

# Governor's Statement



**BANK NEGARA MALAYSIA**  
CENTRAL BANK OF MALAYSIA

The recent decade has seen a rapid growth in the volume of financial transactions, increased complexity of the financial markets and a more interconnected global economy. This has resulted in greater potential vulnerabilities and risks to the stability of the financial system. As part of its core mandate, Bank Negara Malaysia is responsible for promoting a sound and efficient financial system which underpins financial stability. Such a system is characterised by its ability to withstand adverse economic cycles and shocks, thereby preventing inordinate disruptions to the intermediation process and maintaining confidence in the financial system. The Bank discharges this responsibility by preserving the soundness of financial institutions and the financial infrastructure. This is primarily achieved through its regulation and supervision of the licensed financial institutions, by ensuring the continued reliability of major payment and settlement systems, and actively contributing to the development of efficient financial markets.

This inaugural publication of the Financial Stability and Payment Systems Report signifies the Bank's ongoing efforts to promote a better understanding of issues and developments that affect financial system stability. The Report covers the Bank's assessment of key risks and trends in the financial system that emanate both from the domestic and international developments, and their potential implications for the financial system. It also covers the developments surrounding the transformation of the financial sector in Malaysia, including institutional developments, the financial markets, and the payment and settlement systems in the financial and retail markets. With increased knowledge of the pertinent information associated with aspects important to sustaining financial stability, it is hoped that financial institutions, market participants, businesses and households will be able to recognise the risks and vulnerabilities and better prepare for and manage these risks, thereby facilitating orderly adjustments in the financial system.

The Malaysian financial system has continued to strengthen in 2006. This has been achieved through the ongoing restructuring, consolidation, rationalisation, increased investments in technology, and enhanced governance and risk management practices. Financing activities and the recent increased involvement of banking institutions in treasury and investment-related activities have been well supported by strengthened risk management capabilities. This is reflected in the sustained profitability of banking institutions over an extended period and the continued improvements in the quality of assets. Insurance companies and takaful operators have also recorded continued profitability, supported by improved discipline in reserving and underwriting practices. Despite periods of volatility in the financial markets, financial institutions have, on the whole, demonstrated the capacity and resilience to absorb their impact. There were also no disruptions to systemically important payment systems. The implementation of the Payment versus Payment infrastructure in collaboration with the Hong Kong Monetary Authority was among the ongoing enhancements made in the payment system, further reducing the settlement risks for the ringgit and US dollar foreign exchange transactions.

Further structural adjustments continued to shape the financial system in Malaysia, enhancing its capacity to meet the changing needs of the economy. Notably, in 2006, the investment banking framework was successfully implemented with the amalgamation of the core businesses of merchant banks, stockbroking companies and discount houses. The retail product distribution system also continues to be transformed, prompted by increased competitive pressures, technological developments and regulatory reforms. This has paved the way for the more efficient delivery of financial services, with a more extensive range of financial products and services for consumers and businesses. Further consolidation in both the banking and insurance sectors and the increased investments in technology have also strengthened the institutional capacity of banks and insurers to face increasing competition and the more challenging operating environment.

A more diversified financial structure has also emerged. The advanced development of the bond market was a major structural enhancement to the financial system which not only diminished the risk of overconcentration on the banking system, but also facilitated enhanced efficiency and flexibility in financial management in the system. Malaysia's debt securities market today is among the region's most developed. The share of total private sector financing raised through the bond market has more than doubled in this recent decade with the creation of a deeper, broader and more efficient bond market. Continuous innovations and a supportive environment in the corporate bond market have increased access to the capital market as an alternative source of financing for businesses from a wide spectrum of economic sectors, thus further diversifying the sources of financing for the economy.

Improving financial system efficiency remained a focal point of regulatory policy. This includes policy measures aimed at containing increases in economic costs over time, thereby enhancing the agility of financial institutions to effectively adapt to changing conditions, particularly during stress periods. In this regard, the Bank continued to pursue a broad range of progressive deregulatory measures that complement the structural adjustments taking place in the system to foster greater operating and resource efficiencies. The measures include increased management, investment and operating flexibilities which have expanded opportunities to enhance capital efficiency, innovate, improve performance and diversify risk. As a result, there have been notable improvements in the key efficiency indicators of the financial system. Measures implemented to enhance efficiencies in the payment system have also resulted in wider access to payment products and services and more expedient clearing and settlements. Of importance is that a more rigorous supervisory oversight is pursued in this environment of increased flexibilities to ensure that the risks continue to be prudently managed by the financial institutions. Going forward, the Bank will also adopt a differentiated approach to regulation based on the ability of institutions to effectively manage risks in the more deregulated environment.

All of these developments underscore a stronger base from which the financial system would be able to cope effectively with periods of financial stress. With the financial system on a stronger foundation, this enhances the prospects for the economy to realise net benefits from

the progressive liberalisation. Malaysia's continued integration with the global economy remains important to harness new opportunities for Malaysian enterprises and to enhance access for Malaysian businesses and consumers to competitive financial products and services. An important consideration to the liberalisation process is that the benefit gained should be commensurate with the increased risks associated with the liberalisation. Also important is that the preconditions are in place for the system to adjust efficiently and effectively to the changes. The Bank will thus continue to adopt a gradual and progressive approach to liberalisation for the financial sector that aims to strengthen Malaysia's inter-linkages with the global economy, while preserving financial stability.

The significantly enhanced capacity of domestic financial institutions places them in a strong position to withstand greater competition arising from the more open market as well as more discerning consumers and investors. Indeed, given the strong foundation in place, the infusion of best practices in risk management and service standards into the domestic financial system is expected to accelerate further performance improvements by domestic financial institutions. These conditions have enabled the implementation of further liberalisation measures in the financial sector. The liberalisation has been particularly pronounced in the new areas of activity, including in investment banking, insurance and the Islamic finance sectors. In Islamic finance, new Islamic banking and takaful licences were issued, while foreign interest permitted in investment banking, insurance and Islamic finance were raised. In addition, the branching policy for locally incorporated foreign-owned banks was relaxed. There was also further relaxation of the foreign exchange administration rules.

Following the increased foreign presence and participation in the Islamic financial system in Malaysia, further measures were announced in 2006 to enhance the competitiveness of the system, including ensuring the supply of talent and expertise. These are aimed at positioning Malaysia as a key intermediation centre for Islamic finance in the global market and thus, accelerate the international integration of the domestic Islamic financial system. By extension, the resulting growth in inter-regional investment and trade flows, as well as the linkages with other financial systems, are expected to deepen the integration of Malaysia's broader financial system and economy with the global economy.

However, as a small open economy, the global dimension of risk has assumed greater significance with the increased international inter-linkages. The potential sources of contagion risk from global developments in a large part stem from volatile capital flows which could have adverse implications on the domestic financial markets. Macro and micro stress testing results suggest that the financial system would be able to absorb these risks. Moreover, strengthened safeguards – which include a more robust, risk-based regulatory and supervisory framework, an increased emphasis on crisis and business continuity management, as well as continuous enhancements to the institutional framework for consumer protection – will serve to mitigate the identified risks and avert potential disruptions to the financial intermediation process.

The Bank has continued to devote significant resources towards instituting robust surveillance processes that are critical to the effective identification and management of risks in the financial system. The approach to financial surveillance was further strengthened and refined with the establishment of the Financial Surveillance Department in November 2006. The underlying elements accompanying this change, which is part of a wider exercise during the year to realign the regulatory and supervisory functions under a more integrated approach, will foster a stronger macroprudential orientation of surveillance, with respect to both the identification of vulnerabilities and the calibration of assessment methodologies. The more effective use of scenario analysis and stress testing approaches has also facilitated more robust forward-looking assessments, while work continues concurrently on the development of an improved macro stress test framework and early warning system. These enhancements will assist with the early identification of emerging threats to financial stability, enabling the Bank to better monitor and assess the increasingly more complex inter-linkages associated with the international flow of funds across borders, as well as between the financial sector, the corporate sector, the financial markets and the macroeconomy.

Efforts to promote financial stability at the regional level were also enhanced following the completion of the report by the Task Force on Regional Financial Cooperation. It represented an important priority in the roadmap of the future strategic direction of financial co-operation among central banks in the region. As the region moves forward to implement the recommendations of the Task Force, emphasis would be placed on strengthening the regional institutional arrangements and establishing regional mechanisms in the areas of monitoring and risk management, financial market development and integration, crisis management and resolution, capacity building, information sharing and communications. The focus of co-operation in these areas was considered important to achieve the overriding objectives of promoting macroeconomic and financial stability in the region and achieving mutually reinforcing regional growth and prosperity. At the same time, the Bank will continue to forge strong ties with other supervisory authorities to enhance cross-border co-operation in the supervision of internationally active financial institutions.

Promoting greater financial inclusion remains a high priority for the Bank as part of efforts to enhance the effectiveness of the financial intermediation function. The main objectives of these efforts are to improve access to financial services as well as access to financing for all segments of society. This also involves improving the capability of Malaysians to make effective financial decisions and manage their finances. Access to financing to all economic sectors, including small and medium enterprises, continued to improve significantly in 2006. A strategic initiative to introduce and implement a microfinance institutional framework will further improve access to financing for micro enterprises.

Continuing efforts to improve financial literacy have also empowered more individuals to make informed financial choices. The Bank has continued to build on the consumer education platform that was launched in 2003 to increase the reach and coverage of our consumer outreach

initiatives. This has been reinforced by significantly enhanced regulatory standards introduced by the Bank on disclosure and needs-based selling which aim to ensure that consumers are properly advised and fully understand the risks associated with their financial transactions. These efforts support the ability of consumers to assume greater individual responsibility for sound financial planning and to make financial decisions with confidence, which in turn contributes to financial stability by facilitating the more efficient allocation of resources and risk in and through the financial system.

While the overall outlook for growth in 2007 remains positive and the strengthened financial system enhances the prospects for continued financial stability, continued vigilance will be maintained. Bank Negara Malaysia will continue to maintain a close watch on the risk-taking activities of financial institutions through its supervisory and surveillance functions. Much work lies ahead in developing prudential standards that are fundamentally applicable to institutions with varying levels of complexity and diversity. At the same time, enhancements will continue to be made to the existing regulatory framework that will clearly set out the Bank's supervisory expectations with respect to financial institutions' management of new and emerging risks, and to reinforce the building blocks for more robust capital adequacy assessments. The Bank's own internal capabilities are also being continuously strengthened to improve the quality of supervisory assessments as an important precondition for future regulatory adjustments to reflect changing market realities.

The key challenge for financial institutions will be staying the course in upholding sound risk management standards in the face of increasing competition and pressures on margins as forces of change continue to unfold. More importantly, institutions need to embrace the discipline of longer-term assessments of risk and continue to scale up their investments in risk management capabilities commensurately. Such investments will prove to be amply justified as advanced capabilities enable financial institutions to move more meaningfully beyond regulatory compliance to value-enhancing strategies of economic capital and resource management. Ultimately, the objectives of financial stability and sustainable value creation remain inextricably linked.



**Zeti Akhtar Aziz**  
**Governor**

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