



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

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Financial Stability and Payment Systems Report 2007

The Financial Stability and Payment Systems Report 2007 covers Bank Negara Malaysia's assessment of key risks and trends in the financial system, and potential implications for the effective functioning of the system. The Report also reviews developments surrounding the transformation of the financial sector and payment systems, as well as key regulatory and supervisory initiatives to promote financial stability. Its purpose is to promote increased understanding of issues and developments that affect financial system stability.

Assessment of Risks and Financial Stability Outlook

The Malaysian financial system remained resilient throughout 2007 despite challenging external conditions marked by a slowing United States (US) economy, rising global inflationary pressures, increased risk aversion by market participants and more volatile financial markets. The US subprime crisis, while widespread in its impact on some markets, has had minimal impact on the liquidity of the domestic banking system, and on the operations, profitability and solvency of Malaysian financial institutions. Exposures by financial institutions of securities linked to US

subprime mortgages and lending to affected entities accounted for only 0.3% of the banking system capital base. On the whole, financial institutions in Malaysia remained well capitalised throughout the year. The risk-weighted capital ratio (RWCR) of banking institutions remained comfortably above 13% throughout 2007, while insurers ended the year with a solvency margin ratio of 120.6%, both well above the regulatory minimums. In addition, the foundations for long-term stability have continued to strengthen with ongoing improvements in risk management capabilities, governance and operating efficiencies. Interbank and money markets remained amply liquid, with interbank rates holding steady throughout the year and banking institutions maintaining adequate liquidity buffers. Both the large value and retail payment systems functioned efficiently and did not encounter major disruptions during the year. These conditions enabled the Malaysian financial system to continue functioning effectively throughout the year.

Total financing extended to businesses through both the banking system and capital market expanded by 14.1% in 2007. Private investments by businesses remained robust, while demand for financing by households also remained strong with outstanding housing loans and securities financing facilities growing by 5.9% and 11.1% respectively. Overall, outstanding loans from the banking system grew at a stronger pace of 8.6%, while outstanding private debt securities (PDS) expanded by 15.2%. In the insurance sector, life insurers registered a 6.1% growth in new premiums while new family takaful business grew 15.8%, driven mainly by the growing demand for investment-linked products. The general insurance sector also maintained its positive, albeit more modest, growth momentum, increasing by 4.3% in terms of gross direct premiums.

Downside credit risk remained low and manageable. Despite more intense competition weighing down on margins, credit discipline has been maintained. The net non-performing loan (NPL) ratio improved to 3.2%, its lowest level in a decade, underpinned by higher recoveries and the reclassification of NPLs to performing status. The structural characteristics of Malaysian housing finance provide sufficient incentives for banking institutions to control and monitor the quality of the loan portfolio on a continuing basis. This has been borne out by an improvement in asset quality observed in the housing finance segment which saw the NPL ratio decline to 7% in 2007 (2006: 8.7%). The robust overall growth in the business sector, despite weaker exports in some industries, supported further improvements in the delinquency rates. The NPL ratio for the business sector improved to 7.9% in 2007, from the 10.2% registered a year earlier.

Preliminary unaudited pre-tax profits of banking institutions amounted to RM17.7 billion (2006: RM12.9 billion) for the year, mainly attributed to efficiency and productivity gains resulting from ongoing rationalisation efforts and investments in technology, as well as higher income from treasury and other fee-based activities. Life insurance and family takaful businesses also reported increased excess of income over outgo of RM15.3 billion (2006: 12.5 billion), while general insurance and general takaful businesses saw a decline in operating profits to RM1.4 billion (2006: RM1.5 billion), attributed to lower underwriting profits due to sluggish motor vehicle sales and higher claims.

The Malaysian financial system is in a strong position to withstand the expected challenging external environment of further deteriorating credit conditions, continued asset price volatility and corrections in the global financial system before conditions improve. This resilience is supported by stronger balance sheets of households and corporations. While the debt servicing capacity of corporations (based on a sample of 100 listed companies) remained unchanged from the year before with the interest coverage ratio of 5.7 times, listed companies achieved their highest returns on assets and equity since 2000 of 7% and 13.9% respectively. This will add further to buffers accumulated in businesses over the years to withstand the challenges that may be posed by weak export demand in addition to persistently high raw material and energy prices in the year ahead. The stronger wealth positions and improved indebtedness levels of households as well as favourable labour market conditions will place households on a better footing to adjust to higher living costs. Household financial assets expanded strongly by 15.1%. The household financial assets to debt ratio improved to 217.8% (2006: 204.2%), while the ratio of household debts to nominal GDP declined to 66.7% (2006: 69.3%).

The resilience of the financial system is further augmented by the increased risk bearing capacity of financial institutions which are in a healthy financial position. Stress tests conducted by the Bank have also affirmed the financial system's capacity and ability to withstand a range of adverse conditions. As at end-2007, excess capital (above the regulatory requirement) in the banking sector amounted to RM38.5 billion, providing a substantial buffer to absorb potential losses with minimal impact on capitalisation. Similarly in the insurance sector, a solvency surplus of

RM1.1 billion would still be maintained even under an extreme scenario of adverse equity price movements.

The implementation of the revised capital adequacy frameworks – Basel II for conventional banking institutions, the Capital Adequacy Framework for Islamic Banks, and the Risk-Based Capital framework for insurers – will further ensure that regulatory capital requirements are robust and more closely aligned with specific risk profiles of individual institutions. Strengthened regulatory requirements and supervisory expectations, including the move towards a more principle-based regulatory regime and more rigorous supervisory assessments under the Bank's risk-based supervisory framework (RBSF), have also rapidly accelerated the adoption of improved risk management practices by financial institutions.

The payment systems are also highly robust. Fraud in the retail payment systems remains insignificant, with sustained initiatives by the Bank, payment systems operators and other regulatory authorities to combat this risk. Settlement risk has also been reduced significantly following the establishment of Payment versus Payment (PvP) and Delivery versus Payment (DvP) links with Hong Kong which facilitate the simultaneous settlement of ringgit and US dollar payments and securities.

Development of the Financial Sector

The development of the financial sector remained an important agenda to strengthen the foundations for long-term stability and sustainable growth. A more diversified financial system continued to evolve in 2007. The role of the capital

market as a source of funds and avenue for risk diversification gained increasing importance. Debt security issuances during the year increased to RM302 billion (of which RM66.5 billion were PDS), representing a significant increase of 65.3% from issuances in 2006. This has bolstered business efficiency and growth, while dispersing the concentration of credit risk from the banking sector. Total PDS as a percentage of total bank loans and financing extended to corporates was 56.2% in 2007. The more liberal foreign exchange administration policies that have been introduced in recent years also saw the turnover of foreign exchange transactions by non-residents more than double over the previous year, thereby contributing to the development of a more active foreign exchange market to support the effective management of foreign exchange exposures.

The development of Islamic finance gained further momentum. Malaysia strengthened its lead in global sukuk issuances, adding further to the breadth and depth of the domestic capital market. As at end-2007, sukuk originated in Malaysia accounted for 68.9% of global outstanding sukuk. Additional flexibilities in the areas of tax, foreign exchange administration, immigration and foreign ownership rules as well as simplified regulatory processes were also introduced under the Malaysia International Islamic Financial Centre (MIFC) initiative. These incentives together with the comprehensive infrastructure and diversity of players in Malaysia continued to attract significant foreign interest in Malaysia as a preferred centre for sukuk issuances.

Existing institutional structures supporting Islamic financial business were substantially strengthened as two locally-incorporated foreign banks (LIFBs) and the

remaining domestic banking institutions with window operations took steps to transform these operations into full-fledged Islamic banking subsidiaries, thus providing a stronger and dedicated platform to expand the business. A greater diversity of players was also achieved with the approvals granted to two more existing LIFBs to establish Islamic window operations, one new international Islamic bank and two new retakaful players. As part of our efforts to contribute to the continued development of Islamic finance, Bank Negara Malaysia is establishing the International Shariah Research Academy for Islamic Finance (ISRA) within the International Centre for Education in Islamic Finance (INCEIF) to spearhead research in Shariah matters is expected to further expand understanding in new areas of Islamic banking and finance, drive harmonisation in prudential practices and promote mutual recognition of Shariah interpretations, which are essential to the long-term development of Islamic finance.

A key challenge for the financial sector has been the more intense competition for highly-skilled financial professionals. During the year, staff-related expenditure rose by 13.2%. The average staff cost per employee correspondingly increased to RM77,519 (2006: RM74,786). This has however been accompanied by productivity gains, which saw higher profit before tax (PBT) generated per employee of RM168,094 (2006: RM131,785). To meet the immediate demands for talent in the industry, the Financial Sector Talent Enrichment Programme (FSTEP), developed by the financial services industry in collaboration with the Bank, was launched in November to equip new graduates with the essential practical knowledge and skill sets to fill more than 2,000 existing entry-level vacant positions in the industry. Various initiatives were also taken forward to complement the development of

relevant teaching and learning resources in line with the demands of the market and to enhance existing complementarities between the various training providers.

Bank Negara Malaysia continued to promote broad-based and balanced growth through financial inclusion. Loans to small and medium enterprises (SMEs) approved by banking institutions and development financial institutions (DFIs) grew strongly by 34.3% to RM63.2 billion in 2007. The microfinance initiative, introduced in 2006, saw a further RM224.7 million in outstanding financing extended by nine financial institutions to more than 22,000 customer accounts in this category. The strengthened financial position of Bank Pertanian Malaysia, with its paid-up capital increased to RM1 billion following its corporatisation in December, will enable it to further support growth in the agriculture sector. This complements two venture capital funds, established earlier by Bank Negara Malaysia and two other banking groups, totalling RM300 million, aimed at modernising farming, fisheries and livestock practices, as well as to finance new technology-intensive agriculture projects, including biotechnology.

The comprehensive advisory and supporting network for SMEs continued to be enhanced. New initiatives in 2007 included the establishment of the SME Business Advisers Network as a platform for SME business advisers to share expertise, an initiative to set up the SME Credit Bureau which will facilitate credit evaluations of SMEs by financial institutions and the extension of the Basic Banking Services Framework to SMEs. Moving forward, the SME Central Coordinating Agency will be formed as a single Government agency dedicated to spearhead the

development of SMEs across all sectors of the economy under a coordinated national strategy.

The consumer redress and protection framework was enhanced further with the launch of the BNMTELELINK in July 2007 to complement existing channels for the general public to obtain information and seek assistance in relation to financial services. The Credit Counselling and Debt Management Agency also continued to play an important role in helping individuals in managing debts, providing assistance to more than 5,000 individuals with aggregate debts of RM478 million under its debt management programme since its establishment in 2006.

To promote cost effectiveness and efficiency in payment systems, initiatives were undertaken to enhance the payment infrastructure, foster the adoption of new technologies and provide support to stakeholders for the migration to electronic payments. A major initiative in 2008 will be the adoption of the Cheque Truncation and Conversion System (eSPICK), a fully image-based cheque clearing process, which will expedite the receipt of funds by beneficiaries while providing cost savings through the elimination of physical handling and transportation of cheques. This process will reduce the time for the receipt of funds by beneficiaries to one business day, compared to the two to eight business days currently.

Several payment innovations and electronic payment applications were introduced during the year, including the first international mobile-to-mobile money transfer service and mobile remittance services using short messaging services, mobile operator outlets and prepaid cards. On a broader scale, the adoption of

various electronic payment applications by the Government has contributed towards accelerating the pace of migration to electronic payments in the economy. This move by the Government has been strategically important in encouraging the wider use and acceptance of electronic payments in the country. In 2007, the value of Government payments made through electronic channels increased significantly by almost three times from RM16.7 billion in 2004 to RM64.9 billion.

Overall, the number of transactions from all electronic payment channels and modes increased in 2007. Electronic payment transactions made per capita increased to 32.5 transactions in 2007, from 13.8 in 2003. The increase was most evident in the usage of payment cards, mainly in the form of e-money. E-money accounted for nearly half of the electronic payment transaction volume, which was mainly attributed to the ease and convenience of using the Touch 'n Go card for payments in the transportation sector. Notable growth was also recorded in other electronic payment channels such as MEPS Interbank GIRO, Financial Process Exchange (FPX) system, internet banking and mobile banking. The implementation of the Roadmap for Migration to Electronic Payments which was finalised in 2007 will further reinforce this trend.

Priorities in 2008

The focus in 2008 will be on effective surveillance, institutional development, and financial market infrastructure development. The Islamic financial system and the foreign exchange market will be further developed to complement the other components of the financial system. In the area of surveillance, continuous enhancements will be made to the Bank's macroprudential surveillance and

supervisory architectures. Attention will be directed at strengthening the crisis management framework, and further developing the Bank's surveillance tools, in particular to facilitate a more integrated and predictive approach towards risk assessments.

The promotion of a more efficient and competitive financial system, will be balanced by ensuring growth is broad-based. In this regard, financial inclusion efforts will continue to be directed at supporting access to financing to SMEs, including micro enterprises, that will become more significant in the economy.

Bank Negara Malaysia
26 March 2008