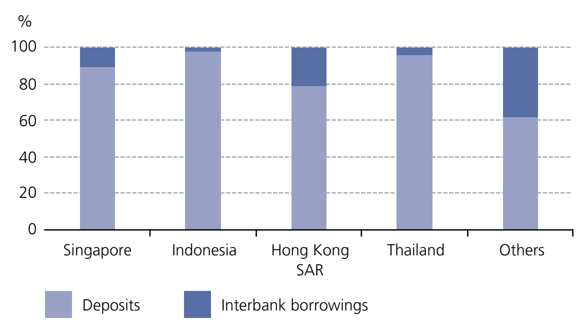
Banking System: Loan Composition of Overseas Operations by Type and Country



Source: Bank Negara Malaysia

Chart 1.54

Banking System: Funding Structure of Overseas Operations



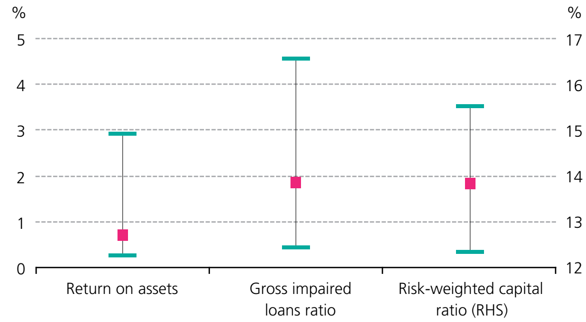
Source: Bank Negara Malaysia

risk of potential funding pressures in the overseas operations of Malaysian banks from propagating across borders to the domestic operations.

The financial position of major overseas establishments of domestic banking groups remained strong with sustained profitability (Chart 1.55). The contribution of all overseas operations to domestic banking groups' profitability ranged between 2% and 35% for individual banking groups. Capitalisation levels of foreign subsidiaries also remained sound, supported by the independent generation of capital from strong earnings. The RWCR of these overseas subsidiaries, computed based on Basel II requirements, ranged between 12.3% and 30.1% as at end-2011. The high level of capitalisation provides adequate buffers against potential credit and market losses in the more challenging external

Chart 1.55

Banking System: Range of Key Financial Soundness Indicators for Major Overseas Operations



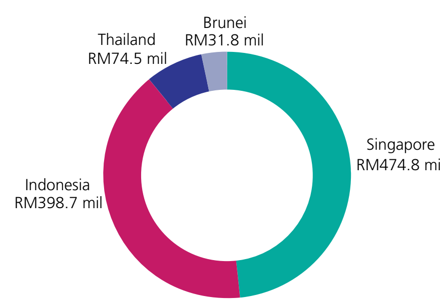
Source: Bank Negara Malaysia

environment. With robust risk management practices and high asset quality both at the foreign entity and group-wide levels, the overall credit risk emanating from the overseas operations of domestic banking groups remained manageable. The asset quality of foreign operations of domestic banking groups remained stable, with sustained declines in the levels of impaired loans. The median gross impaired loans ratio for all foreign subsidiaries of domestic banking groups stood at 2.4% of total outstanding loans from overseas operations. The cross-border operations of domestic insurers remained small with total assets of RM979.8 million (amounting to only 0.5% of total insurance industry assets) spanning four countries in 2011 (2010: RM970.6 million) (Chart 1.56).

The Bank adopts a consolidated approach for the supervision of domestic financial institutions. This includes assessing risks that could emanate

Chart 1.56

Insurance Sector: Asset Size of Overseas Operations



Source: Bank Negara Malaysia

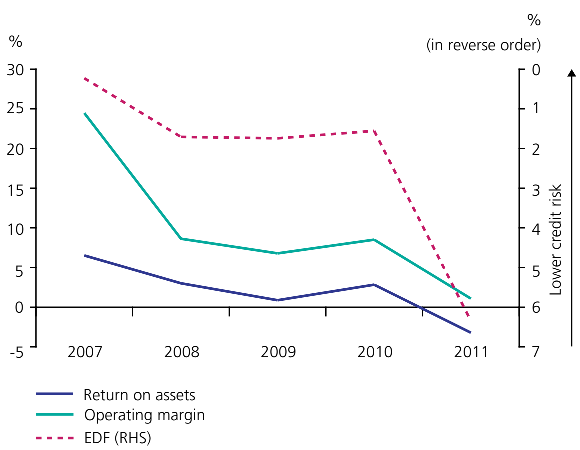
from overseas operations of domestic financial institutions. This is also supported by the ongoing exchange of information between home and host supervisors on developments in local economic and financial conditions, and on supervisory concerns and actions. In 2011 and early 2012, the Bank hosted supervisory colleges for two domestic banking groups with significant cross-border operations. These home-host engagements support the early identification of entity and group-wide vulnerabilities and timely supervisory responses. The ongoing engagements and supervisory assessments to date reaffirm the resilience of the domestic financial institutions to external shocks, both at the entity and group levels.

OTHER DEVELOPMENTS AND RISK AREAS

Domestic business conditions were supported by strong domestic demand and the continued expansion of intra-regional trade. This was, however, moderated to varying degrees, by operating costs which remained elevated amid high prices of raw materials and revised tariffs for electricity and natural gas, and weaker external demand from advanced economies. As a result, credit risk, as measured by the Expected Default Frequency (EDF), trended slightly higher during the year, with more pronounced increases observed in particular in the shipping and building- and construction-related materials (BCM) industries, and to a lesser extent, E&E industry (Chart 1.57, 1.58 and 1.59).

Chart 1.57

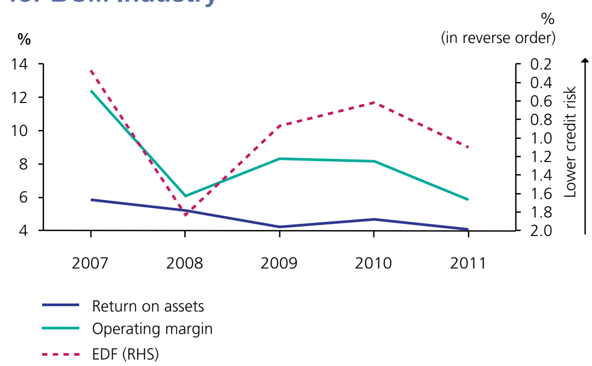
Business Sector: Profitability and EDF for Shipping Industry



Source: Moody's KMV Credit Edge™, Bloomberg and internal computation

Chart 1.58

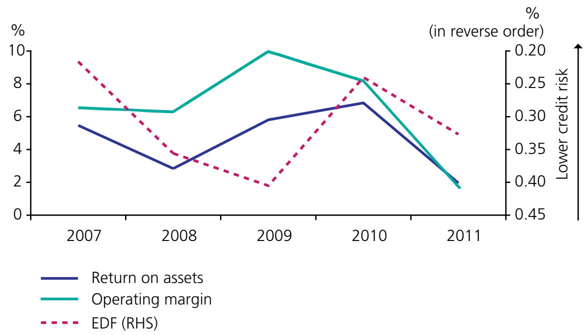
Business Sector: Profitability and EDF for BCM Industry



Source: Moody's KMV Credit Edge™, Bloomberg and internal computation

Chart 1.59

Business Sector: Profitability and EDF for E&E Industry

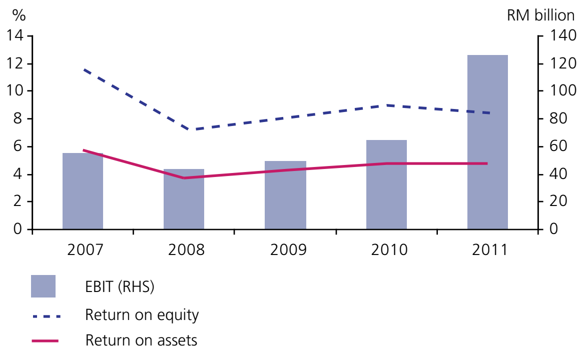


Source: Moody's KMV Credit Edge™, Bloomberg and internal computation

Overall, businesses remained in a relatively strong position, financially and operationally, to cope with these developments. The accumulation of financial buffers over the years and continued improvements in operational efficiency have provided domestic businesses with the enhanced capacity and flexibility to adjust to adverse changes in operating conditions (Chart 1.60). In 2011, aggregate cash balances of businesses increased by 5.6% while operating margins continued to improve to 11.4% (2010: 10.7%). In addition, businesses have continued to maintain relatively low and stable leverage positions since the Asian Financial Crisis, with an aggregate debt-to-equity ratio of 44.8% as at end-2011 (Chart 1.61) and a healthy interest coverage ratio of 6.3 times (2010: 7.5 times) which remains supportive of businesses' continued debt servicing capacity. These factors continue to provide firm support for the quality of banks' overall credit exposures to domestic businesses

Chart 1.60

Business Sector: Profitability Indicators



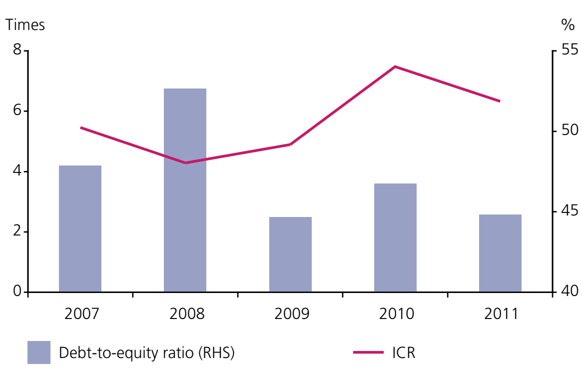
Source: Bloomberg and internal computation

with the credit risk for the business sector as a whole, as measured by the EDF, remaining low at 0.68% (2010: 0.61%).

In 2011, growth in total financing by the banking system to businesses remained strong, increasing at a faster pace of 13.5% (2010: 9.4%). Businesses also continued to meet funding needs through the bond and sukuk markets which drew firm support from a diversified institutional investor base, despite the more challenging market conditions during the year. For the year, a total of RM50.9 billion (2010: RM30.8 billion) in new PDS and sukuk issuances (excluding those issued by financial institutions) was raised. Reflecting the generally sound financial positions of businesses, the gross impaired financing for large businesses and SMEs declined to RM9.3 billion and RM6 billion respectively, with the gross impairment ratios correspondingly

Chart 1.61

Business Sector: Interest Coverage Ratio (ICR) and Debt-to-Equity Ratio



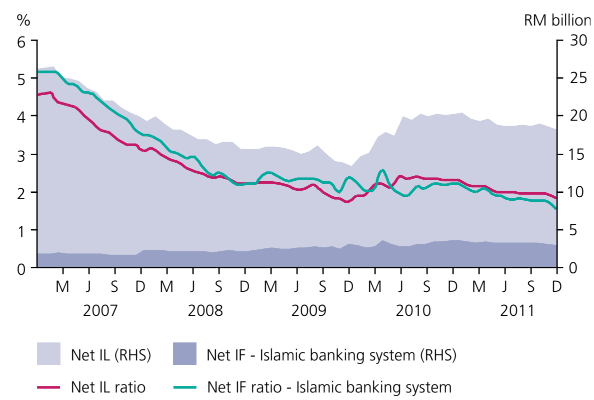
Source: Bloomberg and internal computation

improving to 4.1% (2010: 5.3%) and 3.9% (2010: 5%) respectively (Chart 1.62 and 1.63).

Banking system loans for non-residential property acquisitions and development rose to RM110 billion (2010: RM90.7 billion), representing 11% of total banking system loans in 2011 (2010: 10.3%). While the supply of shop houses and retail space has grown broadly in tandem with demand, ongoing and planned constructions of new office space are pointing to emerging signs of oversupply, especially in the Klang Valley area with the coming on stream of a number of large-scale office buildings. Occupancy rates for office space have gradually declined in recent years to 82.3% at the national level (4Q 2010: 84.2%; 4Q 2009: 85.2%) and

Chart 1.62

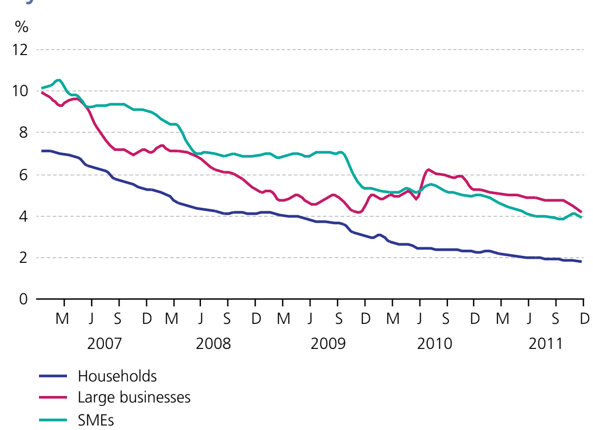
Banking System: Impaired Loans (IL)/ Impaired Financing (IF) Level and Ratio



Source: Bank Negara Malaysia

Chart 1.63

Banking System: Gross Impaired Loans Ratio by Borrowers



Source: Bank Negara Malaysia

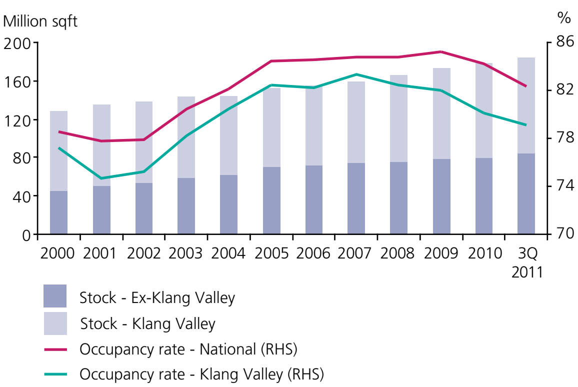
79.1% in the Klang Valley (4Q 2010: 80.2%; 4Q 2009: 82%) (Chart 1.64). Rental rates in the Klang Valley have also stagnated at RM5.56 and RM4.02 per square foot per month for the Golden Triangle and Central Business District areas respectively (Chart 1.65). Further supply expected under the various development projects planned over the next few years could add further pressure on office occupancy and rental rates. Banks have taken a more cautious approach in lending to this segment, with the amount disbursed declining by about 21%, after expanding by 55% in the year before. As at end-2011, the exposure of the banking system to loans for the development of office space remained well contained at RM10.8 billion or 1.1% of total banking system loans. The overall gross impairment ratio for banking system exposures in the non-residential property segment (including shop houses, retail and office space) also remained low at 1.3%.

Profitability of the banking sector (including the Islamic banking system) improved to register returns on assets and equity of 1.6% and 17.4% respectively (2010: 1.5% and 16.6% respectively) as pre-tax profits increased by 14.2% to RM26.2 billion. The Islamic banking system recorded pre-tax profits of RM3.1 billion, with average returns on assets and equity of 1% and 13.7% respectively (including the impact from a large one-off provision by one Islamic bank that undertook a balance sheet strengthening exercise during the year). The strong overall performance was partly attributed to higher interest/financing income (+12.2%), which more than offset higher funding costs on the expanded deposit base. The net interest/financing margin nonetheless narrowed slightly to 0.57 percentage points during the year (2010: 0.62 percentage points) due to strong competition in the house financing and retail lending segments. Impairment charges (net of recoveries) declined for a second consecutive year, reducing by 35.9% in 2011 due to lower newly impaired financing and improved bad debt recoveries. Also contributing to profits were higher fee-based activities (including fees associated with credit facilities, bancassurance and wealth management offerings), net trading and net investment income which grew by 4.5%, 30.1% and 44.3% respectively. Profits have also come under some pressure from higher staff costs which grew by 12% in 2011, higher than the average annual growth of 10.2% in the previous three years. Staff costs continued to increase under an intensely competitive talent market in the financial sector, driven by vacancies in specialist, technical and management positions.

Banks continued to report stable and sound funding positions, with more than sufficient ringgit liquidity to meet demand for credit from households and businesses as well as to weather any unexpected large deposit withdrawals. Banks' liquidity buffers in excess of the minimum regulatory requirement under the Bank's liquidity framework increased to 18.3% and 18.1% of deposits for liquidity needs maturing in less than one week and one month respectively. As in previous years, the banking system remained a net lender in the domestic interbank market, with excess liquidity of RM153.3 billion placed with the Bank as at end-2011. During the year, banks were more aggressive in attracting retail deposits, which expanded by 12.2% in anticipation of more stringent liquidity requirements under Basel III. This contributed to a slight decline in the loan-to-deposit ratio to 80.9% (2010: 81.3%). Banks have also

Chart 1.64

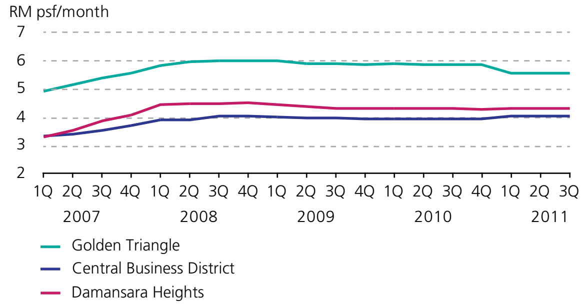
Stock of Offices and Occupancy Rate



Source: National Property Information Centre and internal computation

Chart 1.65

Rental Rates for Office Space in Klang Valley



Source: The Edge

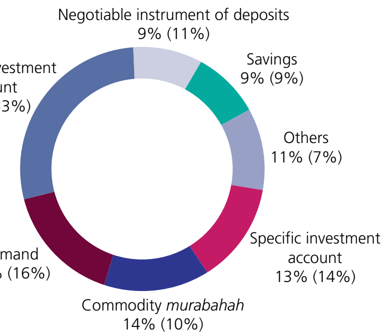
continued to maintain large holdings of high-quality liquid assets, the bulk (68%) of which comprise MGS and Government Investment Issues. The active management by banks of foreign currency liquidity positions have also ensured that overall foreign currency liquidity mismatches in the banking system, particularly in the US dollar, remained low in comparison with the period prior to the height of the Global Financial Crisis in 2008.

Within the Islamic banking system, the rate of return risk is expected to remain manageable, given the positive outlook for financing and stable cost of funding. Islamic profit-sharing investment products based on the *mudharabah* contract (Chart 1.66) formed 41.4% of total deposits. Of this amount, 68.5% was in the form of General Investment Accounts, where depositors typically have an expectation of the protection of the principal investments and certainty in returns. The challenges associated with managing these expectations (or managing displaced commercial risks, DCR) eased during the year given the stable interest rate environment and returns on conventional deposits. The more active management of underlying assets by Islamic banks also supported returns to meet depositors' expectations while observing the Shariah tenets of *mudharabah* contracts (Chart 1.67). While a few Islamic banks drew down on the profit equalisation reserves to meet depositors' expectations on returns, there was also a wider use of other instruments by Islamic banks to manage DCR, including refinements to the profit-sharing ratio to allow flexibility for banks to waive their share of profits, and reducing the concentration on long-term fixed return financing. Collectively, these developments led to a decline in the level of profit equalisation reserves of Islamic banks to RM82.6 million (Chart 1.68).

In addition, some Islamic banks moved to lengthen the maturity structure of the funding base through issuances of medium-term sukuk and negotiable instruments of deposit as a means to achieve greater stability and diversification in the funding structure, thus minimising the risk of funding mismatches. The remaining 31.5% of *mudharabah* deposits were in the form of Special Investment Account deposits where credit and market risks are borne by the fund providers based on the investment mandate dictated by the fund providers. For such deposits, Islamic banks are obliged to provide timely disclosures of the risks and performance of the investments to the fund providers. As in previous years,

Chart 1.66

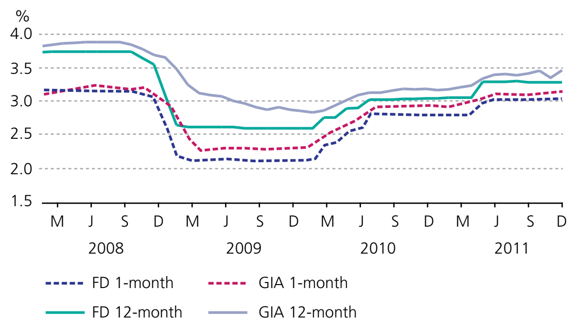
Banking System: Composition of Islamic Deposits



(%): Dec-2010 market share
Source: Bank Negara Malaysia

Chart 1.67

General Investment Account (GIA) Rates and Quoted Fixed Deposits (FD) Rates



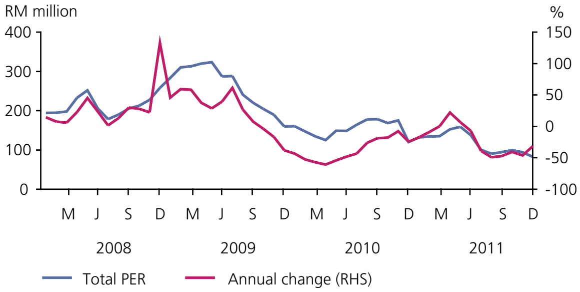
Source: Bank Negara Malaysia

Islamic banks continued to steadily expand the portfolio of floating rate assets as a measure to reduce the repricing gap risk (risk arising from the mismatch between returns earned on fixed-rate assets and repricing of liabilities). During the year, floating rate assets of Islamic banks, mainly in the form of *musharakah mutanaqisah* (diminishing partnership) and *ijarah* (leasing) contracts, grew by 11.6%, resulting in a further reduction of fixed-rate financing assets as a proportion of total financing to 59.2% (2010: 63.7%) (Chart 1.69). Islamic banks were also more focused on offering fixed returns commodity *murabahah* deposits which recorded a significant growth of 74.7% in 2011 to reach RM36.9 billion or 13.8% of total deposits (2010: 9.7%).

The banking system as a whole continues to be well capitalised with strong financial buffers to withstand potential losses (Chart 1.70). More than 70% of total capital remained in the form

Chart 1.68

Profit Equalisation Reserve (PER)



Source: Bank Negara Malaysia

Chart 1.69

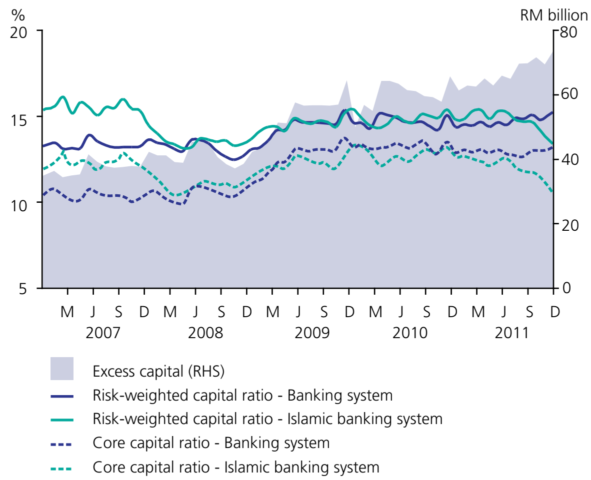
Fixed Rate and Floating Rate Islamic Financing

Note: All figures are in RM billion

Source: Bank Negara Malaysia

Chart 1.70

Banking System: Capital Adequacy Ratios and Excess Capital



Source: Bank Negara Malaysia

of high-quality instruments, comprising common equity and reserves. The aggregate RWCR and core capital ratio (CCR) improved further to 15.1% and 13.2% respectively (2010: 14.8% and 13% respectively), well above current regulatory minimum levels and the higher requirements under Basel III. Consequently, total capital in excess of the minimum RWCR requirement of 8% was above RM70 billion as at end-2011.

The insurance and takaful industry operated under more challenging conditions in 2011 as volatile financial markets and persistent low yields were a drag on profitability amid the continued search for reasonable investment returns. The life and family takaful sector reported lower excess of income over outgo which declined by 9.9% to RM12.7 billion (2010: RM14.1 billion). This result was mainly driven by investment losses which substantially reduced the net capital gains (realised and unrealised) recorded by the industry to only RM0.4 billion, from RM2.6 billion in the previous year. Investment losses peaked at RM1 billion in the third quarter of 2011 at the height of financial market volatility, but subsequently recovered as insurers shed equity holdings as part of portfolio rebalancing activities. The lower profitability was also attributed to higher net benefit payments totalling RM15.6 billion (2010: RM14.6 billion), mainly attributed to medical claims and bonuses paid. The general (re)insurance and takaful sector similarly recorded lower operating profits of RM1.8 billion in 2011 (-14.3%) on account of higher claims. Reinsurers recorded operating losses of RM0.2 billion during the year (2010: operating profits of RM0.3 billion) as claims from business interruption losses surged due to the floods in Thailand. This sharply increased the overall claims ratio for fire business (including cover for business interruptions) to 69.5% (2010: 36.3%).

Underwriting losses for motor third-party bodily injury (or motor 'Act') insurance continued to pose downward pressure on profitability with the claims ratio rising to a record high of 300% (2010: 278.7%). The overall motor claims ratio (including 'comprehensive' business), however, improved to 76.8% (2010: 79.5%). Despite weaker profits, the combined capitalisation level of the general and life insurance industry remained strong with the aggregate capital adequacy ratio (CAR) at 222.5% (2010: 224.6%), well above the supervisory capital requirement of 130% (Chart 1.71).

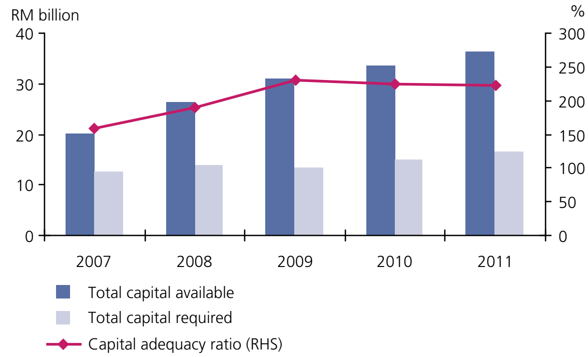
During the year, sustained domestic demand for investment and protection products continued to support business growth. Gross premiums for general insurers and takaful operators grew by 9% to RM15.4 billion, mainly from marine, aviation and transit, fire and motor comprehensive businesses. New business premiums for life insurers and family takaful operators declined by 3.1% to RM10.9 billion, with fewer launches of new endowment products. Premiums from investment-linked and medical and health insurance products, however, continued to expand, growing by 5.5% and 23.6% respectively (Chart 1.72).

Stress tests carried out at the system-wide and entity levels affirmed the resilience of the financial system. Even under assumptions of severe economic contraction and extreme market volatility, overall capitalisation remained satisfactory, meeting the regulatory minimum levels

Stress tests carried out on the banking and insurance sectors at the system-wide and institution levels affirmed the resilience of the domestic financial system to extreme macroeconomic and financial shocks. The scenario-based stress tests adopt both 'top-down' and 'bottom-up' approaches, covering credit and market risk exposures, and are designed to assess the impact of additional provisioning and valuation losses on the capital and profits of the banking system as a result of major downside risks and extreme shocks. In addition, the vulnerability of banks' liquidity buffers to extreme market-wide disruptions and, funding and liquidity constraints for individual institutions is also assessed. The stress test assumptions and shock parameters under baseline, adverse and extreme scenarios are calibrated taking into account the historical worst-case experience for Malaysia. Under the 'bottom-up' approach, the stress parameters applied are overlaid with institution-specific risk profiles based on supervisory assessments of key risk drivers, default history and loss rates, quality of assets and the risk-absorbing capacity of capital, as well as the strength of risk management and governance controls. Given the structure of Malaysian banks, the most significant losses are likely to emanate from credit exposures.

Chart 1.71

Insurance Sector: Capital Adequacy Ratio

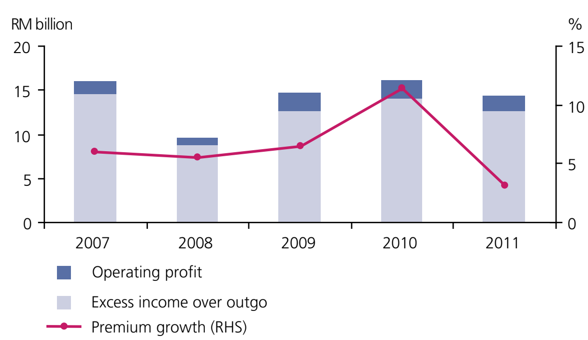


Source: Bank Negara Malaysia

To ensure that the stress tests are sufficiently severe and take into account more recent downside risks, the credit and market risk shock parameters were recalibrated during the year to include potential contagion effects arising from an intensification of the sovereign debt and fiscal problems in Europe and US via the financial and trade channels (Table 1.9). The Bank continues to adopt conservative loan loss provisioning rates in its stress tests, reflective of the significance of the financing portfolio to banks' balance sheets. Under the adverse macroeconomic stress scenario, the RWCR and CCR of the banking system remained above 13% and 11% respectively. Applying more extreme assumptions of economic contraction and financial market volatility under the worst-case macroeconomic scenario, the RWCR and CCR of the banking system would be close to 8% and 6% respectively, still above current regulatory minimum levels. Stress tests

Chart 1.72

Insurance Sector: Profitability and Premium Growth



Source: Bank Negara Malaysia

Table 1.9

Range of Scenario-based Stress Test Assumptions and Shock Parameters

Macroeconomic and financial shocks	Key assumptions and range of shock parameters
Malaysia GDP shock	• More severe than economic contraction in 2009
Revenue shock	• More than 40% decline across different revenue segments
Credit risk shock *[PD = Probability of default;* *LGD = Loss given default]*	• More severe PD and LGD for different loan portfolios – At least doubling of current PD – Higher downturn LGD than historical experience • More severe rating migration and default rates for private debt securities/sukuk than historical worst experience (1998 and 2001) – LGD up to 100% • Acceleration in the utilisation of committed and contingent facilities of up to 100%
Market risk shock	• Extreme decline in FBM KLCI • Sharp appreciation or depreciation in 8 major currencies against the ringgit • Interest rate risk shocks (up to 250 basis points) across different tenures, taking into account: – steepening of the MGS yield curve – widening of credit spreads between MGS and PDS – basis risk

conducted on the insurance industry similarly affirmed the resilience of insurers under the same adverse and worst-case scenarios for market, credit and insurance risk (i.e. risk of under-estimation of insurance liabilities and adverse claims experience) exposures. The post-stress aggregate CAR of the industry remained well above 130%, although some general insurers would be more significantly impacted.

OUTLOOK FOR DOMESTIC FINANCIAL STABILITY AND FOCUS OF SURVEILLANCE IN 2012

Risks to domestic financial stability in 2012 are expected to continue to be mainly externally driven. Lingering uncertainties over the resolution of the European sovereign debt issues and to a lesser extent, concerns over the fiscal position in the US will continue to weigh on global market sentiment and economic growth. This in turn will continue to adversely affect the balance sheets and funding of global banks, hampering efforts to strengthen the financial systems in the advanced economies. Spillovers to domestic financial markets will see market volatility remaining at elevated levels, and continued challenges in foreign currency funding. Weaker economic conditions in the advanced economies could also affect businesses in Malaysia through the trade channel, potentially increasing credit risks for Malaysian financial institutions.

The financial sector is on firm footing and well placed to cope with these developments. The credit risk outlook for the Malaysian financial institutions arising from exposures to businesses and households is anticipated to remain manageable in 2012, under expectations of stable income and employment prospects supported by sustained domestic demand. Measures taken to promote the continued resilience of households should also take firmer hold, in particular through the observance of requirements for banks to properly assess the ability of borrowers to afford to assume new debt. The Bank will continue to actively monitor the financial position of households, coordinating closely with other relevant authorities in implementing appropriate measures to ensure that the resilience of the household sector is preserved.

The Bank's surveillance and supervisory priorities in 2012 to maintain and promote domestic financial stability will focus on:

- Strengthening the Bank's capabilities to identify and measure second-order contagion risks that can affect the financial sector, mainly through a better understanding and improved data capture of the extended inter-linkages within and to the financial system;

- Reinforcing through close supervision and strengthened regulation, where appropriate, prudent and responsible risk-taking by financial institutions which is supported by sound underwriting practices, responsible conduct towards consumers and appropriate risk pricing. Aside from maintaining a heightened vigilance over banks' exposures to households, the Bank will also increase its scrutiny on the quality of banks' business credit exposures and financing to the commercial property sector;
- Promoting effective regional cooperation and coordination in financial regulation and supervision, and crisis management through the Bank's active participation in established multi-lateral platforms, such as the EMEAP. This includes leveraging on supervisory colleges and bilateral arrangements to enhance consolidated supervision on domestic institutions with significant cross-border operations;
- Further enhancing, in close coordination with other regulatory authorities, the Bank's surveillance of the shadow banking and systemic non-bank entities to support the early detection of, and prompt responses to, any build-up of risks and vulnerabilities in the broader financial system; and
- Further strengthening the financial market infrastructure, in particular the payments and settlements systems to support increasing volumes of cross-border and multi-currency transactions, and collaborating with other authorities to improve access to, and the transparency of, information on over-the-counter derivatives exposures.

In 2012, Malaysia will undergo the Financial Sector Assessment Programme by the International Monetary Fund and The World Bank. While the foundations for financial stability is well entrenched, Malaysia will strive to improve further in safeguarding financial stability in a highly dynamic domestic and external environment.

Non-bank Intermediaries in Malaysia

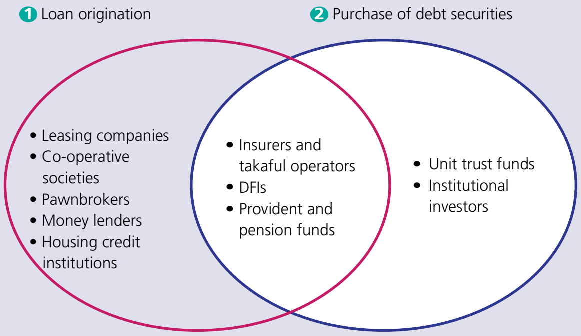
Following the global financial crisis, greater attention has been focused on the role and scope of institutions operating within the shadow banking system in transmitting risks to the financial system. The failure of a number of such institutions during the crisis resulted in significant risks that were transmitted more widely through the financial system which ultimately had a disruptive impact on the intermediation of funds in a number of economies. As a result, there has been a high degree of global attention accorded to the activities of those operating outside the regulated banking system. In facilitating authorities across jurisdictions to become more aware of, and better understand these entities and their activities, the Financial Stability Board had issued some guidance which describes the shadow banking system as credit intermediation undertaken by entities and involving activities outside the regular banking system. Systemic risks from such entities and activities can arise either directly as a result of the prominence of the shadow banking system in supplying credit or liquidity to the economy, or indirectly through its interconnectedness with the banking system. This article provides an overview of the characteristics and size of credit intermediation activities undertaken by non-bank entities within the financial system in Malaysia.

In Malaysia, non-bank credit intermediaries have a complementary role to banks in providing financial services to specific market segments. The nature and scale of their activities are, however, considerably less complex and account for a much smaller share of total credit intermediated by the banking system compared with that observed in some advanced economies during the global financial crisis[1]. Banks represent the mainstay of the financial system, accounting for 61% of total credit intermediated in Malaysia[2] or 142% of gross domestic product (GDP). Including insurers, takaful operators and six development financial institutions (DFIs), about 73% of total credit intermediated or 170% of GDP is attributed to institutions that are prudentially supervised by the Bank.

Chart 1

Non-bank Credit Intermediation Activities and Entities in Malaysia

Direct credit extension



Part of credit intermediation chain or facilitates the credit intermediation process

3 Purchase of credit assets or securitisation:	• Factoring companies, securitisation entities
4 Credit enhancement or guarantee:	• Credit enhancement or guarantee institutions
5 Credit rating or scoring:	• Credit rating agencies or credit reporting agencies

[1] According to a Federal Reserve Bank of New York staff report, the volume of credit intermediated by the shadow banking system in the US was nearly twice (about 1.8 times) as large as the volume of credit intermediated by the traditional banking system prior to the global financial crisis. See Pozsar, Z, Adrian, T, Ashcraft, A and Boesky, H (2010), 'Shadow Banking', Federal Reserve Bank of New York, *Staff Report*, no. 458, July.

[2] Includes loans, holdings of debt securities, securitisation and credit guarantees or enhancements.

Several factors explain the lower propensity of non-bank credit intermediation activities in Malaysia to transmit shocks to the banking system.

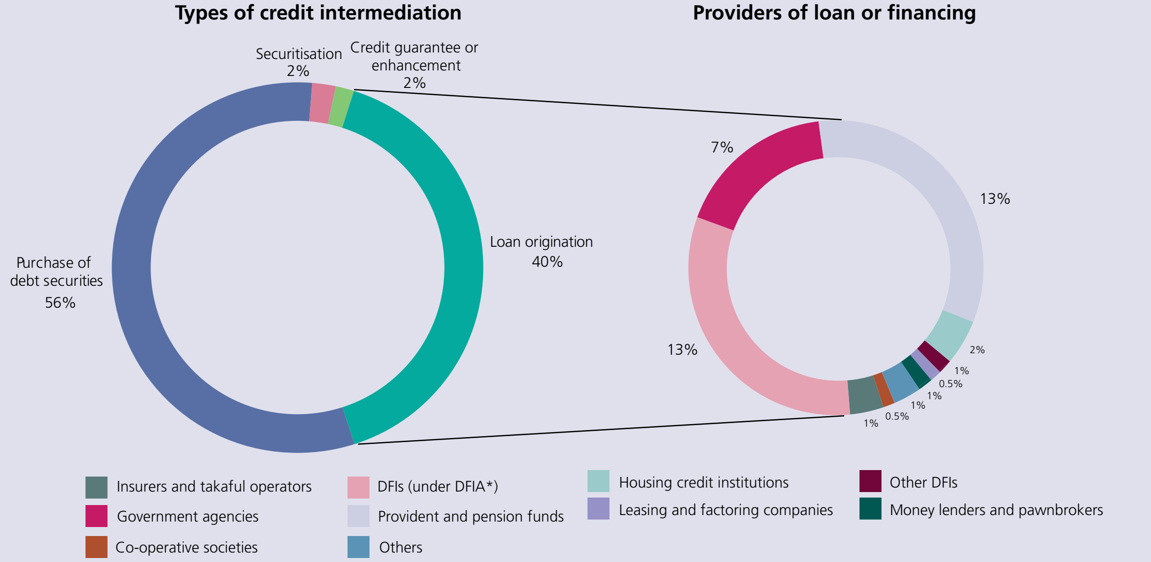
(i) Low complexity of activities and entities

Non-bank credit intermediation activities are predominantly concentrated on the purchase of plain vanilla debt securities and traditional lending activities. Securitisation and credit enhancement activities account for only about 3.7% of credit intermediation by non-bank entities (Chart 2). Structured investment vehicles (SIVs), asset-backed commercial paper conduits and complex securitisation structures are also not common.

A well-capitalised banking system and the continued availability of ample liquidity in the domestic financial system have reduced banks' reliance on securitisation as a source of funding or for capital management, with the loan-to-deposit ratio of the banking system remaining below 85% since 2004. Asset-backed securitisation activities have continued to decline as a share of total debt securities outstanding (2011: RM15.7 billion or 1.8% of total debt securities outstanding; 2010: RM16.2 billion or 2.1% of total debt securities outstanding). Cagamas MBS Berhad, a subsidiary of the national mortgage corporation[3], is the primary issuer of asset-backed securities (ABS) in the Malaysian financial system to account for close to half (45.8%) of ABS outstanding. At present, the ABS issued by Cagamas MBS Berhad is backed entirely by the Government's staff housing loans as the underlying assets. The securitisation of assets originated by a number of banks and non-bank entities account for 18% and 36.1% respectively, with volume remaining very modest in the recent years. Meanwhile, overall risks arising from credit guarantee activities remain low given the small size of outstanding guarantees of RM13.6 billion, including those provided by the Credit Guarantee Corporation to small and medium enterprises (SMEs). The strengthened risk management practices and infrastructure of banks have also contributed towards improved asset quality as evidenced by low impaired loan losses. The use of securitisation or credit enhancement instruments to construct highly-leveraged speculative positions in the domestic financial system is thus well contained.

Chart 2

Composition of Credit Intermediation Activities Undertaken by Non-bank Entities



*DFIA refers to the Development Financial Institutions Act 2002

Source: Bank Negara Malaysia survey, Ministry of Housing and Local Government, various financial statements and internal estimates

[3] The national mortgage corporation, Cagamas Berhad, is majority owned by the banking institutions.

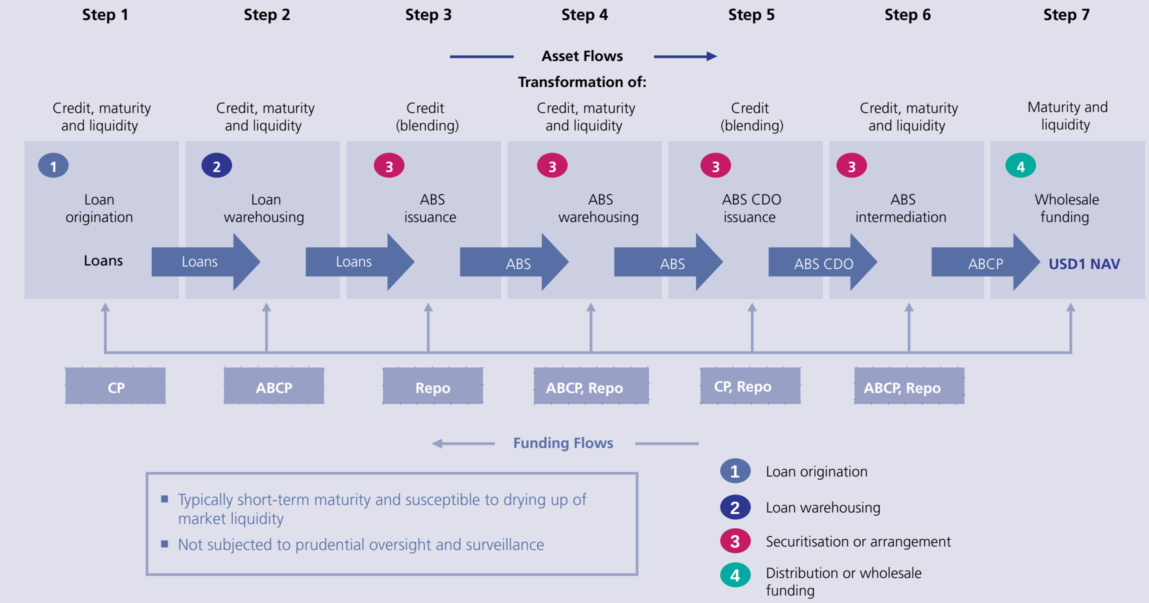
(ii) Low maturity and liquidity mismatch risk

Non-bank credit intermediaries in Malaysia are generally not reliant on complex market-based funding to undertake maturity or liquidity transformation. This reduces the susceptibility of non-bank credit intermediaries in Malaysia to a sudden market liquidity shock or liquidity dislocations. The small share of debt securities issued by non-bank credit intermediaries as a proportion of total outstanding debt securities further limits any impact of stress faced by these intermediaries on overall market liquidity.

Chart 3

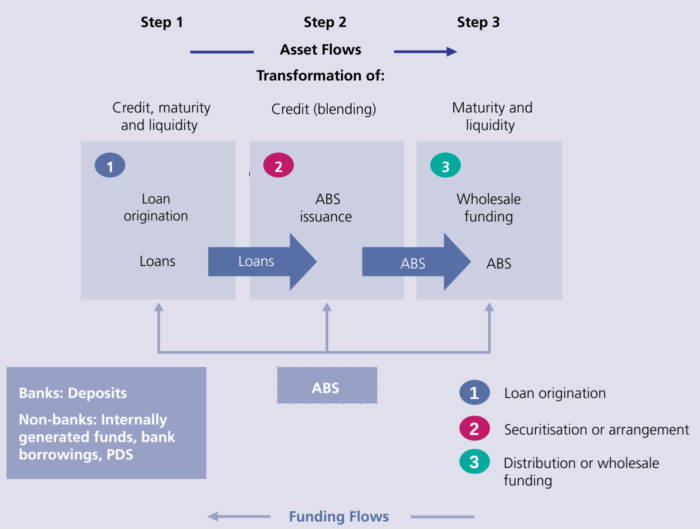
Stylised Representation of Credit, Liquidity and Maturity Transformation Using Market-based Funding

Credit intermediation chain in advanced economies



Source: Federal Reserve Bank of New York Staff Report no. 458

Credit intermediation chain in Malaysia



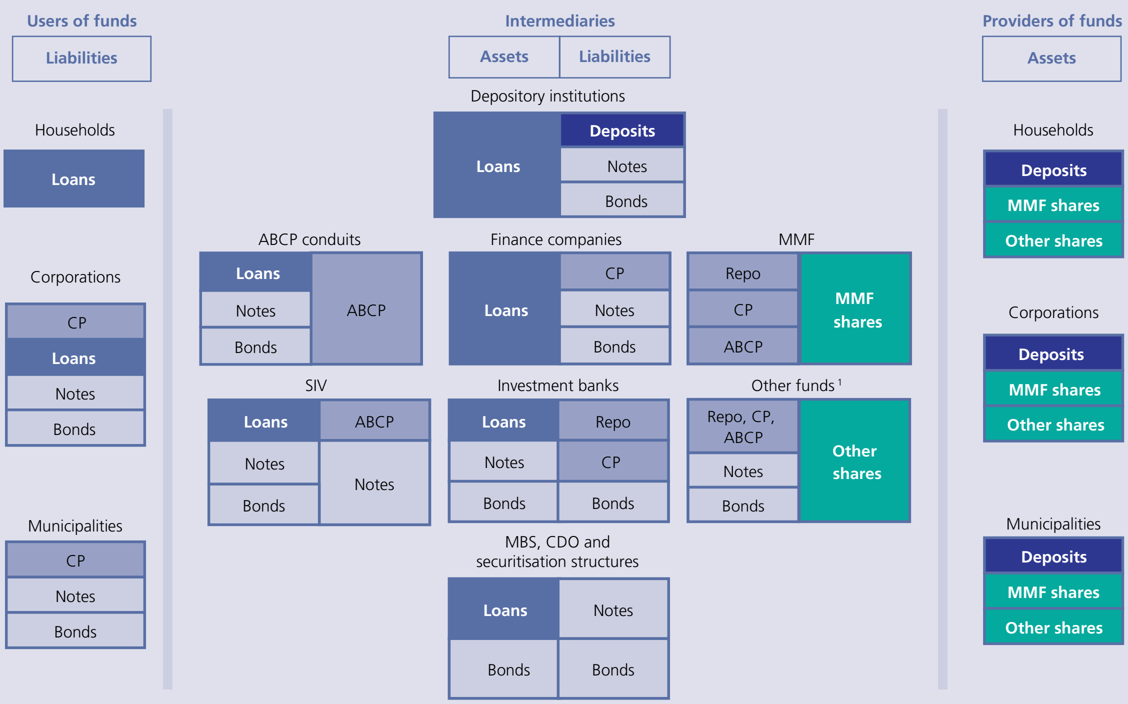
Note: ABS: Asset-Backed Securities, ABS CDO: Asset-Backed Securities Collateralised Debt Obligations, ABCP: Asset-Backed Commercial Paper, CP: Commercial Paper, Repo: repurchase agreements, NAV: Net Asset Value and PDS: Private Debt Securities

Source: Bank Negara Malaysia

While the Malaysian bond market has grown in size and depth over the years, reliance on debt securities by non-bank credit intermediaries to fund credit activities remains relatively low. For the larger non-bank credit intermediaries, the majority of the credit activities are funded from member contributions whilst for the remaining, the main source of funding is internally-generated funds. The private debt securities issued by non-bank credit intermediaries amounted to RM29.6 billion or 3.5% of outstanding debt securities as at end-2011. Of the debt securities issued by the non-bank credit intermediaries, commercial paper accounted for 2.2%, amounting to RM651 million or 11.2% of total commercial paper outstanding. While a small number of non-bank entities have relied on commercial paper, any potential impact on credit intermediation to financial stability arising from any decline in market liquidity is limited, given the small scale of their activities as well as size of standing facilities and credit lines from banks. The exposure of non-bank credit intermediaries to maturity mismatches is also limited, with an average maturity tenure of private debt securities issued of 8.2 years, whilst the financing granted by these entities, which formed the majority of assets, is largely for the medium-term not exceeding nine years.

Chart 4

Complex Financial Interlinkages between Various Components of Financial System in the US



[1] Includes securities lending cash reinvestment pools, hedge funds, mutual funds and other asset managers

Note: CDO: Collateralised Debt Obligations, MBS: Mortgage-Backed Securities, MMF: Money Market Fund, SIV: Structured Investment Vehicle and Repo: repurchase agreement

Source: Financial Crisis Inquiry Commission Preliminary Staff Report, "Shadow Banking and the Financial Crisis", May 2010

(iii) *The interlinkages with the financial system are well contained*

Direct financial interlinkages between non-bank credit intermediaries and the banking system primarily take the form of deposit placements with banks and counterparty risk exposures. Such counterparty risk exposures arise from banks' lending to, or holdings of debt securities issued by, the non-bank credit intermediaries. On an aggregate basis, deposit placements by non-bank credit intermediaries accounted for approximately 10% of total banking system deposits as at end-2011. Provident and pension funds, insurers and takaful operators, and a few large unit trust funds account for the bulk of these deposits (69.7%), with the balance dispersed among other small non-bank financial entities. The placement of deposits by the provident and pension funds, insurers and takaful operators, and unit trust funds are spread out across a number of banking institutions, hence, minimising the risk of funding concentration at the individual bank level. While lending to and holdings of debt securities issued by non-bank credit intermediaries by the banking institutions have expanded over the years, such credit risk exposures remain small, accounting for only 2.9% of total outstanding loans and debt securities held by the banking system or 21% of the capital base of the banking system. Given the relatively small size of non-bank credit intermediation in the financial system, interlinkages among these intermediaries are also limited.

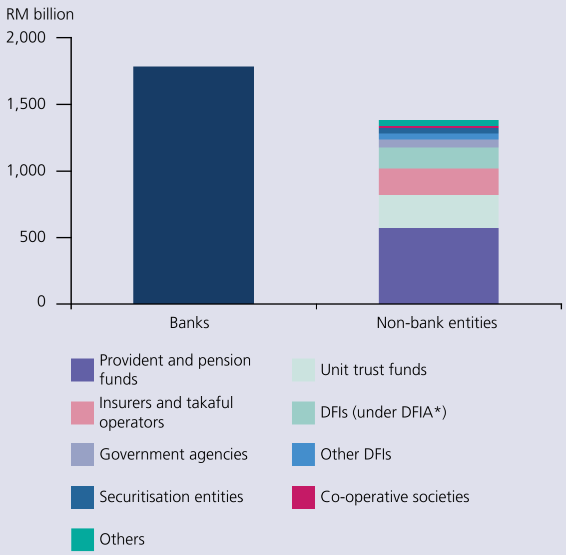
(iv) *The bulk of the activities and entities are subject to oversight*

Insurers, takaful operators and DFIs that are under the prudential oversight of the Bank account for 26% of assets held by non-bank credit intermediaries. Unit trust funds, which account for 18% of assets held by non-bank credit intermediaries, are under the purview of the Securities Commission Malaysia (Chart 5). The five-fold growth of the unit trust industry over the recent decade was driven primarily by the financialisation of the high savings level of households. Another part of the assets (41%) are held by statutory provident and pension funds managed by the Employees Provident Fund and the Retirement Fund (Incorporated) whose establishment, management and operations are governed under specific legislation. As the medium- and long-term and strategic investments by provident and pension funds generally match the long-term nature of their liabilities, these entities have minimal maturity or liquidity transformation risk. In Malaysia, credit rating agencies, which facilitate the credit intermediation process, are also subject to oversight by the Securities Commission Malaysia while the Registrar of Credit Reporting Agencies established under the Credit Reporting Agencies Act 2010, which is expected to commence operations in 2012, will govern the operations of private credit bureaus.

Chart 5

Size of Various Credit Intermediation Entities and Activities and Oversight Structure

Asset size of credit intermediaries

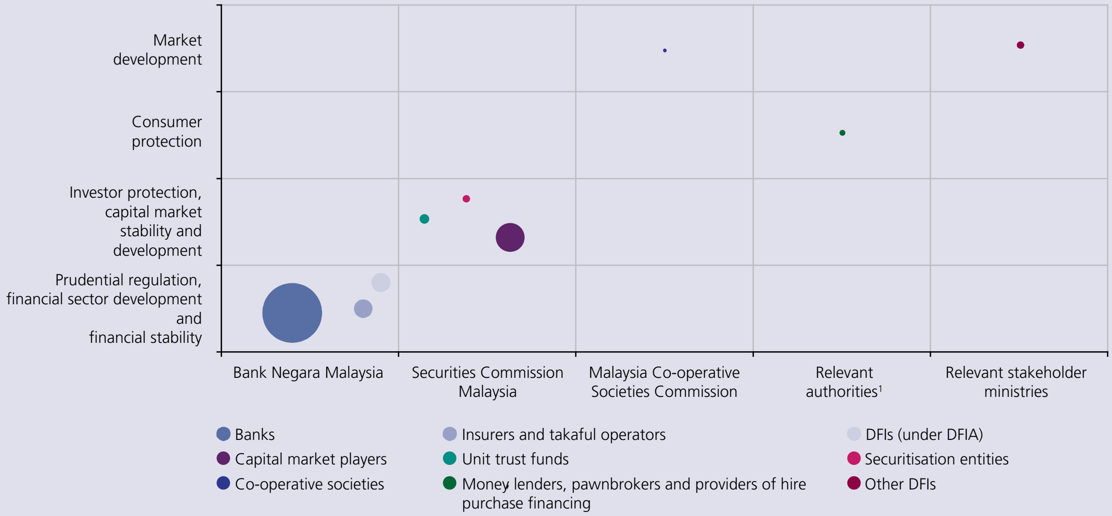


* DFIA refers to the Development Financial Institutions Act 2002

Source: Bank Negara Malaysia survey, Securities Commission Malaysia, various financial statements and internal estimates

Chart 5 (continued)

Size of credit intermediation activities and oversight structure



* DFIA refers to the Development Financial Institutions Act 2002

[1] Money lenders and pawnbrokers are licensed by the Ministry of Housing and Local Government while hire purchase activities are governed by the Hire Purchase Act 1967 which is administered by the Ministry of Domestic Trade, Co-operatives and Consumerism

Source: Bank Negara Malaysia survey, Securities Commission Malaysia, Malaysia Co-operative Societies Commission, Ministry of Housing and Local Government, Ministry of Domestic Trade, Co-operatives and Consumerism, various financial statements and internal estimates

In the more recent period, the activities and size of assets of non-bank lenders, which are not under the prudential oversight of the Bank, have expanded. The growth in financing extended has been mainly focused on the household sector but continues to represent a small share (5.9%) of total financing to households. To ensure these developments do not, over time, contribute towards the imprudent build-up of leverage in the household sector, the Bank's surveillance of developments in lending activities by the non-bank lenders has been strengthened in close cooperation with the relevant supervisory authorities. Specific measures have also been implemented to ensure that credit co-operative societies and large building societies observe responsible financing practices that are consistent with regulations applied to the financial institutions under the Bank's purview.

The ongoing surveillance and oversight of the shadow banking system is supported by the Central Bank of Malaysia Act 2009. The Act accords the Bank the ability to collect data and information on non-bank entities which are not regulated by the Bank for the purpose of monitoring emerging risks in the financial system, and where appropriate, take necessary risk mitigation measures to ensure that the risks are contained. The Bank's monitoring framework has consequently been enhanced to better capture developments in the sector and to monitor the sector's interlinkages with the banking system. Efforts are also underway to establish new, and strengthen existing, inter-agency cooperation arrangements that will provide for the effective exchange of information and improve policy coordination and implementation. This includes continued enhancements to the Bank's Memorandum of Understanding (MoU) with the Securities Commission Malaysia and the formulation of an MoU that is underway with the Malaysia Co-operative Societies Commission. Notwithstanding these efforts, the Bank also remains cognisant of the global issues surrounding the regulation of and proposed safeguards on the shadow banking system, including those under the initiatives of the Financial Stability Board. Where necessary, an assessment will be made for the need for regulatory measures on non-bank credit intermediaries in Malaysia to ensure that the activities of these entities do not contribute towards significant build-up of risks in the financial system.