RISK DEVELOPMENTS AND ASSESSMENT OF FINANCIAL STABILITY IN 2010

OVERVIEW

Domestic financial stability was preserved throughout 2010 providing support for the strong growth of the Malaysian economy. The domestic financial system demonstrated a high degree of resilience against the key sources of risks, as highlighted in the *Financial Stability and Payment Systems Report 2009*. Financial intermediation was broad-based and functioned efficiently; the financial markets remained orderly; and confidence in the financial system was maintained throughout the year. This was reinforced by the strong fundamentals of the financial system and an ample liquidity environment, which ensured conditions for the efficient exit from the blanket guarantee on deposits by the Government on 31 December 2010 without event.

Profitability of the financial institutions recorded a strong recovery, on account of higher interest and fee income for the banks, and investment performance for the insurers and takaful operators. This reinforced the strong aggregate capitalisation of the financial sector, both in terms of the level and quality of capital under normal as well as stressed conditions. Amidst more buoyant financial market conditions arising from capital flow movements, risk-taking by financial institutions remained well-managed, with stress tests affirming the capacity of financial institutions to withstand extreme market volatility and conditions associated with reversals of portfolio flows.

While the household debt level continued to expand, the aggregate financial position of the household sector remains sound, supported by income growth, favourable employment conditions and a high level of savings. Close monitoring was accorded to financial management and lending practices that may place households in a vulnerable position moving forward. In addition, attention was also accorded to lending activities of non-bank entities, which mainly focused on the retail segment, to gauge the extent of over-borrowing by any segment within the household sector. Pre-emptive and targeted measures by the Bank have therefore been directed towards addressing this risk.

Deliberations of these risks and the ensuing policy responses were undertaken by the Financial Stability Policy Committee. This high-level forum is responsible for the assessment of risks to financial stability arising from both system-wide and institutional developments, and decisions on the appropriate policy responses. In arriving at these decisions and in designing the specific policy responses, the Financial Stability Policy Committee would take into account the potential trade-offs and spillovers of such actions to the wider economy as well as any longer-term consequences to the financial system. Policy deliberations for macroprudential responses that can have a wider impact on macroeconomic and monetary conditions are jointly deliberated with members of the Monetary Policy Committee of the Bank.

Risks to domestic financial stability in 2011 are expected to be largely externally driven, with significant uncertainties associated with the uneven global recovery and geo-political tensions. This could affect domestic conditions through the potential build up of asset prices, financial market volatility and rising costs of living. As regional and global financial systems become more integrated with a substantial and growing presence of Malaysian financial institutions in the region, the potential for risk transmission and contagion across borders will also be higher, both in terms of speed and magnitude. While Malaysia's financial system is well placed with both the capacity and flexibility to respond to preserve financial stability, the Bank's surveillance and supervisory functions will remain vigilant to these potential sources of risk.

MANAGING RISING HOUSEHOLD DEBT LEVEL

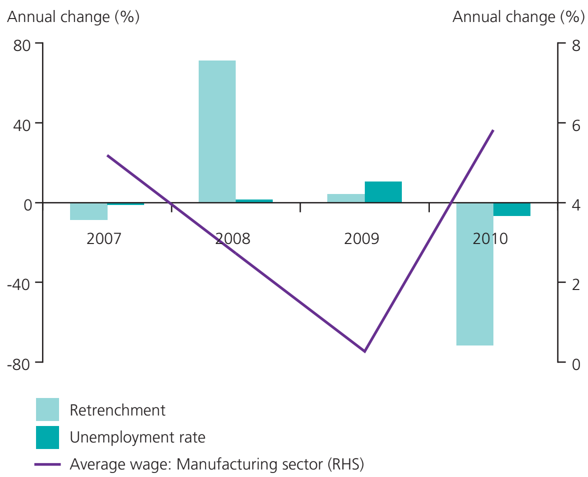
Sound financials enabled households to weather rising prices and higher borrowing costs in 2010

In 2010, households continued to exhibit a strong aggregate financial position, supported by income growth and improved employment conditions. The strong recovery of the domestic economy saw more new job positions created, while unemployment rate continued to improve

(Chart 1.1). This allowed the majority of households to adjust to the rise in food prices, transportation costs and borrowing costs, while preserving their debt servicing capacity (Chart 1.2). Meanwhile, the household debt level continued to expand at a faster pace of 12.5% in 2010, reflecting a rebound in consumer sentiment. The ratio of household debt-to-GDP remained almost unchanged at 75.9% (Chart 1.3). While higher in comparison with other regional economies (Chart 1.4), risks of financial stress in the household sector remain limited at present, as the debt level is comfortably supported by a

Chart 1.1

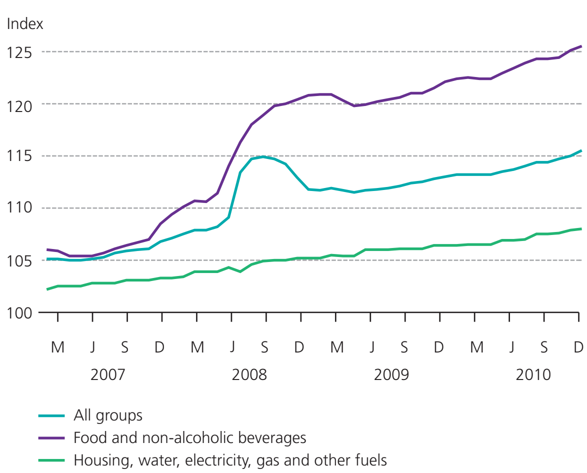
Labour Market Conditions



Source: Department of Statistics, Malaysia

Chart 1.2

Consumer Price Index



Source: Department of Statistics, Malaysia

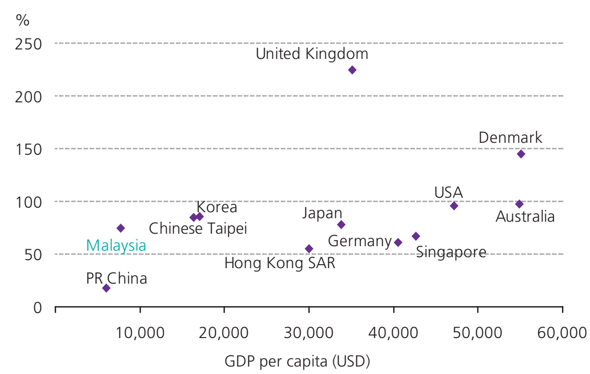
Chart 1.3

Household Debt-to-GDP Ratio

Source: Bank Negara Malaysia and Department of Statistics, Malaysia

Chart 1.4

Country Comparison: Household Debt-to-GDP Ratio

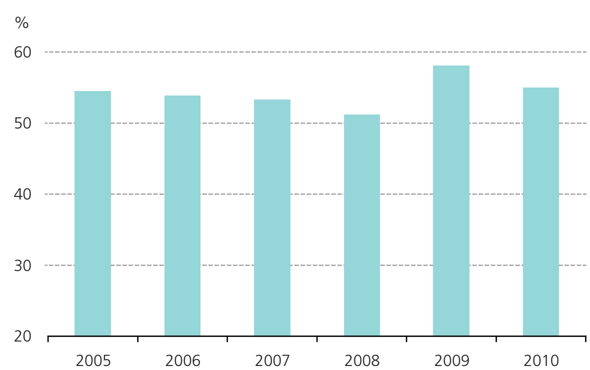


Note: Australia (Q2 2010), Denmark (Q1 2010), Germany (2010), Hong Kong SAR (2009), Japan (Q3 2010), Korea (2009), PR China (2008), Singapore (Q3 2010), Chinese Taipei (2009), United Kingdom (Q1 2009) and USA (Q1 2010)

Source: Bank Negara Malaysia, Department of Statistics, Malaysia; National Authorities and International Monetary Fund

Chart 1.5

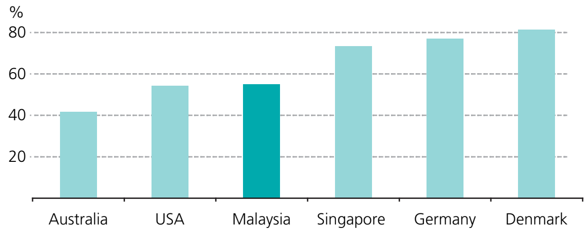
Household Deposit-to-GDP Ratio



Source: Bank Negara Malaysia and Department of Statistics, Malaysia

Chart 1.6

Country Comparison: Household Deposit-to-GDP Ratio

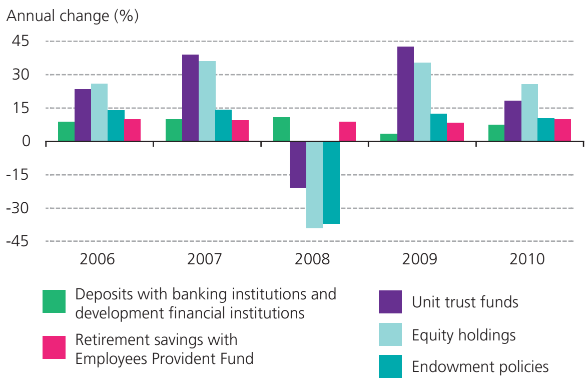


Note: Australia (2009), Denmark (2009), Germany (2009), Singapore (Q3 2010) and USA (2009)

Source: Bank Negara Malaysia, National Authorities and International Monetary Fund

Chart 1.7

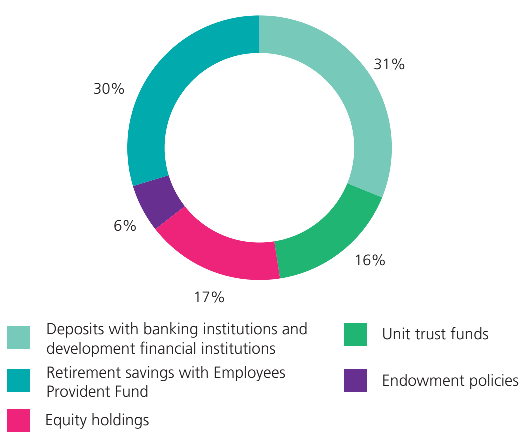
Household Financial Asset



Source: Bank Negara Malaysia, Employees Provident Fund, Securities Commission Malaysia and internal computation

Chart 1.8

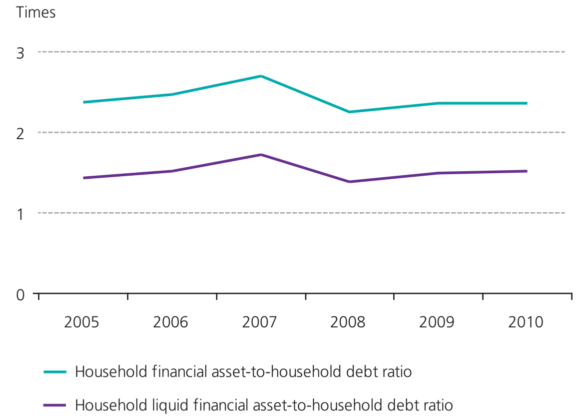
Composition of Household Financial Asset



Source : Bank Negara Malaysia, Employees Provident Fund, Securities Commission Malaysia and internal computation

Chart 1.9

Household Financial Asset-to-Household Debt Ratio



Source: Bank Negara Malaysia, Treasury Housing Loans Division, Employees Provident Fund, Securities Commission Malaysia and internal computation

high level of deposits (Chart 1.5 and Chart 1.6) and other forms of savings (Chart 1.7 and Chart 1.8). Debt coverage, as measured by the household financial asset-to-debt ratio, is more than two times of household debts (Chart 1.9). Delinquency rate is also low at 2.3% of total banking system household financing and has been on a sustained improving trend over the recent decade.

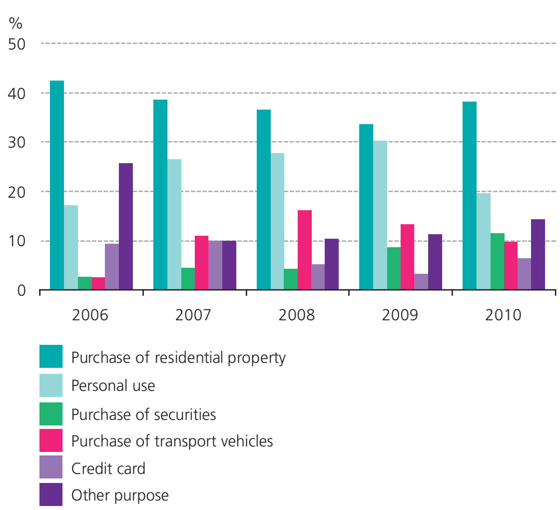
Financial assets of households expanded at 13.1% (2009: 14.9%) for the year. The growth in household financial assets was mainly attributed to the strong performance of the equity market, which bolstered market valuations and holdings of equity by households. With one third of household financial assets in the form of equity, households are susceptible to volatile swings in equity prices as observed in 2008, when a 39.3% fall in the FBM KLCI precipitated a decline in household financial assets. This in turn, may subject household financial position to the vagaries of the equity market. The impact from valuation movements in the equity investments of households is mitigated by a substantial and almost equivalent proportion of household financial assets represented by deposits with financial institutions, which continue to provide a comfortable buffer to support households' debt servicing ability. As at end-2010, the ratio of financial asset-to-debt remained relatively unchanged at 238.4%, with more than 60% of the financial assets held in the form of highly liquid assets (Chart 1.9).

Rising household indebtedness was mitigated by more than two-fold of financial assets buffer. The strong buffer provides a comfortable cushion for households to adjust to the higher cost of living and potentially borrowing costs

Liabilities of households expanded at a slower rate relative to financial assets in 2010. The growth was led mainly by financing for the purchase of properties and for personal use (Chart 1.10 and Chart 1.11). The pace of growth however, was higher than the previous year (12.5%; 2009: 9.4%) (Chart 1.12), although this has largely been offset by a corresponding increase in personal disposable income at the aggregate level. With the continued emphasis of banking institutions on the retail segment (Chart 1.13) and given the rise in household indebtedness, supervisory activity in 2010 remained focused on the robustness of banks' risk underwriting and management practices, as well as the practices and conduct of banking institutions in their dealings with retail customers.

Chart 1.10

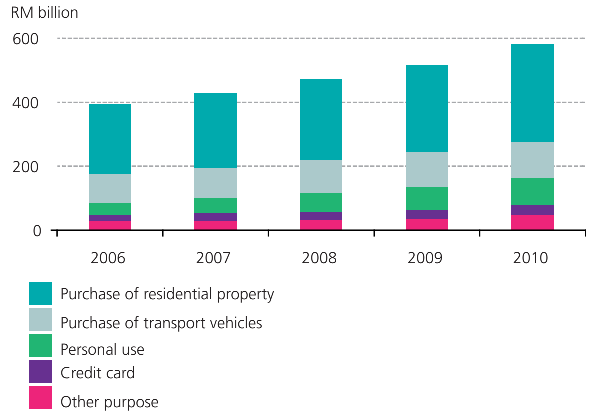
Contributors to Growth of Household Debts



Source: Treasury Housing Loans Division, Bank Negara Malaysia and internal computation

Chart 1.11

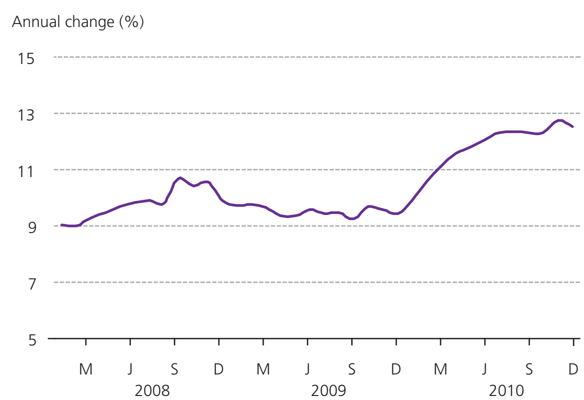
Composition of Household Debts by Purpose



Source: Treasury Housing Loans Division and Bank Negara Malaysia

Chart 1.12

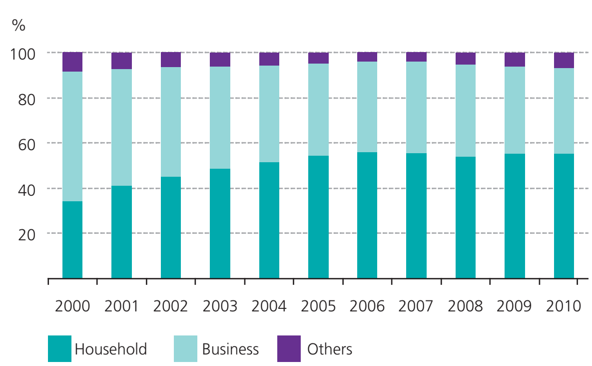
Household Loans Outstanding



Source: Bank Negara Malaysia

Chart 1.13

Proportion of Banking System Loans by Sector



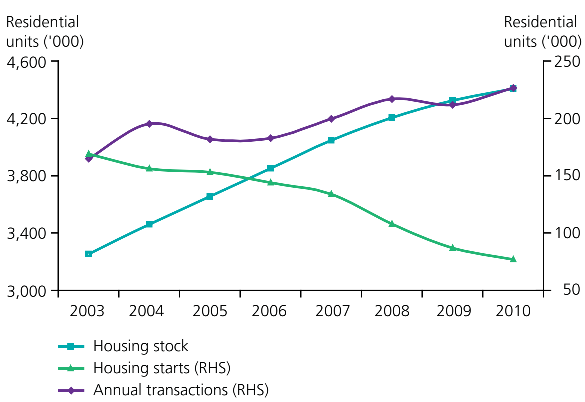
Source: Bank Negara Malaysia

Assessments on banks' underwriting practices so far indicate that the extension of financing on competitive terms such as below base lending rate (BLR) financing rates and extended tenures, have largely been confined to customers that met stringent internal credit standards including those with good financial track records. Such practice therefore ensures that banks' credit risk exposures associated with such financing are contained. In addition, banks also employ other form of safeguards for such financing, which includes the requirement for borrowers to open bank accounts with the lending banks, in order to better monitor payment trends. Credit checks through the Central Credit Reference Information System (CCRIS) ensure comprehensive assessment of borrowers' aggregated debt repayment obligations and credit worthiness. These practices support the continued and improving low delinquency rate for financing to households for the purchase of property which stood at 3.2% of housing loans extended by the banking system (2009: 4.3%).

The residential property market has been experiencing an upturn since the fourth quarter of 2009 as demand rebounded by 7.1% (2009: -2.3%) following improved consumer sentiments. Meanwhile, the increase in housing stock moderated in 2010 as housing starts extended a declining trend (Chart 1.14). The widening gap between supply and demand has kept property prices elevated, although at the national level, the Malaysian House Price Index rose only moderately by 6.2% up to third quarter of 2010 (Chart 1.15). Substantial increases in house prices have been observed in selected locations

Chart 1.14

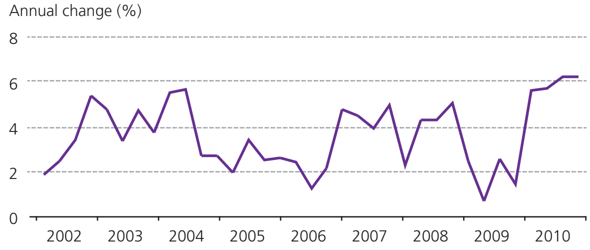
Supply of and Demand for Residential Properties



Source: National Property Information Centre (NAPIC) and internal estimation for 2010

Chart 1.15

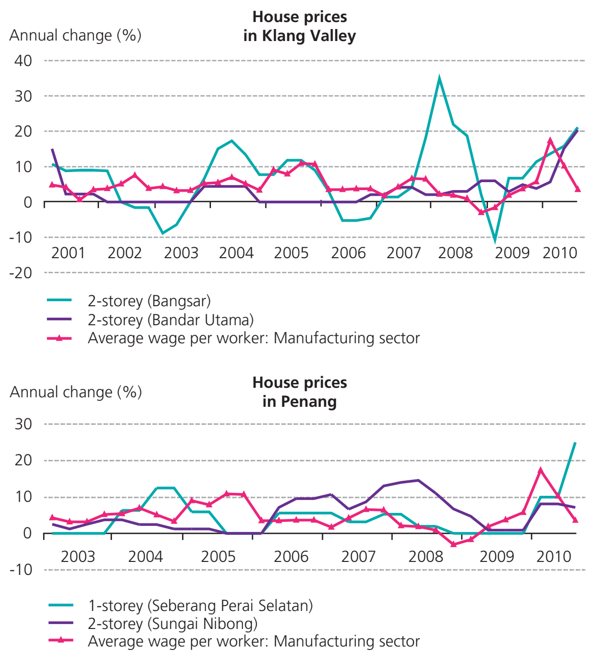
Malaysian House Price Index



Source: National Property Information Centre (NAPIC)

Chart 1.16

Property Prices in Selected Prime Locations

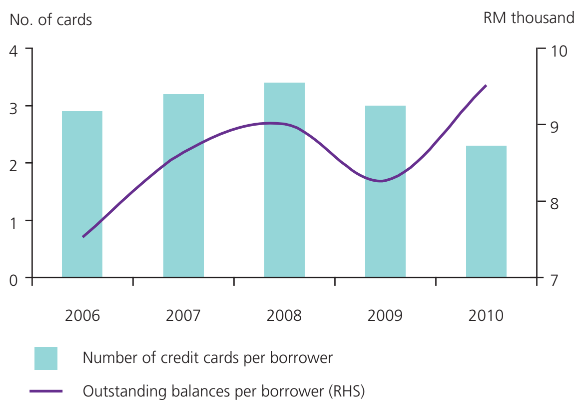


Source: The EDGE and Department of Statistics, Malaysia

within and surrounding the urban areas where price increases were up to four times higher than the national house price index (Chart 1.16). Price increases in these locations have in turn resulted in prices of properties in the surrounding locations to increase, making homeownership increasingly less affordable for average Malaysians. There have also been incidents of applications for financing of multiple residential units within a single development project from a single borrower. To address this development, while safeguarding the risk profile of banks' house financing portfolios, borrowers are subjected to a loan-to-value (LTV) ratio of 70% for the third and subsequent house financing facilities with effect from 3 November 2010. This measure aims to promote a stable and sustainable property market by deterring speculative activity through higher equity requirements for transactions of these nature, without affecting genuine home owners who would continue to be able to obtain financing at the prevailing LTV levels applied by financial institutions based on their internal credit policies. In January 2011, the Bank revised the risk weights applied under the capital adequacy framework from 75% to 100% for housing loans with LTVs exceeding 90% to further reinforce prudent underwriting practices.

Chart 1.17

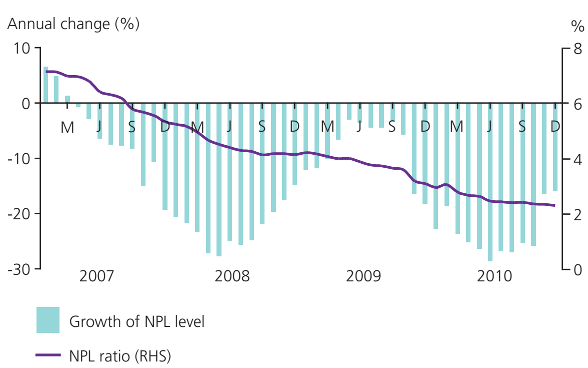
Credit Cards per Borrower



Source: Bank Negara Malaysia

Chart 1.18

Banking System: NPL of Household Sector



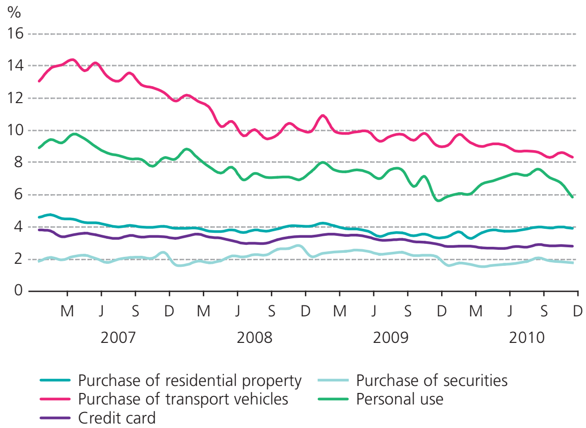
Source: Bank Negara Malaysia

While a large fraction of household borrowings is collateralised (45.3% was for the purchase of residential properties), personal financing has increased significantly in recent periods. In 2010, outstanding personal financing grew by 17.5% to account for 14.6% of household debt (2006: 9.6%). Development financial institutions (DFIs), cooperatives and building societies accounted for the bulk of this growth, with almost 80% granted under salary deduction schemes. Given the salary deduction feature, credit assessments by these institutions are mostly limited to a reliance on incomplete computations of debt-servicing ratios, which are applied for the purpose of qualifying for the salary deduction facility. The absence of robust credit and affordability assessments will result in households being more at risk of becoming over-indebted, while the risk of defaulting on financing obligations, including those obtained from other banking institutions, will be higher for borrowers who have over-borrowed. Excluding the DFIs, personal financing exposures of commercial banks increased at a lower rate of 13% to account for 8.6% of banking system household loans. Sound underwriting standards have largely been maintained by banks in terms of financing limits, tenures and pricing for these exposures.

The higher household debt level is also partially attributed to increases in credit card transactions. Despite a reduction in the number of cards owned by households following the imposition of a RM50 fee by the Government on credit cards in 2010, outstanding credit card balances increased by 15.2% to RM30.8 billion as at end-2010 to account for 5.3% of household debts. Similarly, outstanding balances per credit card holder rose by 15.1% to RM9,516 as at end-2010 (Chart 1.17). The number of credit card holders with revolving balances (excluding defaulters) accounted for 47.9% of total credit card holders. More than half of credit card holders with revolving balances were those earning an annual income of RM36,000 and below. Meanwhile, the level of non-performing loans (NPLs) ratio for credit cards issued by banks and non-banks remained low at 1.7%. To ensure that credit card debts are maintained at manageable levels, a number of pre-emptive measures have been introduced, including raising minimum income eligibility, limiting the number of credit card ownership and aggregate credit limit for those with annual income of RM36,000 and below.

Chart 1.19

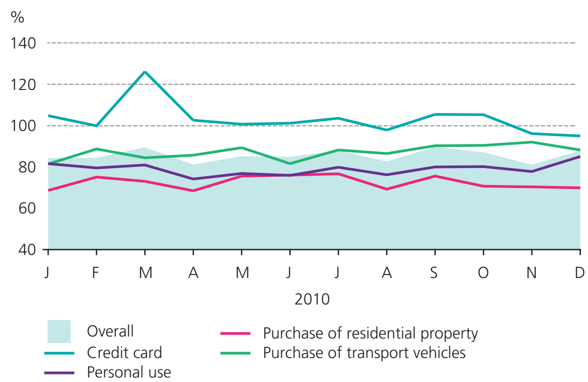
Banking System: Loans-in-Arrears Ratio of Household Sector by Purpose



Source: Bank Negara Malaysia

Chart 1.20

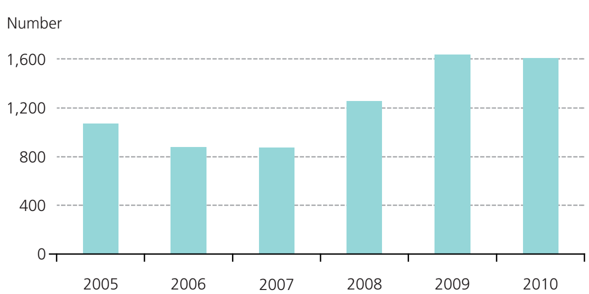
Banking System: Household Debt Repayment-to-disbursement Ratio



Source: Bank Negara Malaysia

Chart 1.21

Number of Bankruptcies



Source: Malaysia Department of Insolvency

Aggregate debt repayment capacity of households remained intact throughout the period of economic contraction in 2009 and has continued to be sustained in 2010. NPLs improved further during the year, both in terms of amount and ratio, underpinned by the relatively stable incidence of new delinquencies (Chart 1.18). Similarly, loans-in-arrears across most categories of household debts remained stable, while loans-in-arrears for personal financing, which drifted upwards in the early part of the year, started to come down in the fourth quarter of 2010 (Chart 1.19). As at end-2010, the NPL ratio for household loans was 2.3%. The ratio of household loan repayment-to-disbursement increased marginally to 87.8% (Chart 1.20). There has been little evidence of an across the board deterioration in underwriting standards and practices to date. Lending decisions have continued to be well supported by the strengthened credit information and the risk management infrastructure put in place by banking institutions. For the isolated instances of a loosening in underwriting practices by individual institutions, the Bank has taken firm supervisory actions. The adoption of Basel II, which became effective in 2008, has also further supported and strengthened risk management practices among the financial institutions.

While aggregate indicators suggest that household financial positions remain sound, the highly competitive environment and the increased indebtedness of households have called for pre-emptive measures to preserve the resilience of the household sector going forward. While the number of personal bankruptcies and relapse rate among borrowers under AKPK's Debt Management Programme has been manageable, it has been on the increase since 2007 (Chart 1.21). Important in taking on increased debts by the households is their capacity and capability to more effectively manage their financial positions.

In response to these developments, a number of initiatives were implemented during the year to ensure the continued resilience of the household sector. These include the introduction of the POWER! Programme, to educate younger and first time borrowers on responsible borrowing, tighter standards for credit cards and enhanced requirements on the conduct of business by financial institutions in retail financing. See box article on *"Pengurusan Wang Ringgit Anda (POWER!) Programme"*. Under the new measures introduced for credit cards, individuals with an

Pengurusan Wang Ringgit Anda (POWER!) Programme

The *Pengurusan Wang Ringgit Anda* (POWER!) Programme was launched in January 2011 as part of the agenda to improve the financial capability of Malaysian financial consumers. It complements the *bankinginfo* and *insuranceinfo* initiatives as the key platforms through which the Bank, in collaboration with its partners, works to support better financial decisions among the adult population.

With more intense competition in the financial sector and increasing complexity of financial product offerings, the ability of consumers to better understand the implications of their financial choices is vital to ensure that they can adapt to unexpected changes in their circumstances, and avoid falling into financial hardship. The young adult population in particular is facing a more demanding environment in which less than optimal financial decisions can have significant longer-term consequences in terms of their ability to meet future expenditures, weather unexpected changes in income levels and provide sufficiently for retirement. Against this backdrop, the POWER! Programme aims to help consumers achieve their financial goals and protect themselves from falling into over-indebtedness through better borrowing decisions. In addition, the programme will empower financial consumers to engage more effectively with financial service providers when making their financial choices and in resolving any debt problems that may arise. Equally significant are the wider benefits to the economy and society that will accrue from financially resilient households, sustainable consumption growth and a strong safety net.

The POWER! Programme is targeted primarily for young individuals and new borrowers to equip them with practical financial knowledge and skills on money and debt management as well as decision-making tools to make sound and responsible financial decisions. The half-day voluntary programme covers six modules delivered in a highly interactive, relevant and creative manner. The modules address topics that will confront most young adults in the management of their financial affairs such as how to analyse and manage personal or household cash flows, maintain manageable debt levels, and the key considerations and processes that a potential borrower should understand when obtaining financing for house and vehicle purchases, or credit card facilities for personal use. The programme uses financial toolkits and focuses on practical applications of financial decisions and their consequences in real life situations that will create a direct and immediate impact in making responsible financial management a way of life among Malaysia's young adults.

The programme is managed and delivered by Credit Counselling And Debt Management Agency (AKPK) in collaboration with banking institutions. Participation in the programme is free of charge and individuals can register for the programme directly with AKPK or through their banking institutions. Meanwhile, work has advanced to develop a wide range of interactive learning and online tools to supplement the POWER! Programme. Through these facilities, participants will be able to simulate their financial affordability, cash flow and financial net worth, engage in discussion forums on financial management and obtain financial tips and advice.

Employers and members of the public can obtain more details of the programme in the websites of AKPK (www.akpk.org.my), *bankinginfo* (www.bankinginfo.com.my) or *insuranceinfo* (www.insuranceinfo.com.my). Interested parties can also contact AKPK at their toll-free number 1-800-88-2575 or Bank Negara Malaysia TELELINK at 1-300-88-5465.

Table 1

Overview of the POWER! Programme

No.	Module	Key contents
1.	Cash Flow Management	• Smart living: identify needs and wants • Develop personal budget and cash flow/net worth statement • Knowing financial position and net worth
2.	Borrowing Basics	• Common sources of personal credit and key features of credit facilities • Key lending criteria • Cost of borrowing and setting own debt limit • Rights and responsibilities of a borrower
3.	Using a Credit Card	• Different types of cards i.e. debit card, credit card and charge card • Understanding the terms and conditions of credit cards • Using credit cards wisely • Responsibility to protect credit cards
4.	Buying a Car	• Factors to consider when buying a car, including affordability, maintenance and other recurring expenses • Terms and conditions of hire purchase agreement, including term charges, early settlement and repossession
5.	Buying a House	• Factors to consider when buying a house, including affordability, types of house ownership, location, cost and maintenance • Understanding the terms and conditions of housing loans/house financing • Understanding the rights and responsibilities of a borrower • Consequences of default
6.	The Importance of Managing Your Debts	• Factors contributing to indebtedness • Consequences of unmanageable debt • Importance of building and maintaining good credit history • Advisory and redress services available to assist in better debt management

annual income of RM36,000 and less will be limited to owning credit cards from not more than two issuers and an aggregate credit limit of not exceeding two times the individual's monthly income per issuer. The minimum income eligibility criterion for credit card applications has also been strengthened to RM24,000 per annum from RM18,000 previously. This is supplemented by new guidelines to be issued by the Bank on the conduct of business in retail financing, which set the minimum standards (including on affordability and suitability assessments), to deliver a more responsible approach to lending by the financial institutions. The guidelines have recently undergone a consultation process with the industry and will be issued in April 2011. Details of the measures are highlighted in box article *"Consumer Protection, Market Conduct and Financial Stability"*.

FINANCIAL STABILITY IMPLICATIONS OF VOLATILE CAPITAL FLOWS

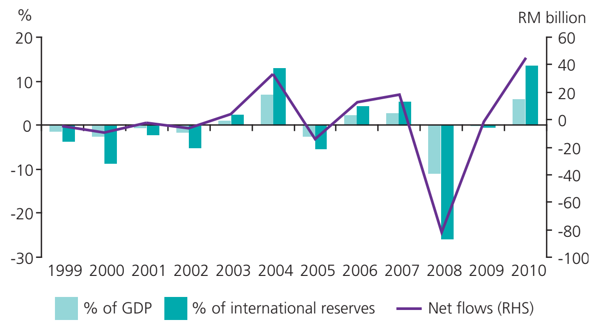
Financial stability implications from volatile portfolio flows remained manageable

The resumption of inflows of portfolio investments into the Asian region, including Malaysia, since the second half of 2009 gained further momentum in 2010. The surge of such flows has posed challenges to the management of liquidity and monetary policy operations in the regional economies, prompting heightened surveillance by authorities for signs of accumulation of excessive risk in the financial system and in the asset markets. A number of the regional economies have introduced measures to manage the surge and volatility in portfolio inflows in order to preserve stable conditions in the domestic markets, including for when the trend reverses. While Malaysia experienced a similar magnitude of portfolio flows, this has not materially altered the risk-taking behaviours of financial institutions, businesses and households. Financial markets in Malaysia have also remained orderly and exhibited an enhanced capacity to intermediate the increased volume and movements of the portfolio flows.

The resurgence in portfolio flows into Malaysia became more evident from the third quarter of 2009 amid better economic growth prospects in the region, including Malaysia, and improvements in the international financial market conditions. Given Malaysia's increased integration with the global financial system, the magnitude and

Chart 1.22

Net Portfolio Flows



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

volatility of the two-way flows have been more pronounced in periods of heightened uncertainty such as that experienced at the height of the global financial crisis and during the financial turmoil in the European sovereign debt markets in mid-2010. For the year as a whole, net portfolio flows were positive, amounting to RM44.9 billion (2009: net outflow of RM1.7 billion) to account for 5.9% of GDP (Chart 1.22).

Portfolio investment flows into the country are now being channeled into more diversified asset classes. In the first half of 2010, the inflows were largely concentrated in the public debt market, in particular, the Malaysian Government Securities (MGS) and Bank Negara Monetary Notes (BNMN), causing MGS yields to decline. As investors' risk appetite improved and search for yields re-surfaced, the positive outlook for the domestic economy drew more funds into the equity and futures markets. This contrasts with the period of large portfolio capital inflows during 1992-1993, when inflows were heavily concentrated in the equity market, which resulted in the exceptionally bullish performance of the Kuala Lumpur Stock Exchange in 1993.

Reflective of these developments, changes in foreign participation in the capital markets during the year were more evident in the public debt securities market. Non-resident holdings of MGS, as at end-2010, rose by 64.2% to RM74 billion to account for 28.3% of outstanding MGS. Holdings of BNMN by non-residents were slightly higher at 32.8% of outstanding BNMN for the same period. While holdings of short-term securities by non-residents increased during the year, longer-tenured securities continued to represent

Consumer Protection, Market Conduct and Financial Stability

The regulation and supervision of the conduct of financial institutions towards consumers has traditionally served mainly to protect individuals from unfair, abusive and predatory practices by financial institutions. More recently however, regulations that protect financial consumers (or market conduct regulations) have also received greater global attention as having an important complementary role to prudential regulation and supervision in protecting the overall financial system from **systemic risk**. This article elaborates the link between market conduct practices of financial institutions and the build-up of systemic risk drawing on observations from the global financial crisis, and provides an insight to the market conduct regulatory and supervisory regime in Malaysia including the focus of current and future initiatives to mitigate systemic risk.

Observations from the financial crisis

From a market conduct perspective, a confluence of several notable developments contributed to events that culminated in the financial crisis:

- The decade predating the financial crisis saw a dramatic increase in subprime mortgage lending which was partly fuelled by a period of substantive deregulation of the features and terms of consumer loans. In particular, the Depository Institutions Deregulation and Monetary Control Act of 1980 which lifted state-regulated interest-rate caps is widely credited with spurring the growth of subprime lending in the United States (US);

- The rapid pace of financial innovation and growing complexity of financial products also significantly widened the information gaps between financial institutions and consumers, in turn rendering ineffective much of the disclosure-based regulations that had replaced the regulation of the terms of consumer loans. Mortgages and consumer credit products offered by financial institutions in the US have evolved to include complex terms that allowed lenders to reset interest rates or charge heavy fees and penalties that were not apparent or adequately explained to consumers. This in turn led to poor and uninformed financial decisions where borrowers were unrealistically led to believe that they could depend on a perpetual rise in house prices to meet potentially onerous financial obligations;

- In an environment of intense competition, misaligned incentive structures in the credit and sales processes also worked against the interests of consumers. Compensation structures were biased towards encouraging lenders and intermediaries to push products that generated the highest profit or commission, with little or no regard for the suitability of the product to a borrower's particular financial circumstances. Incentive schemes that linked commissions to sales volume or particular credit products expectedly reduced incentives for intermediaries to ascertain the customer's financing needs or capacity to repay the debt over the longer term without substantial hardship; and

- The advent of securitisation enabled lenders to easily offload credit risks and generate cash flows (and lucrative servicing fees) that allowed **and** incentivised them to further increase lending exponentially to the subprime segment. Investors in securities that were backed by subprime credits also suffered major losses which were widely blamed on the misrepresentation of securitisation products as low-risk alternatives to deposits. Subsequent regulatory reviews, including in Asia, of market conduct practices in the offering and sale of securities linked to subprime mortgages revealed mis-selling by sales representatives who were ill-equipped to properly explain the risks associated with the products, and failed to establish the suitability of the products for the investors to whom the products were being sold.

These developments had important and ultimately disastrous consequences for the stability of the overall financial system. They contributed towards significantly increasing leverage in the system as a whole as financial institutions, borrowers and investors collectively miscalculated and failed to properly take account of the risks that they were exposed to. When concessionary interest rates on adjustable rate mortgages were reset to market rates and house prices eventually corrected, borrowers defaulted in large numbers, triggering a series of events that would threaten the livelihoods of indebted borrowers, the soundness of financial institutions and ultimately, impair the ability of the financial system to perform its intermediation function. Widespread foreclosures further depressed house values, feeding into a vicious cycle that significantly impeded recovery efforts. This was further compounded by regulatory findings of improper foreclosure practices by some financial institutions which further stalled recoveries that were critical to restore the balance sheets of financial institutions and revive lending to the economy. Continuing allegations of pervasive misconduct on the part of lenders, arrangers and brokers both in the mortgage and securitisation markets saw the widespread erosion of confidence in financial institutions and markets which severely affected the functioning of funding markets during the crisis, and continues today to cast a shadow over the firm recovery of financial institutions which remain exposed to financial losses from legal and regulatory sanctions.

In the wake of the financial crisis, financial regulators in a number of countries have since moved to strengthen existing institutional arrangements and regulations in the area of market conduct. Most notably, authorities in many jurisdictions have introduced higher standards on fair and responsible lending practices, particularly in lending to households and small businesses. These standards have substantially raised the bar on practices by financial institutions in ensuring that credit products offered to individuals are both affordable and suitable for their needs. Other significant developments have included extending the existing consumer credit law to regulate the emergence of a wider array of players in the consumer credit market, the establishment of new agencies and enactment of new legislation to support a stronger focus on consumer protection. This requires significantly higher standards of competency of sales intermediaries and a return to stronger regulatory prescriptions on terms and conditions of credit and circumstances under which complex products may be offered to individuals.

Market conduct regulation and supervision in Malaysia

The financial consumer protection framework in Malaysia for which Bank Negara Malaysia is primarily responsible, comprises five main strands which may be described as follows:

- Regulating and supervising the market conduct practices of financial institutions. This focuses on addressing information asymmetries between financial institutions and consumers, and setting clear expectations on fair, responsible and transparent practices by financial institutions in their dealings with consumers;

- Empowering consumers to make sound and well-informed financial decisions through a comprehensive and sustained financial education programme;

- Providing a comprehensive supporting credit infrastructure that promotes a sound credit culture among consumers and robust credit assessments by financial institutions;

- Setting and enforcing qualification and competency standards for sales and marketing personnel/ agents and other intermediaries such as insurance brokers and financial advisers; and

- Providing effective and expedient redress and support arrangements for financial consumers, including complaints and mediation channels, financial counselling services and debt management programmes.

In an environment of increasingly intense competition, the search for yield among investors, and the globalisation of financial institutions with operations in multiple jurisdictions, Malaysia benefited in particular from several notable elements of the financial consumer protection framework that has been put in place in averting the widespread market conduct failures which were revealed in some jurisdictions at the height of the financial crisis.

Under the framework applied by the Bank for the regulation of financial products, banking institutions were required until 2007 to obtain the Bank's approval for any new financial product prior to offering the product for sale in the market. This allowed the Bank to review the capacity of the financial institution to effectively manage the risks associated with the product, both to the institution itself and the consumers to whom the products would be sold. As part of this process, the Bank can prohibit a financial institution from offering any product, or require the institution to vary the product (including related disclosures to consumers) to address any regulatory concerns. With strengthened risk management frameworks in place within financial institutions, the product approval regime has since been gradually replaced by a notification requirement which improved the time-to-market of new product offerings, while effectively preserving the ability of the Bank to conduct timely regulatory reviews of significant new products. Supervisory actions by the Bank were also expanded to include requiring financial institutions to recall misleading or high-risk products and provide restitution to affected consumers. Further, the Bank has preserved the requirement for financial institutions to obtain the Bank's prior approval of products that are new to the domestic market. Given the expectations under this framework for a financial institution to be able to demonstrate to the Bank its ability to adequately safeguard the interests of consumers and internally manage the risks associated with any new product, financial institutions in Malaysia largely avoided involving themselves in offering the complex securitisation products that had led to significant losses experienced by financial institutions and investors in several countries during the crisis.

Financial institutions are also required to observe requirements to actively consider and properly advise consumers on the suitability of products for their needs. For the introduction of new financial products, in particular sophisticated investment products, financial institutions are required to establish customer suitability procedures that include processes to clearly describe the types of consumers that a product would generally be suitable for, clear lines of authority for approving transactions with customers that do not meet generic customer suitability profiles and the effective oversight of sales personnel. To establish customer suitability, financial institutions must obtain and document relevant information from a prospective customer to determine the financial circumstances, needs and objectives of the customer as a basis for recommending a particular product.

Financial institutions must further comply with specific disclosure requirements that are designed to ensure that disclosures (including product names and descriptions) are not confusing and presented in plain language, and that the key risks of financial products are highlighted in a prominent manner to consumers. The disclosures must also clearly illustrate in defined terms the financial impact to consumers of changes to key variable features of products. Financial institutions must provide relevant disclosures to consumers before and at the point of entering into a financial contract, as well as during the contract.

Another significant element has been the development of a strong national credit infrastructure in Malaysia that is instrumental in financial institutions' management of credit risk. The comprehensive national Central Credit Reference Information System (CCRIS) which has been acknowledged as among the best by the World Bank for its scope, accessibility and quality of credit information, has now been operational for 10 years. The system captures details of all outstanding credit facilities and the month-by-month repayment track record of any individual or company with a credit facility from banking institutions. The system figures prominently in financial institutions' credit scoring systems and assessments of the creditworthiness of prospective borrowers, and thus plays an important role in mitigating the risk of a system-wide deterioration in underwriting standards among financial institutions such as was observed in some markets in the period dealing up to the crisis.

Moving forward

The main strands that characterise Malaysia's consumer protection framework work together to protect consumers from predatory practices and excessive risk, as well as the financial system from systemic risk. In mitigating systemic risk however, the focus is on addressing **collective action failures** by financial institutions or borrowers that can lead to systemic risks. In this respect, current and future initiatives to further strengthen the existing consumer protection and market conduct regime to address systemic risk are focused on:

- addressing specific expectations on responsible conduct by financial institutions in the retail financing segment. This aims in particular to promote more rigorous and consistent practices by financial institutions in considering the factors that should be taken into account in conducting assessments of whether a financing product is affordable and suitable given a borrower's financial circumstances;

- further refining disclosure requirements where appropriate to encourage consumers to focus on key risks (e.g. by using more illustrative disclosures, greater standardisation of how key terms are presented to consumers, or through the more effective use of default and opt-in provisions for more complex or higher-risk product features);

- strengthening institutional arrangements for the regulation and supervision of market conduct. This includes enhancing existing inter-agency coordination arrangements to promote consistent approaches to the regulation and supervision of retail financing activities;

- conducting thematic and focused supervisory reviews of market conduct practices of financial institutions in selected areas to identify behavioural biases that can increase systemic risks. This will include industry-wide assessments of retail financing practices, covering incentive systems, the terms of consumer lending and retail investment products, and the manner in which such products are presented and sold to consumers;

- intensifying consumer financial education efforts to promote responsible borrowing decisions on the part of consumers through the nation-wide roll-out of the POWER! Programme and supplementary financial toolkits for consumers; and

- further developing and leveraging on the credit infrastructure to promote a healthy credit culture among borrowers.

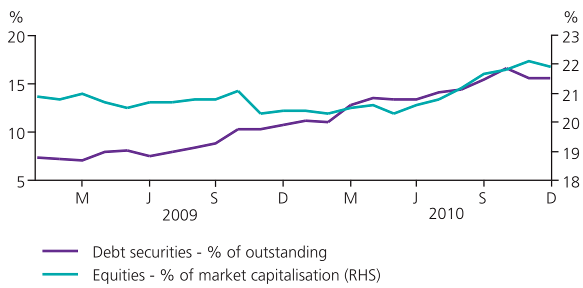
the bulk of their investments, accounting for 73% of total non-resident holdings of domestic debt securities. In the private debt securities (PDS) market, non-resident holdings of PDS remained small and stable at 5% of outstanding PDS. In the equity market, non-resident holdings rose only marginally by 1.5 percentage points to account for 21.9% of market capitalisation as at end-2010 (2009: 20.4%) (Chart 1.23). These holdings however remained lower than the previous peak of 26.2% of market capitalisation in 2007. In the futures market, non-resident holdings of KLCI and crude palm oil futures rose to 39% and 26% respectively of the total number of contracts as at end-2010 (Chart 1.24).

While resurgence in portfolio inflows led to some asset price appreciation, resilience of domestic financial markets was well preserved

The inflows of portfolio investments combined with positive prospects of economic performance contributed to the bullish sentiment in the financial

Chart 1.23

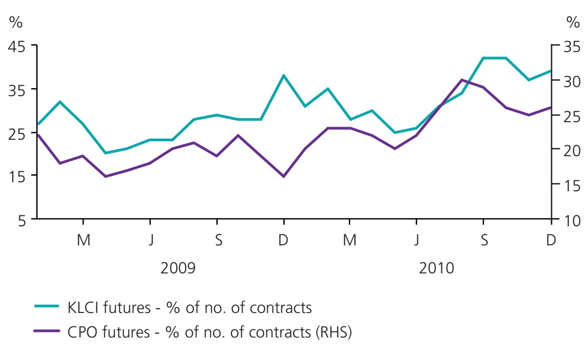
Foreign Holdings of Equities and Debt Securities



Source: Bank Negara Malaysia and Bursa Malaysia

Chart 1.24

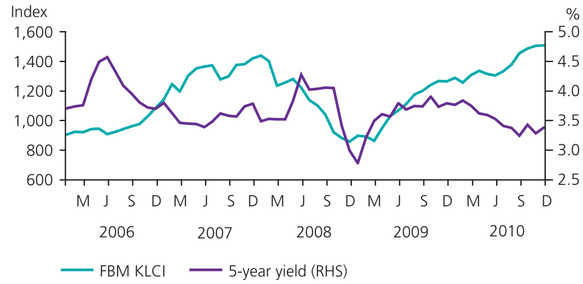
Foreign Holdings of KLCI and CPO Futures



Source: Bursa Malaysia

Chart 1.25

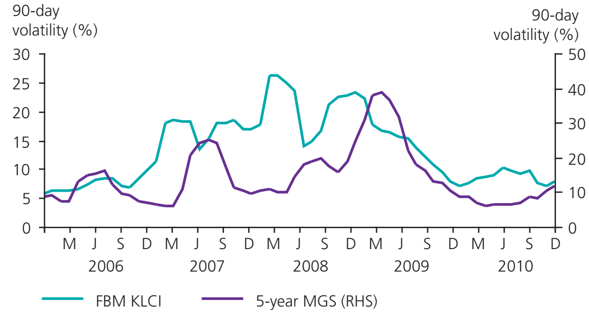
FBM KLCI and MGS Yield



Source: Bank Negara Malaysia and Bloomberg

Chart 1.26

Volatility in FBM KLCI and MGS



Source: Bloomberg

markets and higher prices of financial assets. In the government bond market, the strong demand by non-residents amid lower supply caused MGS prices to rise, suppressing yields in the medium to longer end of the spectrum (Chart 1.25). The average bid-to-cover ratio for MGS auctions rose to 2.12 times in 2010 (2009: 1.77 times), while the yield curve flattened between January and September despite the 75 basis points increase in the overnight policy rate (OPR) during the year. The trend subsequently reversed in October following the release of the Government's budget allocation for 2011, which indicated a potentially higher issuance of MGS. Volatility in MGS (5-year) yield eased, averaging 8.2% for the year (2009: 24.5%) (Chart 1.26). Trading liquidity was favourable with the average monthly turnover ratio for MGS rising to 11.6% (2009: 10.4%) while the average bid-ask spreads for benchmark MGS remained stable at 12 basis points. This reinforced the continued resilience of the government bond market, as reflected in the relatively stable and low ratio of returns to turnover in MGS (2010: 0.04, 2009: 0.06) (Chart 1.27).

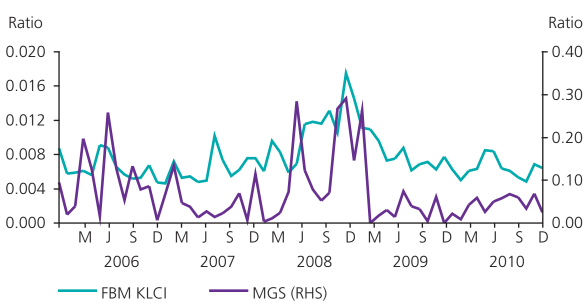
Similarly, domestic equity prices generally trended upwards during the year, driven mainly by favourable corporate earnings, the renewed focus on economic reforms, which further boosted the long-term growth prospects for the economy, as well as market expectations of a stronger ringgit. These favourable developments more than offset externally induced uncertainties associated with the elevated sovereign risks in Europe and policy tightening measures by various economies in the Asian region. The benchmark FBM KLCI gained 19.3% (2009: 45.2%) to reach a historical high of 1,528 points in November while average volatility declined to 8.6% (2009: 15.1%) (Chart 1.26). This gain was more modest in comparison with several other equity bourses in the region, which experienced gains in excess of 30% for the year. The rally in the domestic equity market since 2009 has also not caused excessive valuations, with the average price earnings ratio for FBM KLCI remaining relatively stable at 18.3 times (2009: 18.6 times). Market liquidity remained healthy with average bid-ask spreads tightening to 46.9 basis points (2009: 68.4 basis points) whilst the FBM KLCI average monthly turnover ratio was 42.5% (2009: 49.8%). The ratio of returns to turnover generally trended lower throughout the year, denoting the resilience of the domestic equity market (Chart 1.27).

Favourable financial market conditions, coupled with ample domestic liquidity, did not translate into significant changes in risk-taking behaviour of financial institutions

The trading portfolio of the banking system increased by 49.2% in 2010 after a sluggish trading year in 2009 as risk aversion abated. This led to higher net trading and investment gains, which posted an overall growth of 4% for the

Chart 1.27

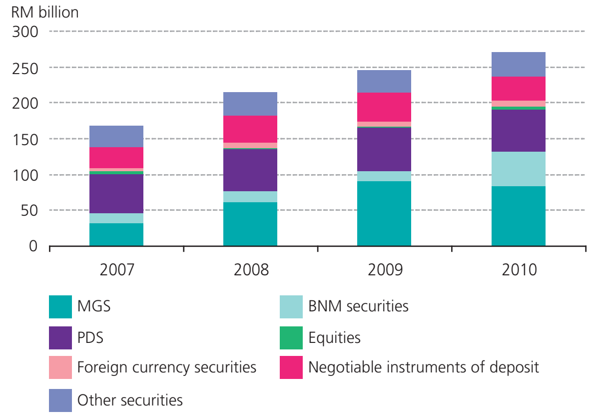
Returns-to-turnover Ratio for FBM KLCI and MGS



Source: Bloomberg, Bank Negara Malaysia, RAM quant shop and internal computation

Chart 1.28

Banking System: Composition of Securities Portfolio



Source: Bank Negara Malaysia

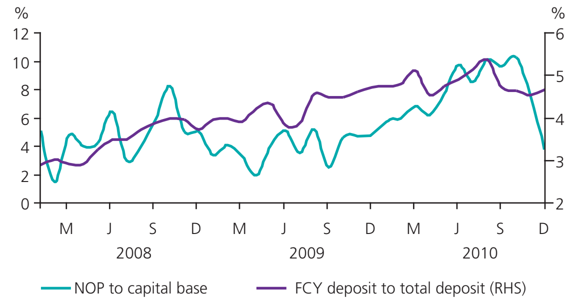
year, to account for 15.4% of the total income of banking institutions (2009: 16.6%). Despite more buoyant conditions in the financial markets and continued surplus liquidity, treasury assets of banks did not change materially in terms of the composition (Chart 1.28). This is reflected in the aggregate interest rate exposure of the banking system, as measured by the duration-weighted position, which remained stable at 4.9% of capital base (5% as at end-2009).

Overall foreign currency exposures of banks, as measured by the net open position (NOP) was at 3.8% of capital base as at end-2010 (2009: 4.4% of capital base). This was primarily attributed to an increase in foreign exchange forward transactions entered into with domestic corporations, as a result of more active hedging activities by businesses in view of the strengthening trend of the ringgit. A small number of banks, which recorded large increases in NOP were brought under closer supervision by the Bank to ensure that the related risks were being properly monitored and effectively managed.

Other foreign currency exposures in the form of foreign currency deposits and foreign currency denominated securities drifted higher but remained small in proportion to total deposits (4.7%) and securities (3.5%) respectively. Deposit flows have continued to witness two-way movements – placement of deposits abroad by Malaysian banks and placement of deposits with Malaysian banks by non-residents. Deposits by non-residents rose slightly, but remained relatively stable as a proportion of the deposit base, at 2.4% and

Chart 1.29

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



Source: Bank Negara Malaysia

10.6% for ringgit and foreign currency deposits respectively (Chart 1.29). Overall, ringgit deposits continued to be the main source of funding for Malaysian banks, accounting for 81.3% of total funding.

Direct exposures of banks to foreign currency asset-liability mismatches remained low, at less than 1% of total assets of the banking system. In terms of indirect exposures emanating from open positions, mainly to corporations in the export-oriented resource-based industries that have maintained unhedged positions, the banking system's credit exposures to these sectors are small at less than 5% of outstanding business loans.

In the insurance and takaful sector, investment portfolios moved into higher yielding assets in tandem with the improved performance of equity market. Equity holdings by insurers grew marginally to account for 16.5% of insurance industry assets, compared to 13.5% in 2009. This was accompanied by additional capital set aside by insurers for market risk, which accounted for 32.5% of total capital required (2009: 29.5%) or RM7.9 billion (2009: RM6.5 billion) as at end-2010 (Chart 1.30). The high capital charge for equity has acted to effectively contain overly aggressive rebalancing by insurers into equity.

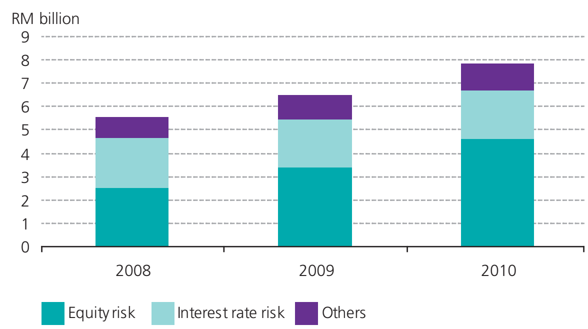
Meanwhile, holdings of long-term PDS remained almost unchanged to account for 38.6% of insurance industry assets, the bulk of which was concentrated in high investment grade papers (AA-rated and above). Holdings of relatively lower yielding assets such as MGS and fixed deposit placements declined to account for 15.5% and 11.2% of total assets respectively as at end-2010 (2009: 15.1% and 13.9% respectively) (Chart 1.31).

Historically low yields have continued to exert pressure on life insurers' asset-liability positions. This was partly eased by the temporary flexibility accorded to insurers to apply the average yields observed over eight preceding quarters (instead of prevailing spot yields) in the valuation of liabilities. This flexibility, which was put in place since April 2009, expired on 31 December 2010. While the reversion to spot yields will result in higher liability valuations, the impact on capital is expected to be manageable given the industry's strong capital buffers and earlier upward adjustments in MGS yields since October 2010.

During the year, a number of new structured products linked to foreign currencies and

Chart 1.30

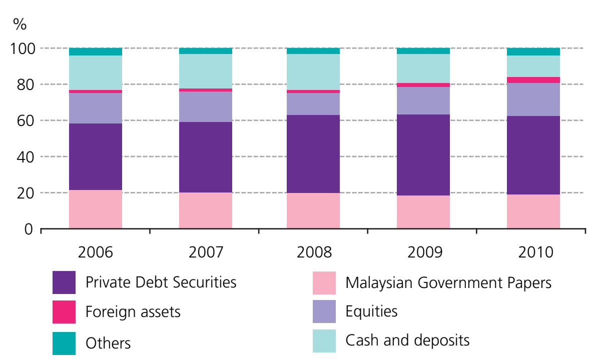
Components of Market Risk Exposures of Insurance Industry



Source: Bank Negara Malaysia

Chart 1.31

Composition of Insurance and Takaful Industry Assets



Source: Bank Negara Malaysia

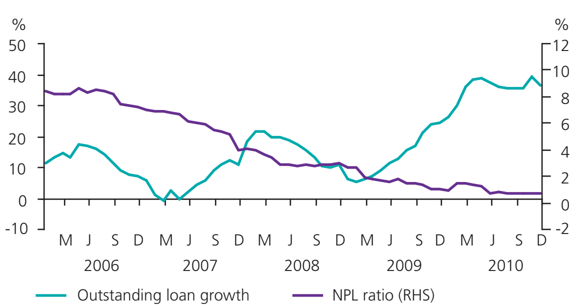
commodities were introduced by financial institutions. These products were mostly simple variations of existing products that are already being offered to corporations, institutional investors and high net worth individuals. Similarly, demand for and the offering of investment-linked products by life insurers also rebounded strongly in line with the equity market performance. With the revival in demand for such products, greater supervisory attention has been directed since the early part of the year towards ensuring that financial institutions take adequate steps to establish that products sold or recommended are suitable, and that customers are clearly and fully informed of the nature and risks associated with those products.

While there was an increased demand for higher-yielding assets by households, risks to the banking system remained well-contained. Despite an increase in trading activity, domestic retail investors' participation in the equity market was relatively stable at 21.2% of total trades in 2010. New loans approved for the purchase of securities amounted to RM13.1 billion, an increase of 39.9% over the preceding year's level (Chart 1.32). Bulk of the new approvals was for the purchase of unit trust funds. Outstanding loans for purchase of securities remained small at only 3% of banking system loans. Combined with the low incidence of delinquency (NPL ratio: 0.7%), the credit exposures of banks associated with such financing are thus limited.

The prevailing market conditions also saw moves by institutional investors, primarily provident and pension funds, to rebalance their investment portfolios towards equity. The provident and

Chart 1.32

Household Sector: Outstanding Loans Growth and NPL Ratio for Purchase of Securities



Source: Bank Negara Malaysia

pension funds form the largest non-bank institutional investors in the capital market, with portfolio investments accounting for 14% of the market capitalisation of Bursa Malaysia and 28% of total outstanding debt securities as at end-2010. Notwithstanding the sizeable exposures, these institutions have considerable flexibility to manage the impact of any increase in asset price volatility on their profitability and cash flow positions. The flexibility is attributable to their low leverage, constant stream of flow of funds from pension contributions and generally non-callable nature of withdrawals of contributions before retirement.

MANAGING EXTERNAL CONTAGION

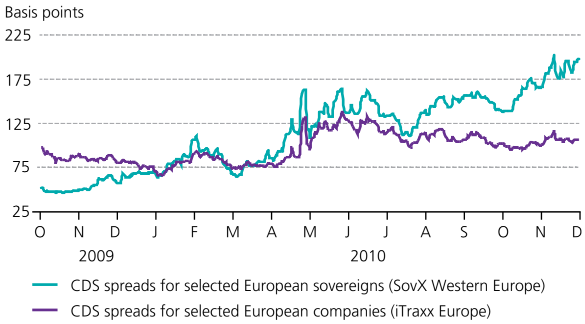
Contagion from external adverse developments was well-contained given the limited exposures of Malaysian financial institutions

Heightened external contagion and counterparty concerns largely emanated from developments in Europe

Unprecedented financial sector support and fiscal stimuli to mitigate the recessionary impact of the global financial crisis have significantly intensified market scrutiny of the fiscal position and sustainability of public debt levels in the advanced economies. Premiums demanded to insure against default for a number of European sovereigns rose sharply and have remained elevated on concerns of sovereign and banking risks (Chart 1.33). Spreads on credit default swaps (CDS) for financial institutions domiciled in the more affected jurisdictions (Greece, Ireland, Italy, Portugal and Spain – GIIPS) also experienced similar upward pressures, renewing the concerns of financial spillovers to major European economies through the close financial linkages in the European banking system (Chart 1.34 and Chart 1.35). Markets remained concerned with the large, concentrated holdings of sovereign debt by financial institutions in these jurisdictions and the lack of progress in implementing fiscal reforms, which would constrain policy options to support economic recovery in the

Chart 1.33

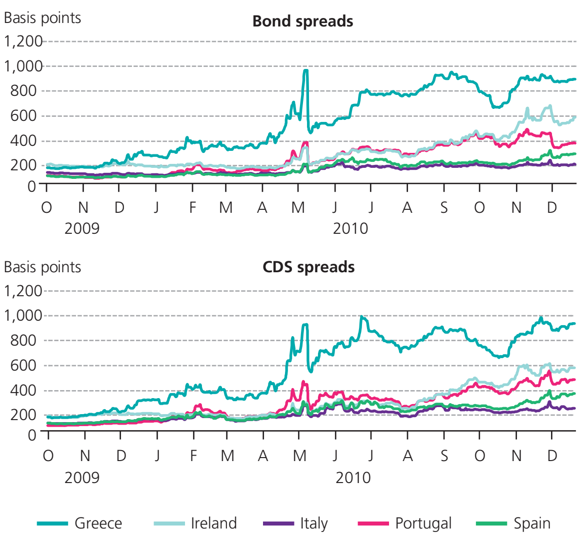
CDS Spreads for European Sovereigns and Companies



Source: Bloomberg

Chart 1.34

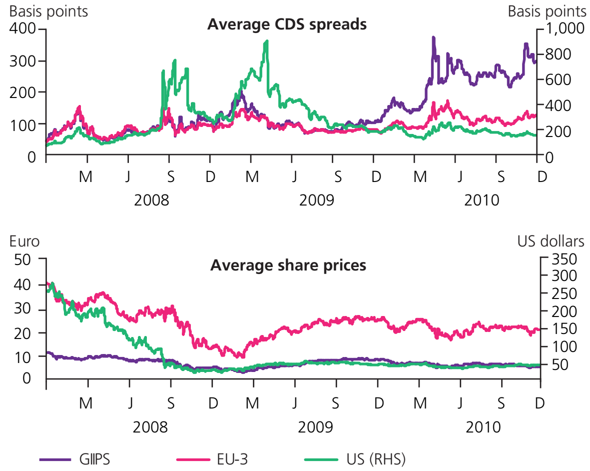
Bond Spreads and 5-year CDS Spreads of GIIPS



Source: Bloomberg

Chart 1.35

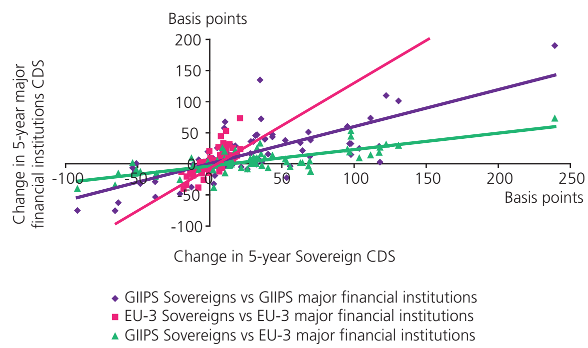
Average CDS Spreads and Share Prices of Major Financial Institutions



Source: Bloomberg

Chart 1.36

Change in 5-year Sovereign CDS vs Change in 5-year Major Financial Institutions CDS



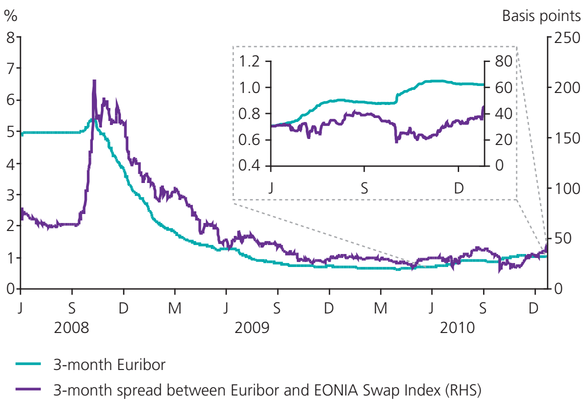
Source: Bloomberg

event that the debt crisis worsens (Chart 1.36). With inadequate transparency on the size of sovereign debt holdings and intra-European exposures, counterparty risks and funding costs of European banks increased considerably. The consequential widespread dislocations in the euro area wholesale funding markets quickly spread into the market for commercial papers, which constitutes an important source of dollar funding for most European banks (Chart 1.37). While funding conditions eased during the second half of 2010 following multi-pronged measures by the authorities[1], banking institutions in the euro area continued to be confronted with the higher risk of loan losses as a result of the continued weakness in the employment and property market.

[1] With reduced access to private capital markets and high reliance on short-term wholesale funding, European banks increasingly tapped on funding from the European Central Bank (ECB) through its monetary policy operations and liquidity facilities, including the reactivation of US dollar swap line with the US Federal Reserve and the expansion of euro lending facility in terms of maturity and size. Other measures include a new €440 billion loan facility for the euro area economies, the European Financial Stability Facility, and an expansion of the existing lending facility by the European Commission in May 2010 that amounted to €60 billion. The ECB also initiated the outright purchase of euro area government bonds to address strains in the sovereign debt markets.

Chart 1.37

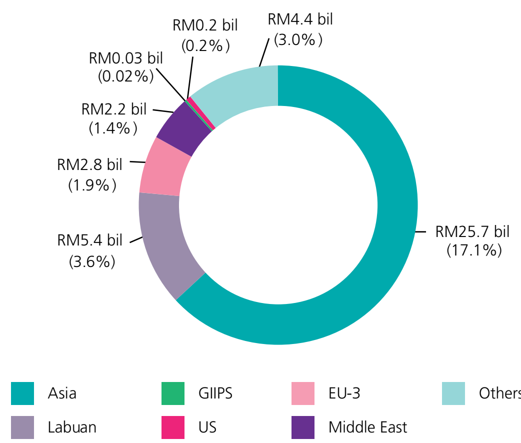
3-month Euribor and Spread between Euribor and EONIA Swap Index



Source: Bloomberg

Chart 1.38

Banking System: Composition of External Exposures by Region or Country (as % of Capital Base)



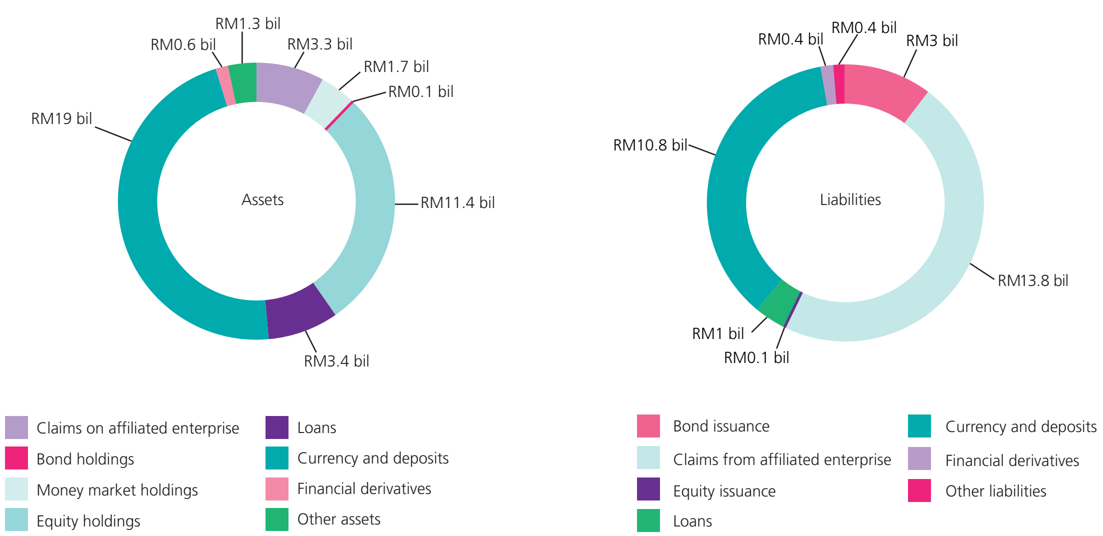
Source: Bank Negara Malaysia

Minimal direct and indirect impact from developments in Europe and the Middle East

Developments in Europe and the Middle East had negligible impact on banks in Malaysia. This was due to limited direct exposures to these economies and the private counterparties domiciled in these jurisdictions, which accounted for 18.3% of total external exposures or 5% of the banking system's capital base as at end-2010 (Chart 1.38). Of this, banking system exposures to GIIPS only accounted for 0.02% of capital base or 0.1% of total external exposures. Holdings of such sovereign papers were mostly in the banking book, thus further limiting the financial impact of movements in market valuations (Chart 1.39). Foreign currency denominated assets held by banking institutions for trading and investments, including securities denominated in euro, were

Chart 1.39

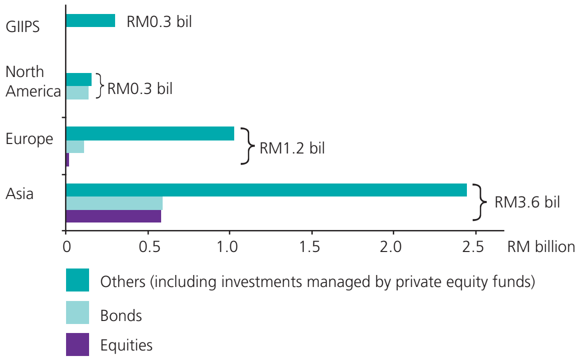
Banking System: Composition of External Exposures by Type of Transactions



Source: Bank Negara Malaysia

Chart 1.40

Insurance Sector: External Exposures by Type of Investments



Source: Bank Negara Malaysia

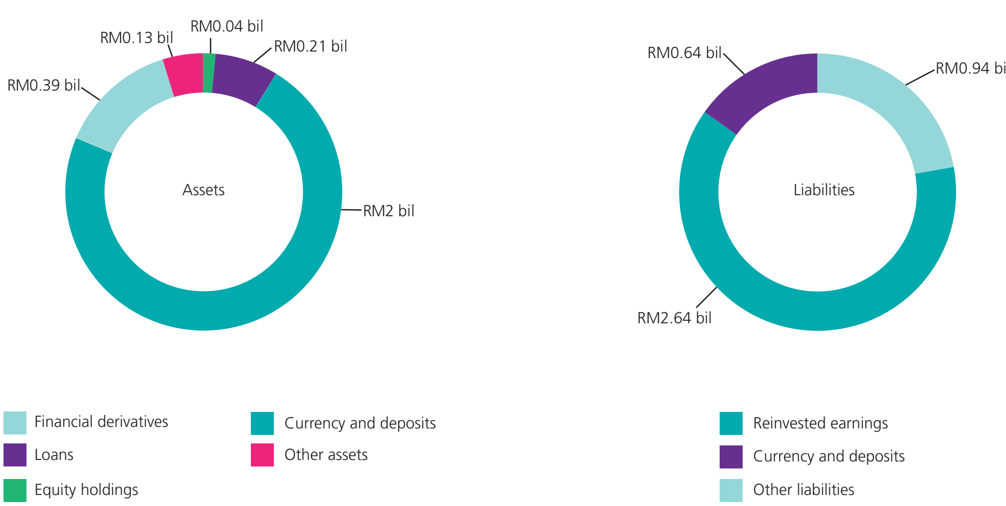
similarly small at 0.6% of total assets and 6.5% of capital base as at end-2010. The bulk of foreign currency denominated external exposures was in US dollar, Australian dollar and euro, which amounted to RM24.2 billion or 16.2% of capital base. Direct exposures of Malaysian insurers and takaful operators (both referred to as insurers hereafter) to Europe and the Middle East amounted to only RM1.45 billion or 27.1% of total foreign exposures, mostly comprising investments that are managed by European-based private equity funds. Exposures to GIIPS were small at 5.6% of total foreign assets. In an unlikely scenario of widespread sovereign defaults by the peripheral euro economies, the potential credit losses would be below 0.05% and 0.0006% of capital buffers of the banking and insurance sectors respectively (Chart 1.40).

Indirect contagion via exposures to other European economies, particularly those with considerable foreign claims to the affected countries, also remained small. While financial institutions in the rest of the euro area are highly interconnected with the peripheral euro economies through various credit and funding channels, the credit risk of Malaysian banks to the rest of Europe remained manageable at 12.9% of total external exposures and 3.5% of capital base. More than half of these direct European exposures were with the EU-3 countries (Germany, France and the UK). Apart from holdings of highly-rated debt securities, parent-subsidiary interbank transactions and derivatives contracts predominantly interest-rate swaps formed a substantial portion of banking system external exposures with major European economies (Chart 1.41). Meanwhile, insurers' investments in the rest of Europe (excluding GIIPS) were negligible at 0.8% of total industry assets.

There were no adverse spillovers from interbank funding strains in the euro area that affected the availability of funds in the domestic money market or to foreign banks in Malaysia with parents headquartered in major European countries. Like their domestic peers, ringgit

Chart 1.41

Banking System: Composition of External Exposures to EU-3 by Type of Transactions

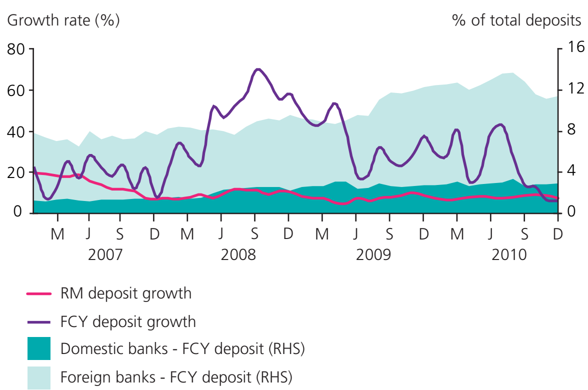


Source: Bank Negara Malaysia

deposits represented the primary funding source for foreign banks' operations (Chart 1.42). In addition, all banks continued to operate under ample domestic liquidity conditions and are required to comply with regulatory standards on liquidity. Domestic interbank rates continued to remain stable across all maturities throughout the year (Chart 1.43). Cross-border financing to Asia by foreign banks domiciled in other jurisdictions was also largely unaffected, with financing to borrowers in Malaysia from banks domiciled in foreign jurisdictions recording a growth of 13.7% in 2010. As at end-September 2010, borrowings by residents from overseas banks amounted to RM90.9 billion. In the event of cutbacks in cross-border lending, particularly by distressed European financial institutions, excess liquidity in the banking system as measured by

Chart 1.42

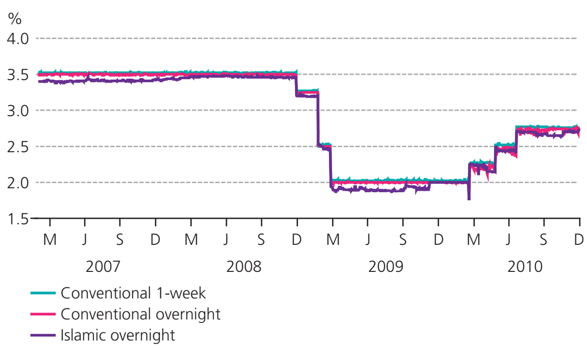
Banking System: Ringgit and Foreign Currency Denominated (FCY) Deposits



Source: Bank Negara Malaysia

Chart 1.43

Banking System: Conventional and Islamic Interbank Rates



Source: Bank Negara Malaysia

net interbank placements with the Bank totalling RM131.7 billion is more than sufficient to meet the borrowing requirements of residents.

While intensification of regional expansion by the Malaysian banks and the entry of new foreign banks have increased the potential for contagion risks, the impact is well-managed given the strong capital buffers and the favourable prospects for the region

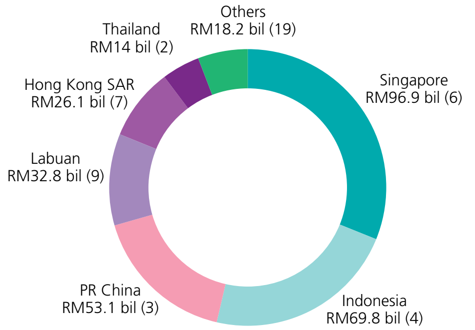
Limited external spillovers from overseas banking operations, underpinned by improved asset quality and profit contribution

Economic and financial integration in Asia has been supported by the continued development of regional capital markets, more integrated financial infrastructure, as well as the growing prominence of regional financial institutions. During the year, Malaysian banking groups further expanded their regional footprint through branch and subsidiary set-ups, particularly in the emerging South East Asian economies. While this has led to the more efficient intermediation of regional financial flows and greater diversification of risks and revenue, the deepened financial linkages have also increased the degree, channels and dynamics of potential cross-border risk transmission.

Adverse spillovers from overseas operations were immaterial throughout the year, due primarily to the strong balance sheet fundamentals and risk management capacity at both the overseas entity and group levels. As at end-2010, Malaysian banking groups had over 50 establishments across 19 countries abroad. The asset size of overseas operations of domestic banking groups expanded to RM311 billion, accounting for 20% of total domestic assets as at end-2010. While several large domestic insurers also expanded their overseas operations, particularly in Indonesia and Singapore, this remained small, accounting for only 0.2% of total

Chart 1.44

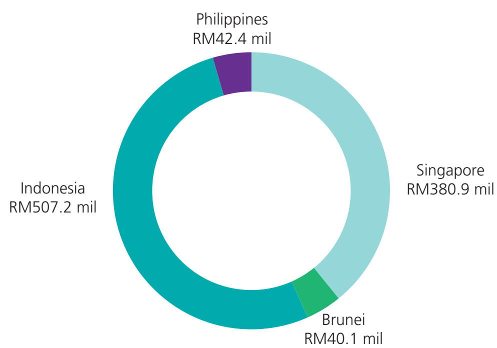
Banking System: Asset Composition of Overseas Operation (and Number of Establishments)



Source: Bank Negara Malaysia

Chart 1.45

Insurance Sector: Overseas Operation by Country and Total Asset Size



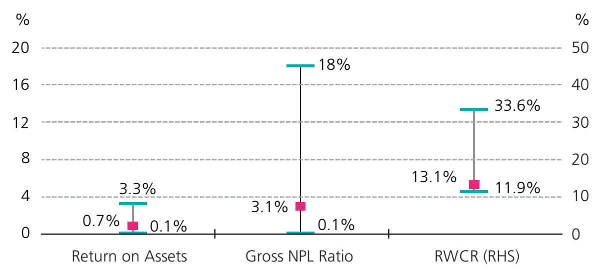
Source: Bank Negara Malaysia

domestic assets (Chart 1.44 and Chart 1.45). Major overseas operations of domestic banking groups continued to record strong profits and higher returns on assets. This has contributed to an increasing portion of the banking groups' profitability, ranging between 0.1% and 33.7%, coming from overseas operations. The earnings capacity of overseas operations also supported the independent generation of capital by foreign subsidiaries of domestic banks. The risk-weighted capital ratios (RWCR) for major foreign subsidiaries of the domestic banks, computed based on Basel II requirements for respective domestic banking groups, were sustained between 12.4% and 33.6% at end-2010, thus providing strong buffers against adverse external developments (Chart 1.46). As with the domestic operations of these banking groups, lending activities in host countries are largely funded through local currency deposits as reflected in the stable loan-to-deposit ratios maintained by foreign subsidiaries. With the low reliance on wholesale funding markets for domestic and overseas operations of Malaysian banking groups, the potential for external liquidity shocks to propagate through cross-border banking operations is thus well-contained (Chart 1.47).

The credit risk emanating from overseas operations remained manageable throughout the year given the strength of banks' risk management capacity. This is further reinforced by favourable factors that influenced debt servicing capacity, including improved economic performance in the region (Chart 1.48). Gross non-performing loans of major overseas subsidiaries, on aggregate, remained stable at 3.3% of total loans. However, the regional operation of domestic banking groups may be affected by the increased capital flows into the Asian region. To cool overheating pressures,

Chart 1.46

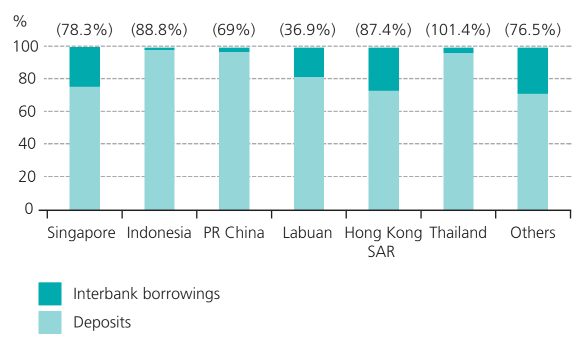
Range of Key Financial Soundness Indicators for Major Overseas Operations



Source: Bank Negara Malaysia

Chart 1.47

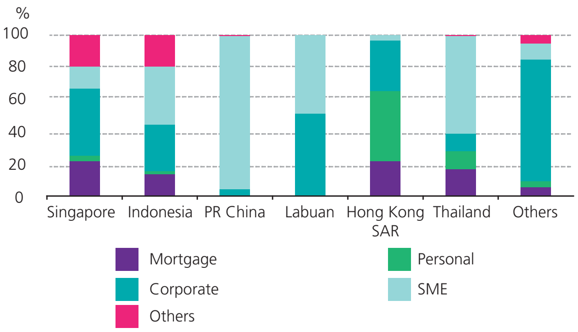
Funding Structure of Overseas Operations (and Loan-to-Deposit Ratio)



Source: Bank Negara Malaysia

Chart 1.48

Loan Composition of Overseas Subsidiaries by Type and Country



Source: Bank Negara Malaysia

notably in the property market, a number of regional jurisdictions have introduced property-related measures to curb the emergence of price bubbles. While these measures may result in some moderation of loan growth and earnings capacity of operations abroad, this is not expected to materially affect the financial position and profitability of the domestic banking groups.

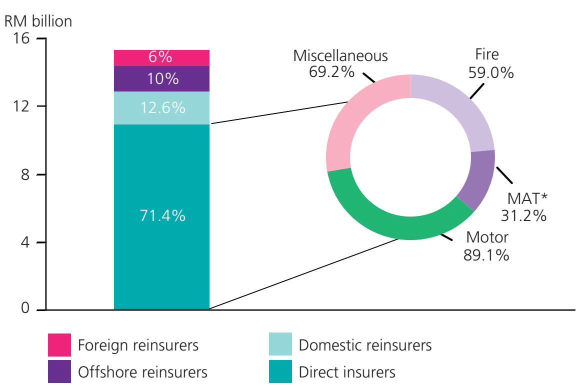
Limited risk from counterparty exposures to European reinsurers

In the insurance industry, a key risk monitored by the Bank was the exposures of Malaysian general insurers to reinsurance claims on European insurers and reinsurers. In addition to the protracted low yield environment, which continued to bear down on underwriting and investment income, estimated insured losses from more than 300 catastrophic events globally, which are expected to reach USD38 billion, will exert further downward pressures on the profitability of these insurers and reinsurers. Meanwhile, contagion risk from the public debt crisis remained elevated due to the large government bond holdings and significant exposures of insurers and reinsurers in the euro area to the vulnerable European banking sector.

Risks to the Malaysian insurance sector arising from the inability of major European reinsurers to honour reinsurance obligations are, however, well-contained. Domestic capacity remains adequate to support the bulk of Malaysian risks, with a net retention ratio of 71.4% (Chart 1.49). The balance of the industry's capacity needs is met by foreign insurers and reinsurers that are rated at least 'A' and above. Total reinsurance exposures to European reinsurers, measured in terms of reinsurance claims outstanding, accounted for 11.9% of total reinsurance recoveries or RM248 million (2009: RM1.25 billion). This represented only 8.5% of total capital available of the general insurance industry as at end-2010, well within prevailing capital buffers maintained by the industry. The risks to capital from potential downgrades of European reinsurers, remain limited amid their improved financial performance during the year. This is further supported by the CDS of the major European reinsurers, which remained below the peak level observed during the global financial crisis (Chart 1.50 and Chart 1.51). Negative spillovers from adjustments in reinsurance rates have also,

Chart 1.49

Insurance Sector: Distribution of Gross Premium Income and Retention Ratio by Major Business Classes

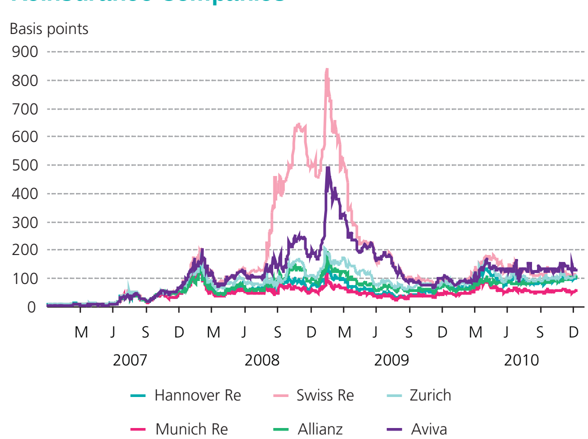


*MAT: Marine, aviation & transit

Source: Bank Negara Malaysia

Chart 1.50

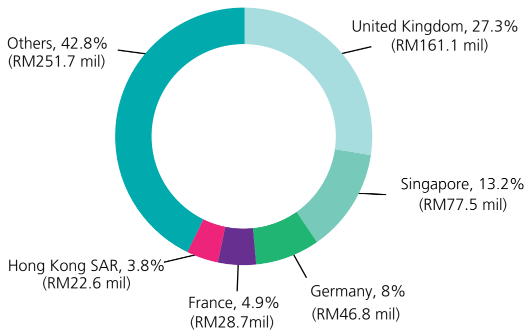
CDS Spreads of Major European Insurance and Reinsurance Companies



Source: Bloomberg

Chart 1.51

Insurance Sector: Composition of External Exposure in terms of Claims Outstanding by Country



Source: Bank Negara Malaysia

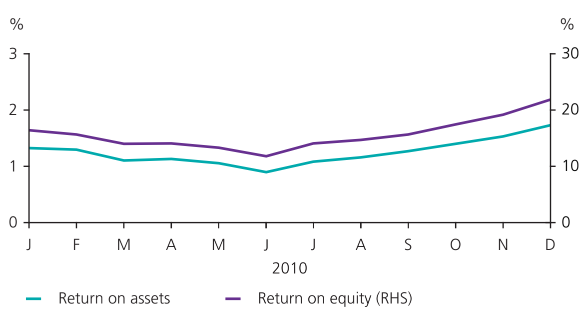
thus far, not been evident. Global reinsurance rates continued to soften for renewals in 2010, supported mainly by the prevailing excess global capacity. This in turn, has preserved cost efficiencies for Malaysian corporations that are highly dependent on insurance for their operations.

MANAGING RISKS PECULIAR TO ISLAMIC BANKING SYSTEM

The Islamic banking system continued to remain resilient throughout 2010 supported by high capitalisation (RWCR: 14.9%) and improvement in asset quality with non-performing financing at 2% in an environment of ample liquidity and improved economic conditions. In terms of profitability, Islamic banking institutions registered a steady and sustained income, thereby improving returns on assets and equity (Chart 1.52).

Chart 1.52

Profitability Ratio



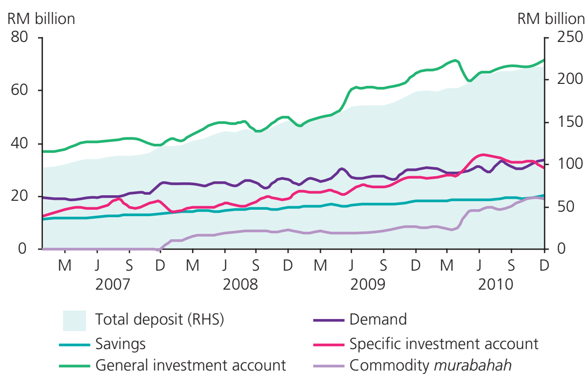
Source: Bank Negara Malaysia

The encouraging profitability recorded has enabled Islamic banking institutions to provide competitive returns to their depositors, thus enabling Islamic banking institutions to continue to attract additional deposits (Chart 1.53). As at end-2010, total deposits of Islamic banking institutions increased by 15.7% to RM218.4 billion.

Almost half of the deposits is in the form of *mudharabah* (profit-sharing and loss bearing) contracts (Chart 1.54). Of this, about 70% was in the form of General Investment Account (GIA) where the depositors have expectations on the protection of their principal investments and certainty of the returns. Given these expectations, Islamic banking institutions have been actively managing their asset portfolio to generate

Chart 1.53

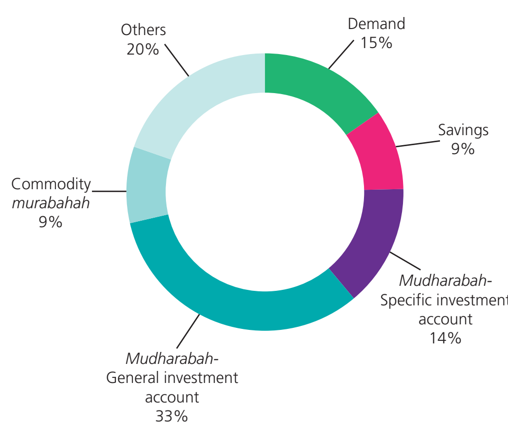
Islamic Deposit



Source: Bank Negara Malaysia

Chart 1.54

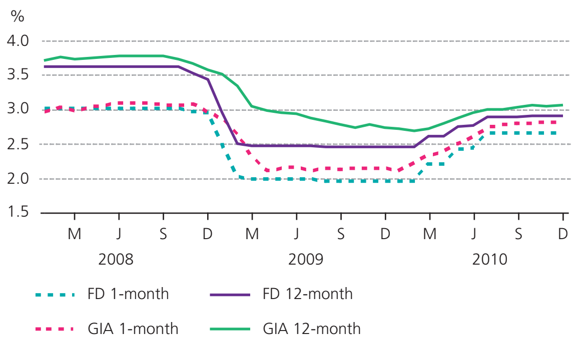
Composition of Islamic Deposit



Source: Bank Negara Malaysia

Chart 1.55

Quoted FD Rates and GIA Rates



Source: Bank Negara Malaysia

sufficient returns to mitigate the displaced commercial risks (DCR). Managing DCR therefore becomes more apparent in a dual banking system environment where rates on fixed deposit and GIA are positively correlated (Chart 1.55). In managing DCR, Islamic banking institutions employ measures such as profit equalisation reserves (PER) that enabled them to provide competitive rate of returns to depositors.

PER would normally be accumulated during periods when the underlying assets generate higher income than the returns expected by *mudharabah* depositors. In situations where the returns on underlying assets are lower or insufficient to meet the depositors' expectations, the accumulated PER will be utilised. This was observed in the second half of 2009 following the slowdown in economic activities. The drawdown in PER continued in the early part of 2010 in response to upward adjustment in conventional rates (Chart 1.56). As economic conditions improved, Islamic banking institutions re-commenced the accumulation of PER for the remaining period of the year. The prudent administration of PER by Islamic banking institutions have enabled the effective management of the DCR. In addition to PER, the purchase of Islamic house financing and hire purchase debts by Cagamas Berhad, the National Mortgage Corporation, while small at this juncture, offers another avenue for Islamic banking institutions to effectively manage DCR.

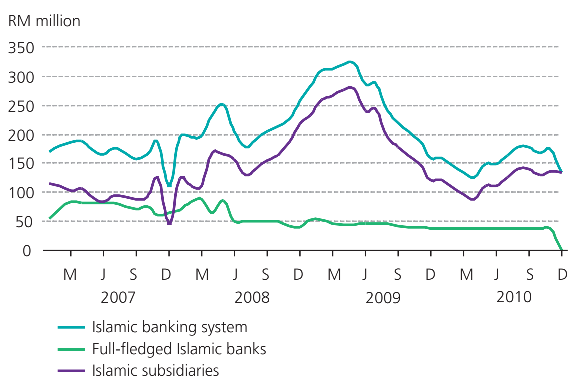
The remaining 30% of *mudharabah* deposits was in the form of Specific Investment Accounts (SIA). In contrast to GIA deposits, investment risks associated with SIA deposits are borne by the investors. The investors' willingness to assume these risks is supported by the requirement for an agreement on the investment mandate and timely disclosure of the risks and performance of the investment to the investors. As at end-2010, total SIA deposits increased by 14.8% to RM31 billion (Chart 1.53 and Chart 1.54).

Meanwhile, approximately 63.8% of Islamic banking assets are contracted on a fixed rate basis. These are predominantly structured using *murabahah* contract, which accounted for 48% of total financing (Chart 1.57 and Chart 1.58).

The fixed rate nature of such financing gives rise to re-pricing gap risk due to mismatch between the returns earned on assets and re-pricing of liabilities. To mitigate the re-pricing gap risk, Islamic banking institutions have increasingly

Chart 1.56

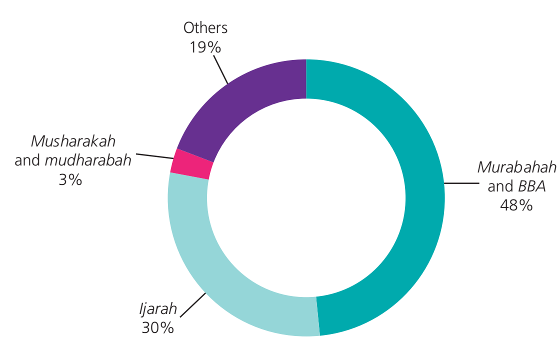
Profit Equalisation Reserves



Source: Bank Negara Malaysia

Chart 1.57

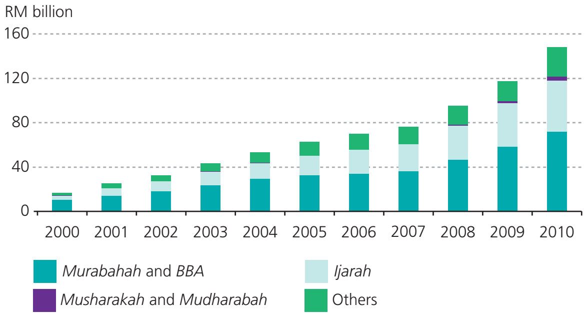
Composition of Financing by Islamic Contract



BBA: Bai Bithaman Ajil
Source: Bank Negara Malaysia

Chart 1.58

Financing by Type of Islamic Contract



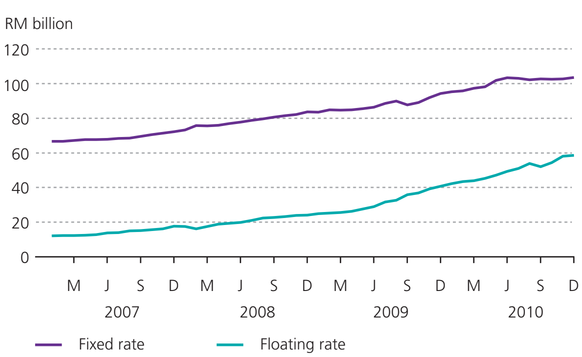
BBA: *Bai Bithaman Ajil*
Source: Bank Negara Malaysia

been utilising hedging instruments such as Islamic profit rate swaps (IPRS) which provide Islamic banks with the flexibility to swap fixed rate receivables with floating rate receivables. In 2010, the notional amount of outstanding IPRS increased to RM2.5 billion. Efforts are being intensified to deepen the liquidity of the IPRS market. These include the development of a *tahawutt* (hedging) Master Agreement, which enables more effective management of counterparty risks, thereby increasing the attractiveness of IPRS market.

There has also been higher volume of variable rate Islamic financing products in the form of *musharakah mutanaqisah* (diminishing partnership) and *ijarah* (leasing) contracts that provide Islamic banking institutions with the avenue to diversify their asset base, hence reducing concentration to fixed rate financing. Such financing increased by 44.1% during the year to amount to RM58.6 billion as at end-2010 (Chart 1.59).

Chart 1.59

Fixed Rate and Floating Rate Financing



Source: Bank Negara Malaysia

OTHER DEVELOPMENTS AND RISK AREAS

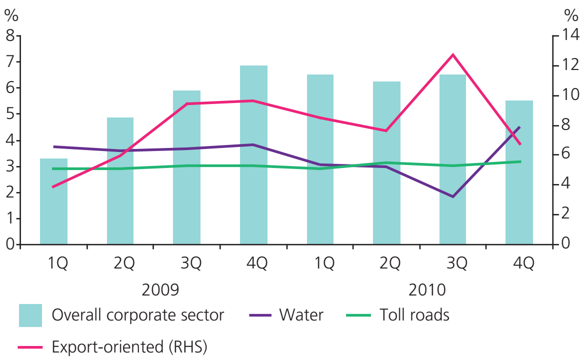
Financial stability remained intact throughout 2010 supported by strong capitalisation and liquidity conditions of financial institutions. Stress test results reaffirmed the capacity of the financial system to absorb potential shocks even at worst case macro economic scenarios

Other external developments such as international regulatory reforms and the series of climate-related events as well as geo-political tensions in the Middle East and North Africa (MENA) region were also closely monitored by the Bank. While these events caused brief periods of increased market volatility and uncertainty, the financial markets and system continued to remain orderly throughout the year.

Favourable conditions in the PDS market continued to facilitate fund raising by corporations particularly from mid-year onwards. For the year, new PDS issuances amounted to RM82.3 billion. Rating actions during the third quarter on debt securities issued by entities involved in the distribution and treatment of water in Selangor had only a limited and temporary impact on market activity. In June, these entities were placed on negative watch by the domestic rating agencies in view of the uncertainty surrounding the protracted restructuring exercise of the state's water industry. Trading liquidity in the secondary market following this rating action was only briefly affected and market conditions remained largely orderly throughout this period even following the downgrade of these debt securities in September. This was due in part to the small size of the issuances, which on aggregate accounted for less than 3% of outstanding PDS. Reflective of the better credit and economic conditions in 2010, credit quality, as measured by the downgrade-to-upgrade ratio improved to

Chart 1.60

Interest Coverage Ratio for Selected Industries

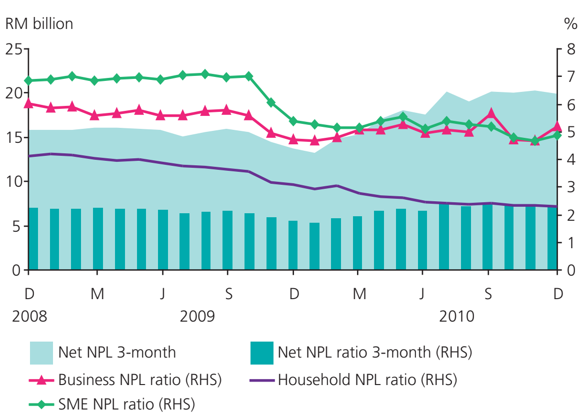


Source: Bloomberg and internal computation

1.47 times (2009: 2.09 times). Improved economic conditions have further bolstered the debt servicing capacity of businesses despite greater exchange rate volatility and higher borrowing costs, thus sustaining the quality of banks' loan portfolios. While the strengthened ringgit resulted in lower export proceeds for businesses in the export-oriented industries, the impact was offset by sustained external demand and relatively cheaper imported raw materials. Meanwhile, corporations with foreign currency borrowings benefited from the strengthening of the ringgit through lower debt servicing costs (Chart 1.60). Developments in exchange rates have also encouraged the more active management of foreign currency exposures by businesses

Chart 1.61

Banking System: NPL[1] Level and Ratio

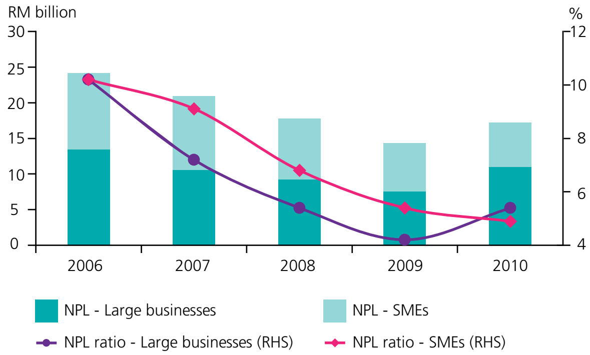


[1] Beginning January 2010, includes impaired loans based on Financial Reporting Standards (FRS) 139

Source: Bank Negara Malaysia

Chart 1.62

Banking System: NPL for Large Businesses and SMEs



Source: Bank Negara Malaysia

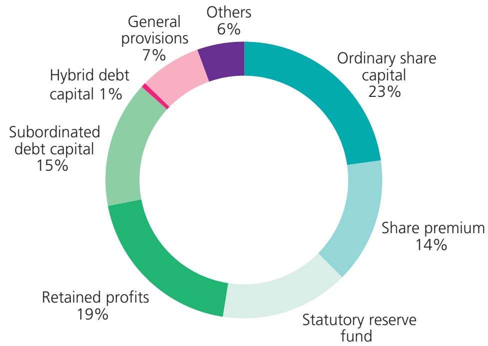
through the use of hedging instruments such as forwards and swap transactions. Businesses continued to maintain a relatively low leverage position, a condition that has prevailed since the Asian Financial Crisis. This has accorded businesses with greater flexibility to cope with rising production and borrowing costs without adversely impacting their debt servicing capacity. As at end-2010, gross NPLs for the business portfolio of banks increased to RM17.2 billion (2009: RM14.3 billion) or 5.2% of outstanding business loans (Chart 1.61 and Chart 1.62). The marginally higher NPLs level is attributed to the adoption of impairment methodology following the coming into effect of the financial reporting standards requirement, FRS 139, since the financial year beginning 2010. Meanwhile, growth in total loans (including loans to households) of 12.7% outpaced the annual expansion in deposits of 7.3%.

Profitability of the banking sector improved further in 2010 to register a return on equity of 16.5% (2009: 14%). Pre-tax profits for the year increased by 34% to RM22.8 billion. The robust performance was partly driven by higher net interest income, which grew at an annual rate of 15.1%, and slightly wider net interest margin of 0.61 percentage points. Fee and other income, which grew by 11.3% and 4% respectively, as well as further decline in impairment charges (-9.1%) also contributed to the increase in profitability.

The capitalisation of the banking sector continued to remain sound with strong financial buffers against potential losses. This is reinforced by the high quality of capital, with 70% of

Chart 1.63

Banking System: Composition of Capital



Source: Bank Negara Malaysia

total capital in the form of common equity and reserves (Chart 1.63). The aggregate risk-weighted capital ratio (RWCR) and core capital ratio (CCR) was 14.8% and 13% respectively, well above the current regulatory minimum levels, as well as the higher requirements under Basel III. See box article on "*Basel III and its Potential Implications on Malaysia and the Financial System*".

In the insurance and takaful sectors, sustained domestic demand for savings and protection products and the improved performance of the equity market supported stronger results for the year. Business growth was primarily driven by a strong recovery in demand for investment-linked products, and higher demand for ordinary life protections as well as motor and fire insurance. Payout of benefits and claims as a percentage of premiums increased slightly to 58.1% for the life business and 62.3% for the general business. Meanwhile, the motor portfolio continues to pose a drag on overall performance given the substantially higher loss ratio of 79.5% (Chart 1.64).

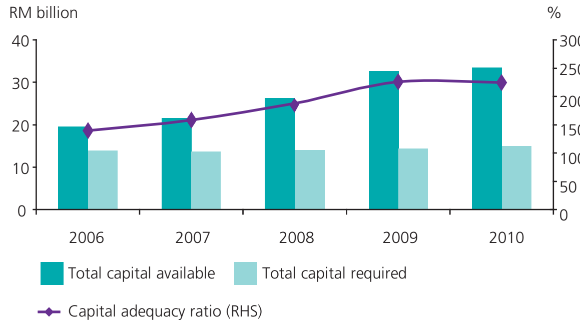
Chart 1.64

General Insurance and General Takaful Businesses: Claims Ratio

Source: Bank Negara Malaysia

Chart 1.65

Insurance Sector: Capital Adequacy Ratio



Source: Bank Negara Malaysia

For the year as a whole, aggregate excess income over outgo for the life and family takaful industry improved to RM14.1 billion (+12.1%) whilst the general sector recorded operating profits of RM2.2 billion (+3.5%). Capitalisation of the insurance industry remained strong with a capital adequacy ratio (CAR) of 224.6% (2009: 225.7%) (Chart 1.65). While the strong equity market performance has bolstered the overall profitability of insurers, the persistent low interest rate environment continues to present challenges to life insurers in their management of asset-liability mismatches and meeting policyholders' expectations.

The risk-bearing capacity of the financial system to weather extreme macroeconomic and financial conditions was reaffirmed by the regular stress tests carried out on the banking and insurance sectors, at both the aggregate and institutional levels. The scenario-based stress tests, covering both market and credit risk exposures, assume a simultaneous materialisation of major downside risks to the Malaysian financial system under varying stress circumstances. These stress parameters are also further calibrated to capture institution-specific risk profiles based on supervisory assessments of key risk drivers, detailed default history and loss rates, quality of assets and the risk absorbing capacity of capital, as well as the strength of risk management and governance controls.

Potential shocks to financial institutions' interest rate risk positions were simulated based on the historical worst-case experience for Malaysia to account for varying degrees of (i) steepening of the MGS yield curve; (ii) widening credit spreads between highly-rated corporate debt securities and MGS; and (iii) higher basis risk to reflect larger differentials between interest rate swaps and MGS yields. For foreign currency denominated exposures, shocks reflected the potential sharp volatility of six major currencies against ringgit, namely the US dollar, Singapore dollar, euro, pound sterling, Hong Kong dollar and yen. Stresses on equity risk were calibrated using extreme declines in the FBM KLCI, which are comparable to the Asian Financial Crisis.

The stress test assumptions for credit risk exposures were largely premised on a weaker-than-expected economic growth in Malaysia, due largely to spillovers from the sluggish economic performance of the advanced economies and major trading partners. While the concerns surrounding a double-dip recession have receded and the multi-track global recovery is expected to continue, the resilience of Malaysia's financial sector against extreme credit losses emanating from a prolonged global and domestic economic slowdown were nevertheless put to test. Under the worst macroeconomic scenario, severe shocks applied on the debt servicing capacity of households and businesses were reflective of the large loan losses experienced during the Asian Financial Crisis.

Both the RWCR and CCR of the banking system post-stress remained above 9% even after having to absorb substantial losses under the most severe economic contraction and extreme financial market volatility. Overall potential cumulative losses from credit shocks far exceeded those from market risk shocks, which accounted for 61.6% and 19.7% of excess capital respectively. This is due primarily to the conservative loan loss provisioning rates assumed, which do not take into account the value of underlying collateral, and is reflective of the large financing composition in banks' balance sheets. The largest potential losses from extreme financial market conditions mainly emanated from banks' interest rate risk exposures, which constituted 78.5% of total market risk losses, followed by losses from the foreign exchange and equity portfolios, which accounted for 14.9% and 6.6% of total market risk losses respectively.

Similarly, the stress test conducted on the insurance industry affirmed the resilience of insurers under adverse and extreme scenarios. In addition to market and credit risk stress scenarios, stress factors were also applied to the insurance risk components to reflect the risk of under-estimation of insurance liabilities and adverse claims experience. The post-stress CAR of the industry remained close to 130%, albeit with an uneven impact among individual insurers.

OUTLOOK FOR FINANCIAL SYSTEM STABILITY AND FOCUS OF SURVEILLANCE IN 2011

The outlook for domestic financial stability in 2011 remains positive supported by underlying strengths of the Malaysian financial system. Financial institutions have accumulated strong financial buffers totaling RM81.4 billion to withstand external risks and domestic challenges, even under extreme scenarios of credit and market stress. This, in turn, will support the continued functioning of intermediation activities by the financial system.

Key challenges to financial stability in 2011 are likely to be largely externally driven, as global economic conditions remain fragile. While expected to be more moderate than in 2010, domestic growth will continue to be underpinned by strong economic fundamentals and further expansion in consumption and investment, although developments in commodity and energy prices will affect cost of living, particularly for average Malaysians living in urban areas.

Shifts in global liquidity will continue to pose challenges to the region, including Malaysia. The global search for higher yielding assets and expectations for the ringgit, alongside other regional currencies, to appreciate will continue to exert upward pressures on the prices of financial assets domestically. While the domestic property market has not experienced a significant broad-based increase in prices as a result of capital inflows, domestic financial markets are likely to remain volatile and impacted by developments on the external front. Financial asset prices and exchange rates remain susceptible to large and volatile portfolio inflows as well as the potential sharp reversals. The pre-emptive measures taken to ensure that risk-taking behaviours by financial institutions continue to remain prudent and measures that aim to create greater financial awareness among households, as well as hedging activities of businesses to manage exchange rate fluctuations, will collectively contribute towards mitigating these risks. This is further reinforced by the robust financial conditions of financial institutions.

Financial institutions will continue to face pressures to generate returns under the ample domestic liquidity conditions. The enforcement of responsible lending practices will act to counter overly aggressive behaviours by financial institutions. Nonetheless, the growing influence and significance of non-bank lenders will need to be managed to avoid excessive build-up of leverage among certain borrower segments.

Given that the recent trend of rising commodity and oil prices is expected to contribute to higher cost of living and cost of inputs for production, it will be particularly important for financial institutions to monitor risk developments in these segments, and to act pre-emptively to assist affected borrowers. This will also contribute towards preserving the overall quality of the banks' loan portfolio. In addition, the existence of the AKPK to facilitate individual borrowers in managing their debts and finances will provide additional support to households.

Moving forward, the Bank will focus on the following strategies to ensure that domestic financial stability continues to be preserved:

- *Ensuring prudent and responsible risk-taking by financial institutions* – The supervisory activity including on-site examination will remain focused on financial institutions' risk-taking behaviours as well as the effectiveness of their risk management and control functions. This will also be complemented by continuous assessment of financial institutions' resilience to credit and market risk shocks. The market competitiveness will also require continuous monitoring by the Bank on business and pricing practices, as well as conduct of financial institutions in their dealings with customers;
- *Ensuring sustainable household consumption and debt repayment capacity* – Emphasis will continue to be placed on inculcating responsible borrowing behaviours by raising the level of financial literacy as a means to promote sound financial and debt management, and hence contain credit risk in the banking system within prudent levels. Such responsible behaviours will also prevent excessive accumulation of debts by households outside the formal financial system. The Bank will also closely monitor the growing presence of, and coordinate with relevant agencies responsible for non-bank financiers, to ensure that their activities do not substantially increase household leverage;
- *Strengthening the risk capture and assessment on entities with systemic implications in the financial system* – To further enhance the Bank's assessment of risks to financial stability, efforts will be focused to better capture and manage contagion risk within and to the financial system. In addition, the Bank will continue to monitor developments in the activities of entities that are not regulated by the Bank;
- *Understanding and assessing the impact of changes in regulatory and accounting environment* – This will include ongoing assessments of the impact to financial stability and behaviours of financial institutions from the enhanced capital and liquidity requirements under Basel III and changes to international financial reporting standards;
- *Strengthening the regulatory laws and prudential guidelines* – The existing legislations will be reviewed to further strengthen the Bank's regulatory and supervisory framework. This will be complemented by enhancements to the governance framework and solvency standards as well as ensuring the smooth implementation of the new financial reporting framework. In the area of Islamic finance, the regulatory framework will be further strengthened to reflect the unique attributes of Islamic financial contracts. This will also include the development of Shariah parameters. Details of these enhancements are contained in Chapter 3 on "Regulatory and Supervisory Framework"; and
- *More active and closer domestic, regional and global cooperation and coordination* – The Bank will continue to pursue cooperation with other supervisory authorities, and through established multi-lateral platforms and bilateral arrangements, in order to effectively identify, and further strengthen the Bank's readiness, to deal with emerging risks to financial stability.