2010

EXECUTIVE SUMMARY

Risk developments and assessment of financial stability in 2010

The Malaysian financial system remained stable and supportive of economic growth in 2010 despite the continuing uncertainties and challenges in the operating environment. During the year, financial intermediation remained efficient and broad-based, supported by the orderly functioning of financial markets. Strong fundamentals of the domestic financial system, coupled with an ample liquidity environment, have provided the necessary conditions for the orderly exit of the temporary blanket deposit guarantee by the Government on 31 December 2010.

The household debt level continued to rise, but remained manageable. This has been supported by the sound financials of the household sector underpinned by income growth, further accumulation of financial assets, favourable employment conditions and a high level of savings. The debt coverage ratio of households (measured as the ratio of financial assets to total debts) was in excess of two times, thus providing households with the flexibility to adjust to changing economic and income conditions while preserving their debt servicing capacity. The strength of the household sector is also evident with the continued improvement in the household delinquency trend. With increased competition among financial institutions in serving the retail segment, supervisory attention remained focused on promoting responsible lending practices and conduct of financial institutions in their dealings with consumers. This was complemented by increased surveillance on the lending activities of non-bank entities to gauge the extent of any over-borrowing by certain segments within the household sector. Pre-emptive and targeted measures have been undertaken by the Bank to ensure effective management of debts by banks and households.

The increased and more volatile portfolio investments into the Asian region, including Malaysia, has prompted heightened surveillance of risk accumulation in the financial system and asset markets. Despite the magnitude of the portfolio flows, implications to financial stability remained contained as risk-taking behaviours of Malaysian financial institutions, businesses and households did not change materially. Orderly conditions in financial markets were also maintained and the increased volume and movements of such portfolio flows were intermediated through a diverse range of asset classes.

The contagion risks arising from external developments, largely stemming from fiscal and banking developments in Europe and geo-political tensions in the Middle East, were well contained and had negligible impact on the financial sector in Malaysia due to the low and mostly indirect exposures of financial institutions to counterparties in these regions. Any potential credit losses in the event of widespread sovereign defaults would therefore be limited. The expansion of Malaysian banking groups in the Asian region in recent years has further deepened financial linkages and while this has increased the potential for cross-border risk transmission, adverse spillovers from overseas operations are assessed to be immaterial. Credit risk to the banking system emanating from overseas operations remained manageable given the strong economic performance of countries in the region. This is further reinforced by the strong balance sheet fundamentals and risk management capacity both at the overseas entity and group levels. In addition, measures have been taken by a number of jurisdictions in the region to curb excessive asset price appreciation.

Profitability of the banking sector improved further in 2010, largely driven by higher net interest income and lower provisioning for impairment. The banking sector remained well-capitalised, reinforced by the high quality of capital, which is predominantly in the form of common equity and reserves. The aggregate risk-weighted capital ratio (RWCR) and core capital ratio (CCR) were 14.8% and 13.0% respectively, well above the current regulatory minimum levels, as well as the higher requirements under Basel III. Similarly, the insurance and takaful sectors registered stronger results backed by sustained demand for savings and protection products and the improved performance of the equity market. The capitalisation of the insurance industry remained strong with a capital adequacy ratio

(CAR) of 224.6%. The risk-bearing capacity of the financial system to withstand extreme macroeconomic and financial conditions was reaffirmed by stress tests carried out on the banking and insurance sectors, at both the aggregate and institutional levels.

The Islamic banking system continued to remain resilient throughout 2010, supported by high capitalisation, improved asset quality and sustained profitability in an environment of ample liquidity. Prudent administration of the profit equalisation reserves by the Islamic banks has contributed towards the effective management of displaced commercial risk. Islamic banking institutions have also been actively managing re-pricing gap risk that arises from the fixed rate nature of the financing portfolio with Islamic profit rate swaps. In reducing the concentration to fixed rate financing, Islamic banking institutions have also increasingly been focusing on variable rate Islamic financing products in the form of *musharakah mutanaqisah* (diminishing partnership) and *ijarah* (leasing).

The outlook for domestic financial stability in 2011 remains positive supported by underlying strengths of the Malaysian financial system. Key challenges to financial stability in 2011 are likely to be largely externally driven, as global economic conditions remain uncertain. Shifts in global liquidity will continue to pose challenges to the region, including Malaysia, whilst developments in commodity and energy prices will affect costs of living, particularly for average Malaysians living in urban areas. The growing influence and significance of non-bank lenders will also need to be managed to avoid an excessive build-up of leverage among certain segments in the household sector. While Malaysia's financial system is well-placed with the capacity and flexibility to respond to emerging risks to preserve financial stability, the Bank will remain vigilant to these potential sources of risk.

Development of the financial sector

Policy measures to develop the financial sector remained supportive of macroeconomic stability and the growth momentum of the economy, while advancing longer-term initiatives to enhance the potential capacity and resilience of the Malaysian financial sector. Initiatives were also directed towards strengthening Malaysia's inter-linkages with the global economy and cementing its position as an international centre for Islamic finance, alongside measures to raise the level of financial inclusion to all consumer segments.

The financial safety net was further strengthened with the coming into force of the new Malaysia Deposit Insurance Corporation (PIDM) Act 2011 on 31 December 2010. The new legislation extended and increased the coverage of the deposit insurance system. In addition, PIDM now has a broader range of intervention and resolution tools that can be deployed in the unlikely event of a member institution's failure. A new financial safety net framework for the insurance and takaful sectors has also been introduced with the implementation of the Takaful and Insurance Benefits Protection System (TIPS), which will provide better protection for insurance policyholders and takaful participants.

In raising the capacity and resilience of the insurance sector, the Bank continued to promote consolidation, particularly in the general insurance industry. Significant resources involving collaboration with multiple stakeholders have been directed towards addressing the structural weaknesses in the motor insurance sector. The new motor cover framework will provide better third party coverage, while paving the way for a gradual and smooth transition towards the removal of tariff in the motor sector.

The prompt policy measures undertaken by the Bank in 2008 and 2009 to provide a conducive enabling environment for business and household sectors to deal with their debt difficulties during this period, and to ensure continued credit flows to the economy, have enabled financial intermediation to continue smoothly and efficiently. Total outstanding financing to both businesses and households recorded robust growth of 9.4% and 13.4%, respectively. The environment for financing to small and medium enterprises (SMEs) continued to improve with continuous efforts to put in place a comprehensive institutional framework for SMEs. This included the creation of additional platforms for outreach and the provision of support and advisory services to SMEs, as well as collective measures by financial institutions to expedite the approval and disbursement of loans to SMEs. Such initiatives continue to provide essential support for SMEs to advance and transform to become larger and more competitive.

The Malaysian financial markets remained vibrant and supportive of corporate funding and international trade, with strong growth in both the ringgit and non-ringgit fund raising activities in the bond and sukuk markets. The foreign exchange market also saw increased breadth and liquidity as a result of the development of new financial instruments, the gradual liberalisation of foreign exchange administration rules and further flexibility accorded to foreign money brokers to increase the competitiveness, efficiency and transparency of the money and foreign exchange markets.

Initiatives to support the development of the Islamic finance sector continued to be an important agenda for the Bank, focusing in particular on capacity building, infrastructure and talent development. The Bank participated in the establishment of the International Islamic Liquidity Management Corporation (IILM) in October 2010 which would form part of the international Islamic infrastructure to support the liquidity needs of the global Islamic financial system. A high-level Law Harmonisation Committee was also set up during the year to develop recommendations to improve the certainty and enforceability of Shariah contracts in Malaysia. Malaysia continued to advance initiatives to deepen Shariah understanding in the industry, while elevating the Shariah advisory profession. This was complemented by more accommodative immigration policies introduced to attract talent into the Islamic finance industry and the continued advancements by the International Centre for Education in Islamic Finance (INCEIF) in the field of higher education in Islamic finance, both of which have enriched the available pool of talent to support the industry's growth. The issuance of four new family takaful licences to joint ventures between global and regional players and strong domestic entities has further reinforced Malaysia's position as a global hub for Islamic finance.

In line with Malaysia's commitment towards gradual liberalisation, five new commercial banking licences were also issued to foreign institutions with new expertise, global networks and strong value propositions to contribute positively to the Malaysian financial system and economy. These institutions are expected to add further diversity to Malaysia's financial system, support new areas of growth and facilitate international trade and investment flows. Existing locally-incorporated foreign banks (LIFBs) were also given greater operational flexibility during the year to establish new branches.

With the rapid expansion of Malaysian banking groups within the region and Islamic finance becoming an integral part of the global financial system, bilateral relationships and cooperation with central banks from around the region and beyond were strengthened. The framework for bilateral relationships and cooperation with central banks continued to be enhanced with the formalisation of a number of memorandums of understanding (MoUs), covering a broad range of areas related to cross-border banking supervision, economic integration, capacity building and strategic developments in both conventional and Islamic finance. A key cooperation initiative was the implementation of the Chiang Mai Initiative Multilateralisation Agreement involving a currency swap agreement for all ASEAN countries, the People's Republic of China, Japan and Korea to further strengthen regional capacity to deal with risks to financial stability.

Financial inclusion represented another area of high priority on the Bank's developmental agenda in 2010. Efforts were advanced during the year to improve the outreach of financial services nationwide, with plans progressed to establish the presence of financial institutions in the remaining unserved districts in Sabah and Sarawak. Greater flexibility has also been accorded for banking institutions to leverage on shared banking service platforms in collaboration with third parties to provide wider access to basic financial services to the public. Access to financing without collateral has seen significant growth since the implementation of the framework for *Pembiayaan Mikro* in 2006, with total outstanding micro financing amounting to RM776 million as at end-2010. This is further complemented by the 1Malaysia Micro Protection Plan (1MMPP), which is being finalised by the insurance and takaful industry to provide a financial safety net for micro enterprises and individuals. Ongoing efforts by the Bank to empower consumers through financial information, education and assistance were sustained, and further intensified through strategic collaborations with consumer associations to conduct financial literacy programmes for communities and youths in both urban and non-urban areas nationwide.

National efforts to curb money laundering and terrorism financing activities were enhanced with the implementation of a National Anti-Money Laundering and Counter Financing of Terrorism

(AML/CFT) Strategic Plan 2010–2012 to deliver high impact outcomes, more optimal resource allocations and improved monitoring of AML/CFT measures. This was supplemented by a comprehensive review of the legal and regulatory regime for the money changing and remittance services industry to elevate and modernise the industry, while further strengthening its defences against illicit activities.

Moving forward, key developmental priorities will be focused on the implementation of a new financial sector blueprint, which aims to enhance the capacity and capability of the Malaysian financial sector to serve the needs of a high-value added and high income economy. Among the basic thrusts of the plan are to reinforce the position of Malaysia as a global hub for Islamic financial services, support the holistic review of the pension and social security system given the demographic and social trends in Malaysia and further deepen Malaysia's inter-linkages with regional and international economies through facilitating further growth of cross-border financial transactions.

Regulatory and supervisory framework

Given the changing landscape and an increasingly integrated global financial system, the financial stability policy framework adopted by the Bank has sharpened its focus on the complementary roles of microprudential and macroprudential policy framework as well as market conduct regulation and supervision.

Global reform initiatives by the Basel Committee on Banking Supervision (BCBS) made significant progress during the year with the release of the new capital and liquidity standards in September 2010. The focus now is to complete the calibration of the remaining parts of the proposals and to coordinate global implementation. Based on preliminary assessments conducted by the Bank, banking institutions in Malaysia are well-positioned to meet the higher capital standards supported by their strong capital positions, continued profitability and prudent risk taking strategies. While the implementation of the new global liquidity standards will be more challenging primarily due to the structural characteristics of the domestic funding market, the extended timeframe and observation period provided by the BCBS will enable the Bank to make further impact assessments prior to implementation.

The implementation strategy for the local adoption of the new international standards will be further detailed in 2011. This will involve a careful assessment of the potential impact on the economy, the overall readiness of the financial system and the benefits that will be gained from strengthening the resilience of the financial system to future shocks.

Global initiatives to strengthen the resilience of the Islamic financial system were also taken forward during the year. The Task Force on Islamic Finance and Global Financial Stability published the Islamic Finance and Global Financial Stability Report which highlighted eight key building blocks for a sound and resilient Islamic financial system in the more challenging global environment. Malaysia is now at an advanced stage in developing these key building blocks as efforts to develop the Islamic financial sector have moved in parallel with the conventional financial system over the recent decade.

The migration of 11 banking institutions to the Internal Ratings-Based (IRB) approach for credit risk and the implementation of the Guideline on Internal Capital Adequacy Assessment Process (ICAAP) – the Pillar 2 component of Basel II – completed Malaysia's transition to Basel II. In addition, further enhancements were also made to prudential standards on corporate governance to promote more effective assessments of the fitness and propriety of persons in responsible positions within financial institutions.

Concurrently, the regulatory framework for the Islamic financial system was further strengthened with the development of a more robust solvency framework, enhanced regulatory framework for the management of takaful funds and Shariah governance standards for Islamic banks and takaful operators. The capital adequacy requirements for takaful operators were further defined, building on the parameters earlier established under the proposed Risk-Based Capital Framework for takaful operators (RBCT) and incorporating risk charges that are calibrated to reflect the underlying differences of business models in takaful operations.

Supervisory activities in 2010 remained focused on shoring up financial institutions' capacity to anticipate and respond to emerging risks as well as ensuring that identified vulnerabilities and weaknesses were followed up on and effectively rectified. The focus was directed in particular at promoting more robust stress testing and capital management processes to ensure the continued resilience of financial institutions under a range of economic and financial scenarios. Thematic supervisory reviews were also conducted to examine board practices among banking institutions as well as to assess the effectiveness of AML/CFT measures implemented by financial institutions. The outcome of these supervisory activities and reviews has enabled the Bank to respond pre-emptively to the vulnerabilities identified with the appropriate supervisory actions.

The Bank also heightened its surveillance of market conduct practices in view of the more intense competition in the retail segment. While banking institutions have generally continued to observe prudent underwriting standards, the rigour of standards applied for assessing the suitability and affordability of products offered to consumers varied considerably. In light of these observations, the Bank considered it appropriate to set clear expectations of responsible behaviour for financial institutions in the conduct of business in retail financing. The new Credit Card Guidelines have also been issued to enhance the security features of the credit card infrastructure, strengthen the protection of consumer's interests and mitigate the potential for fraud risk.

In the area of AML/CFT compliance, substantive improvements, including a higher level of awareness and technical capability, use of more sophisticated and discerning customer acceptance and due diligence practices, as well as more extensive use of centralised transaction monitoring models, have been observed across the industry. To support more effective monitoring and surveillance of any money laundering and terrorist financing activities, the Bank's supervisory assessment framework for AML/CFT has been further enhanced to provide additional guidance for supervisors in conducting AML/CFT assessments to ensure the integrity of the financial system.

Payment and settlement systems

The payment and settlement systems in Malaysia remained resilient and continued to operate smoothly throughout the year contributing to the stability of the financial system and maintenance of public confidence. The focus of supervisory oversight during the year was to ensure the continuous availability of the systemically important payment systems (Real-time Electronic Transfer of Funds and Securities System, RENTAS), with progressive efforts being undertaken to enhance and modernise the systems to achieve greater efficiency and reliability. Greater attention was also directed at ensuring the operational reliability and robustness of the major retail payment systems such as those operated by the Malaysian Electronic Payment System Sdn. Bhd. (MEPS) and Touch 'n Go Sdn. Bhd. (TnG). During the year, measures were undertaken to strengthen regulatory requirements for retail payments to promote the safe conduct of electronic banking services by financial institutions.

The Bank intensified its efforts to achieve greater penetration of electronic payments in targeted sectors. The implementation of electronic share payment and electronic dividend initiatives during the year increased efficiency in the capital market, while providing greater convenience and faster access to funds for investors. Work also progressed to create an open and interoperable mobile banking and payment ecosystem which would promote the wider use of mobile banking and payment channels in the country.

Collaborative efforts among central banks in the ASEAN region and regional industry players in respect of regional integration of payment systems were also intensified to achieve an ASEAN Economic Community by 2015.