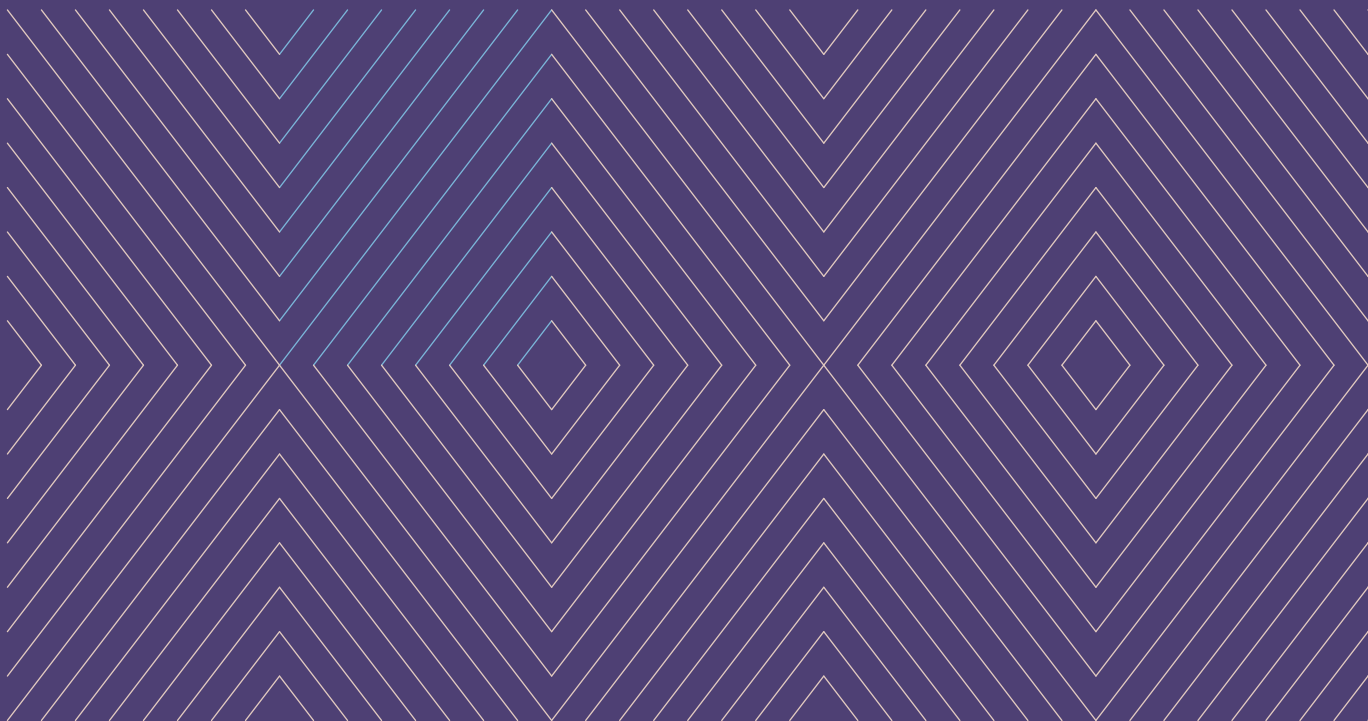


Executive Summary



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The environment underpinning the preparation of the Financial Stability and Payment Systems Report 2009 has been favourable as prospects for recovery in the global and domestic economy improved tremendously. The Report outlines the Bank's assessment of risks and challenges faced by the Malaysian financial system and the capacity of the system to sustain its role in providing critical services to the economy. This report also covers various aspects of prudential and developmental initiatives, including those relating to the payment systems, that were pursued towards strengthening the resilience and integrity of the financial and payment systems. This publication is intended to promote greater understanding on issues affecting financial stability and thus promote appropriate behavioural responses in reinforcing financial stability.

Risk assessment of the financial system

The Malaysian financial system's resilience was strengthened further despite the challenging operating conditions in 2009. The stability and soundness of the financial system were fundamental in ensuring that the financial intermediation process, payment and settlement, and the provision of protection against risk remained uninterrupted and delivered in an efficient and effective manner. Policy responses instituted at the early phase of the global crisis by the Government and the Bank had contributed to the swift recovery in the domestic economy.

The overall stability of the banking system was intact due to strong solvency position and high quality of loan portfolio. The risk-weighted capital ratio (RWCR) strengthened to 14.7% as at end-2009 (2008: 12.6%) with excess capital well above RM50 billion (2008: RM38.7 billion). The bulk of this capital was predominantly in the form of Tier-1 capital instruments that would provide strong buffers against financial losses. While overall earnings were stronger and registered broad-based improvements, revenue from lending activities softened on subdued demand for financing and higher funding expenses due to the larger deposit base. Profitability of the banking system was lower on account of a non-recurring investment

impairment provision by an institution for its overseas operations. Adjusting for the one-off provisioning, profitability of the system registered a growth of 3.2% in 2009. The exposure of the banking sector to interest rate risk and foreign exchange risk remained manageable at 5.0% and 4.6% of total capital base respectively.

The banking system remained supportive of the financial needs of the domestic economy. Financing extended by the banking system expanded further at an annual rate of 7.8% to RM783.4 billion as at end-2009 whilst approval rates were kept steady at approximately 70%. The banks' financing portfolios remained concentrated in the retail-based segment with the households and small and medium enterprises (SMEs) accounting for 55.1% and 15.2% of outstanding financing respectively. Notwithstanding the difficult economic environment, loan quality of the banking system improved on continued recoveries and write-offs. The net non-performing loan (NPL) ratio improved further to 1.8%, the lowest level since the Asian financial crisis. On the sectoral front, the gross NPL ratios for the large business and SME sectors declined to 4.1% and 5.7% respectively as at end-2009 (2008: 5.4% and 6.8%). Similarly, the gross NPL ratio for the household sector improved to 3.1% (2008: 4.1%).

The insurance and takaful sector recorded a higher capital adequacy ratio of 230.0% (2008: 187.6%) with a comfortable capital buffer of RM18.6 billion or 11.4% of total assets. The stronger solvency enabled the insurance and takaful industry to remain as an effective provider of financial protection for businesses and individuals. Total net premiums for insurers and takaful operators grew by 8.2% during the year. Growth was driven mainly by the ordinary life segment for the life and family takaful industry, and a broad-based demand for the general sector. The revival of conditions in the financial markets contributed towards stronger income from investment portfolios and unrealised capital gains for the entire insurance industry. For the general business, improved performance was also achieved on account of lower motor claims ratio.

The domestic financial markets remained orderly and regained the upward momentum as the year progressed on signs that the slowdown in the domestic economy has bottomed out. This coincided with improvements in the earnings performance of businesses and the more favourable employment prospects, which bolstered the debt servicing capacity of banks' borrowers. The subsequent compression of credit spreads led a turnaround in the bond market, as manifested by the recovery in private debt securities (PDS) issuances, including those by foreign issuers. Ample ringgit liquidity in the system also supported the smooth functioning of ringgit money market and interbank market in 2009.

Both the business and household sectors exhibited high capacity and agility in confronting the challenges that surfaced during the year. Loans to households expanded by 9.4% to RM516.6 billion, with borrowings primarily for the purchase of residential properties. Strong financial buffer had accorded businesses with the flexibility to adjust to the conditions whilst ensuring the ability to service debt. Financing extended to large businesses grew 7.8% as at end-2009. Outstanding financing by the banking system and development financial institutions (DFIs) to SMEs registered a slight decline at the end of 2009. This was due partly to the upgrading of SME accounts to large enterprise accounts, the sale of NPLs to an asset management company by one banking group in November 2009 and bad debts written off.

While recovery of the economy has been established, its path is not without challenges. The greater international financial and economic integration will pose continuing risk of contagion that may affect domestic financial stability. Better economic prospects for the emerging economies, particularly in Asia, have drawn large inflows of capital into the region and have once again posed challenges in managing potential unsustainable build-up in asset prices and financial imbalances. Domestically, the improved economic outlook and market sentiment would create greater optimism among financial institutions following opportunities from the recovery. While this takes place, it is critical to ensure that this does not result in unchecked increase in risk appetite and compromise in risk management practices as financial institutions respond to the conditions. The macro- and micro-surveillance functions will

remain heightened to ensure prompt identification of emerging risks. In this respect, pre-emptive policy measures will continue to be introduced to prevent the build-up of systemic risks that could pose threats to the overall financial stability.

Development of the financial sector

The focus of financial sector development policies for the year was to preserve the soundness and integrity of the sector and to ensure the continuous and well-functioning of the financial intermediation activities. This was complemented with the longer-term objectives of strengthening the capacity and growth potential of the sector. In 2009, the Bank also accomplished major strides in its liberalisation plan that serves to facilitate the progress of the sector as a key enabler, catalyst and driver of economic growth and enhance the inter-linkages of the Malaysian financial system with other economies.

Ensuring the continued access to financing for all segments of borrowers, in particular the SMEs, remained a high priority area. A number of measures were introduced towards achieving this objective. These include the establishment of the SME Assistance Guarantee Scheme (SME AGS), the Working Capital Guarantee Scheme (WCGS), the Industry Restructuring Guarantee Scheme and the consolidation of ERF Sdn. Bhd. into Credit Guarantee Corporation (CGC). Both the SME AGS and the WCGS were fully utilised. Meanwhile, as at end-2009, CGC has granted credit guarantees to 402,867 SMEs, which had outstanding financing of RM44.9 billion. During the year, an entity was established to facilitate viable businesses to raise financing from the bond market. Danajamin Nasional Berhad, a financial guarantee insurer was created with the objective of providing credit enhancements to investment grade issuers with viable businesses to raise funds from the bond market at reasonable cost.

In addition to ensuring the continued steady flows of credit to the economy, measures were also introduced to provide avenues for borrowers to manage debt obligations. The Corporate Debt Restructuring Committee (CDRC) recommenced its operations with an expanded mandate to facilitate pre-emptive restructuring of debts including bonds for businesses. The eligibility criteria for cases to be handled under the Small Debt Resolution Scheme were revised in 2009 to enable a wider reach of viable SMEs to seek

assistance to restructure and reschedule the loans with multiple banks. These measures were also complemented by the restructuring and rescheduling of loans by the individual banks and the granting of temporary relief on housing loan repayments for borrowers who were affected by retrenchment or reduction in working hours.

The Bank's liberalisation plan announced in 2009 encompassed three broad strategies namely, the issuance of new licences, increase in foreign equity limits and the offering of greater operational flexibilities to incumbent foreign players. During the year, a new commercial bank licence was issued to the largest commercial bank in the People's Republic of China under a bilateral arrangement to promote strategic partnerships and to enhance collaboration and cooperation with regional economies. The Bank also entered into a Memorandum of Understanding (MoU) with China Banking Regulatory Commission to strengthen cooperation between the two regulatory authorities in the area of banking supervision.

Initiatives to deepen the financial markets focused on creating a conducive regulatory environment, enhancing the infrastructure and broadening the asset class. To further develop the financial markets, the Bank undertook initiatives to enhance the infrastructure with a slant towards promoting Malaysia as an international Islamic financial centre. The Principal Dealer framework was revised in 2009 to incentivise continued participation in the primary auctions and secondary market trading. This revision has also facilitated the introduction of the Islamic Principal Dealer System for the Islamic debt securities issued by the Government and the Bank. A major milestone was accomplished during the year with the launch of Bursa Suq Al-Sila (formerly known as the Commodity *Murabahah* House), the world's first Shariah-compliant trading platform for commodity *murabahah* transactions. This platform is expected to further enhance the trading of commodities for liquidity purposes between Islamic financial institutions in Malaysia and to facilitate cross-border liquidity transactions.

To promote clear understanding and consistent interpretation of Shariah contracts, the Bank undertook to develop a comprehensive codification of Shariah contracts known as Shariah Parameters. The first Shariah Parameter on *murabahah* contract was issued in 2009, whilst the Shariah Parameters for contracts

on *ijarah*, *mudharabah*, *musharakah*, *istisna'* and *wadiah* are expected to be finalised by end-2010. The Bank has also entered into strategic bilateral and multilateral cooperation to promote global partnerships and cross-border business ventures in Islamic finance. Two MoUs were signed between the Bank and the United Kingdom Trade and Investment and the Hong Kong Monetary Authority to promote mutual cooperation in the area of Islamic finance, particularly in talent development and strengthening of business linkages and infrastructure support. A new long term brand *Shaping Islamic Finance Together* was introduced in 2009 to position Malaysia as the intellectual centre for Islamic financial activities. During the year, there was a landmark foreign currency issuance of sukuk by PETRONAS, which received an overwhelming response despite the highly challenging economic environment.

The Bank intensified its efforts to promote fair and equitable market practices and to raise the level of financial capability of consumers to foster continued consumer confidence in the financial services sector and to contribute towards a more efficient and competitive market. The surveillance over market practices was intensified during the year in response to the competitive market condition. This was complemented with the comprehensive disclosure framework for retail financial products that focuses on key product features, risks and benefits, and major terms and conditions of the contract.

Malaysia has continued to demonstrate strong commitment to observe international standards on transparency and exchange of information to curb illegal activities. Malaysia is categorised in the "White List" issued by the Organisation for Economic Cooperation and Development. This achievement bodes well for sustaining the overall confidence, competitiveness and attractiveness of the Malaysian financial system.

Going forward, to realise the vision of attaining the developed economy status by 2020, a new blueprint for the financial sector is being drawn up. The objective is to elevate the role of the financial sector as an enabler, driver and catalyst of economic growth, with enhanced capacity to contribute effectively to the economic transformation process to a high value-added and high-income economy.

Prudential regulation and supervisory framework

Developments in the global regulatory reform arising from the crisis has sharpened the Bank's focus on delivering a prudential framework which is responsive to the changing environment, while maintaining an appropriate balance between regulatory prescriptions and supervisory assessment of the risk management quality of financial institutions. In addition, greater attention was also accorded to macro-regulation in complementing micro-surveillance of individual financial institution.

While the Bank generally supports the proposed international regulatory reforms, which are aimed to strengthen the foundations of financial stability, there is a need to carefully evaluate the potential implications of these proposals from the different dimensions, particularly to safeguard financial institutions' critical role to support sustainable growth of the economy as well as to ensure that such measures do not result in unintended implications on future structures and behaviours of the financial system. Specific consideration needs to be accorded to the regulatory framework that is already in place in the domestic financial system and the extent to which the current framework is adequately delivering the desired outcomes.

The implementation of Basel II Framework progressed further in 2009 with the issuance of the guidance on the adoption of the Internal Ratings-Based (IRB) Approach for credit risk in determining regulatory capital requirements. The supervisory review process (Pillar 2) and market discipline (Pillar 3) components of the capital adequacy framework were also taken forward during the year.

The insurance industry transitioned effectively to the Risk-Based Capital (RBC) Framework on 1 January 2009. The adoption of the RBC Framework has significantly improved insurers' focus on the risk drivers of the business through the risk-adjusted capital calculations and scenario testing elements embedded in the Framework. Significant progress was also achieved on the development of the RBC Framework for takaful operators, with industry consultations and impact assessments to commence in 2010.

Proposed enhancements to the Liquidity Framework have been finalised for implementation in 2010. Further revisions are being considered to

take into account the recently released proposals by the Basel Committee on Banking Supervision (BCBS) on the minimum global quantitative standards on liquidity risk management.

The Bank continued to focus its resources in promoting sound corporate governance and risk management practices through the Financial Institutions Directors' Education (FIDE) initiative. Since the launch of the FIDE programme in 2008, 131 directors of financial institutions have completed the core programme which examines the application of good governance in the specific context of issues and challenges facing the different sectors in the financial industry. Additional specialised and supplementary programmes are being developed as part of the FIDE initiative, to further strengthen the support for boards in providing effective oversight of financial institutions.

Malaysia adopted the Financial Reporting Standard (FRS) 139 for all reporting entities, including financial institutions on 1 January 2010. However, given that international developments in provisioning standards remain fluid, transitional arrangements were provided for banking institutions to determine collective impairment assessments in order to reduce implementation costs associated with further changes needed to comply with the new standards currently being contemplated by the International Accounting Standards Board. The transitional provision will also facilitate the alignment of provision levels more closely to the forward-looking provisioning standards envisaged under the new impairment standard.

In the area of Islamic finance, efforts continued to be directed at strengthening Shariah governance, promoting sound business practices and operational efficiencies at the Islamic financial institutions. The Bank is revising the Rate of Return (ROR) Framework for Islamic banking institutions to promote improved management of profit-sharing policies, reduce information asymmetries between related parties and to provide a broader scope of Islamic banking business. The issuance of the Guidelines in Investment Management and the concept paper on Guidelines on Takaful Operational Framework both aimed to strengthen the governance and management of takaful funds. A Shariah Governance Framework will be issued in 2010 in line with efforts to further enhance Shariah governance of Islamic financial institutions.

An area of high priority in 2010 will be the comprehensive review of all the existing legislations governing financial institutions and payment systems under the Bank's purview to take into account the changing financial landscape and regulatory developments over the last two decades. The proposed legislative changes will further reinforce the strengthened financial stability framework in Malaysia following the enactment of the Central Bank of Malaysia Act 2009 that came into force on 25 November 2009.

Payment and settlement systems

Despite the challenging environment in 2009, the payment and settlement systems in Malaysia remained resilient and continued to operate smoothly throughout the year, contributing to the stability of the financial system.

The transfer of the payment and settlement systems to the Malaysian Electronic Clearing Corporation Sdn. Bhd. (MyClear), a wholly-owned subsidiary of the Bank, was completed without any disruption. This institutional arrangement strengthened the governance structure with the segregation of responsibility to operate Real-time Electronic Transfer of Funds and Securities System (RENTAS) and National Electronic Cheque Information Clearing System (eSPICK) being entrusted to MyClear, while the Bank is responsible for oversight of the payment systems. As part of its oversight role, the Bank has issued supervisory expectations to be observed by MyClear. These include requirements for risk management and compliance with best practices and international standards for payment system operations. During the year, the robustness and adequacy of the business continuity plans of RENTAS and eSPICK members were continuously tested to ensure minimal disruption to the functioning of these systems.

In managing public confidence and in improving the adoption of electronic payments (e-payments) initiatives, the Bank accorded great importance in ensuring the robustness and reliability of the major retail payment

systems such as the Malaysian Electronic Payment System Sdn. Bhd. (MEPS) and Touch 'n Go Sdn. Bhd. (TnG). The Bank continues to collaborate with industry players and the relevant authorities to educate cardholders on the importance of safeguarding cards and card information, despite payment system fraud and attempted fraud rates being contained at negligible levels.

Continuous collaboration and engagement with the Government and private sectors were undertaken to promote the use of e-payments and to achieve the benefit of more efficient transfer of funds. In 2009, the Bank commissioned a study to identify the impediments and issues that are constraining the successful implementation of the e-payment agenda. Approximately 96% of Government payments are now via electronic funds transfer, whilst the use of credit transfer facility for payments to the Government grew substantially to RM41.3 million (2008: RM21.9 million). In the securities sector, collaborative efforts between the Bank, Securities Commission Malaysia, Bursa Malaysia, Association of Banks in Malaysia, Association of Stockbroking Companies Malaysia and MEPS were made to facilitate the adoption of e-payments for the sale and purchase of shares as well as for payment of dividends through e-Dividends.

Continuous emphasis on promoting awareness and enhancing cooperation of more economic sectors to drive the higher adoption of e-payments will be a priority for 2010. The Bank will also focus on establishing regional collaboration for more inter-connected payment systems in the region to deepen the financial integration between the ASEAN countries. Given the more inter-connected payment systems in the region, work has already progressed towards establishing cross-border collateral arrangements within the Executives' Meeting of East Asia-Pacific (EMEAP) region as part of enhancing liquidity crisis management.