

## Executive Summary

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The Financial Stability and Payment Systems Report has been prepared against the backdrop of unprecedented stress faced by the international financial system and deterioration in the global economies. This Report aims to provide an assessment of the risks and challenges faced by the Malaysian financial system and the regulatory and supervisory initiatives undertaken by Bank Negara Malaysia towards preserving market confidence, ensuring continued intermediation of funds and maintaining overall financial stability. The Report also covers developmental initiatives that were pursued towards reinforcing the role of the financial services sector in supporting economic activities and realising its potential as a key growth catalyst for the economy moving forward.

### ***Risk Assessment of the Financial System***

In the midst of the deepening global financial market and economic turmoil, the Malaysian financial sector continued to remain stable and resilient. Pre-emptive measures were taken by the Government and the Bank during the year, which preserved confidence and stability in the financial sector. The banking sector's risk-weighted capital ratio (RWCR) remained resilient at 12.7% as at end-2008, with an excess capital position of RM38.8 billion to buffer against any potential unexpected losses. Profitability of the banking system grew by 8.3% to record an unaudited profit before tax of RM19.2 billion in 2008, partly moderated by lower revenue generated from investment and treasury-related activities. The exposure of the banking sector to foreign exchange risk was within manageable limits, with the net open position accounting for 4.6% of total capital base (2007: 4.9%). Throughout the year, the banking sector remained largely supportive of the financing requirements of the economy and continued to meet its financial obligations. Despite a slight moderation in the total approvals granted for new financing resulting from a decline in the growth of total applications for new financing, outstanding loans and financing grew at a high pace of 12.8% as at end-2008. The financing portfolio was mainly concentrated in the retail-based sectors and small and medium enterprises (SMEs), which accounted for 53.4% and 17.2% of total outstanding loans and financing respectively. Enhanced risk

management capabilities contributed to the better loan quality of banking institutions, with the net non-performing loan (NPL) ratio declining to 2.2% as at end-2008 (2007: 3.2%). Capital enhancement programmes undertaken or being planned by banking institutions would further strengthen their ability to absorb potential risks that may arise from the economic slowdown moving forward and, importantly, would enable the banks to remain effective in performing their financial intermediation function.

The insurance and takaful sector, while maintaining a comfortable solvency position, faced challenges in maintaining the growth in premiums and contributions from new businesses, compounded by intense competition in the industry. Total net premium and contribution income grew by 2.4%, mainly attributed to the expansion in takaful business. However, the operating profit of the general insurance and takaful business, which declined by 44.5% to RM0.7 billion, was affected by the higher claims ratio of 84.2% (2007: 79.6%) arising mainly from higher motor vehicle claims.

The domestic financial markets remained orderly despite heightened price volatility, higher outflows and lower trading volume. This was supported by ample ringgit liquidity in the system. Liquidity in the US dollar market was, however, relatively consistent with the global tightening of the currency. The bond market continued to be a key source of financing for the corporate sector, with private debt securities (PDS) accounting for 57.8% of total outstanding PDS and banking loans to corporations.

The household and business sectors as a whole demonstrated high degree of capacity and flexibility to adjust to the challenges faced in 2008, having entered the challenging environment from a position of strength and supported by strong financial buffers. Despite revenue challenges and more volatile cost pressures, the debt servicing capacity of businesses was sustained at relatively comfortable levels in 2008. The gross NPL ratio for overall businesses declined to 6% as at end-2008 (2007: 8%), with a similar downward trend for SMEs to 6.8% (2007: 9.1%). Importantly,

businesses continued to receive financing from the banking sector with a total of RM147.9 billion in new loans channeled to the business sector in 2008.

The household sector continued to be supported by healthy balance sheets with improved level of indebtedness. Amidst concerns over the employment outlook, demand for new financing declined as households became more vigilant of incurring higher debts. Households' gross NPL ratio continued to improve to 4.2% as at end-2008 (2007: 5.4%).

Moving forward, the Malaysian financial system is expected to remain resilient despite being confronted with the challenging environment which may likely pose greater pressures on revenues and higher delinquencies and defaults. The series of stress tests conducted confirmed that the financial system's ability to embrace these challenges remains sound.

These scenario-based tests on credit, market and liquidity risks were conducted at both the system and individual institution levels to provide a forward-looking assessment of the capacity of financial institutions to withstand potentially adverse and significant macro-financial shocks, as well as the resultant implications on earnings and capitalisation. The stress scenarios were constructed based on the potential magnitude and extent of spillover effects of the intensification of international financial market duress, prolonged slowdown in global and regional growth, persistent volatility in commodities and energy prices as well as expected price levels in the economy. Multiple scenarios based on domestic growth and financial market conditions that are comparable to the historical worst levels were applied.

Based on the stress test results, the financial system has the capacity and flexibility to adjust and cope with the stresses, even under a deeper economic contraction scenario. The banking system's RWCR is expected to remain above the minimum 8% requirement whilst core capital ratio would exceed 6%, before incorporating some of the capital enhancement programmes undertaken or being planned by the banking institutions. This is reinforced by the high quality of banks' Tier-1 capital, where the equity-to-assets ratio of the banking system was at 10% of total risk-weighted assets or 6.8% of total assets.

Internally, the Bank will continue to strengthen its macroeconomic surveillance and supervisory capabilities for the early detection of emerging risks to facilitate pre-emptive actions. Engagements and coordination arrangements between the Bank and other domestic and international regulatory authorities would also be enhanced to ensure that the financial system is well-positioned to manage the implications of the more difficult environment moving forward.

### ***Development of the Financial Sector***

During the year, the Bank's main policy focus was to ensure that the financial sector remained resilient and continued to perform its financial intermediation function effectively in supporting economic activities. Sustained efforts were also undertaken to build a resilient, effective and diversified financial system.

Concerted efforts throughout the year were taken to ensure that businesses continue to have adequate access to financing, in particular the SMEs which account for 99% of the total number of business establishments in Malaysia. The SME Assistance and Modernisation Facilities and the SME Assistance Guarantee Scheme were established in 2008 and 2009 respectively for this purpose. Two additional schemes, namely the Working Capital Guarantee Scheme and the Industry Restructuring Loan Guarantee Scheme, were launched in early-2009 to enhance the avenues for companies to obtain funds for working capital purposes as well as to promote high value-added activities. In addition, the Integrated Contact Centre established by the Bank and *ABMConnect* set up by the Association of Banks in Malaysia serve as important channels in strengthening the financial sector's interface with the public.

Measures taken during the year also included the provision of a blanket Government guarantee through the Malaysia Deposit Insurance Corporation (PIDM) on all ringgit and foreign currency deposits placed with financial institutions regulated by the Bank. Consistent with regional initiatives to preserve confidence in the respective financial systems during the current international financial turmoil, this pre-emptive measure was aimed at safeguarding stability and competitiveness of the domestic financial sector. The financial safety net was also extended to the insurance and takaful sector by allowing insurers and takaful operators to access the Bank's liquidity facility.

The Government has announced the establishment of a Financial Guarantee Institution (FGI), which will commence operations in the first half of 2009, to facilitate access to the bond market for viable corporations to raise funds. The FGI will provide credit enhancements to corporations' bond issuances which will reduce financing costs, address potential maturity mismatches and also diversify funding sources.

In terms of the insurance sector, the Bank continued to pursue consolidation and rationalisation to address the fragmentation in the general insurance sector. Efforts are also in progress to accord greater flexibility to general insurers to manage their expenses. Meanwhile, flexibilities have been granted for insurers to harness bancassurance as a key distribution channel, towards increasing insurance penetration in the country.

Recognising the importance of having a coordinated and collaborative approach to human capital development in the financial services industry, the Financial Services Education Centre (FSEC) was jointly established by the Bank and the Securities Commission to draw on the complementarities and strengths of various training institutes to provide high quality training solutions across the different segments of the financial services industry.

In line with the Malaysia International Islamic Financial Centre (MIFC) initiative, new international Islamic finance players continued to establish their presence in Malaysia during the year. The Bank also embarked on the initiative to develop Shariah Parameters to promote more consistent application of Islamic financial contracts. The establishment of the International Shariah Research Academy for Islamic Finance (ISRA) would also serve as a key platform to enhance interaction and exchange of ideas among industry players and scholars to promote applied research in the area of Shariah and Islamic finance.

Going forward, the Bank's commitment towards strengthening international linkages and supporting regional integration will be spearheaded by the liberalisation roadmap which aims to enhance the contribution of the financial services sector to the growth of the economy. In particular, the liberalisation roadmap intends to strategically position the financial sector to support the national objective of attaining developed economy status by the year 2020.

### **Prudential Regulation and Supervisory Framework**

Amidst a more challenging financial environment, the Bank continued to preserve an appropriate balance between principle-based and rule-based regulations, paving the way towards progressively deregulating the financial sector moving forward.

The implementation of the Basel II framework remained on track with 77% of the banking institutions opting to adopt the Standardised Approaches for determining capital requirements whilst the remaining institutions will be adopting the Internal Ratings-Based (IRB) Approach for credit risk. The option to adopt the IRB Approach was also extended to Islamic banks that are part of banking groups adopting the IRB Approach to leverage on group infrastructures and policies. The Bank also outlined the approach for the implementation of the supervisory review process (Pillar 2) and disclosures on capital adequacy (Pillar 3) of the Basel II framework. In addition, the Capital Framework for Development Financial Institutions (DFIs) was introduced, which appropriately supports the specific nature of DFIs' mandates and operations.

In addition, details of the proposed capital framework for securitisation based on the Standardised Approach were released and a revision to the liquidity framework to promote further improvements in liquidity risk management practices is in progress for implementation in 2009. Coupled with these efforts, the Bank also embarked on the process of ensuring that the preconditions are in place for banking institutions to adopt FRS 139: Recognition and Measurement of Financial Instruments. The importance of inculcating sound risk management practices in banking institutions was further reinforced by PIDM's move towards risk-based premium pricing under its Differential Premium System.

In the insurance sector, the previous Margin of Solvency regime was replaced by the Risk-Based Capital (RBC) Framework on 1 January 2009. The framework provides for better alignment between insurers' underlying risk exposures with regulatory capital requirements and allows for insurers to operate at different risk levels that are commensurate with their risk management infrastructure and practices. Preliminary groundwork was also laid in 2008 for the development of a similar RBC Framework for takaful operators.

To enable the Bank to discharge its role effectively in maintaining financial stability in the years ahead, a holistic review of the Central Bank of Malaysia Act 1958 was completed during the year. The proposed Central Bank of Malaysia Act will provide greater clarity to the Bank's role in regulating and supervising financial institutions and promoting a sound and progressive financial system. Moving forward, prudential regulatory and supervisory priorities will remain focused on ensuring the Bank's and financial institutions' responsiveness to risks through ongoing enhancements to the regulatory framework and heightened supervision.

### ***Payment and Settlement Systems***

In the wake of the financial turmoil, the payment and settlement systems continued to function smoothly. The aim during the year was to ensure the continuous well-functioning of the payment and settlement infrastructure, with ongoing efforts being undertaken to enhance and modernise the systems to achieve greater efficiency and reliability. As a result, the Real-time Electronic Transfer of Funds and Securities (RENTAS) system, which clears more than 90% of total non-cash payments in the country, remained resilient without any major disruptions and achieved 99.9% system availability in 2008.

During the year, the Bank also established the Malaysian Electronic Clearing Corporation Sdn. Bhd. (MyClear) to operate RENTAS and the Cheque Truncation and Conversion System (eSPICK) as well as to spearhead the Bank's

agenda of migration to electronic payments (e-payments). The establishment of MyClear further reinforces the Bank's oversight responsibilities and allows effective surveillance, independent assessment, evaluation and monitoring of the different types of risks on the major payment systems.

The pace of migration to e-payments was sustained with close collaboration with the Government to expedite the implementation and adoption of e-payments in the public sector. Public awareness on the wide array of online payment services by Government agencies was enhanced through the Government's "myBayar" promotional initiatives. The Bank has also been strongly advocating the higher usage of e-payments in the insurance and securities industries and has initiated and coordinated efforts with the relevant stakeholders to achieve this. Another encouraging area of growth for e-payments is mobile banking services offered by financial institutions, which is exhibiting potential to emerge as a mainstream payment channel.

Addressing the price distortion between paper-based payments and e-payments and having in place effective incentives to drive the migration to e-payments will be key focus areas of the Bank moving forward. The widespread adoption of e-payments will pave the way towards the development of a more efficient payment system which would ultimately improve the competitiveness of the economy.