

Executive Summary



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The Financial Stability and Payment Systems Report aims to promote increased understanding of issues and developments that affect financial system stability. The Report covers Bank Negara Malaysia's assessment of key risks and trends in the financial system, and potential implications for the effective functioning of the system. The Report also reviews developments surrounding the transformation of the financial sector and payment systems, as well as key regulatory and supervisory initiatives to promote financial stability.

Risk Assessment and Performance of Financial Institutions

The Malaysian financial system remained resilient throughout 2007 despite challenging external conditions marked by a slowing United States (US) economy, rising global inflationary pressures, increased risk aversion by market participants and more volatile financial markets. During the year, global financial markets experienced unstable and increased uncertainties after a prolonged period of exuberance.

On the whole, financial institutions in Malaysia remained well capitalised throughout the year. In addition, the foundations for long-term stability have continued to strengthen with ongoing improvements in risk management capabilities, governance and operating efficiencies. Interbank and money markets remained amply liquid, with interbank rates holding steady throughout the year and banking institutions maintaining adequate liquidity buffers. These conditions enabled the Malaysian financial system to continue functioning effectively without major disruptions, in spite of the bouts of elevated volatility experienced in domestic financial markets.

Total financing extended to businesses through both the banking system and capital market expanded by 14.1% in 2007. With improved operating and financial performance, private investments by businesses remained robust. Demand for financing by households meanwhile also remained strong, with outstanding housing loans and securities financing facilities growing by 5.9% and 11.1% respectively. Overall, outstanding loans from the banking system grew at a stronger pace of 8.6%, while outstanding

private debt securities (PDS) expanded by 15.2%. In the insurance sector, life insurers registered a 6.1% growth in new premiums while new family takaful business grew 15.8%, driven mainly by the growing demand for investment-linked products. Despite sluggish motor vehicle sales and continued pressure from higher claims exerted on underwriting margins, the general insurance sector maintained its positive, albeit more modest, growth momentum, increasing by 4.3% in terms of gross direct premiums.

Despite more intense competition weighing down on margins, credit discipline has been maintained. The net non-performing loan (NPL) ratio improved to 3.2%, its lowest level in a decade. The structural characteristics of Malaysian housing finance, including the deposit-based funding structure and more prevalent "originate-and-hold" business models adopted, provide sufficient incentives for banking institutions to control and monitor the quality of the loan portfolio on a continuing basis. This has been borne out by an improvement in asset quality observed in the housing finance segment which saw the NPL ratio decline to 7% in 2007 (2006: 8.7%).

With limited direct exposures to markets affected by the US subprime crisis and supportive domestic economic conditions, the profitability of banking institutions in Malaysia improved further. Preliminary unaudited pre-tax profits amounted to RM17.7 billion (2006: RM12.9 billion), mainly attributed to efficiency and productivity gains resulting from ongoing rationalisation efforts and investments in technology, as well as higher income from treasury and other fee-based activities. Improved returns were also harnessed from more efficient capital management programmes while continuous product innovations enabled banks to retain and grow their market shares.

Development of the Financial Sector

A more diversified financial system continued to evolve in 2007. The role of the capital market as a source of funds and avenue for risk diversification gained increasing importance. Debt security issuances during the year increased to RM302 billion (of which RM66.5 billion were PDS),

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representing a significant increase of 65.3% from issuances in 2006. Of significance, some new issues were also of longer maturities, shifting above 10 years. This has further lengthened the maturity structure of fixed income securities, thereby providing opportunities for insurance companies and pension funds to match and narrow the maturity gap between assets and liabilities. The more liberal foreign exchange administration policies that have been introduced in recent years also saw the turnover of foreign exchange transactions by non-residents more than double over the previous year, thereby contributing to the development of a more active foreign exchange market. This, in turn, will enable businesses and banks to manage their foreign exchange exposures more effectively, while reducing the cost of doing business.

The development of Islamic finance gained further momentum. Malaysia solidified its lead in global sukuk issuances, adding further to the breadth and depth of the domestic capital market. As at end-2007, sukuk originated in Malaysia accounted for 68.9% of global outstanding sukuk. Existing institutional structures supporting Islamic financial business were substantially strengthened as the remaining domestic banking institutions and two locally-incorporated foreign banks (LIFBs) with window operations took steps to transform these operations into full-fledged Islamic banking subsidiaries, thus providing a stronger and dedicated platform to expand the business.

A greater diversity of players in the market was also achieved with the introduction of Islamic banking operations by two more existing LIFBs, while 16 new approvals for the conduct of international currency business were granted under the Malaysia as an International Islamic Financial Centre (MIFC) initiative. Product innovations thrived during the year, supported by the pragmatic approach taken by the Shariah Advisory Council to ensure that new Islamic finance products offered are Shariah-compatible while encouraging innovation.

Going forward, the Shariah Advisory Council will be further supported by the International Shariah Research Academy for Islamic Finance (ISRA) which has been established under the International Centre for Education in Islamic Finance (INCEIF) to spearhead research in current Shariah issues. Additional flexibilities in the areas

of tax, foreign exchange administration, immigration and foreign ownership rules as well as simplified regulatory processes were also introduced under the MIFC. These incentives together with the comprehensive infrastructure and diversity of players in Malaysia continued to attract significant foreign interest in Malaysia as a preferred centre for sukuk issuances. Total approvals for the issuance of foreign currency-denominated debt securities in 2007 increased by 58% in value to USD12.3 billion, of which 68% was foreign currency-denominated sukuk.

With the robust growth and rapid evolution of the financial sector, competition for highly-skilled financial professionals has remained intense. At the same time, the global dimension of such competition has become more pronounced as fast-growing financial markets in the region increasingly look to the same limited pool of talent to meet their needs. Competition for talent has been particularly intense in the fields of Islamic finance and investment banking, while specific expertise in the areas around Basel II, risk management and financial reporting continued to be in short supply.

The development of a strong talent pipeline for the financial sector was therefore identified as a key priority of the Bank in 2007. Significant resources have been invested by the Bank in driving and supporting initiatives in this area, paving the way for a more coordinated and effective approach to address the critical talent demand and supply gaps. While the needs remain significant, important progress was achieved during the year both in meeting the immediate short-term needs of the industry, and laying the foundation for longer-term collaboration between institutions of higher learning, the industry training institutes, the financial services industry as well as the Government and other regulatory agencies to identify and develop future talent. In November, the Financial Sector Talent Enrichment Programme (FSTEP), developed by the financial services industry in collaboration with the Bank, was launched to equip new graduates with the essential practical knowledge and skill sets to fill more than 2,000 existing entry-level vacant positions in the industry. Various initiatives were also taken forward to complement the development of relevant teaching and learning resources in line with the demands of the market

and to enhance existing complementarities between the various training providers. INCEIF and the International Centre for Leadership in Finance (ICLIF) also continued to enhance their roles in providing a solid educational foundation in the field of Islamic finance, and harnessing the effectiveness of current and future leadership in the financial services industry respectively.

Prudential Regulation and Supervision

The development of a sound, effective and efficient prudential framework remained an important priority in 2007. The standardised approaches under the revised capital framework for conventional banks (Basel II) and the Capital Adequacy Framework for Islamic Banks, came into effect on 1 January 2008, while the Risk-Based Capital Framework for insurers entered a second year of parallel run. The Bank continued to work closely with financial institutions to ensure the smooth implementation of these revised frameworks, and more importantly, to integrate the frameworks with more robust risk management processes and systems within the institutions. On the whole, the net increase in capital requirements as a result of the revised capital frameworks is not expected to be material for most institutions.

The Bank's risk-based supervisory framework (RBSF) has been further enhanced to facilitate more granular and holistic risk assessments of financial institutions. During the year, the Bank also strengthened the supporting structure, processes and core capabilities required to effectively implement RBSF. This included putting in place a rigorous quality assurance framework, strengthening the specialised risk units and enhancing the Bank's supervisory information systems and infrastructure. The closer integration and coordination between the Bank's macro- and micro-surveillance functions have also served to reinforce sound supervisory assessments of financial institutions taking into account developments in the broader macroeconomy, while providing early signals of potential vulnerabilities at the macro level from developments observed at the institutional level. As at end-2007, the Bank's supervisory assessments affirmed that the vast majority of financial institutions remained in healthy positions with the capacity to manage the increased risks associated with the more volatile external environment.

A more principle-based regulatory regime continued to evolve, while preserving an appropriate balance between principle-based and rule-based regulations. This process has facilitated a more proportionate approach to regulation according to the size, complexity and risk profiles of different institutions. Financial institutions are also better positioned as a result to respond quickly to changing market conditions from both risk and competitiveness perspectives, without being unduly constrained by detailed rules. In supporting the transition from a rule- to principle-based regime, the Bank continued to direct significant attention at strengthening the necessary preconditions for sound risk management under the more flexible regime. In this regard, marked improvements in the effectiveness of board oversight and senior management continued to be observed, reinforced by firm supervisory actions taken by the Bank to address material deficiencies in financial and business practices within individual institutions. These developments have continued to support the growing momentum towards principle-based regulations in more recent periods. More than 50 prudential standards have been developed or reviewed under a more principle-based regulatory approach since 2001.

Financial Inclusion

Bank Negara Malaysia also continued to promote broad-based and balanced growth through financial inclusion, with a particular focus as in previous years on the small and medium enterprises (SMEs) and micro enterprises. SME loans approved by banking institutions and development financial institutions (DFIs) grew strongly by 34.3% to RM63.2 billion in 2007. The microfinance initiative, introduced in 2006, saw a further RM224.7 million in outstanding financing extended by nine financial institutions to more than 22,000 microfinance customer accounts. During the year, financial capacities and institutional arrangements of DFIs were also strengthened to complement access to special funds and financing facilities that are aimed primarily at supporting the agricultural sector and Malaysian companies venturing overseas.

New credit enhancement products introduced by the Credit Guarantee Corporation Malaysia Berhad and the launch of a securitisation programme by Cagamas Berhad for SME loans further enhanced the capacity of banking

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institutions to lend to SMEs. A more comprehensive advisory and support network has also been put in place for small borrowers over the years to assist in business expansions and effective management of debts. In 2007, this network was further expanded to include a one-stop web-based directory that allows SME business advisers to share expertise, while the Small Debt Resolution Scheme, which is aimed at assisting financially distressed SMEs, saw the participation of an additional three DFIs in the scheme.

Financial Capability and Fair Market Conduct

A more challenging environment continued to confront financial consumers. Specifically, consumers have to contend with the increasing choice and complexity of financial products offered in the market, while coping with easier access to credit and substantially reduced direct contact between financial institutions and consumers as a result of outsourcing trends and greater use of automated delivery channels for financial services. Extended life expectancies have also increased the need for consumers to take greater individual responsibility for sound financial planning.

Equipping consumers to manage these challenges remained an important part of the Bank's efforts to maintain confidence in the financial system, contain household indebtedness within prudent levels, and minimise the erosion of investments and savings as a result of unethical sales, servicing or advisory practices. For this purpose, product disclosure and transparency standards were further enhanced during the year, while best practices were introduced to improve the professionalism of insurance and takaful intermediaries and outsourcing service providers that interface with consumers. Heightened market conduct surveillance and enforcement activities undertaken by the Bank have led to improvements in the industry's overall observance of fair market conduct practices as evidenced by the Bank's follow up assessments, and corrective actions taken by institutions to address the market conduct deficiencies identified by the Bank.

The consumer redress and protection framework was enhanced further with the launch of the BNMTELELINK in July 2007 to complement existing channels for the general public to obtain information and seek assistance in relation to financial services. Public response to this new

channel has been overwhelming, with more than 25,000 enquiries received in the first five months of its operations. The Credit Counselling and Debt Management Agency also continued to play an important role in helping individuals in managing debts, providing assistance to more than 5,000 individuals with aggregate debts of RM478 million under its debt management programme since its establishment in 2006.

During the year, the Bank led a more targeted approach to raise the level of financial capability among Malaysian financial consumers. Consumer education programmes and activities in 2007 focused in particular on women, school children, college and university students, rural communities and retirees. The Bank and the financial industry were also able to leverage more effectively on collaborative arrangements with schools, training institutes, regulatory agencies and interest groups to expand the reach of the Bank and industry's financial capability initiatives.

Payment System Safety and Stability

Both the large value and retail payment systems functioned efficiently and did not encounter major disruptions during the year. The value of non-cash payments handled by the Real-time Electronic Transfer of Funds and Securities (RENTAS) system in 2007 increased by 23.6% to RM124.5 billion in payment transactions daily. A self-assessment of RENTAS carried out during the year against the Bank for International Settlements Core Principles for Systemically Important Payment Systems affirmed a high level of robustness of the RENTAS system which came close to achieving full observance of the Core Principles. Fraud in the retail payment systems remained insignificant, with sustained initiatives by the Bank, payment systems operators and other regulatory authorities to combat this risk. Settlement risk has also been reduced following the establishment of Payment versus Payment (PvP) and Delivery versus Payment (DvP) links with Hong Kong which facilitate the simultaneous settlement of ringgit and US dollar payments and securities.

Payment System Efficiency

To promote efficiency in payment systems, initiatives were undertaken to enhance the payment infrastructure, foster the adoption of new technologies and provide support to stakeholders for the migration to electronic payments. The adoption of a fully image-based cheque clearing

process in 2008 will expedite the receipt of funds while also providing cost savings through the elimination of physical handling and transportation of cheques. The year also saw the functionalities and availability of automated teller machine (ATM) services provided by banking institutions enhanced with the introduction of 24-hour ATM facilities on the shared network and expanded services offering mobile phone top-up facilities and interbank funds transfer services. Such services have also been expanded across borders through strategic partnerships signed between Malaysian Electronic Payment System (1997) Sdn. Bhd. and overseas ATM network operators in Indonesia, Thailand, Singapore and China.

Facilitative regulatory policies and support from the Government have continued to foster payment innovations and the adoption of

various electronic payment applications. In this regard, several innovations were introduced during the year, including the world's first international mobile-to-mobile money transfer service and mobile remittance services using short messaging services, mobile operator outlets and prepaid cards. On a broader scale, the adoption of various electronic payment applications by the Government has contributed towards accelerating the pace of migration to electronic payments in the economy. This move by the Government has been strategically important in encouraging the wider use and acceptance of electronic payments as observed from the significant increase in value of Government payments made through electronic channels which has increased by almost three times from RM16.7 billion in 2004 to RM64.9 billion in 2007.



