

Risk Assessment of the Financial System

OVERVIEW

The financial sector performs a key intermediary role in the Malaysian economy. Given this function, the growth and stability of the financial sector has significant interlinkages with developments in the real sector as well as macroeconomic conditions. In addition, with the increasing level of openness of the Malaysian economy and the financial system, resulting in greater integration with the external sector, the task of preserving stability of the financial sector becomes more complex and challenging. This is because developments in the external sector including global financial markets can substantially influence conditions and developments in the domestic economy and financial system as well as behaviours and risk attitudes of financial market players. This is further amplified by increased capital flows into emerging markets and in particular, into the region following greater capital account liberalisation. These and other developments, underscore the need for a heightened and more robust surveillance framework that expands beyond developments in the domestic economy in order to ensure that emerging risks and vulnerabilities are sufficiently identified and addressed in a timely and effective manner.

An important area of focus in 2006 was on identifying risks and vulnerabilities in the financial markets associated with the significant movements in capital flows particularly into emerging markets in Asia and Latin America amidst an environment of prolonged surplus liquidity. On the domestic front, issues confronting the household and corporate sectors emanating from supply-side inflationary pressures arising from higher prices of petrol and utilities, and expectations of rising interest rates, dominated the focus of macroprudential surveillance efforts particularly in the first half of the year.

The Malaysian financial system remained highly resilient in the face of a number of challenging developments including the impact

on the economy of the higher oil and commodity prices and increased volatility in the financial markets, in particular the equity price movements in May 2006 and in late February 2007. This resulted from the enhanced risk management capability, financial infrastructure development combined with strengthened governance and oversight at the institutional level. Moreover, the stronger financial position and improved key financial soundness indicators have also contributed to the continued resilience of the system. In particular, capitalisation remained high at levels above 12.5% throughout the year, profitability was sustained with preliminary unaudited pre-tax profit of RM13 billion and return on equity of 16.1%, and asset quality continued to improve recording a net NPL ratio of 4.8% at end-2006. The strong performance of the banking system is supported by the improved financial infrastructure and a robust regulatory and supervisory framework.

The financial system and institutions continued to remain sound and stable, demonstrating strong resilience to the challenging environment, driven primarily by stronger financial positions, more sophisticated risk management and strengthened governance amidst enhanced regulatory and supervisory framework.

The outlook for the financial system stability remains highly favourable as the strengthened resilience and robust financial performance as well as stronger institutional set up has strengthened further the capacity and capability of the financial sector, both at the system and institutional levels, to withstand future disturbances. The more diversified financial infrastructure will also enable

risks in the financial system to be managed in a more effective and efficient manner.

GLOBAL MACROECONOMIC AND FINANCIAL DEVELOPMENTS

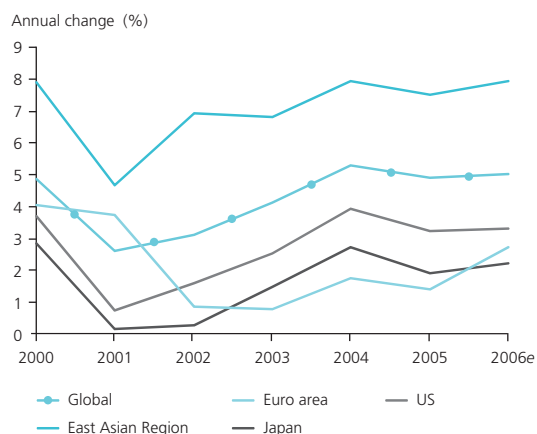
Continued expansion in industrial countries and sustained growth momentum in the Asian countries amidst moderation in the US economy

Global growth continued at a firm pace in 2006, marking its fourth consecutive year of expansion above 4%, although it moderated in the latter half of the year following some slowing of the US economy. Despite an environment of high oil prices, rising interest rates, and increased volatility in the financial markets, global growth broadened, with continued recovery in Japan and the euro area reinforced by sustained expansion in the Asian region. Meanwhile, global inflation has started to stabilise amidst easing oil prices. Crude oil prices declined to below USD55 per barrel in January 2007 for the first time since mid-2005, after peaking at over USD77 per barrel in July 2006.

Monetary tightening in major economies and in parts of Asia

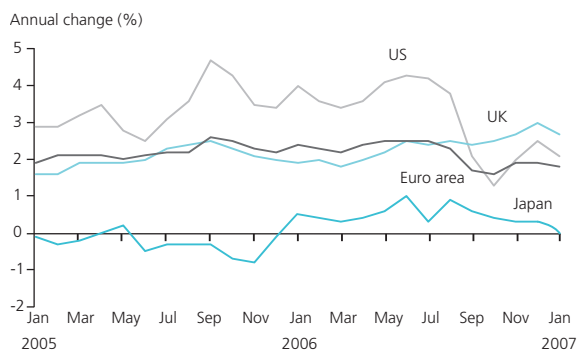
The need to manage inflationary expectations and potential pass-through pressures to underlying inflation led most central banks to pursue a

**Chart 2.1
Real GDP Growth**

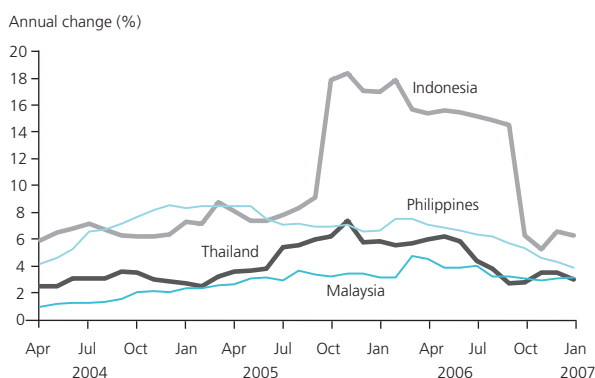


e Estimate
Source: National Authorities

**Chart 2.2a
Headline Inflation in Major Industrialised Countries**



**Chart 2.2b
Headline Inflation in Regional Countries**



Source: National Authorities

tightening bias in monetary policy stance in 2006. Such a stance was pursued until signs of inflationary pressures clearly receded. The Federal Reserve Board raised rates to 5.25% by June 2006 and maintained its stance for the rest of the year while the Bank of Japan ended its zero interest rate policy in July 2006 following a return to positive inflation rates. Similarly, both the European Central Bank and the Bank of England raised interest rates to curb incipient inflationary pressures. In the Asian region, China raised rates to reduce the pace of credit and investment growth, while the higher rates in Korea were aimed to moderate the rapid rise in house prices. Other regional economies including Chinese Taipei and India also tightened monetary policy in 2006, the former to normalise real interest rates and the latter to contain inflationary pressures. In

Chart 2.3a
Major Industrial Countries: Official Interest Rates

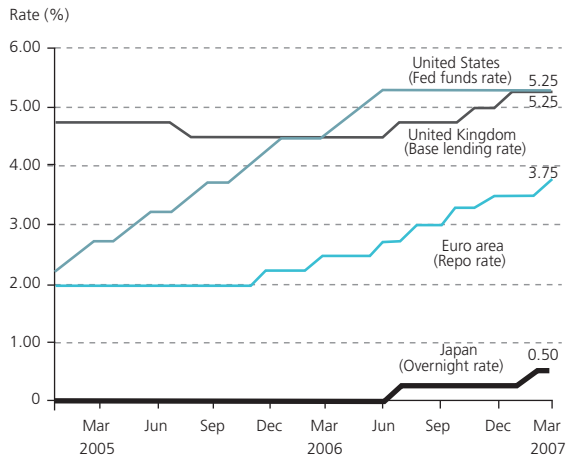
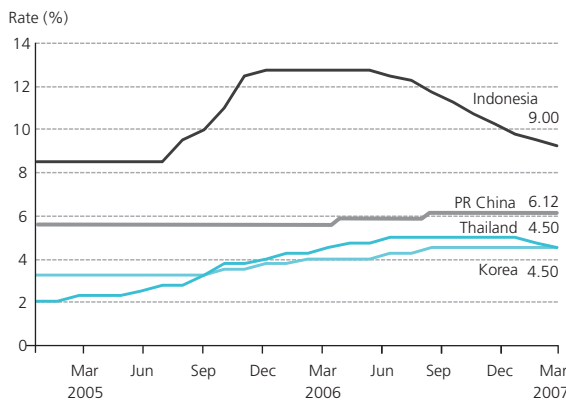


Chart 2.3b
Regional Countries: Official Interest Rates



Source: National Authorities

Indonesia and Thailand however, interest rates were reduced amidst moderating inflation.

Low volatility and risk premia permeated global financial markets

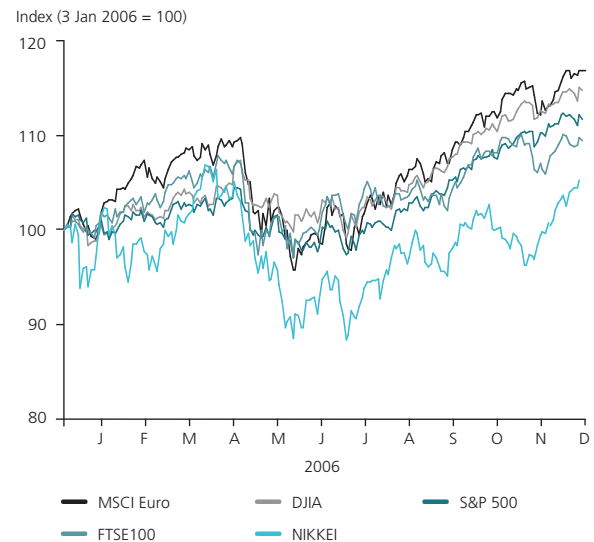
The prolonged environment of ample liquidity set the stage for larger global movements in capital in search of higher returns, reflecting a higher appetite for risk taking spurred by improved prospects for global economic conditions. Substantial capital flows into emerging market economies, which were mainly channelled to the equity markets, were also influenced by the improving corporate earnings and the overall macroeconomic environment.

Sound fundamentals in many emerging market economies, supported by stronger export performance, improved fiscal positions, as well as more developed financial sectors, were key drivers supporting these trends.

Coupled with a number of merger and acquisition activities and better than expected profit announcements by several large corporations globally, the equity market posted strong performance in the period leading to May 2006 (Charts 2.4a and b). Equity markets in emerging economies, being the primary beneficiary of the capital flows, registered strong gains as proxied by the MSCI Emerging Market Index. Similarly, in an environment of historically low corporate default rates, this period witnessed strong interest in high-yield corporate bonds. Strong buying into corporate bonds of emerging markets subsequently contributed to the narrowing of emerging market bond spreads to their historical lows.

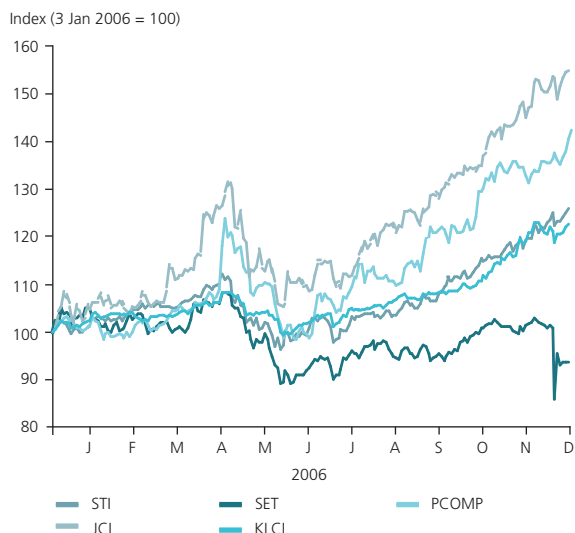
By May 2006, commodity prices including oil, copper and gold were at their record highs. This triggered a reassessment of risks on account of heightened uncertainties as well as increased expectations of inflationary pressure and monetary

Chart 2.4a
Performance of Major Equity Indices



Source: Bloomberg

Chart 2.4b
Performance of Regional Equity Indices



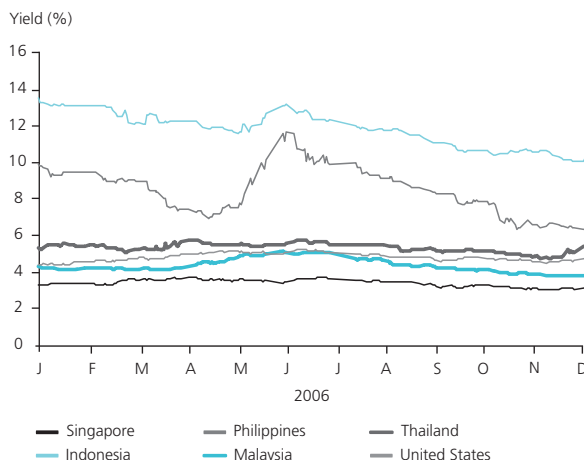
Source: Bloomberg

tightening in some economies, which culminated in a major sell off of financial assets particularly in the equity market. This had a considerable impact on equity markets in the emerging economies of Asia and Latin America. In the bond market, heightened risk aversion of investors following the reassessment of risk led to flight-to-quality trades, in favour of higher rated albeit lower yielding investments. In addition, yields on long-term US Government bonds rose, to more than 5% by end-June. Similar developments were observed in regional economies, particularly in Indonesia and the Philippines (Chart 2.5).

Notwithstanding the significant price movements observed in May 2006, the financial markets continued to be characterised by an overall low level of volatility (Charts 2.6a and b). To some extent, this was reflective of the improved fundamentals, greater sophistication in the financial sector and more efficient markets in recent years, as well as the optimism in financial markets' expectations regarding future risks and outlook for growth.

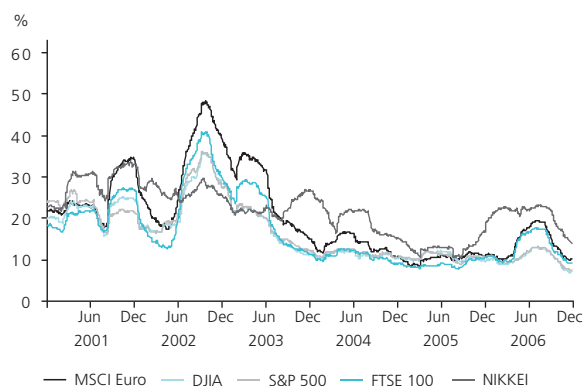
Most financial markets recovered strongly and swiftly after the correction in May on account of improved expectations on risks and outlook. In particular, with the economic fundamentals

Chart 2.5
10-Year Government Bond Yields for Selected Countries



Source: Bloomberg

Chart 2.6a
Volatility of Major Equity Markets

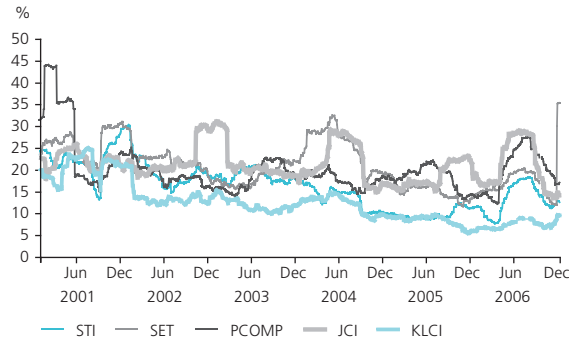


Note: Volatility is measured as the rolling standard deviation of daily returns over a 90-day period

Source: Bloomberg

remaining broadly intact, recovery took place against a backdrop of moderating oil prices, more stable commodity prices and a more optimistic global growth forecast including the expectation of a softer landing of the US economy and the continued low level of long-term interest rates. Together, these developments contributed to the resumption of capital flows into the emerging markets that drove equity prices to higher levels in the remaining period of the year. Similarly, inflows of capital especially in the longer end of the

Chart 2.6b
Volatility of Regional Equity Markets



Note: Volatility is measured as the rolling standard deviation of daily returns over a 90-day period

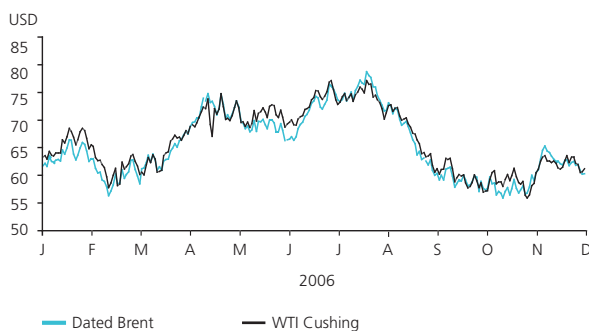
Source: Bloomberg

Chart 2.7
Goldman Sachs Commodity Index



Source: Reuters

Chart 2.8
Oil Prices



Source: Bloomberg

bond market caused a reversal in the yield curve as yields on longer-term bonds declined.

Volatility had no destabilising effects in the region

Whilst there were no visible signs of severe adverse implications on regional economies, financial markets within the region experienced brief periods of volatility arising from investors’ heightened risk sensitivities to regional political developments and domestic measures to manage capital inflows. The impact of these developments on the region as a whole, was minimal and largely well-contained, albeit with some markets experiencing increased volatility. Overall, the region was relatively unaffected by these sporadic developments given its strong fundamentals, reinforced by lower public and corporate sector leverage, build-up of foreign reserves and improved investors’ confidence, and by expectations of sustained economic growth and relatively well contained inflationary pressures.

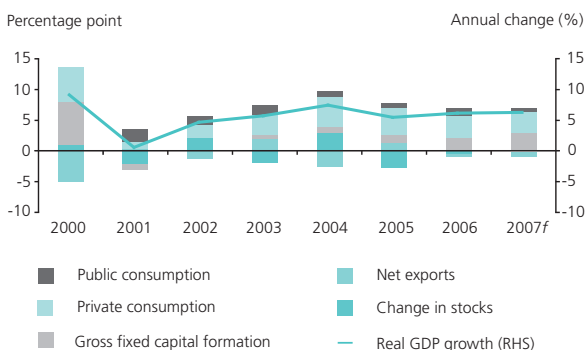
MALAYSIAN MACROECONOMIC AND FINANCIAL DEVELOPMENTS

Domestic economy expanded, underpinned by growth in private sector activity

The Malaysian economy expanded by 5.9% in 2006. Growth was broad-based, led by the services, manufacturing and agriculture sectors. Private consumption expenditure remained strong, increasing by 7% in 2006, supported by higher disposable income amidst healthy labour market conditions, favourable export earnings and rising commodity prices. Gross fixed capital formation increased by 7.9% in 2006, led mainly by private sector capital spending in line with the favourable business sentiment. Strong investment spending was recorded in the manufacturing, services, oil and gas sectors, which all benefited from sustained growth in domestic and external demand.

Public consumption increased with Federal Government operating expenditure registering stronger growth of 17.7% during the second half of the year, arising from higher expenditure on emoluments, supplies and services. The Federal Government had also increased the disbursement

Chart 2.9
Contribution to Real GDP Growth



f Forecast

of development expenditure during the course of the year especially on projects for education, agriculture and rural developments as well as public utilities.

Ringgit Developments

The ringgit exhibited greater two-way movements in 2006, influenced by the underlying trade surplus, investment and financial flows into the region arising from favourable economic growth prospects and market expectations for exchange rate appreciation. By the same token, outward direct and portfolio investment, repayment and prepayment of external loans and the repatriation of profit and dividends also influenced movements in the ringgit.

Inflation Developments

The combination of favourable global growth conditions and rising commodity prices contributed to the increase in domestic inflationary pressures in Malaysia in 2006. The average headline inflation rate, as measured by the annual change in the Consumer Price Index (CPI), increased from 3% in 2005 to 3.6% in 2006, mostly on account of adjustments to administered prices and supply-related factors.

A major contributor to the increase in the headline inflation rate was the higher transportation costs, following the increase in price of retail petroleum products in March 2006. Nonetheless, the inflationary pressures remained contained, as headline inflation moderated in the

second half of the year. This reflected the limited second-round impact of higher resource costs into consumer prices, which in turn, was attributed to the well-anchored inflationary expectations.

Monetary Policy Developments

The Overnight Policy Rate (OPR) was raised twice in the early part of 2006 to align monetary conditions to the prevailing environment, against the backdrop of firm prospects for economic growth, and rising inflation. As the year unfolded, uncertainties emerged in the external environment, arising from sustained high energy prices, and geopolitical risks which could contribute towards some moderation of global growth. Amidst signs of limited second-round effects from higher prices, and the lack of demand-induced inflationary pressures, monetary policy took a pause to preserve the balance between sustaining the economic growth momentum and price stability. The OPR was maintained at 3.5% for the rest of the year.

Financial Market Developments

Financial markets performance reflecting underlying growth momentum and in tandem with developments in global financial markets

The performance of the Malaysian financial markets was influenced largely by both global and domestic developments. Amidst an environment of surplus global liquidity and the consequential demand for higher yielding investments, Malaysia, with its strong economic fundamentals and more developed financial markets was one of the investment destinations. This led to significant capital flows into the country especially towards the year-end reinforced further by expectations of a stronger ringgit. While the year experienced some periods of distinct volatilities, implications on the financial sector remained well-contained.

As a whole, the Malaysian equity market ended the year on a significantly positive note despite a cautious start to the year (compared with regional counterparts), and notwithstanding some distinct periods of volatility. The Kuala Lumpur Composite Index (KLCI) concluded the year with an annual gain of 21.8%, the highest since 2003, to reach

1,096.24 points, surpassing the psychological level of 1,000 points. Total turnover in Bursa Malaysia was RM250.6 billion (2005: RM177.3 billion), with market capitalisation growing 22.1% in 2006 to RM848.7 billion or 155.3% of GDP as at end-2006.

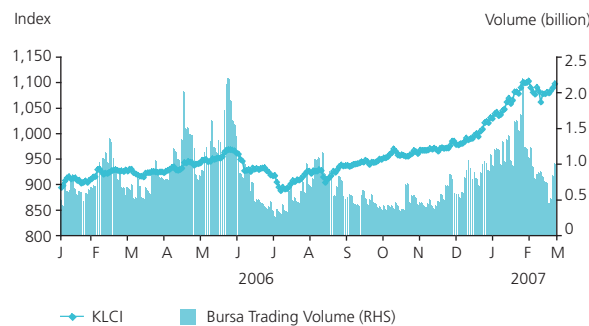
Prior to the mid-year correction, expectations of stronger export performance for the electrical and electronics sector influenced inflows of capital into technology counters in the Second Board and MESDAQ. Following the price correction in May, these portfolio flows left the country and resulted in a broad-based increase in volatility in the domestic equity market. The volatility level nonetheless remained well below that recorded during the Asian financial crisis (Chart 2.12). The impact of these developments

was relatively minimal and short-lived, as the equity market recovered strongly, largely on account of the stream of positive economic and corporate indicators that led to resurgence of capital inflows into the country, particularly into the larger counters and blue chip stocks on the Main Board. There were also upward revisions of corporate earnings forecasts by analysts, and increased merger and acquisition activities (84 successful deals valued at approximately RM90 billion in 2006 compared to RM47.3 billion in 2005). The rally in the equity market was also supported by optimism ahead of the implementation of the Ninth Malaysia Plan.

The equity market continued with its strong performance in the early part of 2007, supported by further inflows of non-resident funds. The KLCI reached a high of 1,283.47 points on 23 February 2007 before the correction in late February and early March. This was the result of the contagion effect from the weaker numbers in the US and developments in the Chinese financial markets, as well as some profit-taking activities given the considerable growth recorded. As the strong underlying fundamentals remained unchanged, the equity market has since recovered. As at 7 March 2007, the KLCI stood at 1,156.58 points or 5.5% higher compared to end-2006.

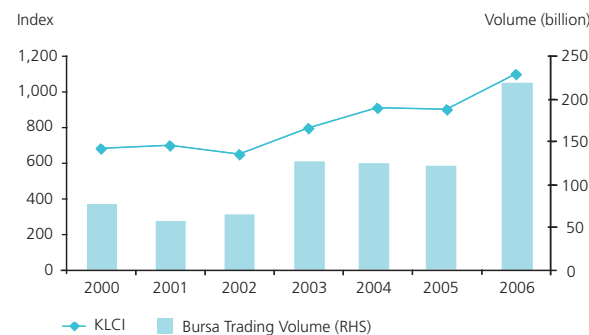
Similarly, the performance of the domestic bond market was influenced by domestic and global developments. The inflation outlook and direction of monetary policy largely influenced

Chart 2.10
KLCI Performance



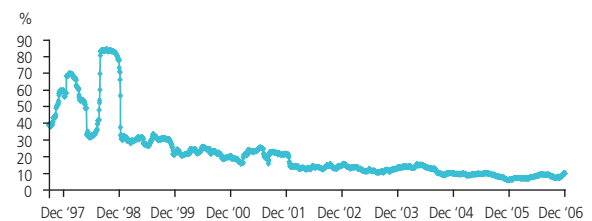
Source: Bursa Malaysia

Chart 2.11
Historical KLCI Performance



Source: Bursa Malaysia

Chart 2.12
Volatility of KLCI Index



Note: Volatility is measured as the rolling standard deviation of daily returns over a 90-day period

Source: Bloomberg

the rising trend in yields in the early part of 2006. By June 2006, yields on the Malaysian Government Securities had risen by as much as 80 basis points. As the inflation outlook improved, coupled with expectations of further strengthening of ringgit and supported by the continuing ample liquidity, the yields peaked in June following a marked reversal in the outlook and assessment of risks. The return in capital flows in periods following the mid-year correction sparked buying interest in the longer end of the bond market as investors' risk appetite increased, which caused long-term yields to decline. The possible inclusion of the Malaysian bond market in the Citigroup World Government Bond Index, also in part led to pre-emptive buying by global fund managers in the latter part of the year.

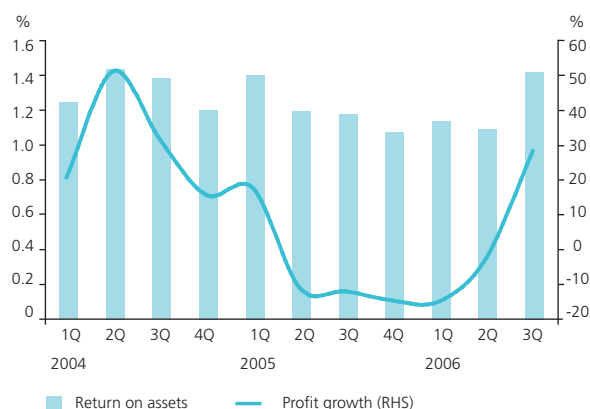
NON FINANCIAL SECTOR

Strong business sector tolerance amidst initial uncertainties

Developments in the business sector remained favourable for the greater part of the year. Accounting for 39.6% of banking system loan exposures and with more than RM186.1 billion of corporate bonds outstanding, the strong business sector performance had favourable spillover effects on the banking sector and financial markets. Businesses appeared to have adapted, at a relatively rapid pace, to the new levels of operating costs following higher costs of transportation, raw materials and financing.

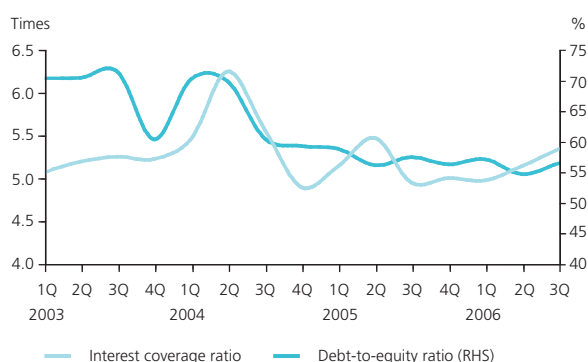
In the corporate sector, aggregate profits of a sample of listed corporations, representing more than 70% of Bursa Malaysia's total market capitalisation, rebounded strongly in the third quarter. After being in the range of below 1.2% for three quarters, the average return on assets for these listed companies improved to 1.4% in the third quarter of 2006. Meanwhile, the overall debt-to-equity ratio remained almost flat at 56.3%. The stronger profit performance and stable leverage position resulted in an improvement in the debt servicing capacity (measured as the ratio of earnings before interest, depreciation and taxes to total financing cost) of these corporations to 5.3 times. In addition, spreads on corporate bonds

Chart 2.13
Profitability



Source: Bloomberg

Chart 2.14
Debt Servicing and Leverage

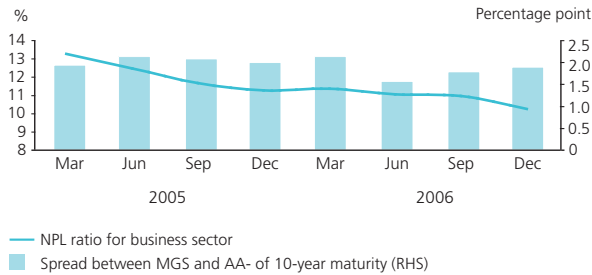


Source: Bloomberg

narrowed and the NPL ratio declined further in 2006 broadly reflective of the improvement in the performance of the business sector. With improved balance sheets and financial positions, a conducive operating environment and continued strengthening of confidence and business sentiment, the corporate sector remained well-positioned for future expansion in 2007. On aggregate, downside risks to the banking system emanating from developments in the corporate sector remained subdued.

The performance of the corporate sector was to a large extent, influenced by the inter-linkages among the industries in the economy. Reflecting strong domestic and external demand

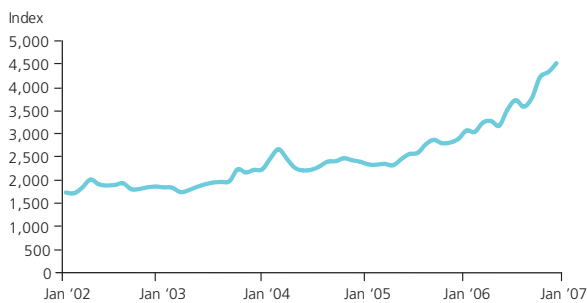
Chart 2.15
Spread and NPL Ratio



as well as high commodity prices, improved profitability was apparent for businesses in the manufacturing, primary commodity and services sectors (Chart 2.16). Within the manufacturing sector, a robust pick-up in the earnings of the metal processing and fabrication, and building materials industries was highly correlated with the improvement in the construction sector.

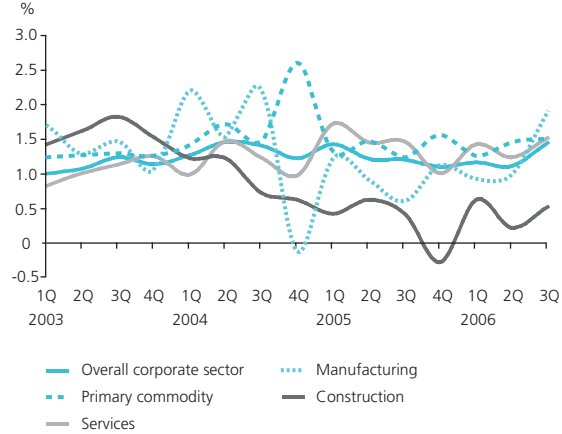
Similarly, the strengthening in the profitability of businesses in the primary commodity sector was driven largely by higher commodity prices including crude oil, palm oil and rubber. Nonetheless, while higher petroleum prices had benefited the oil and gas industry, the transport and storage businesses had to contend with the rising costs that had affected their profit levels. Meanwhile, within the construction sector, prospects for growth of the civil engineering segment improved considerably following the implementation of the Ninth Malaysia Plan.

Chart 2.16
Movement in Plantation Stock Index



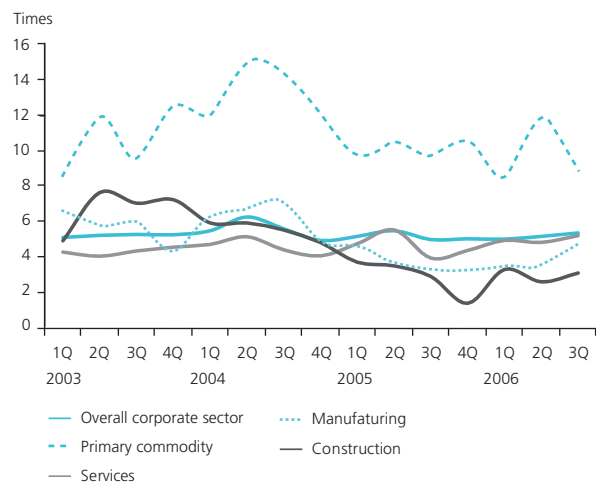
Source: Bloomberg

Chart 2.17
Return on Assets for Selected Sectors



Source: Bloomberg

Chart 2.18
Interest Coverage Ratio for Selected Sectors

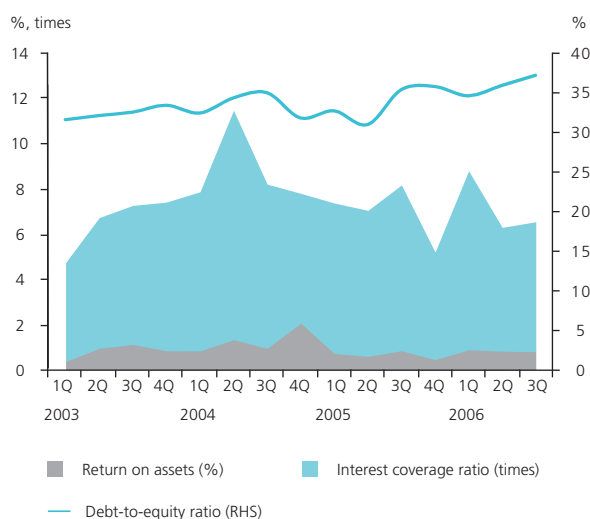


Source: Bloomberg

At the industry level, the effects of adjustments in demand-side factors particularly moderation in the sale of residential properties and passenger vehicles, on selected industries remained manageable.

In the property sector, the moderation in overall demand for residential properties has led to lower sales and revenue growth hence, raising some concerns on the debt servicing capacity of some property developers (Chart

Chart 2.19
Financial Strength of Selected Companies in the Property Sector



Source: Bloomberg

2.19). The increased cost of living combined with higher prices of new launches appeared to have induced more cautious behaviour amongst prospective homebuyers. On the supply side, property developers appeared to have factored these developments, resulting in moderation in units launched in 2005 and 2006. Overall demand was boosted however, by demand for high-end and prime location properties which were also supported by increased interest from foreign purchasers and investors. Intense competition has also driven developers to offer new housing concepts and designs as well as innovative housing products in the market. With the continued rise in urbanisation set to continue amidst growing affluence, prospects for property developers are expected to improve.

Meanwhile, slowing demand for new passenger cars saw the softening of the automotive sector, with total industry sales (including commercial vehicles) declining by 11.1% to 490,768 units in 2006 (2005: +13.3%, 552,316 units). This translated into the lower demand for new bank financing as reflected in the 23.9% decline in applications for car hire purchase. Cautious consumer behaviour has overshadowed the lower prices of vehicles following the announcement of the National Automotive Policy in March 2006. The corresponding decline in prices of used cars in particular, has discouraged trade-ins and replacement of existing cars. With lower sales, profits of the automotive sector (based on a sample of auto companies representing more than 85% of Bursa Malaysia’s market capitalisation for the auto sector) declined in the first nine months of 2006 causing a decline in the debt servicing capacity (Charts 2.20 and 2.21).

A related implication of the decline in vehicle sales was on the performance of the auto parts manufacturers. Notably, the interest coverage ratio of the auto parts manufacturers declined to 6.5 times (Q3 2005: 9.9 times) and their debt-to-equity ratio increased to 38% (Q3 2005: 29.2%). Nonetheless, the banking sector remained well-positioned to absorb the potential risk given that its exposure in this segment of the business sector has remained low at only 0.5% of banking system business loans as at end-2006.

Overall, developments in the automotive industry are not expected to pose any systemic risk to financial stability. Expected launches of new models by both national and non-national

Table 2.1
Residential Property Transactions

Period	2000	2001	2002	2003	2004	2005	2006
Residential property transactions							
Units	170,932	176,208	162,269	164,723	195,241	181,762	176,277
Value (RM billion)	21.9	22.2	21.1	23.0	29.3	28.4	28.7

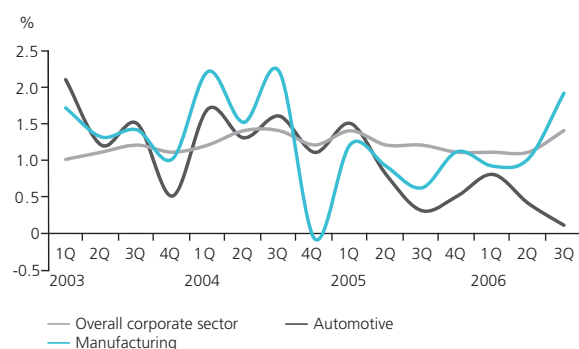
Source: National Property Information Centre (NAPIC), Valuation and Property Services Department

Table 2.2
Sales of Vehicles (in units)

Period	2000	2001	2002	2003	2004	2005	2006
Passenger cars	282,103	327,447	359,934	320,524	380,568	416,692	366,738
Commercial vehicles	33,732	37,623	42,727	50,882	70,948	97,820	90,471
4x4 vehicles	27,338	31,311	32,293	34,339	36,089	37,804	33,559
Total	343,173	396,381	434,954	405,745	487,605	552,316	490,768

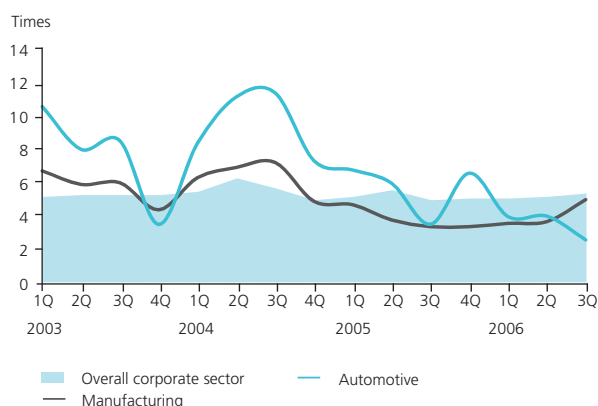
Source: Malaysian Automotive Association

Chart 2.20
Return on Assets for Selected Companies in the Automotive Industry



Source: Bloomberg

Chart 2.21
Interest Coverage Ratio



Source: Bloomberg

car makers and moderating inflationary pressures are expected to provide the impetus for sustained performance in 2007.

Potential catalyst and risks to corporate performance moving forward

With the growth momentum of the Malaysian economy expected to remain favourable in 2007, the financial position of the corporate sector will likely strengthen further. Several sectors are expected to perform strongly benefiting from the implementation of projects under the Ninth Malaysia Plan and the Visit Malaysia Year 2007 (VMY 2007) programme. These include a total of 880 new construction-related projects totalling RM15 billion which would have a favourable impact mostly on the civil engineering subsector. The manufacturing sector, particularly construction-related industries, which supply raw materials to the construction sector, is also expected to benefit from robust demand amidst improving market conditions. For the services sector, the tourism industry, during VMY 2007, is expected to have positive spillover effects in the retail, leisure and hospitality sub-sectors.

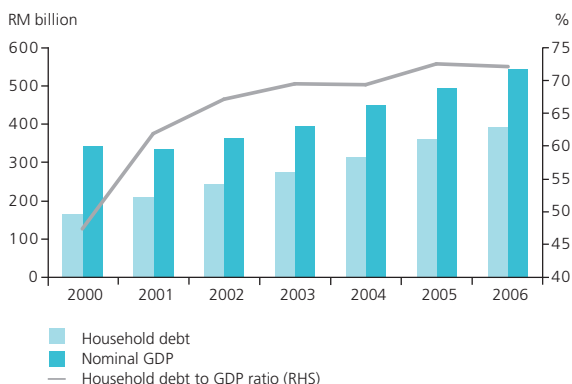
Increased merger and acquisition activities involving major listed companies from various sectors such as plantations, construction, oil and gas, manufacturing and services (utilities and gaming sub-sectors) are expected to provide further synergistic improvement to the corporate sector. In the long run, these adjustments provide significant potential for improved profitability as well as greater financial resilience for the sector. Another major catalyst is the positive impact expected from further reforms of the Government Linked Companies (GLCs) under Phase 3 of the GLC Transformation Programme in 2007.

Household sector remained resilient amidst challenges

Not unlike the business sector, the household sector is closely linked to developments in macroeconomic conditions. While higher commodity prices and strong gains in the equity market partly contributed to firmer growth in the financial assets of households, expectations surrounding the rising cost of living appeared to have prompted households to become more cautious particularly for large item spending. Underpinned by the more subdued housing and automotive markets, household debts grew at a moderate pace of 9.8% in 2006 after six years of rapid growth. In line with these developments, the debt service ratio (DSR) of the household sector (calculated as the share of disposable income devoted to principal and interest repayments on debt) appeared to have stabilised with the overall credit quality of household sector exhibiting improving trends.

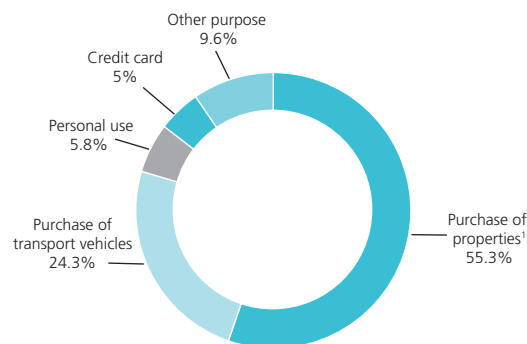
The ratio of household debt to nominal GDP stabilised at 72.3% (2005: 72.6%) on the backdrop of an easing in household debt accumulation which, in turn, was attributed to lower purchases of cars and residential properties (collectively accounted for approximately 70% of total household debts). Moderation in household borrowing was broad-based across the different credit providers. The banking system remains the primary financier given their extensive branch network and more flexible financing packages.

Chart 2.22 Household Indebtedness



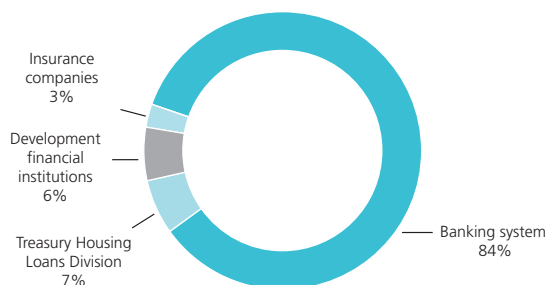
Source: Treasury Housing Loans Division and Bank Negara Malaysia

Chart 2.23 Composition of Household Debt by Purpose



¹ Includes residential and non-residential properties
Source: Treasury Housing Loans Division and Bank Negara Malaysia

Chart 2.24 Composition of Credit Providers to Household Sector



Source: Treasury Housing Loans Division and Bank Negara Malaysia

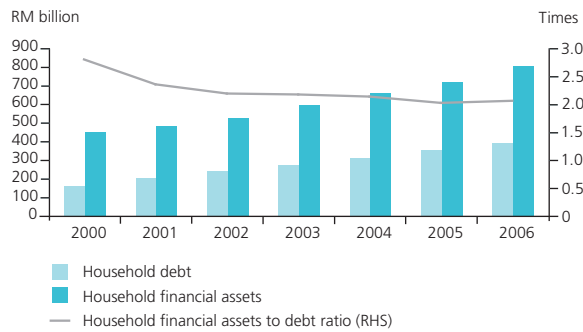
Nevertheless, household's financial assets grew by an estimated 11.9% mainly boosted by strong performance in the equity market especially towards the end of 2006, and growing investments in unit trust funds. The strong growth in financial assets reflected the improved financial positions arising from the increase in wealth of the household sector. At end-2006, the household financial assets to debt ratio was 205.1% compared to 201.2% at end-2005. In addition, liquid assets, comprising deposits with banking institutions and DFIs as well as investments in unit trust funds, recorded a buoyant growth of 12.8% (2005: 7.5%) to account for more than half of total household financial assets. Supported by a

sufficiently high liquid assets to household debt ratio of 109.3% (2005: 106.4%), the household sector is well-positioned and has the capacity to service its debt even in the short run.

Supported by stable labour market conditions, continued growth in income levels, and the moderate pace of increase in indebtedness, the household sector now has greater capacity to withstand shocks.

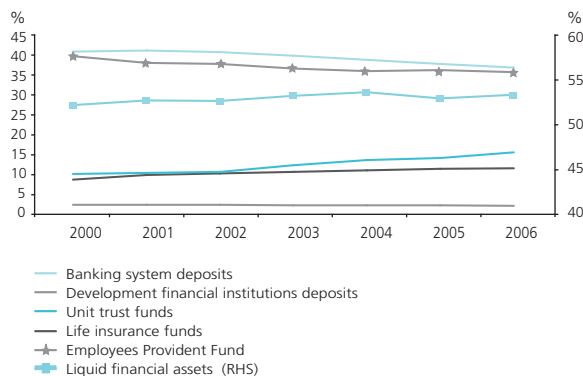
The debt servicing capacity of the household sector improved, as reflected by the decline in the ratio of repayments to disposable income to 40.9% (2005: 41.3%). Notably, the overall position of the household sector continued to remain favourable supported by stable labour market conditions as reflected by lower unemployment rate and continued income growth, moderation in the pace of new household borrowings, and the higher level of commodity prices. Growth in wages and salaries in the manufacturing sector was sustained whilst strong commodity prices during the year continued to support income of workers in rural areas. A survey of a few banks indicates, however, that there were some early signs of distress, resulting in some households restructuring their loan facilities or lengthening repayment periods to allow for a more orderly management of the debts. Aggregate household NPL ratios continued to downtrend to 7.1% (2005: 7.8%). In addition, the number of bankruptcies declined by 14.3% in 2006 (2005: -2.4%). Collectively, these factors suggest that the vulnerability of the household sector to adverse shocks continue to remain low (Chart 2.27).

Chart 2.25 Household Financial Assets to Debt Ratio



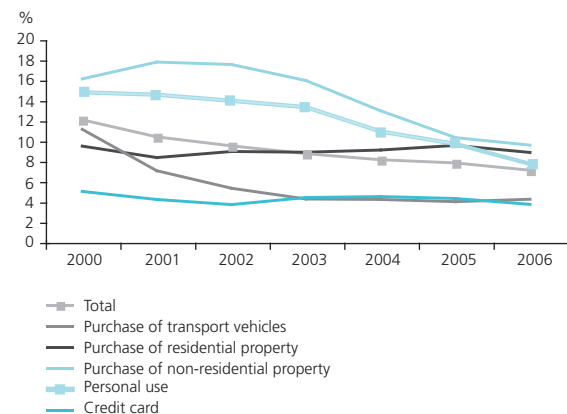
Source: Treasury Housing Loans Division, Employees Provident Fund, Securities Commission and Bank Negara Malaysia

Chart 2.26 Composition of Household Financial Assets (Expressed as a Percentage of Total Household Financial Assets)



Source: Securities Commission, Employees Provident Fund and Bank Negara Malaysia

Chart 2.27 Non-performing Loan (NPL) Ratio of Household Sector



whilst credit card balances rose by 19% (2005: 17.3%). An important highlight is that bulk of the increase in credit card balances was not from transactions involving cash advances, which remained marginal, accounting for only 6.1% of total credit card transactions (2005: 6.5%), supporting the assessment that the liquidity position of the households remains at manageable levels. Delinquencies for credit cards were largely associated with imprudent spending behaviour. The Credit Counselling and Debt Management Agency (CCDMA) has provided debt management advice to such customers where 53.5% of the individuals faced difficulties in servicing their debts due to misuse of credit cards, rather than difficulty in meeting the repayment obligations for mortgages or car financing. Notwithstanding, the overall NPL ratio for credit cards has declined to 3.7% in 2006 (2005: 4.3%). Moreover, the proportion of credit cards in circulation with revolving balances (2006: 56%, 2005: 55.1%) remained fairly stable, lending support to the assessment that a majority of credit card holders settle their card balances in full upon due date. These indicators seem to suggest that vulnerability arising from credit card usage remained broadly limited and well-contained.

While aggregate information on household indebtedness and delinquency patterns is well-established, micro level information such as household income, wealth and expenditure, in particular the distribution of wealth across various asset classes and income distribution are either not readily available or less comprehensive. In some instances, the collection of such information is done less frequently, across a smaller sample size and coupled with the lack of granularity. Efforts are being made to enhance data collection on a wider spectrum of households' financial assets and liabilities as well as to collect micro level data on financial position. This would contribute significantly to an enhanced surveillance framework that would facilitate effective detection and assessment of emerging vulnerabilities to the financial system arising from evolving developments in the household sector.

The banking sector has weathered well the challenging external and domestic developments in 2006. Supported by strengthened financial structures and profit performance as well as risk management capability, the banking sector has greater capacity to weather future challenges.

FINANCIAL SECTOR RISK ASSESSMENT

Banking system resilience unfettered amidst challenges

The banking sector sustained its resilience amidst the challenging external and domestic developments in 2006. Contributing to a strengthened capacity to buffer against future challenges, banking institutions remained well-capitalised and exhibited sustained profit performance. This was further underpinned by the improving level of non-performing loans (NPLs), partly reflecting general improvements in credit quality and enhanced risk management standards and practices over the years. The resilience of the banking system will be further reinforced with ongoing efforts towards the implementation of Basel II, which is expected to provide a significant boost to the capacity and capability of the banking institutions in risk measurement and management. The Malaysian banking system has also accumulated significant financial buffers of profits and capital over a number of years that will contribute to insulating the industry from future shocks and disturbances. Collectively, these developments contribute to better prospects for improved efficiency in the allocation of resources and distribution of risks within the economy.

Credit quality remained stable amidst higher debt service level

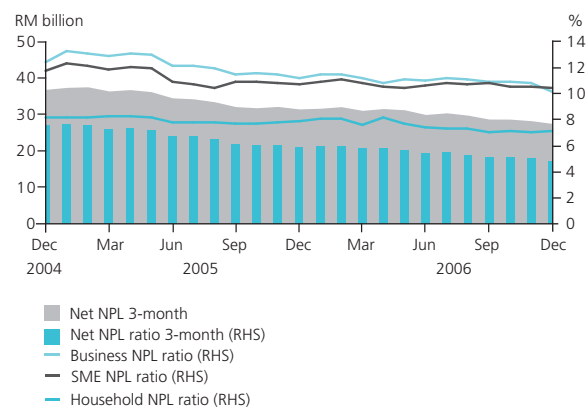
The higher interest rates, coupled with inflationary

pressures experienced during the first half of 2006, had no evident signs of significant deterioration in the debt servicing capacity of borrowers. This is consistent with the higher tolerance demonstrated by the household and business sectors. The level of NPLs continued to improve further in 2006, underpinned by the sustained encouraging economic environment amidst progressive strengthening of risk management practices and infrastructure by banking institutions. As at end-2006, the net NPL ratio (net of loan provisions) declined to 4.8% (end-2001: 11.5%), attributed mainly to the higher rate of reclassification of NPLs to performing status and continued write-offs, while the loan loss coverage of the banking system strengthened to 64.7% (end-2005: 59.1%).

With approximately 64% of banking system loans based on variable-rate financing, increases in the level of interest rates would result in higher repayment obligations for borrowers. While this is generally the case for businesses, households however, tend to be more insulated as approximately 45% of lending to households comprised fixed-rate hire-purchase financing and residential mortgages based on the Islamic financing concept. Notwithstanding the higher exposure to variable-rate financing, the NPL ratio for businesses had improved to 10.1% as at end-2006.

While the portfolio exposure to the retail sectors has increased in recent years, this development has resulted in a more balanced overall credit portfolio where 56.2% of total banking system loans as at end-2006 constituted household sector lending (end-2000: 34.4%). The low value high volume nature of household loans enables a more efficient distribution of credit risk exposure across the sector. Moreover, the high ratio of financial assets to debt of households of 205.1% provides added flexibility for households to adjust to the changing environment. Meanwhile, total lending to the small and medium enterprises (SMEs) expanded to account for 17.6% and 44.5% of total loans and business loans respectively. Under the new SME definition which covers a greater number of entities, the NPL ratio for SMEs improved slightly to 10.2%.

Chart 2.28
Banking System Non-Performing Loans (NPL) Level and Ratio



With the outlook for growth and employment remaining positive in the year ahead, the risks for credit deterioration in the immediate and near term remain moderate. This is evidenced by the 2.4% decline in total loans-in-arrears (net of NPLs) of between two and three months to RM10.1 billion to account for 1.7% of total outstanding loans.

Risk of increased concentration in household sector mitigated

On the supervisory front, an industry-wide thematic examination was conducted during the second quarter of 2006 to ensure that the rapid expansion in banking institutions' exposures to the household sector would not pose increased risk to financial stability. The examination included an assessment of the adequacy, robustness and effectiveness of the risk management infrastructure, standards and practices of banking institutions. Specifically, issues relating to governance, market conduct, product development, loan origination and underwriting processes, collateral valuation and management, portfolio management, loan maintenance and recovery, as well as information management and reporting systems, were included in the scope of the examination.

Overall, the supervisory findings were satisfactory. Although some weaknesses surfaced, the examinations showed that measures were already being implemented by banking institutions

to mitigate the identified risk areas. These include the progressive strengthening of risk management infrastructure and practices through the use of retail credit scoring and ratings, improved information and portfolio management systems, as well as enhanced loan administration, monitoring, management and recovery. These measures, while at varying stages of progress and implementation, contribute towards lowering the potential risks from increased exposure to the household sector.

The Bank also performed stress tests at both the system and individual institution levels to assess risks to macro and micro stability. The tests were conducted in mid-2006 to assess the impact of exceptional but plausible adverse events, including adjustments in bond prices, deterioration in corporate sector performance and weakened financial position of the household sector. The outcome of the scenario testing was favourable. The overall potential impact on the banking system remained manageable given the strong capitalisation and profit levels.

Interest rate mismatch remained manageable

Increases in the OPR had a limited impact on the banking sector's risk position. While the size and volume of fixed-rate instruments offered by banking institutions as well as their involvement in treasury and investment-related activities have, in recent years, expanded to account for

36% of banking sector assets, the risk exposure remained fairly low. Indeed, the impact of a one percent increase in interest rates on the solvency position of banking institutions, measured on the duration-weighted net position (DWP) approach, was estimated to result in a 1.6 percentage points decline in the RWCR (Table 2.3).

Amidst a sustained competitive environment, spreads between average lending rates (ALR) and average cost of funds (ACF) remained almost unchanged given the relatively rapid response and consequent adjustments in the deposit and money market rates. These swift adjustments reduced the potential for higher margins arising from increase in lending rates. Following the OPR increases, the average quoted base lending rate has risen by a total of 74 basis points since end-November 2005 to 6.72% as at end-2006, which corresponded with a 59 basis points increase in the ALR to 6.57% per annum.

Supported by continued ample liquidity in the system, deposits outstanding grew by 15.5% during the year outpacing the 6.3% expansion in outstanding loans. This added downward pressure on the gross interest margin which declined marginally to 2.80 percentage points as at end-December 2006.

Given Malaysia's dual banking system, the brief periods which saw limited interest rate

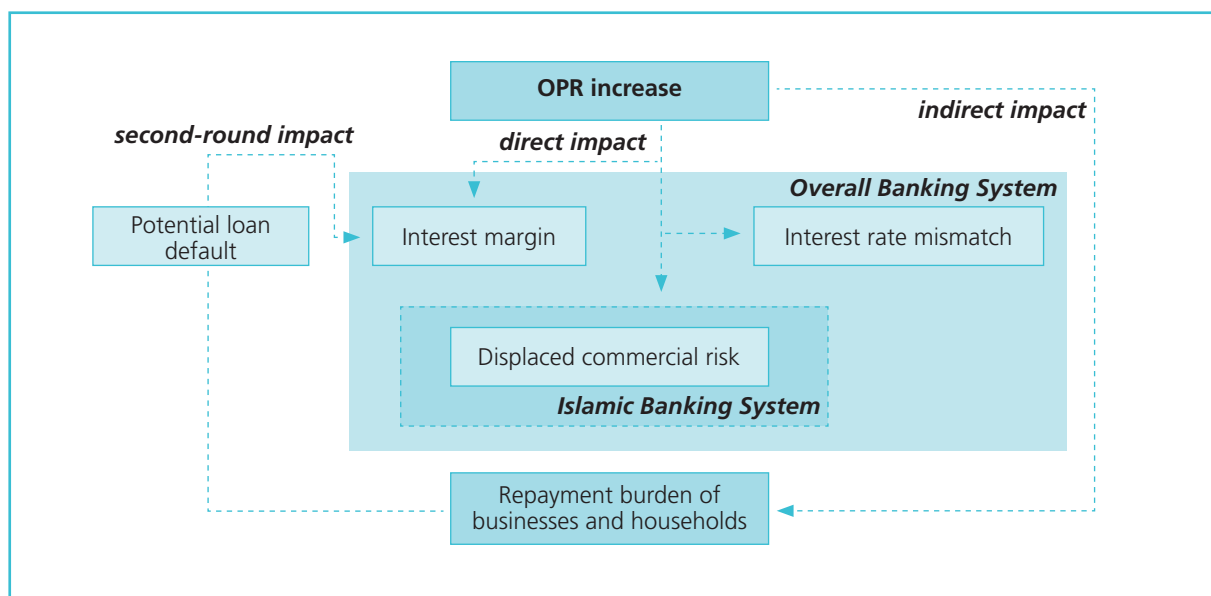
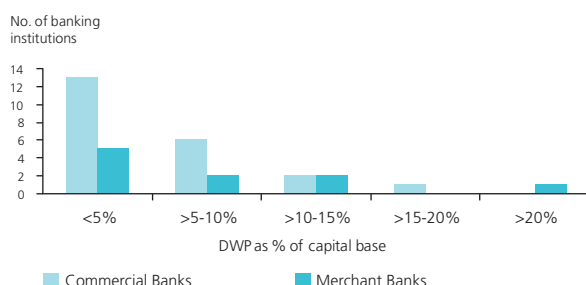


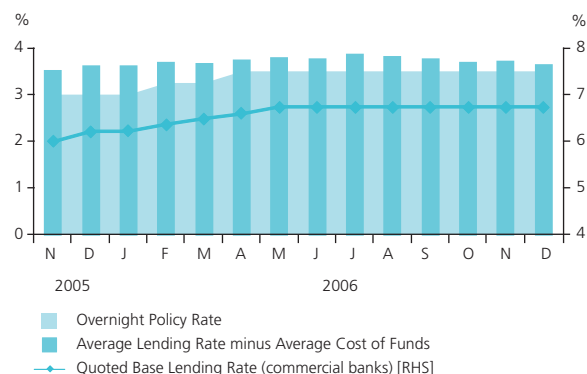
Chart 2.29
Banking System¹: Distribution by Duration Weighted Position as Percentage of Capital Base as at 31 December 2006



¹ Excludes Islamic banks but includes price risk of Islamic type exposure

hikes in the conventional financial system added, to some extent, to competitive pressures in the Islamic financial system in terms of meeting revised expectations on the rate of return payable to depositors. A key feature of Islamic banking, the return payable to the depositors is mainly influenced by the actual yield earned on the assets of an Islamic banking institution as opposed to contractual fixed interest rate payable to conventional depositors. In view that finance income has consistently accounted for more than 80% of total income of Islamic banking institutions over the past three years, the rate of return on Islamic deposits is largely dependent on the income generated from financing activities which are mostly fixed-term in nature (Chart 2.32). This has the impact of somewhat limiting

Chart 2.30
Movement in Interest Rates since the First Increase in the Overnight Policy Rate in November 2005



the responsiveness of Islamic banking institutions to increases in interest rates.

The higher conventional deposit rates observed during the early part of the year in response to OPR increases resurfaced the issue of displaced commercial risk faced by Islamic banking institutions. In managing the expected rate of return to depositors, the profit equalisation reserves (PER) were utilised to smoothen the distributable returns to depositors. This caused the PER to decline steadily for the greater part of the year. However, as upward adjustments in the financing rate took place towards the end of 2006, PER began to accumulate once more.

Table 2.3
Banking System: Impact of 1% Rise in Interest Rate on Capital Strength

	Duration-weighted net position					
	RM million		As percentage of capital base (%)		Impact on risk-weighted capital ratio (percentage point)	
	As at end					
	2005	2006	2005	2006	2005	2006
Commercial banks ¹	-6,453	-5,803	-8.4	-7.5	-1.7	-1.4
Merchant/Investment banks	-311	-478	-6.3	-8.4	-2.3	-6.5
Banking system ²	-6,765	-6,281	-8.3	-7.5	-1.7	-1.6

¹ Includes finance companies

² Excludes Islamic banks but includes price risk of Islamic type exposures

Note: Total may not add up due to rounding

Chart 2.31
Movement in Gross and Net Interest Margins

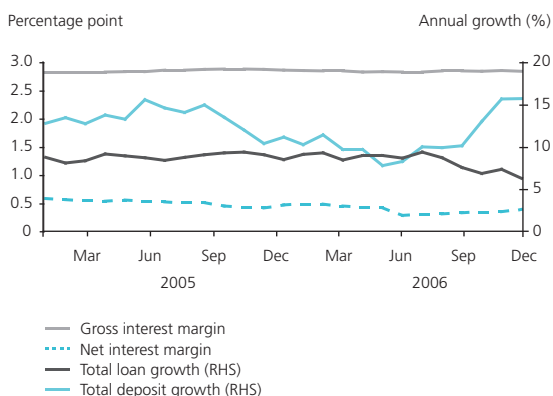


Chart 2.33
Movement in PER and Average Quoted FD Rates

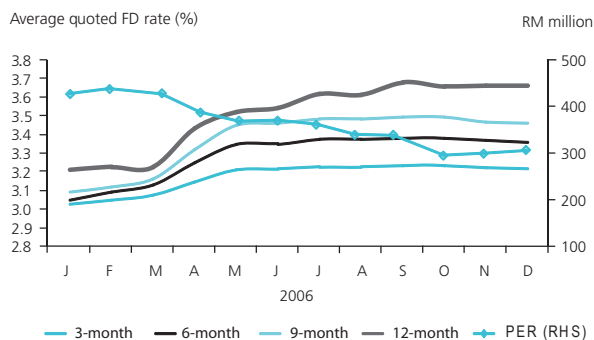
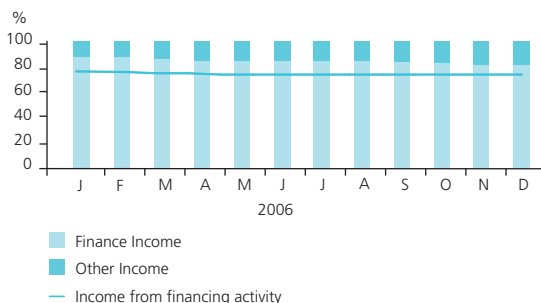


Chart 2.32
Income Composition of Islamic Banking Institutions¹



¹ Includes Islamic windows

Potential impact from market movements remained marginal

The exposure of the banking system to equity and foreign exchange risks remained small and continued to pose minimal risk to systemic stability. In terms of equity, risk exposures arising from holdings of quoted and unquoted shares only accounted for 0.2% and 2.6% of the banking system assets and capital base respectively. Equity holdings increased slightly by 3.4% to RM3.1 billion as at end-2006 attributed mainly to limited acquisition of shares following fewer loan restructuring activities during the year. Likewise, the volume of net trading income remained low, accounting for 6.4% of total banking system income during the year. Financing extended for purchase of securities remained small at 3.3% of

outstanding banking system loans with an NPL ratio of 9.5%.

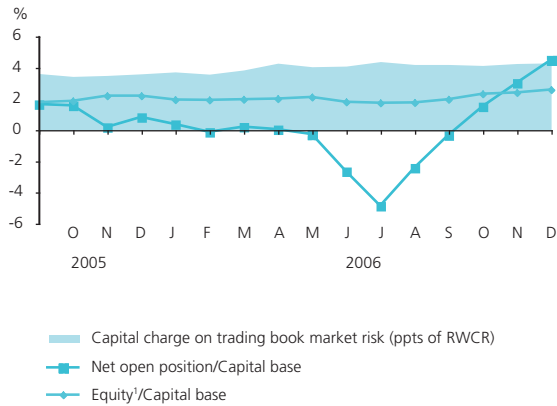
With an aggregate exposure to the equity market, in the form of proprietary holdings and, loans and financing, of only 2% of banking system assets, the risk to the banking sector remained negligible. This was further evident with the recent increased volatility in the equity market in February 2007 that had no impact on the resilience of individual banking institutions as well as the overall financial system.

Meanwhile, on the foreign exchange front, the net open foreign currency position (NOP) exhibited greater fluctuations since the adoption of the flexible exchange rate regime in July 2005. Its level, nonetheless, remained small to account for only 4.5% of capital base. Consistent with this position, total capital charge for market risks in trading books of banking institutions only accounted for 4.3% of capital base. This translates into a one percentage point decline in the risk-weighted capital ratio (RWCR) as at end-2006.

Strong capitalisation providing ample buffer against potential adverse shocks

The banking system was well-capitalised throughout the year as banking institutions continued to diversify and lower the cost of capital while maximising value to shareholders. With RWCR at 12.8%, the current level of capitalisation provides a strong buffer against credit and other risks facing the banking institutions as well as

Chart 2.34
Banking System: Market Risk Exposures



³ Amount of investment in quoted shares

being supportive of continued expansion of lending and trading activities.

Since 2004, there has been active capital management activity to enhance returns to shareholders. The positive spread between US and domestic interest rates as well as expectations of a stronger ringgit spurred the issuance of US dollar-denominated subordinated debt. In addition, greater regulatory flexibility, which recognised innovative capital instruments as Tier-1 capital led to issuances of ringgit-denominated hybrid capital instruments by some banking institutions. The issuance of these hybrid instruments is not expected to dilute the strength of Tier-1 capital as such transactions remained largely limited given that total issuance of innovative Tier-1 capital instruments are capped at 15% of total Tier-1 capital. Tier-1 capital continued to be the major component of banking system capital with the core capital ratio maintained sufficiently high at between 10-12%. The bulk of the Tier-1 capital constituted paid-up capital, retained earnings and reserves, which can provide substantial support against risks accumulation. This was further supported by RM31.9 billion of capital available in the banking system in excess of the minimum capital requirement of 8%.

Ample liquidity environment amidst intensifying competition

Liquidity in the banking system continued to remain ample following higher inflows of export earnings and steady inflows of foreign direct investment and portfolio funds. As at end-2006, the cumulative liquidity surplus of the banking system was projected at RM76.1 billion based on estimated liquidity demands and unexpected withdrawals of up to one-week. On an individual basis, all banking institutions also projected surpluses both in the one-week and one-month buckets, in excess of existing regulatory requirements.

An area of close monitoring is that the increasing competition in an environment of excess liquidity in the banking system could have implications on risk-taking behaviour or risk-pricing by banking institutions.

Insurance and takaful sector sustaining its resilience

The strong performance of the insurance and takaful sector in 2006 contributed towards enhanced

Chart 2.35
Banking System: Components of Capital (% of total)

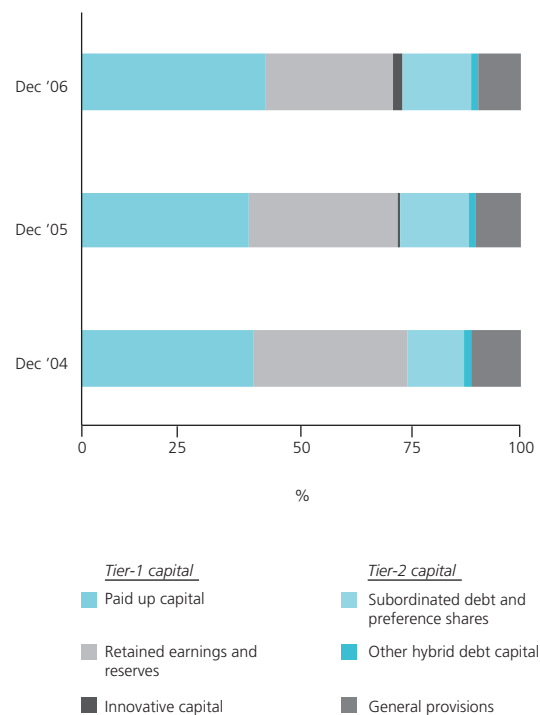


Table 2.4
Banking System: Liquidity Projection as at 31 December 2006

	Cumulative mismatch (RM billion)		Buffer as % of total deposits	
	1-week	1-month	1-week	1-month
Commercial banks	59.5	64.2	10.7	11.5
Islamic banks	8.5	13.1	17.0	26.3
Merchant/Investment banks	8.2	8.5	51.3	53.2
Banking system	76.1	85.8	12.2	13.7

Note: Total may not add up due to rounding

resilience and soundness of the sector. This was further boosted by continued improvement in risk management practices especially in areas of underwriting and investment practices. Overall, these developments led to further strengthening of the capacity of the industry to withstand the more challenging operating environment. No new major risks have emerged whilst existing vulnerabilities remained manageable. The solvency margin ratio for conventional insurers measured in terms of excess of admitted assets over the computed amount stood in excess of 200%, well above the minimum regulatory requirement of 100%. The proposed implementation of the risk-based capital framework for insurers will complement measures aimed at improving risk management practices by insurers. It is also expected to contribute towards more optimal allocation of capital by the insurance sector.

Managing the mismatch in assets and liabilities continued to be a key challenge for life insurance and family takaful businesses. While financial markets have gained depth and breadth, the supply of longer-term financial instruments that are of acceptable quality and yield to match the long-term nature of insurance liabilities, which typically range between 20 to 30 years, remains limited. Reflecting the extent of the mismatch, a survey conducted by the Bank based on life fund positions for the financial year ended 2005 revealed that mismatch risk accounted for up to 17.5% of total capital charges. The introduction of investment-linked products which essentially transfer the investment risk to policyholders, greater flexibility in investment management including investments abroad and the continuous measures to develop the financial markets,

constitute important developments that help life insurers manage and mitigate the effects of mismatch risk. Meanwhile, the impact of developments in the domestic financial markets on the insurance companies was fairly limited. Despite movements in the bond yields, the profitability and thus the solvency positions of insurers were not adversely affected as bonds held by insurance companies are valued based on cost rather than market price.

In respect of general insurance, the increasing trend in escalating court awards for motor accident fatalities and injuries is a source of concern. Added to this is the potential for reduction in reinsurance capacity for unlimited liability covers in relation to bodily injury losses. Moreover, developments in the automotive industry have implications on the performance of the general insurance sector, in particular, the motor business segment. A prolonged period of low sales that is accompanied by increased competition can exert greater pressure for general insurers particularly those that are niche players in this business segment, to seek out new areas of growth in order to diversify their business and sustain future revenue. These developments and their impact on the general insurance industry will continue to be monitored closely by the Bank so as to ensure that such risks are adequately addressed.

Changes in meteorological phenomena and increase in natural calamity events, while not evident and conclusive, could potentially be an emerging source of risk for the insurance sector. Preliminary estimates on gross insured losses stemming from the recent flood incidences in the

southern part of Peninsula were in the region of RM178 million. While some insurers have yet to fully establish the actual extent of the losses, especially in respect of the second and third waves of flood occurrences, those losses are expected to be within manageable levels and will not constitute a threat to the solvency position of the insurance companies.

Due to a recent court case, the long held principle that a fire policy is a contract of indemnity is now in question. The Bank is monitoring developments and reviewing implications of this case, and is studying various policy options on the matter including amendments to the Insurance Act 1996.

RISK ASSESSMENT GOING FORWARD

Global economic growth is expected to be sustained at a level above 4% in 2007. Notwithstanding some weaknesses in the residential and automotive sectors, the US economy is expected to sustain its underlying growth, whilst growth prospects in the euro area is anticipated to improve. In the region, the Japanese economy is expected to strengthen further. Economic conditions across the region are expected to remain favourable and corporate earnings growth is likely to exceed that of companies in developed markets. The sustained growth outlook for Asian economies suggests continuing sizeable portfolio inflows to the region. Meanwhile, on the domestic front, the growth prospects for the Malaysian economy is expected to remain favourable. While the export sector could be impacted somewhat by moderation in the external environment, continuing robust domestic demand including sustained private consumption and investment activity would provide support for the growth momentum of the domestic economy. This would be further complemented by the progressive implementation of the Ninth Malaysia Plan and other development projects such as the Southern Johor Economic Region project, Penang Bridge and Monorail projects which will have positive spill-over effects on the domestic front.

Surveillance efforts in 2007 will focus on developments in the external environment, movements in capital flows and, implications on asset prices and their potential implications on the financial sector will be continually assessed to ensure risks to financial stability will be effectively managed.

Potential risks

Notwithstanding these positive developments, risks to the stability of the financial system continue to be monitored closely. Given the openness of the Malaysian economy and the increased integration with other markets and economies, the country is not insulated from the risks of contagion.

Global growth remains exposed to risks of disorderly adjustment to global imbalances including a sharper-than-expected slowdown in the US economy

While recent developments suggest that the US current account deficit is stabilising, aided by the decline in oil prices and improved growth prospects in other major industrial countries, the risk of a disorderly adjustment cannot be discounted. While the effect of the cooling housing market on the US economy has largely been concentrated in residential property investment, the prospect of further housing market weakness still exists. This is based on the share of residential property investment in GDP which remains above the historical average, the high level of inventories and homeowner vacancy rates, all of which seem to suggest that oversupply persists. Weakness in this market is likely to have an adverse impact on private consumption and capital spending that could lead to a sharper-than-expected slowdown in US growth which could also potentially lead to a diversification of portfolios away from dollar-based assets. Similar pressures could arise from continued monetary

policy tightening in other industrial countries which, in turn, may affect carry trade activities and reduce the support for dollar due to narrowing yield differentials. These risks and vulnerabilities continue to be an area of focus for surveillance at this point in time.

Sudden surge in oil prices could rekindle inflationary pressures

Although oil prices have declined from the July 2006 peak, uncertainties persist as to whether the lower prices would be sustained. A sudden reversal of this trend could increase the potential for slower global growth and rekindle inflationary pressures. Based on the International Energy Agency estimates, global oil demand is expected to rise faster in 2007 by 1.6% compared to 0.9% in 2006. There are also potential supply-

side shocks. With the current spare capacity at low levels, any disruption or further escalation of geopolitical concerns in the key oil-producing economies could lead to another upward oil price spike. Mitigating factors, including investment in new production and refining capacity both within and outside the OPEC, diversification into alternative energy sources and increased conservation efforts, would only be felt in the medium term.

Persistency of capital flows could potentially lead to higher asset prices and formation of asset bubble

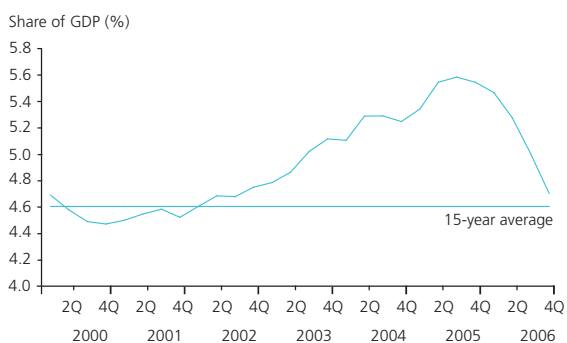
Global financial markets have grown significantly, driven by expanding capital flows and growth of new financial intermediaries. These developments are generally favourable and desirable, and have to a large extent contributed towards the strengthened performance of these markets. At the same time, capital flows could also stimulate growth and contribute towards increased wealth creation. Whilst increased investors' optimism on the macroeconomic conditions and outlook bodes well for these economies, sustained periods of excessive capital flows into financial markets coupled with high capital mobility, could potentially result in the formation of asset price bubbles particularly if the trades are speculative in nature and are not supported by strong fundamentals. Sudden withdrawals by foreign investors that are accompanied by a marked correction of asset prices may pose risk to economies.

In addition, capital flows could also stimulate prices in the real estate market and induce greater activity to take place. Given the size of banking sector exposures to the broad property sector, any material and sustained movements in real estate and property prices could have implications on credit quality of banking institutions' loan portfolios.

Phenomenon of low volatilities and risk premia, and reversal in capital flows could potentially have destabilising effects

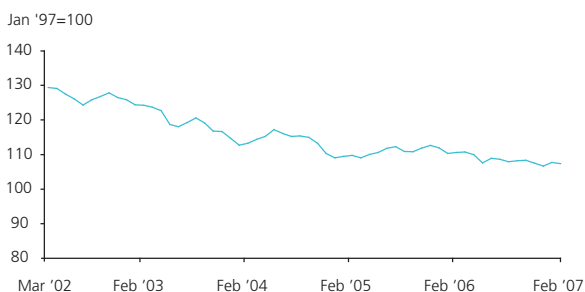
In addition to the implications of movements in asset prices, the build up in exposures particularly in emerging markets raises the vulnerability of

Chart 2.36
US Residential Property Investment as Percent of GDP



Source: Bureau of Economic Analysis, US

Chart 2.37
Trade-weighted Movement of USD



Source: The Federal Reserve Board, US

financial markets to sudden and sharp reversals in capital flows. An impulsive change in expectations or a dramatically heightened risk aversion of investors may lead to a reassessment of risks causing a sharp reduction in asset prices resulting from rapid and disorderly portfolio adjustments and liquidations. Given the potential destabilising effects, such risks continue to be the subject of close monitoring by the Bank so that appropriate and pre-emptive policy measures can be undertaken to address and mitigate the implications.

Outlook for financial system stability remains favourable

The financial system exposures to credit, market and liquidity risks associated with the households

and businesses as well as their involvement in financial markets remain well-contained within prudential limits. While developments in the external environment and domestic market may exert pressures, the robust financial performance and high capitalisation of the financial system following years of strong profit performance and increasingly more diversified revenue base, will enable the financial system to withstand such developments and the attendant shocks and disturbances. The more diversified financial infrastructure and the more developed capital markets will similarly enable the financial system to manage risks more effectively and efficiently.



Malaysia's Anti Money Laundering/ Counter Financing of Terrorism (AML/CFT) Programme

Overview

The national AML/CFT regime is implemented based on strategic collaboration between Bank Negara Malaysia, the authority appointed by the Minister of Finance to administer the Anti Money Laundering Act 2001 (AMLA), and the relevant government agencies and supervisory authorities. The AML/CFT programme is aimed at preventing Malaysia's financial institutions as well as the designated non-financial businesses and professions from being targeted as the conduit for money laundering and financing of terrorism activities. The strong support given by the other supervisory authorities, law enforcement agencies and the private sector, in particular, financial institutions, has been instrumental in ensuring the successful implementation of the AML/CFT programme. The effective implementation of the AML/CFT regime is a key area of focus in ensuring that Malaysia's financial system remains resilient and able to facilitate and support the economic growth process.

The experience suggests that the main source of money laundering originates from illegal proceeds of drug trafficking activities as evidenced by the proceeds seized or confiscated under the Dangerous Drugs (Forfeiture of Property) Act 1988 [DD(FOP)]. However, the drug trafficking problem in Malaysia has been mitigated by the constant and vigorous enforcement carried out by the Royal Malaysia Police which enforces the DD(FOP).

Thus far, the Attorney-General's Chambers of Malaysia has prosecuted 21 money laundering cases, of which, two cases were convicted in 2005 and 2007 respectively. The other 19 cases are at various stages of prosecution. These cases involved a total of 738 charges of money laundering offences with an accumulated amount of RM262.1 million.

At the regional and international level, Malaysia continues to play an active role within the Association of Southeast Asian Nations (ASEAN) by fostering efforts to enhance regional capacity building of personnel involved in the effort to counter money laundering and terrorist financing activities.

Recent Developments in the National AML/CFT Programme

Extension of the AMLA Regulatory Net

Continuous efforts have been undertaken to extend the implementation of the AMLA to other categories of reporting institutions. This is complemented by outreach initiatives to raise the awareness on AMLA requirements to new as well as prospective reporting institutions. In 2006, the AMLA regulatory net was extended to include moneylenders, pawnbrokers, registered estate agents, unit trust management companies, fund managers, futures fund managers, trust companies, the Malaysia Building Society Berhad, non-bank remittance service providers and non-bank affiliated issuers of charge cards and credit cards.

The extension of the AMLA provision has been undertaken in two stages beginning with the invocation of the reporting of suspicious transactions, followed by the remaining provisions under Part IV of the AMLA that deal with customer due diligence and compliance programme. These remaining legislative provisions in Part IV were invoked on gaming establishments, a development financial institution, company secretaries, accountants, lawyers and notaries public on 10 August 2006.

Cash threshold reporting (CTR) requirement of RM50,000 and above in a day was invoked in September 2006. Banking institutions were the first group of reporting institutions required to submit CTR to Bank Negara Malaysia under the AMLA. The invocation of the CTR complements the mandatory legal obligation imposed on banking institutions and other categories of reporting institutions to submit suspicious transaction reports (STR). These submissions by the banking institutions are expected to enhance the analysis of the financial intelligence currently conducted by Bank Negara Malaysia.

Enhancing AMLA Regulatory & Supervisory Mechanism

I. AML/CFT Guidelines

A set of revised AML/CFT Guidelines were issued in November 2006 to the banking institutions and insurance and takaful industries to replace the guideline on “Know Your Customer Policy” (GP9) and JPI/GPI 27 Guidelines on Anti-Money Laundering that were issued in 1995 and 2001 respectively. These revised AML/CFT Guidelines specify the regulatory requirements that are in line with the Financial Action Task Force on Money Laundering (FATF)’s 40+9 Recommendations and the AMLA. Among others, the revised Guidelines place significant emphasis on effective oversight by the Board of Directors to ensure that the policies and procedures adopted by the institution are in compliance with the AMLA and the related regulatory requirements.

II. Compliance Monitoring

The policy measures in 2006 continue to focus on ensuring AML/CFT compliance and the effectiveness of the AML/CFT internal programme established by the reporting institutions. The designated compliance officer at each reporting institution plays an important role to ensure that the reporting institution adopts, develops and implements internal AML/CFT programmes, policies and controls to guard against and to detect money laundering or financing of terrorism offences. The reporting institutions are also required to carry out an independent audit on the internal AML/CFT compliance programme to ensure that their internal AML/CFT measures are effective, up to date and comply with the requirements of AMLA and regulatory guidelines that are issued by Bank Negara Malaysia. Consistent with this policy, Bank Negara Malaysia has implemented a comprehensive AMLA supervisory framework to facilitate effective supervision of the financial institutions’ AML/CFT measures. The continuous surveillance of the AML/CFT programmes by the supervisors has contributed significantly towards improved compliance of the institutions to international standards on AML/CFT as well as the quality of STRs submitted to Bank Negara Malaysia.

III. Leveraging on Information and Communication Technology

Bank Negara Malaysia has also embarked on a project to enhance its Financial Intelligence System (FINS) since November 2005, to among others, enable online submission of CTRs by the banking industry. In addition, FINS would also enhance the quality and timeliness of the financial intelligence analysis through the use of advanced intelligence analytical software, case management tools and information dissemination software. The newly added features of FINS would also significantly facilitate the law enforcement agencies in expediting investigations.

International Co-operation

Asia/Pacific Group on Money Laundering Mutual Evaluation Exercise

Malaysia has now undergone a second round Mutual Evaluation Exercise conducted by the

Asia/Pacific Group on Money Laundering (APG) in February 2007. The purpose of the Mutual Evaluation (ME) is to assess member countries' compliance with the international standards, namely, the Financial Action Task Force on Money Laundering (FATF) 40 Recommendations on money laundering and 9 Special Recommendations on terrorist financing. Unlike the APG ME in 2001, the ME in 2007 is based on the FATF **revised** 2004 Methodology that sets out over 250 essential criteria for the 40+9 Recommendations. It covers Malaysia's legal system, related institutional measures, preventive measures in financial institutions and designated non-financial businesses and professions, as well as, national and international co-operation.

Consistent with the international trend, laws need to be put in place to criminalise acts of terrorism and terrorist financing. In this connection, the relevant legislative provisions in Malaysia have been brought into force in March 2007. The ME is expected to highlight areas in which Malaysia has yet to comply with the FATF standards and recommendations by assessors to address any identified gaps that still remain. These recommendations will be incorporated in the Mutual Evaluation Report that will be forwarded for adoption at the APG Annual Meeting in July 2007.

Egmont Group of Financial Intelligence Units

Bank Negara Malaysia is a member of the Egmont Group of Financial Intelligence Units (FIUs) since July 2003. The objective of the Egmont Group is to provide support for FIUs to improve their respective national AML/CFT programmes. This support includes expanding and systematising the exchange of financial intelligence among its 100 members, and improving expertise and capabilities of the intelligence personnel. The Egmont Group, which is an informal grouping, provides opportunities for Bank Negara Malaysia and other FIUs to rapidly exchange critical information on transnational crime. Currently, this grouping is in the process of formalising its structure. As the Chair for Asia, Malaysia is a member of the Implementation Committee that oversees the initiatives to formalise the Egmont Group through the setting up of a Permanent Secretariat in Toronto, Canada and the drafting of the Egmont Group Charter Document.

Memorandum of Understanding (MoU) on the Sharing of Financial Intelligence

Bank Negara Malaysia continues to promote the importance of cross-border sharing of financial intelligence and capacity building of officials. In June 2006, Bank Negara Malaysia signed an MoU with the People's Bank of China to exchange financial intelligence as well as co-operation in the area of staff training. In addition, MoUs were also signed with the FIUs of Australia, Indonesia, the Philippines and Thailand to share financial intelligence. More MoUs are scheduled to be signed once the deliberations are completed.

Technical Assistance/Partner Support Programme

Bank Negara Malaysia continues to provide technical assistance in anti-money laundering efforts to its ASEAN partners. In October 2006, Bank Negara Malaysia with the collaboration of the FIU of Australia and a domestic banking institution, conducted a technical assistance programme for two state-owned commercial banks from the Lao People's Democratic Republic to establish a basic AML/CFT regime that is in line with international standards. This technical assistance was funded by the Asian Development Bank as part of its Banking Sector Reform programme. In addition, Bank Negara Malaysia also provided resource persons to various AML/CFT training programmes organised by international organisations including the International Monetary Fund and the World Bank.

Capacity Building

Human Capital Development

I. Certified Financial Investigator Programme (CFIP)

The National Co-ordination Committee to Counter Money Laundering (NCC), being the highest policy making body for the AML/CFT programme, continues to play its significant role in harnessing the expertise of its members which comprise 13 Ministries and Government agencies. Under the leadership of the NCC, the inaugural CFIP, which was introduced in March 2006, saw a total of 24 officers from the supervisory authorities as well as the law enforcement agencies graduating in December 2006. The CFIP aims at raising the level of professionalism and enhancing the skills and knowledge of financial investigators in fulfilling their tasks and duties to curb financial crimes. It also represents a major milestone in Malaysia's effort to enhance capacity building initiatives with a view to develop a pool of qualified financial investigators.

II. Workshops for Compliance Officers

Taking cognisance that reporting institutions' compliance officers are responsible for implementing the AML/CFT internal programmes, capacity building programmes were also organised by the respective training institutes to provide the necessary continuing professional education in the field of AML/CFT. These training workshops provide the compliance officers with the latest information on money laundering typologies as well as contribute towards better understanding of internal risk controls for enhanced AML/CFT procedures and controls in the institution.

III. ASEAN SOMTC Training Initiatives

Malaysia, as part of its leadership role on money laundering at the ASEAN Senior Officials Meeting on Transnational Crime (SOMTC), successfully organised the Basic and Advanced Net Worth Analysis Workshops in March and July 2006 respectively. The workshops constituted part of the work plan for the ASEAN+3 (China, Japan and Republic of Korea) Cooperation to Combat Transnational Crime and were organised by Malaysia's Ministry of Internal Security, in collaboration with Bank Negara Malaysia and the Inland Revenue Board of Malaysia. The workshops aimed to promote the upgrading of knowledge and skills required in financial investigations, so as to enhance regional capabilities in investigation, intelligence gathering, surveillance, detection, and monitoring of money laundering and other criminal activities. The participants for the workshops consisted of officers from law enforcement agencies and FIUs in the ASEAN+3 countries.

Future training initiatives will continue to emphasise on enhancing knowledge and skills of law enforcement officers in the investigation of money laundering and terrorist financing activities. Meanwhile, co-operation with foreign agencies including participation in relevant training programmes organised by foreign training providers will facilitate the sharing of experience and expertise among the enforcement community.

AML/CFT Awareness Programmes

I. Study Visits by Foreign Parties

Bank Negara Malaysia continues to assist other foreign counterparts by sharing our experience in the AML/CFT programme. In 2006, the FIU received study visits from Bank Indonesia, Da Afghanistan Bank, and the FIU of Sri Lanka.

II. Non-Profit Organisation (NPO)

The international AML/CFT community places attention to NPOs in view of the potential use of NPOs to finance terrorism. The APG has requested that its members conduct domestic review

of the NPO sector with the objective of reviewing the adequacy of the legislative and regulatory requirements to prevent or detect such activities. In this respect, an NPO sector review was jointly organised by Bank Negara Malaysia, the Registrar of Societies and the Inland Revenue Board of Malaysia. The review showed no significant regulatory weakness in the sector. Nonetheless, Bank Negara Malaysia in collaboration with the Registrar of Societies, has embarked on a nationwide awareness programme beginning in October 2006 to enlighten NPOs on Malaysia's AML/CFT regime and the potential vulnerability of NPOs to abuse by terrorist financiers and other criminals.

Challenges Ahead

Moving forward, Bank Negara Malaysia in collaboration with other members of the NCC will continue to be vigilant and responsive to evolving AML/CFT threats, as well as AML/CFT standards and trends. A key challenge for regulators is in striking an appropriate balance, in terms of the regulatory focus, between overall risks pertaining to the financial system and those relating to AML/CFT. There are currently also no globally accepted models that can be used to quantify money laundering or terrorism financing risk in a given financial system. As such, the studies conducted by international bodies such as the FATF, the APG or the World Bank on AML/CFT threats would continue to be used to formulate best practices in Malaysia.

The scheduled expansion of the AMLA regulatory net to other categories of financial institutions and designated non-financial businesses, such as real estate agents, e-money issuers, dealers in precious metals/stones as well as leasing and factoring companies, requires the NCC to develop appropriate regulatory measures that are practical and provide adequate safeguards against abuse by perpetrators of criminal activities. In this respect, the disclosure system needs to be supported by a robust suspicious transaction reporting mechanism. This will be reinforced by an expanded collaborative relationship among the stakeholders, in particular the NCC members. In this regard, Bank Negara Malaysia will continue to accord attention to the development of the legislative and regulatory requirements that are in accordance with international standards and will also intensify efforts to enhance co-operation amongst domestic agencies.