

Governor's Statement



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Despite the challenging conditions in 2009, financial stability has been maintained and the Malaysian financial sector has remained resilient throughout the year. With the deepening of the global financial crisis and the sharp deterioration in external conditions in 2008 and early 2009, the Malaysian economy experienced an economic contraction over three consecutive quarters before resuming growth in the fourth quarter of 2009. During this period, Malaysian financial institutions continued to have a high capitalisation level, sound asset quality and sustained profitability. Following a decade of financial reforms and the strengthening of the regulatory and supervisory framework and the building of the domestic financial infrastructure, the financial sector is well positioned to respond to the more challenging environment.

Financial institutions in Malaysia have built up strong capital and loan provisioning buffers, with significant improvements in underwriting and risk management practices. Prompt measures were taken as early as 2008 by banking institutions to shore up capital in anticipation of deteriorating economic conditions thus enhancing their institutional capacity. This served to avoid lending constrictions that would have severely impaired economic activity during this period. The financial intermediation process was not interrupted with the credit supply being sustained and providing the important support for economic recovery. Banking institutions have also responded to signs of distress by facilitating the restructuring of credit facilities extended to borrowers confronted with difficulties during this period.

The measures implemented by the Government and Bank Negara Malaysia (the Bank) have also contributed towards maintaining a high level of confidence in the financial system and ensured continued access to funding. The measures included the Government guarantee of deposits that was put in place in October 2008 and access to the Bank's liquidity facility for insurance companies and takaful operators. These measures served to avoid excessive risk averse actions by depositors, policyholders and market participants. None of these facilities have in fact been drawn upon. Other special funds, credit enhancement facilities and institutional arrangements for debt restructuring were also introduced.

During the year, the Bank's prudential framework, supervisory arrangements and processes, and the surveillance frameworks have been strengthened further. While these have performed well, continuous improvements were made to further enhance the existing framework and arrangements taking into consideration the issues that have surfaced during the global financial crisis. The focus has been to refine further the stress testing approaches, improve the supervisory cooperation across regulatory agencies and across borders, enhance risk and information capture in the prudential and surveillance frameworks, reinforce liquidity support and resolution arrangements, and further strengthen the financial safety net. These efforts are firmly underpinned by the significantly stronger foundation for financial stability that is now provided in our new Central Bank of Malaysia Act 2009 (CBA) that has come into force effective November 2009. The CBA provides greater clarity with respect to the Bank's mandate for financial stability and provides the necessary powers and arrangements for achieving the mandate.

In preparation for the coming into force of the CBA, the governance of the financial stability mandate in the Bank has also been strengthened. This involves the operationalisation of the transformation of the Division that is assigned with the dedicated financial stability function in the Bank. While the components in the Division includes surveillance, prudential regulation, supervision and financial sector development, it also draws on the work of the entire Bank that covers macro-economic management, oversight of the money and foreign exchange markets and the payment systems. The Financial Stability Policy Committee of the Bank is accountable for the assessment of risks to financial stability and the management of these risks. The Financial Stability Policy Committee is thus responsible for reviewing developments affecting risks to financial stability and deciding on policy actions, including macroprudential policy responses to address systemic risks.

Under circumstances where such systemic risk involves institutions beyond the regulatory reach of the Bank and where it involves public funds, it will be addressed by the Financial Stability Executive Committee which has been established under the CBA. These include resolution powers for financial institutions not in the regulatory capture of the Bank, but that would have systemic implications on the overall financial system. The Bank's accountability for financial stability is additionally supported by the publication of this financial stability report which provides the Bank's assessment of risks to financial stability, actions taken by the Bank to avert such risks as ongoing initiatives to strengthen the foundations for financial stability.

The stabilisation of the global environment has prompted a search by the international community for a more permanent solution that will put the international financial system on a more solid foundation. The enormous scale, scope and costs of the global financial crisis has led governments, and regulatory and supervisory authorities from around the world to mount one of the most aggressive agendas of reform to financial regulation. The potential impact that these reforms will have in re-defining the financial landscape in the future are significant, with significant implications for competition, innovation and ultimately, on the overall economic activity. It is hoped that indeed the regulatory reform will in fact deliver greater financial stability and that it will take into account the potential unintended consequences of the proposed reforms envisaged, in particular, on the behaviour of institutions, on innovation and on the potential increased cost of financial intermediation which would in turn affect overall economic activity.

The Bank will continue to maintain appropriate supervisory approaches that promote financial stability while remaining supportive of the wider objective of financial sector development. The Bank fully intends however, to implement changes that will achieve a regulatory framework that is more forward looking and responsive to risk, and that will further strengthen incentives for the adoption of sound and robust risk management practices by financial institutions. The Bank will also continue to develop and further refine its macroprudential approaches to regulation to complement the supervision of individual institutions to pre-emptively address the build up of system-wide risks. Also important is ensuring that the institutional arrangements for prompt and orderly resolution of problem institutions continue to remain effective.

Despite the global financial crisis and severe economic slowdown, Islamic finance has continued to progress on a path of sustained growth. As an increasingly important component of the global financial system, there has been greater recognition of the significant prospects for Islamic finance to contribute towards global growth and financial stability. During the year, the Bank continued to contribute towards the work of the Islamic Financial Services Board (IFSB) and the Islamic Development Bank through an active role in two taskforces - the Taskforce on Islamic Finance and Global Financial Stability and the High Level Taskforce on Liquidity Management. The IFSB is an international prudential standard-setting organisation and has an important role in promoting

soundness and stability of the Islamic financial services industry by issuing global prudential standards. In Malaysia, the CBA has positioned the Shariah Advisory Council of the Bank as the final authority for deciding on Shariah matters relating to Islamic banking and finance. The legal foundation was further augmented by the issuance of the Shariah Parameters on *murabahah* which provides a common reference on Shariah for the development of Islamic financial products.

The Bank continued to advance the development of a sound, stable and progressive insurance and takaful industry to further enhance its performance and contribution to the Malaysian economy. Initiatives have focused on strengthening the market structure, better aligning incentive systems and further strengthening governance and risk management practices. A major initiative was launched in 2009 to review and improve the structure and practices in the motor insurance sector which accounts for 46% and 67% of general insurance premiums and claims respectively. The review aims to ensure the long-term viability of motor insurance business through the more efficient pricing and effective management of claims costs, while preserving an appropriate level of essential protection for policyholders at reasonable cost. It also aims to position the industry for the move towards a more deregulated pricing environment for motor insurance. The safety net for the protection of policyholders is also being strengthened with plans underway to put in place a more effective insurance compensation system that will also contribute towards financial stability.

Significant institutional building, financial infrastructure development and the progressive deregulation of the industry have enhanced the capacity of the domestic financial system to face the increased challenges from a more liberalised environment. Further liberalisation in the domestic financial system was announced in 2009 to accelerate further the deepening of the domestic financial system and promote greater integration with the global financial system. With the implementation of the ten-year Financial Sector Master Plan almost completed, a new blueprint is being developed to chart the transformation of the financial sector over the next decade beginning 2011. The new blueprint will articulate strategies to further evolve the Malaysian financial sector to support and drive the next phase of Malaysia's economic development. This will encompass strategies that will address the desired financial structure for Malaysia, the financing for new growth areas, the development of financial markets, talent development and the deepening of international linkages and regional financial integration.

With an improved economic outlook in 2010, efforts will be directed at facilitating mutually reinforcing developments that will contribute to macro-economic and financial stability to support the sustainability of this emerging trend. This includes having in place a financial system that is able to support a strong private sector, and that is able to facilitate the economic transformation to transition the Malaysian economy to its next phase of development. Continued vigilance will also be maintained to promptly identify and respond to potential risks in this post-crisis environment to ensure that financial stability will provide the foundations for achieving the ultimate goals for the economy.



Zeti Akhtar Aziz
Governor

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