

# 2011

## DEVELOPMENT OF THE FINANCIAL SECTOR

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## DEVELOPMENT OF THE FINANCIAL SECTOR

Financial restructuring and reforms coupled with the deepening of the financial markets post the Asian Financial Crisis have provided a strong foundation that has supported the continued solid performance and resilience of the financial sector in 2011 despite the difficult external environment. This allowed the financial sector's development priorities to focus on reinforcing Malaysia's long-term growth potential by strengthening the capacity of the financial sector in intermediating funds for new growth areas and promoting regional and international financial linkages. In these efforts, stability considerations remain paramount with importance attached to ensuring that the economy's demands for new financial services can be met without undermining the overall stability of and confidence in the financial system. On many levels, Malaysia has the preconditions that will allow the financial sector to respond positively to the demands on the sector. This includes the strong risk-absorbing capacity of Malaysian financial institutions, improved governance and risk management practices, and the effective safety net that includes deposit insurance and a sound regulatory and supervisory system. The Bank continues to strengthen these preconditions as appropriate to reflect the changing environment, and in some areas, such as building consumer capabilities to make informed financial decisions and expanding the supply of high-quality talent, more work lies ahead in the collaboration with other stakeholders to close the prevailing gaps.

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The Financial Sector Blueprint aims to position the financial sector to assume an enhanced role in supporting Malaysia's transformation towards becoming a high value-added, high-income economy

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The Financial Sector Blueprint, a comprehensive strategic plan that charts the future direction of

the Malaysian financial system in the next 10 years, was completed and published in December 2011. The Blueprint aims to position the financial sector to assume an enhanced role in supporting Malaysia's transformation towards becoming a high value-added, high-income economy. The Blueprint builds on the achievements of the first Financial Sector Masterplan and encapsulates four broad areas, namely: (i) evolving a financial sector that best serves the Malaysian economy; (ii) enhancing regional and international financial linkages; (iii) safeguarding the stability of the financial system; and (iv) enhancing key enablers that support the development of the financial system. Further details of the Blueprint can be found in the white box 'The Financial Sector Blueprint'.

### ENHANCING MARKET STRUCTURE

Banking institutions continue to play a central role in the Malaysian financial system, accounting for approximately 55% of total financial system assets in 2011, relatively unchanged from a year ago. During the year, a merger between two domestic banking groups was completed to form the fourth largest banking group in Malaysia. Malaysia now has eight domestic banking groups that account for 73% of banking system assets, while 23 foreign-owned banks operating as locally-incorporated subsidiaries account for the balance. Banking institutions in Malaysia compete effectively in the market, with the top five banking groups sharing 61.5% of total banking system assets, which is not a significant concentration by international comparisons. A broad product range is offered in the banking sector, and a high level of competition continued to be observed during the year in terms of pricing and distinctive product offerings, particularly in the retail segment. Competition in the banking sector is also reinforced by the requirement for banks to provide clear information regarding financial products that is comparable across institutions, more flexible branching policies, and the entry of new institutions into the market in recent years.

The Competition Act 2010, which came into effect on 1 January 2012 and governs firms

in all industries including the financial sector, will reinforce an appropriately competitive environment in the financial sector. The Act complements the Bank's efforts to enhance the overall consumer protection framework in Malaysia by promoting and safeguarding the process of competition. Working closely with the Malaysian Competition Commission, the aim is to ensure the smooth implementation of the Act in the financial sector, and in particular, to ensure that its implications for existing practices lower risks to the industry and ultimately improve outcomes for consumers through lower costs or improved benefits. Of importance is that these objectives are well-understood and aligned with the intended objectives of the Act.

In the insurance industry, the requirement to comply with higher capital standards under the Risk-based Capital Framework has strengthened incentives for consolidation among insurers, particularly within the general insurance sector. The year saw four more merger and acquisition schemes completed, while negotiations involving three other insurance companies are currently ongoing. As a result, the general insurance industry has become less fragmented, contributing to more effective competition and enhanced viability prospects for the smallest insurers in the industry. The 20 smallest general insurers now collectively account for 47.2% of total gross premiums in the general insurance industry, up from 38% in 2010.

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### The capacity of the general insurance industry to continue supporting demand for compulsory motor liability insurance protection over the long-term was also boosted with the approval of the new motor cover framework

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The capacity of the general insurance industry to continue supporting demand for compulsory motor liability insurance protection over the long-term was also boosted with the approval of the new motor cover framework during the year to provide a holistic approach to long-standing

issues concerning pricing distortions and related inefficiencies in the claims settlement process. The new framework, developed in consultation with relevant stakeholders, encompasses 11 initiatives aimed at: (i) enhancing the claims settlement process which, over time, is expected to contribute towards better management of claims cost; and (ii) allowing gradual adjustments to the premium levels over a four-year period beginning January 2012. To ensure continued access by the public to motor insurance while supporting the ability of insurers to continue providing cover at agreed market premium rates during the transition to the new framework, the Malaysian Motor Insurance Pool (MMIP) was extended to provide a mechanism for the industry to pool the increasing number of private car and motorcycle risks that were being declined by individual insurers due to inadequate premiums, in addition to its present function as the insurer of last resort for 'high motor risks'. Through the MMIP, the industry will continue to support cover for non-high risk vehicles at market premium rates and these risks would not attract higher premiums normally imposed by MMIP as the insurer of last resort. Also a part of the new framework is the imminent establishment of a 24-hour nationwide call centre to expedite the claims settlement process for accident victims, alongside the ongoing efforts by the General Insurance Association of Malaysia to implement an electronic system for the notification, confirmation and reimbursement of third party property damage claims. Collectively, these efforts will address the necessary conditions for the sustainable provision of motor insurance over the longer term.

### PROMOTING EFFECTIVE AND EFFICIENT INTERMEDIATION OF FUNDS TO SUPPORT ECONOMIC GROWTH

In 2011, the financial sector continued to perform its intermediation function smoothly to meet the diverse needs of the economy. Total outstanding banking sector financing increased by 13.6% to RM1,003.5 billion as at end-2011. In particular, funds continued to be directed to support the small and medium enterprise (SME) sector as an important driver of economic growth, with SME financing growing by 17.1% to RM165.4 billion as at end-2011. More importantly, financial sector support for

## The Financial Sector Blueprint

The Financial Sector Blueprint (the Blueprint), which was launched on 21 December 2011, charts the direction of the financial sector as the country transitions into a high value-added, high-income economy by 2020. In line with the Bank's mandate under the Central Bank of Malaysia Act 2009 to promote a sound, progressive and inclusive financial system, the Blueprint provides a vision for the financial sector towards fulfilling the roles of enabler, catalyst and driver of economic growth.

### The Blueprint as a Catalyst for Financial Sector Transformation

Preceding the Blueprint, the Financial Sector Masterplan (FSMP), which was launched in 2001, outlined the path for the orderly development of the financial sector: beginning with institutional and infrastructure development, followed by the introduction of increased competition through deregulation with strengthened supervision, and culminating in greater liberalisation and international integration. The FSMP also afforded a high degree of regulatory certainty which provided a conducive environment for financial institutions to commit to long-term investments in capacity building and strategic undertakings. This has resulted in a more dynamic and resilient financial sector today, with improved corporate governance, risk management practices, and enhanced competitiveness and efficiency.

Building on the achievements of the FSMP, the Blueprint moves beyond the sector-based approach adopted in the FSMP to one that reflects a more integrated financial sector with increased cross-sectoral and cross-border interlinkages. The recommendations in the Blueprint converge around key strategic imperatives for Malaysia's transformation towards becoming a high value-added, high-income economy. This approach looks past traditional structural segmentations, and promotes complementarities between different components of the financial system, with appropriate safeguards, to foster a conducive ecosystem for a vibrant financial sector. Under the Blueprint, it is envisaged that participants in the financial system will play a much more significant role in realising the vision of a more competitive, dynamic, inclusive, diversified and integrated financial sector. In adopting these new approaches, the Blueprint maintains continuity of purpose in providing clear direction to spur the transformation of our financial landscape over the next decade.

### Focus Areas under the Blueprint

The nine strategic outcomes envisioned under the Blueprint which provide a framework for the specific recommendations are:

- Supporting Malaysia's transformation into a high value-added, high-income economy through the **effective and efficient intermediation** of funds towards meeting new and more diverse needs of business and households;
- **Developing Malaysian financial markets** to meet the funding, investment and risk management needs of a more developed and internationally-integrated economy;
- Ensuring all members of society, including the underserved, have **access to, and usage of, quality and affordable essential financial services** towards greater shared prosperity;
- **Strengthening regional and international financial integration** through a more open, competitive and diversified financial sector with greater connectivity within the region;
- **Enhancing the Islamic financial ecosystem** to support increasing volumes of international Islamic financial flows;
- Preserving an **effective regulatory and supervisory regime** that safeguards financial stability and promotes the resilience of financial institutions within a more dynamic and internationally-integrated landscape;
- **Accelerating the migration to electronic payments** as the preferred medium for financial transactions in Malaysia;
- **Empowering financial consumers** through effective financial education and strengthened consumer protection frameworks; and
- **Ensuring an adequate supply of skilled talent** for a dynamic and innovative financial sector.

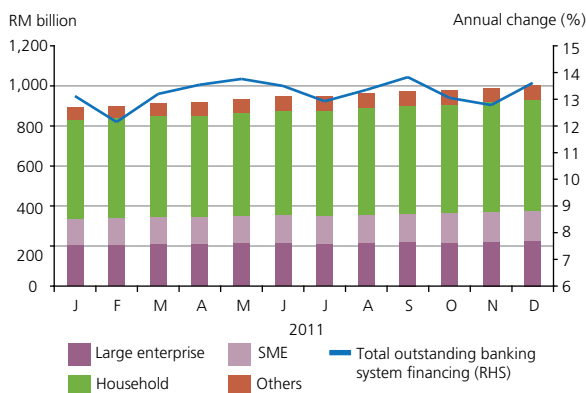
The Blueprint sets out 69 recommendations and more than 200 initiatives that support these strategic outcomes. Initiatives which take precedence will be the ones that address the necessary preconditions, safeguards, or enabling environment for other recommendations under the Blueprint to succeed. In 2012, priority will be accorded to the following initiatives:

- A comprehensive review of the legislative framework to ensure that regulatory laws remain current in the emerging landscape. This will include adequate safeguards to support greater financial sector liberalisation and financial integration;
- Further strengthening the financial infrastructure to support effective intermediation, including enhancements to the credit information framework and establishment of platforms to improve information flows;
- Enhancing the role of financial institutions and the capital market in providing risk capital financing to support new growth areas in collaboration with relevant agencies;
- Widening product range and participation in the foreign exchange and money markets through the introduction of new instruments, facilitative foreign exchange measures and expanded trading platforms;
- Supporting initiatives to promote regional financial integration, including developing a comprehensive framework for the orderly expansion of ASEAN financial institutions within the region;
- Accelerating the development of innovative channels such as agent banking and mobile banking to ensure a wide outreach of financial services;
- Strengthening of payment systems infrastructure and pursuing pricing reforms to strengthen incentives for migration to electronic payments;
- Establishment of a committee of relevant authorities to formulate and operationalise a new consumer credit law; and
- Establishment of a Financial Services Talent Council for greater focus and coordination in talent development to support the development of the financial sector.

Building on the consultations held during the development of the Blueprint, the Bank will continue to intensify its engagements with relevant parties, both through formal and informal means, in the implementation of the Blueprint. Indeed, on many fronts, the close collaboration with and support of the industry, government agencies and other stakeholder groups including consumers, will be critical towards ensuring the success of the Blueprint.

Chart 2.1

## Outstanding Banking System Financing



Source: Bank Negara Malaysia

SMEs has had a significant impact on improving the prospects for success among SMEs. In 2011 alone, more than 700 SME accounts with a combined financing value of RM4.5 billion were upgraded to become large enterprise accounts. Firms in new growth areas and innovative industries also continued to draw support from the financial sector to meet their financing needs.

Comprehensive strategies have been taken to strengthen the resilience of financial institutions, develop the bond market as an important source of funding for the corporate sector, and improve the infrastructure to support financial intermediation. Building on these foundations, initiatives in 2011 focused on developing the capacity and enabling environment for the financial sector to provide financial solutions that will meet the economic and demographic imperatives of the new economy. The key priorities were:

- (i) Enhancing the supporting infrastructure and institutional arrangements to meet the financing and developmental needs of SMEs;
- (ii) Developing the capacity of the financial sector to support new growth areas and innovative industries; and
- (iii) Developing a robust pension framework to enable households to manage their retirement financial needs.

**(i) Enhancing the supporting infrastructure and institutional arrangements to meet the financing and developmental needs of SMEs**

The Credit Bureau Malaysia Sdn. Bhd. (formerly known as SME Credit Bureau Sdn. Bhd.) provides access to information

and ratings on SMEs for credit evaluation purposes. It has had an important role in addressing information asymmetries that are relevant to establishing the repayment ability of businesses, a factor that had previously constrained access to financing for SMEs. The Bureau, which was initiated by the Bank and Credit Guarantee Corporation Malaysia Berhad (CGC), is accessible to financiers, credit guarantors and SME trade partners. Since beginning operations in 2008, 41 financial institutions and 28,249 non-financial institutions have registered to become members of the Bureau. More than 370,000 reports have been generated by the Bureau to facilitate more effective credit assessments and significantly reduced turnaround times (by up to 75%) on loan and guarantee approvals. In October 2011, the Bureau also launched the Self Credit Monitoring system to enable the self-monitoring of credit performance by SMEs, thus encouraging a sound credit culture and good repayment behaviour among SMEs which in turn improves the prospects for obtaining financing to support current and future business requirements.

Access to financing for SMEs has also been made significantly more efficient with efforts taken by eight banks to simplify processes and procedures for SME loan applications under the PARTNER initiative which was launched by the Association of Banks in Malaysia (ABM) in November 2010. A key improvement under the initiative has been the standardisation of loan application documents to facilitate a more efficient SME loan application process. This also expedites the credit evaluation of loan applications from SMEs. Additional support has also been made available to SMEs through the SME Financing Help Desks established at business chambers and SME associations nationwide. During the year, 122 trainers from 19 SME associations and business chambers nationwide were trained under the 'Train-the-Trainers' programme as part of ongoing efforts to equip the Help Desks to better dispense advice to SMEs on the availability of financing avenues, important credit factors that banks consider before granting a loan, and ways in which SMEs can improve their credit standing.

**(ii) Developing the capacity of the financial sector to support new growth areas and innovative industries**

The development of expertise within the financial sector to support new growth areas, such as green technology, is a critical imperative for Malaysia's transformation into a high value-added, high-income economy. At the same time, such ventures have to be supported by the sound assessment of project risks and viability, and appropriate risk-sharing arrangements that will protect depositors from excessive risk-taking by banking institutions. The Bank spearheaded the establishment of a Joint Action Committee (whose members include financial institutions, industry practitioners and government agencies) to support the optimal utilisation of the RM1.5 billion Green Technology Financing Scheme introduced by the Government in 2010. In 2011, the Committee resolved a number of operational issues related to the Scheme and introduced enhanced processes, including business review presentations on applications for financing under the Scheme to provide a platform for borrowers and participating financial institutions to form more comprehensive assessments of the viability of green technology projects. These initiatives improved the prospects of obtaining financing for projects under the Scheme, as evidenced by a marked improvement in the quality of applications and a higher approval rate of 56% in the fourth quarter of 2011, compared to 41% in the previous quarter. Two out of the five new foreign commercial banks that were awarded licences to operate in Malaysia in 2010 would also provide added support and capacity for green financing ventures, in addition to assisting the Government in the implementation of environmentally-sustainable projects in Malaysia. This includes an initiative already in progress to develop environmentally-sustainable townships in Malaysia.

**(iii) Developing a robust pension framework to enable households to manage their retirement financial needs**

Given Malaysia's changing demographic profile with a more mature population moving forward, the need to enhance Malaysians' financial preparedness for old age and retirement has become increasingly

important. Efforts at the national level to develop a robust pension framework in Malaysia envisage an important role for the financial sector, specifically insurance companies, takaful operators and banking institutions, in intermediating funds for retirement. This is more so with the announcement this year by the Government of a RM3,000 annual tax relief on contributions to insurance and takaful annuities for a period of 10 years beginning 2012. The development of a robust and vibrant pension industry will also promote better-matched funding sources to meet the longer-term financing needs of the economy. The Bank will continue to facilitate the development of sound financial solutions, supported by strong underwriting and risk-bearing capacity of financial institutions, that will genuinely fulfil the old age and retirement financial requirements.

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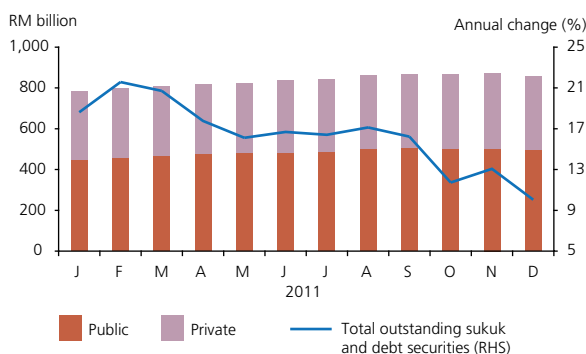
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**DEVELOPING DEEP AND VIBRANT FINANCIAL MARKETS**

The Malaysian financial markets continued to support the effective and efficient intermediation of funds for economic activity, while further diversifying domestic funding sources which contributes to financial stability. In 2011, the outstanding value of the debt securities market (public and private) expanded further to RM860.9 billion (2010: RM782.4 billion), or 103.8% of GDP. Financing through the corporate debt securities and sukuk markets increased significantly to account for 58.3% of total outstanding corporate financing as at end-2011 (2010: 46.4%) as more Malaysian businesses tapped the debt securities market for financing. Sukuk issuances accounted for a higher proportion (2011: 36%; 2010: 32.7%) of total

Chart 2.2

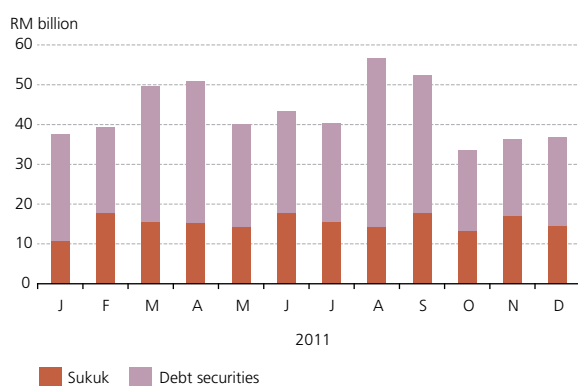
## Outstanding Sukuk and Debt Securities



Source: Bank Negara Malaysia

Chart 2.3

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



Source: Bank Negara Malaysia

issuance of debt securities driven by stronger demand for more innovative Islamic financial products and services.

During the year, Danajamin Nasional Berhad, which was established as Malaysia's first financial guarantee insurer to support access by corporations to the bond market, approved RM7.4 billion in guarantees to 25 corporations across a broad range of economic sectors. Of these approved guarantees, RM2.9 billion worth of bonds and sukuk has been issued. Danajamin has also introduced co-guarantee and syndicated guarantee arrangements with commercial banks under which commercial banks guaranteed the shorter-maturity tranche, while Danajamin guaranteed the longer-maturity tranche. This has enabled commercial banks to participate in the

larger bond issuances with longer-dated maturity structures to meet the needs of the issuers. Four out of the 12 guarantee programmes supported during the year involved such structures. This has contributed to the lengthening of the maturity profile of bonds to a maximum of 20 years, compared to 10 years previously.

The foreign exchange market experienced robust growth during the year. The average daily turnover of the foreign exchange market grew by 44.2% to USD12.3 billion (2010: USD8.5 billion), reflecting a long-term growth trend driven by higher cross-border direct investment and portfolio capital flows. In March 2011, The Financial Markets Association (Persatuan Pasaran Kewangan Malaysia, PPKM) implemented continuous trading hours from 8:30 a.m. to 5:00 p.m. for direct dealing of all products. As a result, the monthly average USD/MYR spot trading volume increased by 42.3% to USD27.1 billion in 2011 (2010: USD19 billion). In addition, in the Islamic financial market, a number of new financial instruments were issued by the Bank during the year, further contributing to a more vibrant foreign exchange market (Refer to section on "Malaysia as an International Islamic Financial Centre").

To promote the legal certainty of financial market contracts (specifically relating to over-the-counter derivatives and repurchase agreement transactions) which is essential for the efficient functioning of financial markets, the Bank actively engaged the International Swaps and Derivatives Association on the intended application of provisions in the Central Bank of Malaysia Act 2009 with respect to powers provided thereunder for the Bank to undertake orderly resolutions of systemically important financial institutions. The Bank will be proposing legislative changes in 2012 that will preserve the contractual rights and obligations of counterparties under netting and collateral arrangements, subject to a temporary stay on early termination rights. This is in line with the attributes of effective resolution regimes for systemically important financial institutions promoted by the Financial Stability Board which call for legal frameworks governing netting and collateralisation that are clear, transparent and enforceable during a crisis or resolution of financial institutions, and at the same time, should not hamper the effective implementation of resolution measures. The clarification of current provisions and imminent legislative changes is expected to substantially remove any remaining uncertainties with respect to

the operation of financial market contracts and to allow financial institutions to determine exposures to counterparties in Malaysia under such contracts on a fully net basis.

## PROMOTING AN INCLUSIVE FINANCIAL SYSTEM

Financial inclusion initiatives in Malaysia continue to be pursued during the year with several notable achievements:

- Financing outstanding to micro-entrepreneurs via the *Pembiayaan Mikro* framework increased by 14.3% to RM887.6 million, while the number of microfinance accounts grew by 7.1% to 71,535.
- All 144 districts in Malaysia now have access to essential financial services provided through physical branches, mobile banking units of banks and development financial institutions (DFIs), or under shared banking services arrangements with Pos Malaysia Berhad.
- The Bank launched MobileLINK, further expanding the financial outreach to consumers in semi-urban and non-urban areas.
- Under the My First Home Scheme (Skim Rumah Pertamaku), loans were granted to

### Key Highlights of Financial Inclusion Indicators in 2011

- 1.7 access points per 10,000 adults at the national level
- 30,355 deposit accounts per 10,000 adults
- 8,949 loan accounts per 10,000 adults

\*based on Core Set of Financial Inclusion Indicators of the Alliance for Financial Inclusion (AFI)

384 middle-income households in urban areas to provide assistance to purchase homes.

While Malaysia has among the highest financial inclusion levels in the world, it is the aim of the Bank to not only ensure all Malaysians have access to financial services, but also equip them to use financial services effectively and wisely. In particular, the Bank seeks to ensure that households are adequately supported through affordable and suitable financial products, financial education, and advisory and counselling services which are

### Launch of MobileLINK to Expand Financial Outreach to Consumers

MobileLINK was introduced by the Bank in December 2011 to provide an innovative channel for consumers in semi-urban and non-urban areas to interface with the Bank. MobileLINK serves consumers through the deployment of a custom-made coach equipped with facilities and technologies to allow users access to information on basic banking services in collaboration with financial institutions. The public can also obtain information on personal credit through the Central Credit Reference Information System, information on Bank Negara Malaysia through

a self-service web-based terminal, and advisory services on other finance-related matters including insurance and SMEs' financing-related matters. MobileLINK also provides an avenue for the Bank to engage directly with consumers and to gather feedback on the Bank's policies and issues they may face in relation to access to financial services. MobileLINK began its outreach with an inaugural visit to the district of Mersing, Johor and will cover about 50% of the identified semi-urban areas nationwide between 2012 and 2014. The first phase of its journey will cover 14 destinations by December 2012.

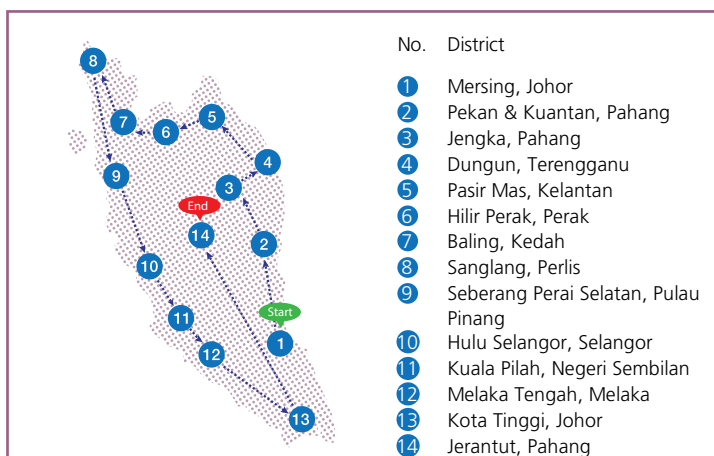


Diagram 2.1 MobileLINK Route Map

important to protect households from becoming over-indebted. Initiatives in 2011 therefore were focused on developing deeper insights into the financial requirements and behaviour of the underserved as a basis for the formulation of policies, the roll-out of targeted education programmes, and in addressing the specific challenges facing low- to middle-income households in urban centres that have had to cope with rising costs of living. Efforts also continued to further widen access to financial services at the sub-district levels.

Survey findings to examine consumer attitudes towards financial services have also provided important input for the formulation of financial inclusion strategies. Coupled with the completion of an exercise to map the existing access points to financial services covering all sub-districts nationwide, the Bank was able to direct more targeted efforts to identified areas that lacked adequate access to essential financial services.

Moving forward, a comprehensive agent banking framework is being developed to broaden the outreach of financial services to the sub-district levels. Consumer protection considerations will be key to delivering sustainable agent banking solutions for the underserved. The framework

will therefore specify minimum requirements for qualifying agents, the types of permitted services, and obligations of banks and agents to ensure adequate protection for consumers against fraud. This will be accompanied by awareness programmes to educate consumers on taking appropriate precautions to avoid dealing with unauthorised agents. A national agent banking logo and a central repository for authorised banking agents are also being developed to aid public recognition of these agents.

To support the ability of middle-income households living in urban centres to afford homes, the Government launched the My First Home Scheme in March 2011. The Scheme, developed in consultation with the Bank and the financial industry, allows young adults earning RM3,000 and below to finance 100% of the value of homes costing RM220,000 or less through a guarantee provided by the Government (via Cagamas Berhad) on the down payment of the house. Eligible borrowers must also meet the banks' credit assessments of the ability to afford the loans. Subsequent enhancements to the Scheme during the year allowed for purchases of larger value houses of up to RM400,000 by households with a combined monthly income of RM6,000 or less.

### Key Findings of the Financial Inclusion Demand-Side Survey

**Profile of Survey Respondents:** 2,000 Malaysian adults aged between 16 to 64 years old, approximately 54% male and 46% female, 28% in rural and 72% in urban areas, with 79% of the respondents earning a monthly income of RM1,500 and below.

#### Convenience

- 80% of the respondents indicated that access to financial services is convenient.
- 80% of the respondents indicated that either petrol stations, Automated Teller Machines (ATMs) or post offices are located within a 5km radius of their residential area. The post office is also the most prevalent avenue for making bill payments.
- 84% of the respondents were unaware of agent banking services.

#### Preference and Behaviour

- 92% of the survey respondents have deposit accounts, but only 68% of the respondents save. On the average, deposits are made once a month while withdrawals are made twice a month.
- 89% of those who saved did so for emergency expenses.
- 60% of the respondents indicated that financial institutions are the most preferred source of borrowing.
- ATMs and bank branches are the most popular methods of transferring money.
- 95.3% of the respondents do not conduct mobile or Internet banking.
- On the average, survey respondents rated their satisfaction with financial services at 7.7 out of 10, primarily due to simplicity of procedures and ease of access.

## ENHANCING MALAYSIA'S INTERLINKAGES WITH REGIONAL AND INTERNATIONAL ECONOMIES

In recent years, Malaysia's financial integration within the region and through Islamic finance, with other parts of the world, has gained considerable momentum. As at end-2011, six out of eight Malaysian banking groups have overseas operations in 19 countries worldwide, a majority of which are centred in Asia (see Chart 1.52 in Chapter 1). The total overseas assets of these groups have increased to RM264.7 billion as at end-2011, accounting for 19% of total assets, while operating income derived from overseas accounted for 30% of total operating income. The enhanced presence of Malaysian banking groups in these countries performs an important role in contributing to the development of financial systems in the countries, aside from also strengthening support for Malaysian businesses expanding abroad.

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Efforts to strengthen Malaysia's interlinkages with the regional and international economies are pursued in a mutually advantageous manner for the parties involved, with the broader aim of enhancing the overall growth potential of the region and promoting regional financial stability. Indeed, the Malaysian financial system has also benefited from the increased presence of foreign financial institutions. Arising from the 2009 liberalisation measures, three new locally-incorporated foreign banks (LIFBs), one new International Islamic Bank (IIB) and two new joint-venture family takaful operators commenced operations in Malaysia in 2011. Given the strong global network of these financial institutions, their presence is expected to harness the large untapped potential of new

growth areas such as the takaful industry, further strengthen Malaysia's linkages with international economies and increase the diversity of Malaysia's financial sector. These newly-established financial institutions are also further expected to generate important spin-off benefits for the country through the reconfiguration of their regional activities to leverage on Malaysia's comparative advantage in areas such as training, and shared services and outsourcing.

To facilitate more meaningful participation of the LIFBs operating in the domestic financial sector, greater operational flexibility has been accorded to enable LIFBs to establish new physical branches. For LIFBs which have yet to attain a sizeable scale of operations in Malaysia, flexibility has been accorded for them to establish up to eight new branches nationwide without location requirements with effect from 2011. This flexibility will hence allow these LIFBs to scale up operations in Malaysia in order to better serve targeted customer segments and niche areas, and contribute more effectively to the Malaysian economy. To date, two LIFBs have leveraged on the greater operational flexibility and obtained approvals to open three new branches in market centres around Malaysia.

One of the priorities for economies in the region is the development of infrastructure. In support of this, nine ASEAN member countries, including Malaysia, pooled resources for infrastructure development in the ASEAN region through the establishment of the ASEAN Infrastructure Fund in September 2011. The Fund, which will be domiciled in Malaysia, will be backed by an initial equity contribution of USD485.2 million, of which USD335.2 million will be contributed by the ASEAN countries with the balance funded by the Asian Development Bank (ADB). The Fund will eventually issue foreign currency debt to finance infrastructure projects in the region in partnership with the ADB and other development organisations. The Fund is thus expected to have an important role in mobilising and channelling regional funds towards productive investments in Asia, and help enhance the breadth and depth of the regional financial markets.

An important milestone in promoting deeper regional financial integration was the endorsement of a high-level framework by the central banks of ASEAN countries to advance regional financial integration towards realising the vision of an

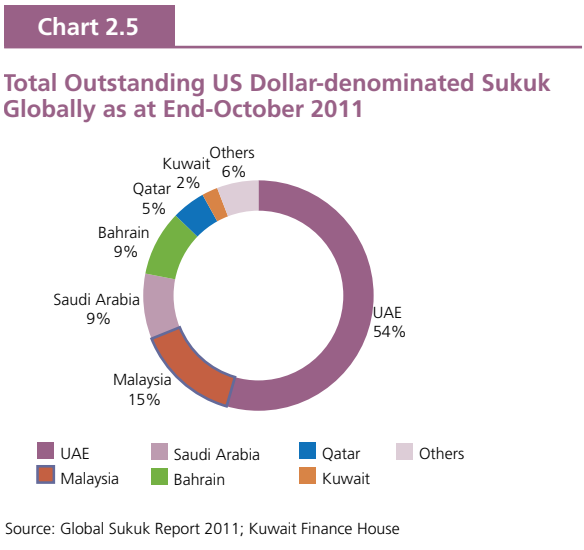
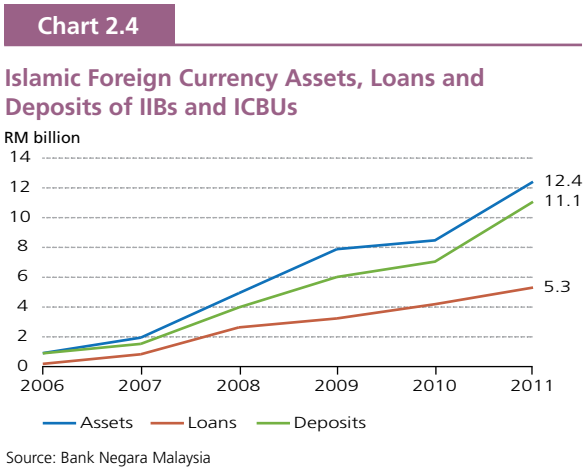
ASEAN Economic Community. The framework will reinforce cross-border coordination and cooperation among ASEAN member countries in support of a more dynamic role for ASEAN banks in driving regional integration. It aims, amongst others, to build capacity and promote sound regulatory frameworks as important preconditions for the expansion of ASEAN banks in the region, while preserving regional financial stability.

A high-level framework has been endorsed to reinforce cross-border coordination and cooperation among ASEAN member countries in support of a more dynamic role for ASEAN banks in driving regional integration

Another important achievement in regional cooperation was realised with the establishment of reciprocal bilateral arrangements among the central banks in the region to promote more efficient cross-border liquidity management during normal times and provide critical liquidity support in periods of stress. The Bank was among the first to initiate these cross-border collateral arrangements. Under such arrangements, Malaysian financial institutions with operations in foreign countries which are parties to the agreement can pledge ringgit-denominated sovereign and central bank securities to the respective central banks for liquidity facilities. Reciprocally, foreign banks operating in Malaysia will also be able to pledge home currency-denominated sovereign and central bank securities to obtain ringgit liquidity from the Bank. The Bank has signed Memoranda of Understanding with the Monetary Authority of Singapore and the Bank of Thailand to effect such cross-border collateral arrangements, with others expected to be concluded in 2012. These initiatives complement ongoing arrangements for financial cooperation in the region which have continued to intensify. In particular, the Bank continues to participate actively in regional surveillance through the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) Monetary and Financial Stability Committee, and is actively involved in a current undertaking to strengthen the regional framework for crisis management and resolution among EMEAP economies.

**MALAYSIA AS AN INTERNATIONAL ISLAMIC FINANCIAL CENTRE**

Malaysia made further progress as our Islamic financial system transitions to become an international Islamic financial centre, recording commendable growth despite the volatile international financial markets and uncertainties clouding the global economy. Total assets in the Islamic banking sector (including DFIs) increased by 23.8% to RM434.6 billion to account for 22.4% of total banking system assets as at end-2011. The volume of Islamic foreign currency business conducted by IIBs and International Currency Business Units (ICBUs) within licensed Islamic banks has also increased substantially over the years (Chart 2.4). In the takaful sector, total assets of takaful funds increased by 15.8% to RM17 billion as at end-2011, while total takaful contributions



## Advancements in Liquidity Management in Islamic Finance

A robust and efficient liquidity management framework is integral to the development of a comprehensive and stable Islamic financial system. Such a framework is an important component for the operations of Islamic financial institutions in conducting funding and investment activities. Over the recent decade, liquidity management in Islamic finance has become increasingly important with the significant growth in Islamic banking deposits. The growth in Islamic banking deposits has outpaced its conventional counterpart by almost three times, growing at a 10-year average annual rate of 17.6%, compared to 7.1% for the conventional deposits. The continuous demands and challenges of effectively managing liquidity and the associated asset-liability maturity mismatches, as illustrated in Chart 1, have provided the impetus for wide-ranging efforts to further enhance the liquidity management framework in Islamic finance.

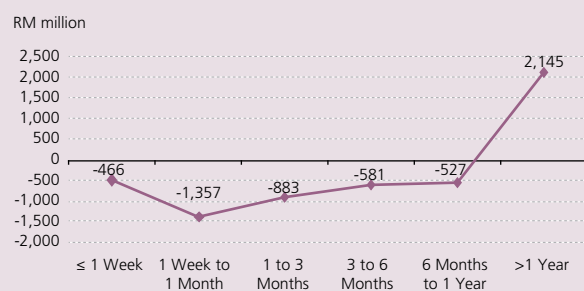
The measures that have been introduced have focused on developing and strengthening six key components that support more effective liquidity management, namely: (i) introducing wide-ranging Shariah-compliant liquidity instruments; (ii) establishing an efficient infrastructure to facilitate the issuance of Islamic financial instruments; (iii) promoting an active secondary market; (iv) ensuring a sound regulatory, supervisory and Shariah framework; (v) securing a strong financial safety net; and (vi) putting in place robust institutional policies and procedures. For each of these components, the important milestones and ongoing efforts are presented in Diagram 1.

These measures have collectively contributed towards the advancements in Islamic liquidity management, including the following:

- The development of a deep and vibrant Islamic money market with 55 registered interbank players and an annual trading volume exceeding RM1 trillion (Chart 2). This enables Islamic financial institutions to obtain and manage funds in a cost-efficient manner.
- The size of the Malaysian sovereign and corporate sukuk market has almost tripled from a total of RM120 billion in 2005 to RM353 billion in 2011, with an upward trend in total sukuk issuances (Chart 3). Malaysia remains the global leader in the sukuk market with a market share of 60% or USD108 billion in outstanding sukuk as at end-2011. Issuances of foreign currency-denominated sukuk in Malaysia have also increased steadily, accounting for 14.5% of US dollar-denominated sukuk issued globally (Chart 4). This provides Islamic financial institutions with a wider choice of investment avenues in managing the portfolio liquidity and expected returns of fund providers.
- The financing-to-deposit ratio of Islamic banks has gradually increased to stabilise within the range of 60% to 80% as Islamic finance continues to facilitate the efficient mobilisation of savings to finance economic activity (Chart 5).

Chart 1

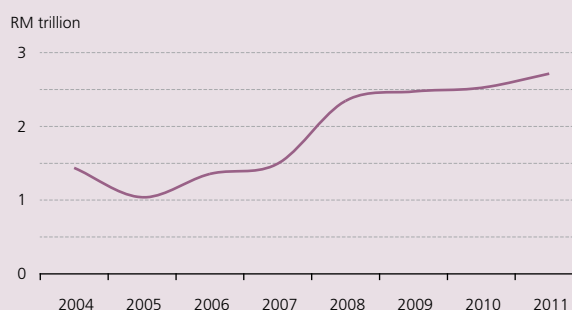
Assets Net of Liabilities of Islamic Banks by Contractual Maturity Buckets as at end-2011



Source: Bank Negara Malaysia

Chart 2

Islamic Interbank Money Market Transactions



Source: Bank Negara Malaysia

Diagram 1

Advancements in Liquidity Management in Islamic Finance

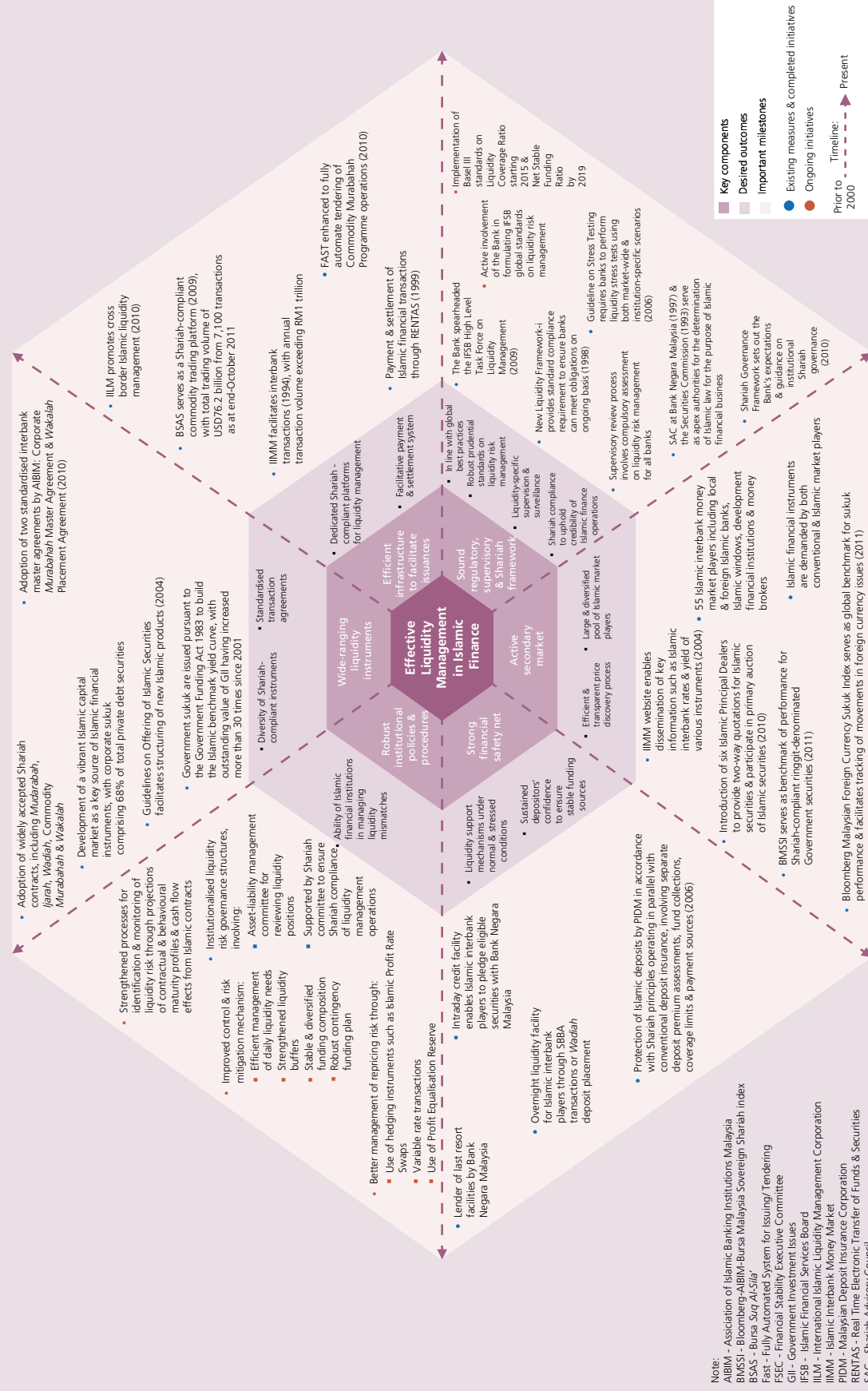


Chart 3

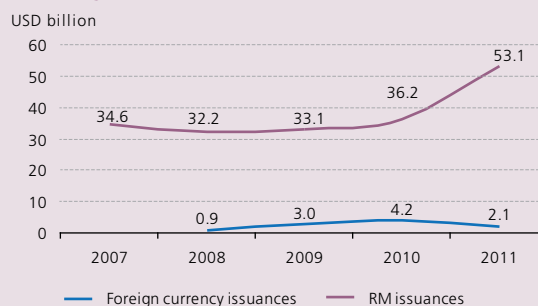
## Total Government and Corporate Sukuk Outstanding



Source: Bond Pricing Agency Malaysia

Chart 4

## Total Ringgit and Foreign Currency Sukuk Issuances in Malaysia



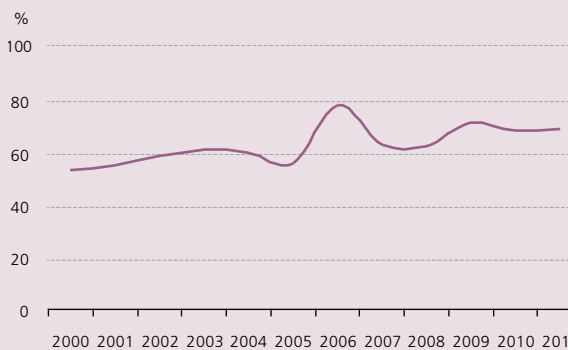
Source: Bank Negara Malaysia

- Innovations in Islamic finance have seen Islamic financial institutions offer a wider range of Shariah-compliant deposit and investment products, with more than 100 types of products and services currently available in Malaysia, providing competitive returns comparable to the offerings of conventional financial institutions. While sukuk in Malaysia used to be predominantly structured using debt-based contracts, the composition of sukuk structured using non-debt-based contracts such as *ijarah*, *wakalah*, and *musyarakah* contracts has now doubled from 12% in 2001 to 24% as at 31 December 2011 (Chart 6). Such continuous innovation widens the range of available financial solutions, enabling Islamic finance to fulfil the diverse financial needs of businesses and consumers.

Malaysia's framework for liquidity management in Islamic finance now encompasses all the necessary components to enable the efficient and stable functioning of the Islamic financial system. Moving forward, Malaysia, collaboratively with other Central Banks, are working towards securing a robust and resilient cross-border liquidity management infrastructure, promoting the development of globally-accepted Islamic liquidity instruments, and ensuring a conducive environment for the issuance of foreign currency instruments. The International Islamic Liquidity Management Corporation (IILM) will have a central role in such efforts towards supporting the global expansion of Islamic finance. In addition, with the implementation of the Basel III liquidity standards, efforts would also include a review of the structure and tenor of current Islamic funding sources to achieve a more stable funding base for Islamic financial institutions.

Chart 5

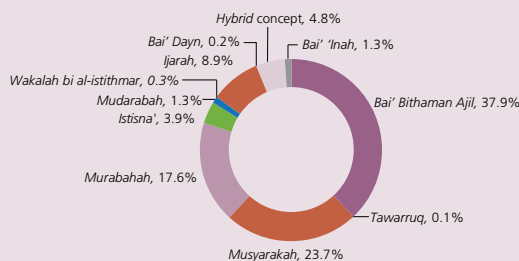
## Average Islamic Banks' Financing-to-Deposit Ratio



Source: Bank Negara Malaysia

Chart 6

## Outstanding Sukuk by Shariah Contracts in Malaysia as at end-2011



Source: Bank Negara Malaysia

accounted for 13% of total premiums and contributions in the insurance and takaful industry, up from 12.4% in 2010. Malaysian Islamic banks and takaful operators have also attained global recognition, with 39 institutions ranked among the world's top 500 Islamic financial institutions, and 21 institutions within the top 100 in The Banker Magazine's latest rankings published in 2011. Malaysia also continued to dominate the global sukuk market and remains a top investment destination for Islamic funds, with sukuk issued in Malaysia accounting for 73.2% (2010: 72.5%) of global sukuk issuances in 2011. In addition, outside the Gulf Cooperation Council region, Malaysia accounted for the highest amount of outstanding USD dollar-denominated sukuk globally (Chart 2.5).

In developing a comprehensive Islamic financial sector, priority has been accorded to developing a deep and liquid Islamic financial market that is able to mobilise funds effectively and efficiently, in accordance with Shariah principles. An important catalyst for this has been innovations in financial market instruments. In June 2011, the Wakala Global Sukuk amounting to USD2 billion was issued by Wakala Global Sukuk Berhad on behalf of the Government. As the first 10-year sovereign USD sukuk in the world, the issuance marked a significant milestone in the development of the sukuk market and attracted an overwhelming response from investors which saw the issuance over-subscribed by 4.5 times. In addition, the year also saw the landmark issuance of the world's first renminbi sukuk out of Malaysia.

The Bank also issued Bank Negara Monetary Notes-*Istithmar* in 2011 to increase the diversity of Islamic instruments in the Islamic money market and provide additional avenues for market participants to manage liquidity more efficiently. The Shariah-compliant Exchange Traded Funds (ETF), an innovative product launched in 2008, received an additional boost of RM200 million in seed funds as part of efforts to broaden the options available for investments of Islamic portfolio funds. These initiatives made important contributions to the promotion of vibrant and liquid Islamic financial markets to meet the varied needs of investors. The launch of the first international Islamic Interbank Benchmark Rate developed by Thomson Reuters in collaboration with the Association of Islamic Banking Institutions Malaysia (AIBIM) and major global financial institutions in November 2011 further supported the efficient pricing of Islamic financial products.

The Islamic financial market infrastructure has also been strengthened to promote a higher level of transparency and improved liquidity of Islamic financial products. In early 2011, Bloomberg launched its Islamic Finance Platform in Kuala Lumpur to capture key Islamic financial market information, including financial data, analytics and proprietary news. The Bloomberg Malaysian Foreign Currency Sukuk Index, a non-ringgit-denominated index developed in collaboration with the Bank, also became an important reference measure of the performance of sukuk. A new global milestone is set to be achieved with the expected issuance of the first short-term sukuk by the Islamic Liquidity Management Corporation (IILM) by mid-2012. This instrument will help to address the supply of short-term papers in the Islamic financial markets, thus facilitating the more effective and efficient intermediation of cross-border financial flows, and supporting global liquidity needs in times of crisis. The initiatives that have been undertaken over the years to enhance the overall Islamic liquidity management framework in Malaysia is elaborated in the white box 'Advancements in Liquidity Management in Islamic Finance'.

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### The Bank actively facilitates the entry of international Islamic finance experts to complement and enrich the Islamic finance talent pool in Malaysia

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With the rapid pace of development in Islamic finance, addressing the demands for talent has been identified as a key priority to support the sustained growth and development of Islamic finance in Malaysia as well as globally. Initiatives have focused both on filling prevailing talent gaps, and building a deep and sustainable talent pool for the future. In this regard, the Bank actively facilitates the entry of international Islamic finance experts to complement and enrich the Islamic finance talent pool in Malaysia. During the year, the International Centre for Education in Islamic Finance (INCEIF) added 159 Chartered Islamic Finance Professionals to the talent pool. Currently, approximately 2,000 students from more than 70 countries have enrolled in the

various Islamic finance programmes, including the post-graduate programmes. INCEIF's global outreach and relevance were also solidified with the establishment of strategic alliances with 10 countries from the Middle East, Asia, Europe and Africa.

For existing industry talent, a training roadmap has been developed by the Islamic Banking and Finance Institute Malaysia (IBFIM). The Islamic Finance Qualifications Framework and Progression Route, drawn in consultation with the Bank and the financial industry, fills an important gap in structured and cohesive training programmes and approaches for the industry. It supports a progressive training path for the industry professionals in Islamic finance which reflects the business demands at different career levels and roles in the industry, thus allowing individuals and institutions to better plan training initiatives in a way that would deliver the desired impact on performance.

As part of efforts to promote deeper global dialogue and discourse on Shariah concepts in Islamic finance, Malaysia participated with Indonesia in the 5th *Muzakarah Cendekiawan Syariah Nusantara* (Regional Shariah Scholars' Dialogue), which explored the prospects and challenges in expanding equity-based financing applications in Islamic finance. Malaysia also hosted the 6th International Shariah Scholars Forum, which had resolved to conduct applied research to examine various aspects of the current financial system that can be aligned to achieve the objectives of Shariah (*maqasid*). The Bank also forged strategic alliances with the Turkish and Indonesian financial and business communities to promote cross-border investment opportunities and enhance cooperation in the areas of product development, trade finance and liquidity management. These efforts will further cement Malaysia's interlinkages with international economies through Islamic finance.

Initiatives to facilitate the promotion of Malaysia as an international Islamic financial centre also continued under the MIFC banner in 2011, with Malaysia emerging as an important destination for events relating to international Islamic finance, including seminars, conferences and training programmes.

## ENHANCING CONSUMER EDUCATION AND PROTECTION

Consumers have an important role in promoting effective, efficient and responsible financial intermediation activities through the discipline that they can provide over the financial intermediaries. Helping consumers evaluate financial choices and understand the consequences of the financial decisions they take is therefore an important component of strategies to deliver better outcomes for consumers, and contribute towards building a stable and competitive market for financial services in Malaysia.

Over the recent few years, sustained awareness campaigns by the Bank and financial industry, together with improved disclosures on financial products and services, have contributed to a notable increase in the level of consumer engagement on financial matters. This can be seen from the increasing number of financial consumers that use various channels provided by the Bank and industry to seek financial information, advice and redress. The Bank's Integrated Contact Centre received 320,028 enquiries from individuals and businesses in 2011 compared to 284,020 in 2010, and 29,004 five years ago. The Centre also handled 9,975 complaints against financial institutions, helping to resolve more than 90% of these cases. A cross-country study undertaken by the Organisation of Economic Co-operation and Development (OECD) on the financial behaviour

### Key Findings from the OECD Pilot Survey on Financial Literacy

- Financial literacy level is 11% higher in the central region (Selangor, Kuala Lumpur and Negeri Sembilan) compared to the overall population.
- Insignificant differences in financial literacy across gender and race.
- Joint financial decision-making with spouse is commonly practised.
- Malaysians tend to be cautious about spending and recognise the need to save for the future.
- Malaysians understand the risk-return trade off but are less familiar with the concept of diversification or risk spread/reduction.

and knowledge of Malaysian households in money management showed that financial literacy levels in Malaysia are comparable to those in the developed economies. The survey also revealed a strong positive correlation between financial literacy levels and the level of education. However, Malaysians are found to have a relatively lower understanding of financial risk management. These and other findings from the survey provided useful insights for improving the financial capability of Malaysian consumers.

One priority has been to build the foundations for financial capability at an early age. During the year, the Bank collaborated with the Ministry of Education to embed financial education within the formal school curriculum to provide early exposure to financial knowledge and promote responsible financial values. The aim is to enhance financial education in a way that students can relate to as they progress through school and higher education, and enable them to retain knowledge and understanding of financial matters in managing their financial affairs in their adult lives. Substantial foundational work has been advanced to incorporate basic money management disciplines such as saving and investing, spending, credit and debt management, financial risk management, and consumer responsibilities in selected core subjects taught at the primary and secondary school levels, in stages beginning in 2014. This is being accompanied by preparatory workshops organised for teachers with the support of financial institutions and industry associations to enhance their knowledge in financial matters in order to lead these subjects.

The POWER! Programme introduced in 2011 for young adults and first time borrowers has had a significant impact in reaching Malaysian borrowers to provide practical financial knowledge and skills, and tools to aid them in making sound and responsible borrowing decisions. In 2011, 23,000 individuals nationwide had participated in the roadshows, classes and seminars organised by the Credit Counselling and Debt Management Agency (Agensi Kaunseling dan Pengurusan Kredit, AKPK). The POWER! Online Learning Portal, a web-based alternative learning module launched in November 2011 will further widen the reach of the POWER! Programme and

encourage the application of lessons learned through access to interactive toolkits, including budget planners and financial calculators to help consumers account for their finances. Moving forward, plans are already underway to extend the POWER! initiative to address specific financial education priorities for other target consumer groups.

The Bank continues to reach out to consumers through the Financial Awareness Week, or *Minggu Kesedaran Kewangan 2011* (M2K 2011), organised together with the Securities Commission Malaysia, the Financial Mediation Bureau, AKPK, Malaysia Deposit Insurance Corporation (Perbadanan Insurans Deposit Malaysia, PIDM) and financial institutions. The event attracted over 10,000 visitors to the various educational briefings, activities, exhibitions and financial clinics featured. In conjunction with M2K 2011, the Bank also launched a new financial education website, *Islamicfinanceinfo*, which features information on Islamic finance such as Shariah concepts and products available in the Islamic retail finance market to facilitate consumer understanding of Islamic financial products and services and aid decision-making.

## **TALENT DEVELOPMENT IN THE FINANCIAL SECTOR**

The development of talent for the financial sector continues to present considerable challenges for the industry as demand continues to exceed supply. In the medium to longer term, this can increase pressures on wages, and undermine the ability of financial institutions to maintain competitive positions and effectively control risks. Significant investments have therefore been made by the Bank to support the development of high quality talent for the financial sector, across all levels, from entry to leadership positions.

Since its implementation in 2007, the Financial Sector Talent Enrichment Programme (FSTEP) developed by the Bank in collaboration with the financial industry has prepared more than 1,000 new graduates for careers in the financial sector. FSTEP has achieved a remarkable success rate with almost all of its participants rapidly absorbed into permanent employment by financial institutions. The programme was further enhanced in February 2011 to incorporate more

diverse forms of experiential learning through the use of case studies, role-plays and simulations, in addition to practical attachments with financial institutions. As a reflection of its success, more financial institutions are electing to be sponsors of FSTEP participants as a preferred strategy to recruit and train entry-level staff, affirming the value and quality of the programme in preparing graduates for employment in the financial sector.

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### FSTEP has achieved a remarkable success rate with almost all of its participants rapidly absorbed into permanent employment by financial institutions

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For professionals already employed within the financial industry, the Asian Institute of Finance (AIF) and its affiliate institutions, namely the Institute of Bankers Malaysia (IBBM), the Malaysian Insurance Institute (MII) and IBFIM, have a key role in building and strengthening core competencies to meet the new demands of the fast-changing and more complex financial landscape. The Risk Management Centre and the Applied Finance Research and Publication Centre which were established by AIF in 2010 have developed and introduced nine programmes which aim to support continuing improvements in risk management capabilities in the conventional banking, Islamic banking, insurance, takaful and capital markets sectors, having regard to new and emerging risks. This is reinforced by applied research in risk management undertaken by AIF which would provide input to upscale and improve the quality of these programmes over time. During the year, AIF also established the Financial Inclusion Centre to develop training programmes on

microfinance. The Centre is on track to roll out its first programme in 2012 which will focus on leadership and technical skills required to successfully manage microfinancing operations. The application of AIF's Learning Programme Assessment and Accreditation Framework standards to programmes offered by its affiliate institutions has further contributed towards enhancing the overall quality and relevance of training programmes offered for the industry. Beginning from 2011, all programmes offered by AIF affiliate institutions must meet, and be independently assessed against, the standards set under the Framework. The involvement of trained and experienced industry practitioners in the assessment of industry training programmes has been an important contributing factor in substantially raising the quality of training provided for the industry.

The Iclif Leadership and Governance Centre (Iclif) remained focused on building strong leadership and governance capabilities in developing world-class leaders, in particular for the financial industry. Iclif continued during the year to expand the diversity of its training offerings to address critical leadership and organisational challenges in modern business and finance. Given the often unique nature of these challenges, demand also increased for Iclif's advisory services which are supported by experts from world-leading institutions. Iclif also continued to support the continuing education of financial institution directors through the Financial Institutions Directors' Education (FIDE) programme. The programme continues to have a demonstrable impact in promoting more effective boards in the financial sector. Further information on FIDE is provided in Chapter 3: Regulatory and Supervisory Framework under the section "Corporate Governance". Moving forward, Iclif will also produce proprietary research on leadership and governance which is Asian-focused with global perspectives.

## **Proposals for New Legislative Framework for Financial Regulation and Supervision**

In 2011, the Bank completed a comprehensive review of existing regulatory laws governing financial institutions, markets and payment systems under the Bank's purview. The review built on the foundations for promoting financial stability that have been established in the Central Bank of Malaysia Act 2009, and in particular, puts forward proposals to support three primary functions of the Bank under that Act – regulating and supervising financial institutions under the Bank's purview, providing oversight over the money and foreign exchange markets, and exercising oversight over the payment systems.

The review aims to ensure that the regulatory laws remain current and effective in enabling the Bank to discharge its regulatory and supervisory mandate in a way that would preserve the stability of the financial system, while recognising important differences between the regulated industries and institutions. The Bank drew extensively on its experience in regulating the financial sector and the resolution of financial institutions as well as lessons and recommendations emerging from the global financial crisis that served as inputs to the review. The review focused on the following key outcomes:

- Opportunities for regulatory arbitrage should be minimised through a consistent approach in dealing with similar risks in the financial system, regardless of where they originated. In line with this, proposed changes also aimed to close current gaps in legislation with respect to the oversight of business conduct, group-wide supervision, and systemically important financial institutions that were not subject to prudential supervision.
- Regulation and supervision should be proportionate to the risks posed by regulated institutions and markets.
- The Bank should have the ability to take early actions to avert failures, including sufficient flexibility to influence and correct imprudent market behaviours in a timely manner as conditions changed.
- Where failures did occur, the Bank should have the necessary tools to minimise losses to depositors and policyholders as well as costs to the overall financial system.
- There should be clarity of supervisory mandates for which the Bank is accountable, and an appropriate level of transparency in the way that the Bank discharged those mandates.

A starting point for the review is the proposed consolidation and rationalisation of existing regulatory laws to achieve a more cohesive legislative framework. A dual framework will be maintained for the conventional and Islamic financial business consistent with the dual financial system in Malaysia. Within this dual framework, the prudential and market conduct supervision of institutions and markets under the Bank's purview will be integrated under the proposed new legislation which will replace the existing Banking and Financial Institutions Act 1989, Islamic Banking Act 1983, Insurance Act 1996, Takaful Act 1984, Payment Systems Act 2003 and Exchange Control Act 1953.

Other key recommendations from the review are discussed below.

### **Clarity of Regulatory Objectives**

In pursuing the principal object of the Bank to safeguard financial stability, the proposed legislation seeks to provide clarity on the accountability of the Bank. This allows for directing resources to the key responsibilities, while carefully balancing the outcomes of regulation and supervision that drive the Bank's priorities. It will also serve to identify areas where coordination with other authorities will be important. The proposed legislation accordingly aims to reflect the Bank's current commitment to foster: (i) the safety and soundness of financial institutions; (ii) the integrity and orderly functioning of the money market and foreign exchange market; (iii) reliable, safe and efficient payment systems and payment instruments; and (iv) fair, responsible and professional

business conduct of financial institutions. This will provide clarity on the observance of international core principles on effective banking and insurance supervision which require the mandates and responsibilities of the regulator to be clearly specified in legislation.

### Differentiated Intensity of Regulation and Supervision

Under the Bank's risk-based approach to supervision, the scope and coverage of regulatory requirements and level of supervisory intensity applied to institutions and markets under the Bank's purview are differentiated based on the level of systemic risk posed by such institutions or markets. Systemic risk refers to the potential for the failure of an institution or market that will disrupt the financial intermediation process, the orderly functioning of key markets, or precipitate a general loss of confidence in the financial system. In line with this approach, the review aims to provide a clearer distinction in the legislation, specifically through differentiated frameworks described below, to promote a more transparent and accountable regime in which powers accorded to the Bank are proportionate to the need for such powers in order to deliver the Bank's legislated mandates.

	Applicable regime (proposed)	Intensity of Regulation and Supervision
<ul style="list-style-type: none"> <li>Banking institutions</li> <li>Insurers</li> <li>Takaful operators</li> </ul>	Licensing	Subject to comprehensive prudential, business conduct and consumer protection requirements.
<ul style="list-style-type: none"> <li>Systemically important payment systems</li> </ul>	Designation	Subject to requirements to ensure the safety, efficiency and reliability of designated payment systems.
<ul style="list-style-type: none"> <li>Insurance/takaful brokers</li> <li>Money brokers</li> <li>Financial advisers</li> <li>Payment system operators</li> <li>Designated payment instruments issuers</li> </ul>	Approval	Subject mainly to business conduct and consumer protection requirements.
<ul style="list-style-type: none"> <li>Loss adjusters for insurance or takaful claims</li> <li>Providers of merchant acquiring services in conjunction with payment systems</li> </ul>	Registration	Oversight primarily focused on promoting professional conduct in activities that relate to businesses that are licensed or approved.

### Transparent Assessment Criteria for Authorisation and Shareholder Suitability

A key aspect of a sound financial regulatory system is a rigorous process for authorising institutions to carry on regulated financial businesses, including assessment of their significant owners and controllers. The Bank proposes to improve the transparency of this process and reinforce the integrity of the regulatory framework, by defining the factors that are taken into consideration in admitting institutions into the financial sector. It also seeks to pre-emptively manage concerns on complex structures and incentives or conditions that encourage excessive risk-taking which can significantly complicate the effective supervision of financial institutions. The proposed factors therefore include, in addition to an institution's financial strength and track record, a consideration of whether it can demonstrate sound and realistic business plans for its operations, the extent to which its corporate structures could impede effective regulation and supervision, and the potential for altering market structures or conditions in a way that would increase risks to financial stability.

### Provisions for Oversight over Non-regulated Institutions

A focus of reforms following the global financial crisis has been around concerns that the coverage of prudential supervision has been too narrow. This has led to calls for regulatory regimes to take

appropriate account of systemic risks that can emerge from the interaction between regulated and unregulated institutions, activities and markets. The Central Bank of Malaysia Act 2009 provides for the Bank to obtain information on institutions that are systemically important, and where necessary direct an institution not regulated by the Bank to take specific measures to avert a risk to overall financial stability. These important powers were designed to promote financial stability, and are corrective in nature to respond to specific risks to financial stability. There is now wide consensus, including by the Financial Stability Board, that it would be necessary for non-bank institutions with significant financial intermediation activities or which are closely connected with the banking system to be brought under a system of continuing prudential oversight to minimise any regulatory arbitrage and promote conduct that is compatible with financial stability. Based on this rationale, it is recommended that the Minister of Finance may subject an institution that is engaged in financial intermediation activities to ongoing regulation and supervision if it is determined that the institution poses or is likely to pose a risk to overall financial stability.

### **Greater Focus on Business Conduct and Consumer Protection**

While current regulatory laws impose clear obligations for financial institutions to comply with prudential regulatory prescriptions that promote safety and soundness, the obligation to comply with business conduct requirements is less defined. This has to some extent limited the enforcement actions that the Bank can take, including public action, to address business conduct concerns. The proposed legislation seeks to close this gap in three main ways: (i) charging the Bank with a clear mandate for consumer protection with respect to the conduct of financial service providers regulated by the Bank; (ii) clarifying the obligations of financial service providers to comply with business conduct standards, and equipping the Bank with effective tools to enforce these standards; and (iii) strengthening existing arrangements for consumer redress through the approval and oversight by the Bank of a financial ombudsman scheme for the resolution of disputes involving financial service providers under the Bank's purview. However, this will not alter the existing arrangements with regard to market conduct of investment banks which are now under the purview of the Securities Commission.

### **Flexibility to Specify Prudential and Business Conduct Standards**

Consistent with the differentiated intensity of regulation and supervision, it is important for the Bank to be able to: (i) specify prudential and business conduct standards that may be differentiated between regulated institutions or categories of regulated institutions according to their risk profiles; and (ii) calibrate such standards over time as conditions require, to address new or emerging risks. This also results in important efficiency gains in allowing the Bank to provide appropriate flexibility to institutions to manage their business in the most optimal way when the risks have been effectively managed. To this end, specific recommendations have been made to recast existing requirements and introduce new provisions that will support this flexibility. The provisions include specific responsibilities placed on the board to oversee the risks and internal control strategies of financial institutions to promote their long-term viability and fair dealings towards consumers.

### **Sharper Focus on Shariah Compliance and Governance in the Islamic Financial Sector**

In a dual financial system in which conventional and Islamic financial products are offered in parallel, a critical aspect of the regulatory framework is the consistency of rules and regulations across both sectors to eliminate possibilities for regulatory arbitrage. At the same time, there is a need to reflect the fundamental differences in the nature of risk inherent in Islamic financial products and services. The proposed new legislation for Islamic finance seeks to provide greater visibility to Shariah compliance and the effective implementation of Shariah governance by Islamic financial institutions, thus ensuring a coherent regulatory framework. Among others, proposed provisions have been put forward to allow the Bank to specify standards on Shariah matters, including on Shariah governance, principles and practices of Shariah in relation to the business and affairs of an Islamic institution, as well as requirements for Shariah compliance audits. In line with Shariah requirements, the proposed new law will also clarify the process and priority of payments in the event of a winding up of a financial institution involved in Islamic financial business.

**Strengthened Ability to Supervise Financial Groups on Consolidated Basis**

The effective supervision of financial groups has emerged as one of the more important charges of the regulatory reform agenda in the wake of the global financial crisis. The primary prudential aim of group supervision is to minimise contagion risk from group operations that could affect the safety and soundness of regulated institutions within a group. While current legislation and practice support the supervision of regulated institutions on a solo basis, the framework for the supervision of financial groups is not as well-advanced. To support the Bank's current work to put in place appropriate formal arrangements, including prudential requirements for the supervision of financial groups, the proposed new legislation seeks to provide a clear mandate for the Bank to exercise oversight over financial groups that have one or more licensed institutions within the group. This includes powers for the Bank to formally authorise financial holding companies, obtain information on and examine any entity within the group, apply appropriate prudential standards to the holding companies or other subsidiaries, and require corrective measures to be taken to mitigate any identified risks to the licensed institution or the financial group. Such powers will be supplemented with enhanced provisions for the Bank to cooperate with other domestic or foreign supervisory authorities, in areas including the sharing of supervisory information and the conduct of examinations.

**Enhanced Supervisory Interventions**

Central to the Bank's current supervisory approach is the early identification of risks, and a robust process for progressively escalating the intensity of supervisory interventions. Reflecting this approach, proposed legislative changes will also seek to strengthen the Bank's ability to intervene at an early stage. The proposals seek to expand the range of pre-emptive supervisory tools available to the Bank to address a problem, and allow for different approaches to be taken in circumstances where an institution's problems are less serious and the management is cooperative, as opposed to situations that require more formal actions with severe penalties for non-compliance. This is consistent with promoting supervisory measures that are proportionate. Proposals include strengthened provisions for the Bank to direct an institution to take specific remedial actions to address the Bank's concerns, and the ability to enforce commitments by institutions to implement measures designed to maintain the safety and soundness of the institution. It is also proposed that the enhanced supervisory interventions be reinforced with a new penalty framework that will include, in addition to criminal sanctions, the ability for the Bank to impose monetary or non-monetary administrative penalties and pursue civil actions, thus allowing for more expedient enforcement actions which are proportionate to the nature and gravity of non-compliances.