Governor's Statement

BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

The Malaysian financial system faced an exceptionally challenging external environment in 2008. The conditions in the global financial system deteriorated sharply during the second half of the year as the unprecedented funding and asset liquidity strains and the larger-than-expected impairment losses associated with sub-prime-related portfolios weakened the balance sheets of many global financial institutions. The extent of these losses has now seen authorities from several major economies significantly scale up intervention measures in attempts to restore stability to their financial systems. The extensive reach of this crisis has underscored the need for more comprehensive policy responses to avoid its systemic implications on financial systems in other parts of the world. Equally vital is to restore the intermediation function and thus the flow of credit to support the economic recovery.

Despite the prolonged global liquidity squeeze and the continued weak global credit market, the overall confidence in the Malaysian financial sector has remained intact. Malaysia has benefited from the years of financial reforms and capacity building in the financial sector that has yielded a high level of resilience. In addition, negligible exposure to the sub-prime-related risks and the ample liquidity conditions also contributed to mitigate the risks of systemic contagion, thus allowing for the continued functioning of the domestic financial markets, payment systems and the overall financial intermediation of the financial system.

Institutional resilience has also been supported by the continued improvement in asset quality and the adoption of rigorous provisioning practices by banking institutions. This has maintained the total loan loss provisioning level of the banking system at its highest level since the Asian financial crisis. Similarly, the healthy profits recorded over several years allowed for the accumulation of capital buffers by banking institutions and insurance companies. Enhanced risk management infrastructures that had been instituted have also contributed towards reducing the degree of risk aversion by banking institutions. The implementation of the risk-based differential premium for deposit insurance by the Malaysia Deposit Insurance Corporation (PIDM) in 2008 has further strengthened incentives for sound risk management by banking institutions. The establishment of PIDM itself has also strengthened the framework that is in place for pre-emptive and effective resolution to be undertaken in the event of problem institutions.

The impact of the current global economic downturn on the domestic economy can be expected to exert some pressure on the asset quality of banking institutions. Banking institutions have, however, responded pre-emptively to these emerging risks. Several banking institutions have initiated steps to shore up their capital positions through rights issues and issuance of hybrid Tier-1 capital instruments in 2008, in anticipation of a further deterioration in the global credit market and deeper consequential impact on the Malaysian economy. The resulting much stronger capital positions have placed the banking institutions on a stronger footing to absorb the impact of the economic slowdown and to be positioned to seize the opportunities that present themselves when the economy recovers.

In this period of heightened uncertainty, increased vigilance will be critical. The Bank's surveillance of the financial system has been maintained in a heightened state of alert to any emerging sources of risk, with increased scrutiny of all areas of significant exposures in the financial sector. Multiple scenario-based stress tests conducted at both micro and macro levels have continued to show that the system is adequately positioned to absorb shocks with the risk-weighted capital ratio well above the minimum regulatory level even under adverse conditions. The Bank has also maintained close communications with the board of directors and senior management to ensure that risk assessments are sufficiently robust and forward-looking in light of the high level of uncertainty that remains. This process is critically supported by robust information and surveillance systems that have been put in place that cover the broad segments of the financial markets to facilitate the timely detection of emerging risks within the financial system.

Malaysia has also put in place effective institutional infrastructures over the recent decade which have been able to deal pre-emptively with emerging risks in both the retail and business segments. Special funds have been set up to ensure that there is continued access to financing for the small and medium enterprise (SME) sector, particularly for the purpose of modernising their business infrastructures and upgrading their production capacity. A Small Debt Resolution Scheme which was set up in 2003 provides relief to small businesses facing temporary cash flow problems by facilitating more effective restructuring and rescheduling of credit facilities with the banking institutions. In addition, the Credit Counselling and Debt Management Agency (AKPK) which was established in 2006 has increased its branch network throughout the country to provide credit management counselling services to households and thus avail the retail borrowers the opportunity to restructure their credit facilities.

The global financial turmoil has affected investor sentiment and pricing in the raising of funds via the domestic bond market. Recognising the importance of re-energising the domestic bond market to enable corporations to better manage their funding needs at more cost-efficient prices, the Government and Bank Negara Malaysia is in the process of establishing a Financial Guarantee Institution (FGI) to provide credit enhancement for bond issuances by viable corporations. The Bank is also introducing an enhanced corporate debt workout mechanism, which will provide a platform for corporations to effectively restructure their borrowings with multiple lenders as well as debt securities issued by them. These measures are reflective of the Bank's commitment to address the potential stresses at an early stage of the problem.

The overall financial stability during the year has allowed the Bank to pursue its longer-term developmental strategies, which serve to strengthen the foundation for further growth and transformation of the domestic financial system. During the year, the Islamic finance sector continued to record strong performance, with the Islamic banking sector achieving an average annual growth of 20% over an eight-year period. The setting up of new Islamic banking subsidiaries by domestic banking institutions, the world's largest retakaful company, and the granting of new licences for the conduct of international currency business under the Malaysia International Islamic Financial Centre (MIFC) flagship in 2008 would further strengthen Malaysia as an international hub for Islamic finance. Product innovation based on the musharakah concept is being more widely pursued, including in the retail segment, in response to increased demands for competitive financial solutions that comply with Shariah requirements. The solid growth of the Islamic finance industry will continue to be supported by strong supervisory oversight to ensure an orderly growth of the industry into the mainstream of international finance.

A more robust legal framework is also being put in place with the proposed Central Bank of Malaysia Act, which will provide greater clarity on the financial stability mandate for the Bank. The proposed Act will strengthen the Bank's capacity to discharge its mandate for financial stability taking into account developments in the financial system which has now become highly interconnected with more complex financial innovations, more internationalised capital markets and with greater convergence of financial intermediaries and products. The strengthened legislative framework is positioned to allow the Bank to address the challenges of the modern financial system.

As the Bank prepares for greater liberalisation of the financial sector, the experience of the current global financial turmoil offer further insights on risk and governance practices that would be useful for Malaysia in setting the new thresholds and expectations on cross-border banking activities and the nature of foreign participation in the domestic financial landscape. Of importance is to ensure that liberalisation will be mutually beneficial and will contribute positively to Malaysia's economic agenda while also preserving financial stability. The underlying philosophy remains that the degree of liberalisation should be commensurate with the capacity of the financial sector to cope with the consequent changing landscape.

While the current challenges facing the financial sector are significant, the strong focus on sound governance and risk management which underpins the regulatory and supervisory regime in Malaysia has been instrumental in ensuring that developments in the financial sector do not outstrip its capacity to manage the associated risks. Central to this regime has been the emphasis on ensuring that the preconditions are met before deregulation and liberalisation measures are pursued, while maintaining an appropriate balance between rule-based and principle-based approaches. This approach will continue to frame the Bank's regulatory direction going forward. Lessons will be drawn from the current global financial crisis to further strengthen the main lines of defence against institutional and systemic risks in the financial sector. This will include further enhancements to the Bank's surveillance systems, the strengthening of the institutional arrangements for dealing with threats to the financial system, improvements to the incentive structure, the promotion of sound corporate governance and risk management practices, and the development of the necessary conditions for increased market discipline.

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Governor

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