

Macroprudential Approach to Financial Surveillance and Regulation in Malaysia

The use of macroprudential regulations is not new in Malaysia. Macroprudential policy instruments (MPIs) have in the past been deployed to manage excesses and imbalances in the financial system and in managing capital flows. The development of the macroprudential surveillance framework gained momentum after the Asian financial crisis which surfaced two fundamental issues: (i) the need for macro-level risk assessment to complement micro-level supervision; and (ii) the need for assessment on cross-institutional and cross-sector risk transmissions.

Considerations for the design and use of MPIs

In Malaysia, the use of MPIs is generally targeted towards achieving the objectives of ensuring financial system resilience and addressing procyclicality (leaning against the financial cycle). These MPIs were mainly directed towards enhancing financial institutions' resilience against business cyclical variations, through the promotion of enhancements to risk management capabilities and the accumulation of financial buffers during upturns (automatic stabilisers). Bank Negara Malaysia has used MPIs to manage destabilising capital flows, the level of credit growth and risk-taking activities, such as to prevent the build-up of asset price bubbles or other imbalances, or to stimulate financing of economic activities during downturns for particular sectors. In choosing between the different types of MPIs, the Bank ensures a balance between a direct and targeted approach vis-à-vis a more indirect approach to manage credit supply. For example, MPIs imposed on the assets side of banks' balance sheets, such as lending controls or loan-to-value ratios would directly interfere with lending strategies of banks, while MPIs such as capital charges on lending to different segments and counterparties would be an indirect approach in influencing credit supply.

The use of MPIs in Malaysia takes into account the balance between costs of prudence and efficiency, as well as to complement monetary and fiscal policies, in order to achieve an effective equilibrium in preserving financial and monetary stability, and preserving the potential for growth. The use of MPIs to address the "cross-sectional dimension" of macroprudential concerns thus far has been limited mainly to capital and liquidity requirements on individual financial institutions for purposes of maintaining institutional, and consequently, systemic resilience. An example is the minimum risk-weighted capital ratio requirement of 8% for all banks. Such an approach could have less equitable outcome as the requirements are not differentiated according to the systemic importance of the institution, and in fact, the costs associated with systemic risk may be socialised without the benefits. Nonetheless, Malaysia has reinforced the framework through the complementary use of measures to address the "time dimension" of macroprudential concerns. This is achieved mainly through the use of counter-cyclical MPIs to limit the costs of financial distress in the contraction phase and restrain the build-up of risks during the expansion phase of the financial cycle. In the recent two decades, while the introduction of MPIs tend to be "discretionary-based" in nature, as the Bank reacted to pre-empt or manage risks to financial system stability, some of these MPIs have been retained over time and modified from its initial form to become more permanent in nature to manage the accumulation of systemic risks, particularly in the segments that are more prone to the build-up of price bubbles and imbalances. The permanency of some of the MPIs is also in response to structural changes and evolution of the financial sector and the economy.

Malaysia's experiences in the deployment of MPIs

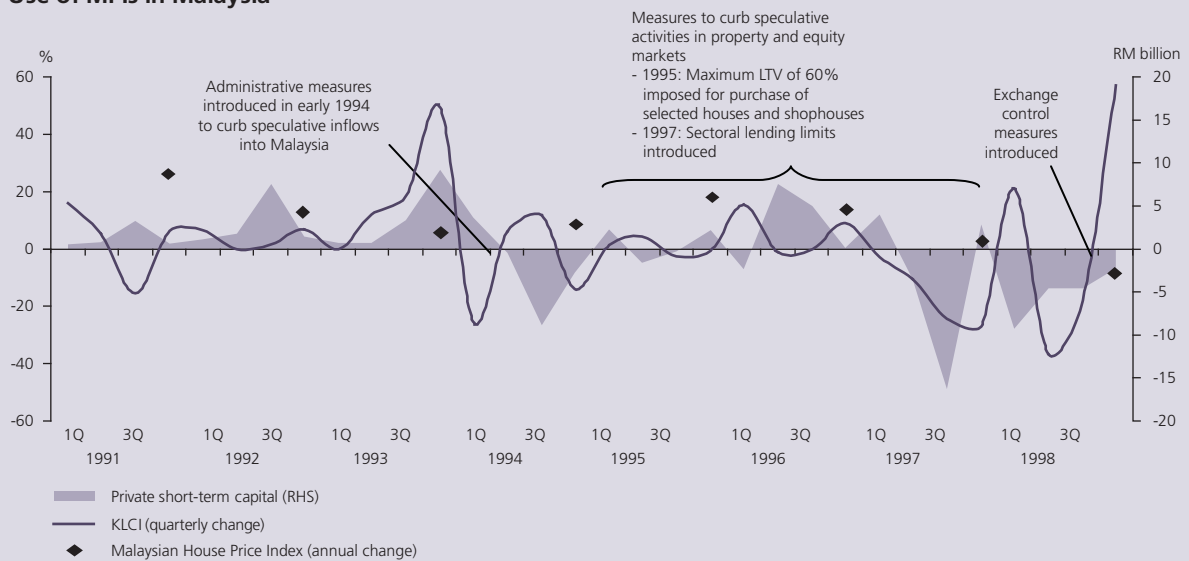
Strong economic growth and buoyant stock market activities in early 1990s had induced massive capital inflows into Malaysia. Such externally induced liquidity created upside pressures on prices of financial assets and real estate. To manage the destabilising effects of such short-term flows on the financial sector and economy, a series of macroprudential measures were implemented during the course of 1993. These measures, namely imposition of limits on non-trade related external liability position of banks, prohibition of forward transactions (on the bid side) and non-trade related swaps by commercial banks with foreign customers, restriction on sales of short-term monetary instruments to non-residents, and limitation on purchases of residential property exceeding RM250,000 by non-residents. These measures were all aimed at discouraging large scale inflows of short-term funds into the country and hence, provided some

calmness in the financial market. These measures were discretionary and temporary and were removed when conditions returned to desired levels. In 1998, a range of selected exchange control measures were implemented to reduce the internationalisation of the ringgit caused by speculative activities where high interest rates of 20%-40% offered by offshore centres for the ringgit had resulted in outflows from the onshore market and had destabilising impacts on the domestic financial markets.

Between 1994-96, macroprudential measures such as loan-to-value ratio limit on the purchase of non-owner occupied residential properties and tighter conditions on lending extended for the purchase of shares were introduced to curb excessive credit expansion that had fed into asset prices. These measures complemented the use of monetary policy. Increasing interest rates too high during periods of formation of asset bubbles would dampen investments in the productive sectors of the economy. The macroprudential measures were implemented in stages to address the specific issues at hand and to avoid an adjustment in the financial markets.

Subsequently, more stringent requirements were introduced in April 1997 to limit bank lending to finance the purchase of shares, and to finance investments in broad property sector. This was in response to concerns of bank lending contributing to the potential formation of an equity and property price bubble¹, and at the same time the adverse impact of a steep correction in these markets on banking system stability². For each of these areas, limits were imposed on different forms of credit exposures such as loans and financing, guarantees and holdings of corporate debt securities issued to finance activities in the broad property sector and equity market. As these limits were targeted at areas only where concerns of speculative activity existed, certain specific sub-sectors were excluded. These include the construction of low-cost residential properties, the development of infrastructure projects, public utilities and amenities, the purchase and construction of industrial buildings and factories, the purchase of owner-occupied

Chart 1
Use of MPIs in Malaysia



Source: Bloomberg, CEIC, Bank Negara Malaysia and internal computation

¹ As at end 1996, the proportion of total outstanding loans allocated to the broad property sector and share markets amounted to 39%. House prices in 1996 rose by 12.9%, while share prices on the Main and Second Boards of the Kuala Lumpur Stock Exchange rose by 24.4% and 93% respectively.

² In 1997, lending to the broad property sector and lending for the purchase of shares were characterised by high non-performing loan (NPL) ratios of 6.3% and 6.5% respectively. By 1998, these worsened to 14.2% and 23.2% respectively.

residential and commercial properties, and the purchase of land for agricultural and industrial activities. In 1995, limits were also introduced to limit the rapid growth on consumer credit, especially lending for purchase of passenger vehicles. The re-imposition of such limits was based on the success of the measures in moderating previous episodes of soaring hire purchase credits between 1990 and 1993. During this period, growth in credit for motor vehicles slowed down to 7.6% at the end of 1992 from a high of 81% in May 1990.

Following the implementation of the limits, the loans to the broad property sector and for the purchase of shares declined to 22% of total loans as at end-1997 from 39% of total loans as at end-1996. Financing for share financing only grew by RM2.3 billion in the second half of 1997, compared to RM12.2 billion in the preceding half year. Property prices plateaued and the annual growth in the Malaysian House Price Index moderated substantially to 1.9% by end-1997 (1996: 12.9%). This alleviated further build-up in property prices which could have had more damaging effects on the economy following the intensification of the Asian financial crisis in 1998. Subsequently, the crisis resulted in a sharp contraction in overall aggregate demand including speculative activities that led to further contraction in banks' lending and decline in financial asset prices. The limits were introduced as part of a broader package of pre-emptive prudential measures³ which worked in concert.

The Bank exercises discretion by making appropriate adjustments to the limits where and when necessary, to ensure its continued relevance and effectiveness while minimising the potential adverse consequences on the financing of economically productive activities. For example, given that the property overhang situation remained substantial in certain sub-sectors, such as high-end properties and commercial real estate, the provision of credit for these sub-sectors was temporarily prohibited in 1999. The price threshold for residential properties exempted from the lending limits was increased to include properties valued up to RM250,000 (previously RM150,000) to meet growing demand for medium-cost properties in tandem with the higher income levels and house prices. Similarly, the continued pressure in the consumption credit segment led to upward adjustment in the limit in margin of financing for the purchase of passenger vehicles from 75% in 1995 to 70% in 1997.

Continued enhancement of the macroprudential framework in Malaysia

The macroprudential framework in Malaysia has evolved substantially over the years and the strategy adopted has been all-encompassing in terms of the framework and infrastructure development, capability enhancement, governance structure and communication. These changes are aimed at ensuring that the macroprudential framework remains dynamic and relevant in addressing the present and future challenges. More recently, as a by-product of the global financial crisis, international debates on the use of the macroprudential regime to dampen cyclical "overshooting", as well as to assess, manage and mitigate contagion risks from unregulated entities and markets, have also provided new insights into the conduct of the macroprudential policy framework in Malaysia. In relation to this, the Bank places significant emphasis to ensure robust governance structures and processes in the conduct of the framework, including considerations of the relationship between macroprudential functions and monetary policy. The Bank is cognisant of the importance of effective coordination between the macroprudential, microprudential and monetary policy framework to facilitate holistic and comprehensive deliberation of the identified risks and issues, as well as formulation of appropriate policy responses.

In addition, the increasing regionalisation of the financial system also saw greater collaboration and knowledge sharing in efforts to manage macroprudential issues and risk of contagion at the regional level. The Monetary and Financial Stability Committee (MFSC) of the Executives' Meeting of East Asia-Pacific (EMEAP) Central Banks have raised the level of regional cooperation in information exchange and joint monitoring of the impact of the recent global crisis on regional economies. In addition,

³ For example, the issuance of guiding principles for banking institutions extending loans to the property sector.

Table 1
Types and use of macroprudential policy instruments in Malaysia

Asset side	Quantity	<ul style="list-style-type: none"> • Sectoral lending limits, or ceiling on loan growth to specific sectors (1997: to curb lending to the broad property sector and for the purchase of shares and unit trust funds) • Loan growth targets (1998-99: stimulate bank lending) • Investment limits (Islamic banks are subjected to a limit on exposures to property development projects and property investment activities of 25% of eligible capital base) • Loan-to-value (LTV) or loan-to-income limits <ul style="list-style-type: none"> o 1991: Maximum margin of financing of 75% for purchase of motor vehicles (lifted in 1993) o 1995: Maximum LTV of 60% for the purchase of houses above RM150,000 and shophouses above RM300,000 (not used for own dwelling or conduct of own business) to curb speculative activities o 1995: Maximum margin of financing of 75% for the purchase of passenger cars (1997: 70%) • More stringent loan loss provisioning or collateral valuation rules for specific types of loan or risk-profiles (e.g. legacy loans, high LTV, etc.)
	Price	<ul style="list-style-type: none"> • Controls on lending/financing rates <ul style="list-style-type: none"> o Floor rate: to dampen demand for credit or address underpricing under intense competition to capture and retain business market share o Ceiling rate: to influence the supply of credit by restricting lending to high risk customers
Liability side (capital and debt)	Quantity	<ul style="list-style-type: none"> • Capital requirements – e.g. higher capital charges for specific types of loans (by sectors, risk profile, etc.) • Under Pillar 2 of Basel II, higher capital requirements and other supervisory actions can be undertaken when banking institutions fail to address credit risk concentrations • Funding requirements (to limit the use of less stable sources of funding e.g. loan-to-deposit ratio limit) • Liquidity requirements (1998: to increase commercial banks' loanable funds)
	Price	<ul style="list-style-type: none"> • Deposit ceiling rate can be used to constrain financial institutions' ability to fund rapid credit expansion with high deposit rates to attract retail and institutional depositors

the Bank has also fostered closer regional cooperation in the formulation of exit strategies through the establishment of a Tripartite Working Group with the Hong Kong Monetary Authority and the Monetary Authority of Singapore to map out a coordinated strategy for the exit from the full deposit guarantee by the end of 2010.

The effectiveness of the Bank's macroprudential functions was augmented with comprehensive legislative powers with the coming into force of the Central Bank of Malaysia Act 2009 since November 2009. The Act enhances the Bank's capacity to undertake macroprudential surveillance and to act pre-emptively to avert risks to financial stability. Of importance, are the expanded powers to undertake surveillance and resolution on entities that are not regulated by the Bank but are likely to pose threats to financial stability, and powers to engage with and to collaborate with other domestic and international authorities to achieve greater coordination via a more macro approach towards maintaining financial system stability. The Act and other legislations relating to the regulation and supervision of financial institutions also provides the Bank with the powers and flexibilities to instil strong discipline through a robust governance framework to ensure a sufficiently systematic, transparent and accountable policy regime.

Conduct of macroprudential functions within the Bank

There is a dedicated division in the Bank that is accountable for financial stability mandate, with functions distributed across several departments. In 2006, a transformation exercise was undertaken to facilitate a more integrated, holistic and harmonised approach to regulation and supervision and thereby

further strengthen the conduct of financial stability within the Bank. This transformation exercise has now yielded positive results. The macroprudential orientation and conduct of surveillance in the Bank was further enhanced with the setting up of the Financial Surveillance Department in late 2006. The department is entrusted to undertake comprehensive and integrated identification of vulnerabilities and the calibration of assessment methodologies via collaborative mechanisms within the Bank and with other domestic regulators to facilitate robust assessment of the risks emanating from domestic and international developments on the overall stability and functioning of the financial system. As part of its overall surveillance framework, the department also works closely with the supervisors to ensure that risk assessment incorporates and integrates both macroprudential and microprudential perspectives.

The reorganisation of the financial stability division of the Bank was also complemented with strengthened governance and processes. Depending on the sources and nature of the emerging threats or issues, macroprudential policy assessment and recommendations can be spearheaded by any of the 10 regulatory and supervisory departments under the financial stability arm of the Bank. These issues will first be deliberated among the departments at a technical level, prior to escalation to the Financial Stability Policy Committee (FSPC) for deliberations and approval where necessary. The FSPC is chaired by the Governor, with membership comprising the Deputy Governors and selected Assistant Governors involved in financial stability functions. With the coming into effect of the Central Bank of Malaysia Act 2009, the role and responsibilities of the FSPC has now been enhanced further in relation to the microprudential and macroprudential framework that is now in place. Specifically, the FSPC also serves as the forum to deliberate and decide on macroprudential policies to address risks to financial system stability, including on microsurveillance responses and on resolution measures. Another enhancement relates to the decision on the imposition of macroprudential measures on any person/institution not regulated by the Bank. The extended powers of the Bank in dealing with emerging risks from outside the Banks' regulatory perimeter, including the resolution powers, are overseen by the Financial Stability Executive Committee (FSEC). The FSEC consists of the Governor, one Deputy Governor and three to five other members appointed by the Minister of Finance upon the recommendation of the Bank's Board of Directors. The FSPC, being the highest level decision making forum in the Bank will also be entrusted with recommendations to the FSEC on matters relating to financial stability, including the provision of liquidity assistance to and resolution of institutions not regulated by the Bank.

The forward-looking approach to surveillance accords an important priority on the development of forward-looking quantitative tools to aid coherent and integrated analysis as part of the macroprudential surveillance framework. In 2007, the Vulnerability Indicator for the Banking Sector was developed to measure the intensity of the banking system distress at a particular point in time. This was followed by the development of Z-score and modified distance to default models in 2008 to assess and forecast the level of credit risk of corporations. On-going efforts are being undertaken to enhance the use of scenario analyses and macro stress testing to facilitate more robust forward-looking assessments. This includes enhancements in assessing the dynamics of interbank linkages, the potential contagion paths and the degree of liquidity spillovers within the banking system.

Focus is also accorded to ensure effective communication of financial stability issues to the various key stakeholders. The conclusions of the Bank's macroprudential analyses are communicated to its various stakeholders through various channels. Since 2007, the Bank has begun to publish an annual Financial Stability and Payment Systems Report that communicates the outcome of its macroprudential risk assessment and to highlight emerging sources of vulnerabilities. The publication seeks to promote greater awareness and understanding of issues relevant to the safeguarding of overall financial system stability, and where appropriate, to induce adjustments in behaviours of financial players and market participants to better manage the build-up of systemic risks. The Report also contains the implementation of risk mitigating measures by the Bank that aim to strengthen the resilience of the system against any threats to its stability.