

Governor's Statement



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Financial stability issues were dramatically brought to the forefront in 2007. The resilience of the global financial system has come under significant pressure following problems in the US subprime mortgage market which has rapidly broadened into large-scale liquidity strains. As events surrounding the turmoil continue to unfold with heightened concerns over global growth prospects, central banks and regulators are maintaining a close watch on the direction of risks to the financial system. Of importance, is the need to contain the implications of these developments on financial stability, and ensuring the ability to exercise firm and coordinated actions, including facilitating orderly resolutions, to avert a full-fledged crisis of global proportions.

The Malaysian financial system has so far been relatively insulated from the global financial turmoil, with negligible direct exposures of Malaysian banks to US subprime investments and ample liquidity in the system, in addition to an insignificant reliance by Malaysian banks on funding in offshore wholesale debt markets. The effects of widespread financial market volatility, however, were felt in the domestic financial markets. Increased two-way portfolio flows led to heightened volatility in the prices of financial assets during the year. Despite the increased volatility, banking institutions on the whole turned in a solid performance for the year, supported by strong loan growth, higher income from treasury and fee-based activities and continued improvements in the quality of credit exposures. Non-performing loans have declined to their lowest level since the Asian financial crisis. The capital and solvency positions of the banking and insurance industries remained strong during the year, while the payment systems has continued to perform well with no disruptions being experienced.

Malaysia's financial sector has continued, during the year, to transform and mature. The transformation combines market-based incentives, changes in the institutional configuration and the expansion of the depth and breadth of the financial markets. All of Malaysia's domestic banking groups have evolved into financial conglomerates, providing the comprehensive suite of financial solutions that cater to the broader range of consumers and businesses. Financial services are now provided through multiple and more convenient channels. This has significantly expanded the scope and reach of financial services. There has also been a more pervasive infusion of best business practices into domestic institutions with financial services taking on an increasingly international dimension. This has been reinforced by the liberalisation that has increased the diversity of the players and foreign participation in our financial system.

The continued strengthening of the financial sector has enabled Malaysia to pursue a progressive deregulation and liberalisation agenda. Deregulation and liberalisation measures have been carefully sequenced to promote improved performance, while avoiding destabilising implications arising from premature liberalisation. Important preconditions are strengthened domestic institutional capacity, efficient financial markets, a robust financial infrastructure, an inclusive financial system and a comprehensive financial safety net. As these have strengthened over the years, the Bank has progressively liberalised the financial sector to strengthen further our linkages with the global economy and promote new business activities. While this liberalisation has been accelerated, it has not only been accompanied by increased economic and financial resilience, but also the enhanced capacity of the Bank in surveillance and management of the risks associated with the liberalisation.

With the significant deepening of our financial markets, Malaysia's bond market in particular is now among the more developed in the region. This has bolstered business efficiency and growth by providing an alternative avenue for financing, while dispersing the concentration of credit risk from the banking

sector. An exciting development has been being at the frontier in the development of Islamic finance. Islamic finance has flourished with its international dimension gaining greater significance. The Islamic financial system in Malaysia has become among the most comprehensive and active in the world. Accompanying this development has been the strengthening of the regulatory framework and the Shariah governance practices. The advanced stage of development of the Islamic financial system has enabled Malaysia to play a significant role in shaping the global Islamic financial landscape. In these efforts, Malaysia has considered it vital for greater engagement across jurisdictions to drive harmonisation and convergence on prudential practices and mutual recognition of Shariah interpretations. This greater international engagement and interface that has taken place thus far contributed to significant convergence. The establishment of the International Shariah Research Academy for Islamic Finance (ISRA) by Malaysia to be an academy within the International Centre for Education in Islamic Finance (INCEIF) aims to provide a formal institutional structure to facilitate this process. All of these developments have contributed to the efficient functioning of the financial system, its resilience and thus, to financial stability.

The Bank will remain vigilant to the new emerging trends and challenges to the Malaysian financial system which could result in risks to financial stability. In the domestic environment, competition in the banking sector has continued to intensify, with growing pressures on interest margins. The shift towards market-based credit intermediation through securitisation activities is also gaining momentum. This will add to the complexity and opacity of credit risk distributions in the system and the linkages between the credit markets and financial institutions. This raises the need for financial institutions to address the valuation challenges with the adoption of fair value measurement, and to have in place robust processes for valuations of complex instruments.

During the year, the Bank's surveillance capabilities were significantly strengthened. The external and domestic developments are being closely monitored for early signs of systemic implications on the financial system. Attention is also being focused on any deterioration in credit evaluations, any significant changes in the liquidity profiles of banking institutions or any impairment in the ability of institutions to effectively monitor and measure risk concentrations on a continuing basis. Such signs have not materialised. More rigorous supervisory assessments and the deployment of enhanced surveillance tools have been adopted to capture the more complex linkages between the different components of the financial system. The prudential regulatory framework has also been strengthened in a number of key areas – including capital adequacy standards, stress testing, risk management practices and corporate governance. The risk management processes within financial institutions have now become more robust, reflecting improved techniques for measuring and managing risk. The realignment of the regulatory and supervisory functions has also facilitated a more integrated approach to regulatory reforms and surveillance, and has enabled the more efficient allocation of supervisory resources within the Bank.

The institutional infrastructure to support greater financial inclusion is now well entrenched. An extensive support network has been established for small and medium (SME) and micro enterprises. This includes the newly transformed Credit Guarantee Corporation Malaysia Berhad, the SME Business Advisers Network, the Small Debt Resolution Scheme, the SMEinfo Portal, the SME Credit Bureau and more recently, the establishment of the Cooperative Societies Commission. Preparations are on track to establish the SME Central Coordinating Agency which will be responsible for coordinating SME policies and Government programmes across all sectors. In addition to strengthening the institutional structure, there has also been a proliferation of new financial products tailored to meet the specific needs of SMEs, while microfinancing strategies by financial institutions have gained significant momentum. These developments have significantly improved access to financing for this segment that has traditionally been underserved by the financial system, contributing to greater financial inclusion and increased participation of the sector in the economic mainstream.

The Bank continued to act proactively to contain consumer indebtedness within prudent levels. Consumer education remains a central piece of the Bank's efforts in equipping consumers to make well-informed financial decisions, to protect themselves from predatory lending practices, and to effectively

manage their debts. Outreach efforts by the Bank expanded further during the year, through providing basic financial education to the younger population at earlier stages of the formal education process. The launch of BNMTELELINK further complements existing channels for the public to obtain information and assistance relating to financial services. The Credit Counselling and Debt Management Agency has expanded its presence in key regions in the country. In less than two years since its establishment, assistance has been provided to almost 50,000 consumers, including specific debt counselling and management assistance to more than 5,000 individuals with combined debts totalling RM478 million.

The institutional arrangements put in place by the Bank to strengthen the consumer protection framework has also had a significant and positive impact on the financial system. In particular, the Malaysia Deposit Insurance Corporation (MDIC) has established a strong domestic and international reputation as a model of best practice for deposit insurance systems, and is the first in the world to provide coverage on both conventional and Islamic deposits within one system under a Shariah-compatible model. The MDIC will enter its third assessment year in 2008 with the implementation of a differential premium system for premium contributions from member institutions, thereby reinforcing incentives for sound risk management within the institutions.

The Malaysian economy has continued to reap significant dividends from the efforts to develop and strengthen the resilience of the financial sector. The financial sector has now become a major source of economic growth, while broader access to financing and financial services has improved prospects for more Malaysians and businesses to benefit from economic progress. It has also contributed towards sustaining domestic-led growth, thus reducing Malaysia's vulnerability to external market conditions. There is a high level of confidence in Malaysia's financial system and the regulatory and supervisory regime. At the same time, improvements in the level of financial capability among Malaysian households and small businesses have promoted more prudent financial management, and encouraged innovation and a more competitive financial system.

Against a backdrop of an increasingly uncertain external environment, the Malaysian financial system is therefore well positioned, both financially and structurally, to weather the more challenging outlook for 2008. In the coming year, the focus will be on effective surveillance, institutional development, financial market and infrastructure development, as well as to ensure a state of readiness to cope with any potential shocks to the system, and thus sustain overall stability and confidence in the financial system. This will be achieved by further accelerating the development of a more diversified financial sector – that includes the Islamic financial system and the foreign exchange market so as to complement the other components of the financial system, strengthening the resilience of financial institutions to market-based shocks, and finally, enhancing the Bank's crisis management framework and surveillance capabilities. Significant attention is being devoted to intensively develop and secure skilled human capital resources needed to support the continued growth and development of the financial sector as well as the Bank's accountabilities in a far more challenging environment. Key pieces of financial sector legislation will also be strengthened and updated to reinforce a sound legislative framework for financial stability. The Bank is committed to achieving these results.



Zeti Akhtar Aziz
Governor

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