BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Ref. No.: 03/07/04

EMBARGO: Not for publication or broadcast before 1800 hours on Wednesday, 21 March 2007

PRESS RELEASE

Financial Stability and Payment Systems Report 2006

Bank Negara Malaysia releases the inaugural publication of the Financial Stability and Payment Systems Report 2006 today.

The Report aims to promote better understanding on issues and challenges to financial stability. The Report highlights the Bank's assessment of key risks and vulnerabilities to financial stability arising from developments in the domestic and global environment. Reflecting the developmental role of the Bank, the Report also covers the efforts made in shaping and transforming the financial sector and payment systems in Malaysia and the progress that has been achieved.

Assessment of risks and implications on financial stability

The financial system remained resilient and healthy amidst a backdrop of domestic and global developments that took place during the year. The resilience has been the outcome of enhanced risk management capability and strengthened governance and oversight of the financial institutions, supported by the progress achieved in financial infrastructure development and a more robust regulatory and supervisory framework. The stronger financials and

strong profit performance recorded in recent years have enhanced the capability and capacity of the financial system to weather challenges and increased competition during the year. Trends in key financial soundness indicators have remained favourable throughout the year.

The banking sector's risk weighted capital ratio (RWCR) stood strong at 12.8% as at end-2006 (end-2005: 13.7%), supported by preliminary pre-tax profit of RM13 billion (2005: RM12.4 billion) and return on equity of 16.1% (2005: 16.7%). Asset quality of the banking sector improved with net NPL ratio based on 3-month classification basis declining to 4.8% (2005: 5.8%). The more diversified portfolio mix and enhanced loan administration and management have strengthened the capacity of the banking sector to deal with the challenges faced by both the households and businesses primarily in the early part of the year. The higher interest rate environment and several periods of increased volatility in the financial markets had minimal impact on banking system stability. Similarly, the banking sector's low exposure to equities insulated it from movements in equity prices, whilst exposures to foreign currency movements continued to be maintained at prudent levels.

The Islamic banking system remained well-capitalised, supported by improvement in higher pre-tax profit. Both RWCR and core capital ratio was strong at 16.6% and 12.6% (2005: 14.3% and 11.6% respectively) respectively as at end-2006. Preliminary unaudited profit before tax for Islamic banking system grew by 9.6% to RM1.7 billion whilst return on assets and return on equity stood at 1.3% and 16.4% respectively. This favourable result was largely contributed by growth in financing income, income from funds placement and recoveries from non-performing assets.

The overall insurance and takaful sector has also remained sound. Solvency surplus for the insurance industry was sustained at comfortable levels of RM16 billion (on an unaudited basis) as at end-2006 albeit higher claims experienced primarily from the motor business. Operating profits for general insurance and takaful was sustained at RM1.5 billion whilst the excess of income over outgo for life insurance and family takaful expanded

by 17.8% to RM12.4 billion (2005: -7.6% to RM10.6 billion). This was achieved on account of stable growth in premiums and contributions, and the favourable investment climate during the year. The resilience of the sector was further boosted by improvement in risk management practices especially in areas of underwriting and investment practices. Combined premiums and contributions registered a growth of 6.8% to RM26.6 billion (2005: 7.4% to RM24.9 billion), driven primarily by the strong growth in investment-linked business which offset the lower business volume in the motor sector as well as the softening of premium rates for commercial property, aviation and cargo risks.

The takaful industry continued to register stronger performance during the year. Combined takaful contributions increased to RM1.7 billion whilst total assets expanded by 17.9% to RM6.9 billion. New business contributions for family takaful increased strongly by 74.6% to RM1.3 billion (2005: 725.5 million). This was contributed mainly by expansion in the mortgage and investment-linked businesses which accounted for 68.2% of new business. The general takaful maintained its strong growth momentum in 2006 with gross direct contributions increased by 29.4% to RM713.7 million attributed by higher contributions in the motor and fire businesses.

Both the business and household sectors exhibited strong resilience to the environment of higher prices, transportation cost and interest rates. In the corporate sector, stronger profit performance and stable leverage position resulted in an improvement in the debt servicing capacity to 5.3 times. Average return on assets of selected listed corporations improved to 1.4% in the third quarter, whilst the debt-to-equity ratio remained almost flat at 56.3%. Meanwhile, household debts grew at a moderate pace of 9.8% in 2006 after six years of rapid growth to stabilise at 72.3% of gross domestic product, underpinned by the more subdued housing and automotive markets. In addition, strong growth in financial assets contributed to an increase in wealth and correspondingly, improved financial positions of households. At end-2006, the household financial assets to debt ratio was 205.1% compared to 201.2% at end-2005. The debt service ratio of households appeared to have

stabilised with the overall credit quality exhibiting improving trends. At end-2006, the NPL ratios declined to 10.1% and 7.1% for businesses and households respectively.

Transformation of the Financial Sector and Payment Systems

Significant progress was achieved during the year in the transformation of the Malaysian financial sector and in the area of payment systems oversight and infrastructure. Progress was wide ranging with significant accomplishments recorded in the area of Islamic finance, rationalisation of the financial sector, deepening of financial markets and financial inclusion as well as in enhancing safety and reducing systemic risks in the payment systems. This was complemented by organisational transformation within the financial stability arm of the Bank.

The financial landscape was rationalised further during the year with the creation of investment banks and the completion of mergers of two commercial banks and two insurance companies. A significant milestone was also achieved during the year with the emergence of investment banks, arising from the rationalisation of merchant banks, stockbroking companies and discount houses. Three universal brokers also successfully paved their way to become investment banks, having met the necessary pre-requisites. In the area of Islamic finance, the year also saw the commencement of business by new Islamic licensees as well as the transformation of 'Islamic windows' of several conventional banks into Islamic subsidiaries. The Bank also approved two retakaful licences.

Further progress was achieved in developing the financial markets and in promoting and strengthening consumer education and protection framework. Measures were directed at increasing market liquidity in secondary trading, strengthening documentation for repo transactions and creating an enabling environment for the offering of new products and entry of new participants. In 2006, the development financial institutions (DFIs) are allowed to participate in the interbank market and issue and trade NIDs and

Islamic Negotiable Instruments. Being a participant of the interbank market, DFIs have the added flexibility and efficiency in managing funds. Another major milestone was the commencement of operations of the Credit Counselling and Debt Management Agency in April 2006 that has since provided debt management assistance to more than 2,000 individuals.

The regulatory philosophy continued to evolve towards facilitating an environment conducive for innovation, and fostering equitable and efficient competition towards the development of a more diversified, efficient and customer-centric banking sector. Emphasis continued to be accorded to ensure the smooth transition to Basel II, and in the case of Islamic banks, the proposed implementation of the Capital Adequacy Standards issued by the Islamic Financial Services Board. The Bank has also finalised a risk-based capital framework for insurers, due for implementation in 2008. In addition, efforts were also directed at enhancing convergence with developments in Financial Reporting Standards and introducing greater flexibility in investment and product offerings. On the supervisory front, initiatives were focused at enhancing collaboration and co-operation between the Bank, the Securities Commission and Malaysia Deposit Insurance Corporation.

The Bank continued to accord significant emphasis on financial inclusion with the aim of ensuring that all levels of society have access to financial products and services. During the year, the Bank embarked on an important strategy to promote the development of the microfinance industry in Malaysia to complement the existing Government-sponsored microfinance programmes. These include measures to enhance the role of DFIs as microfinance providers, promote the participation of banking institutions in microfinance and develop a “Graduation Programme” to enable micro enterprises to obtain the right type and amount of financing as their businesses grow. The Bank has also embarked on several initiatives to ensure continuous access to financing by the agriculture and agro-based sectors which include the restructuring of Bank Pertanian and the setting up of two venture capital funds amounting to RM300 million. In addition, the Bank

also established a RM1 billion Overseas Project Fund at the EXIM Bank to finance overseas projects by Malaysian companies.

A significant development in the area of Islamic finance was the launch of the Malaysia International Islamic Financial Centre (MIFC) initiative in August 2006 that provides for a holistic approach to further enhance the country's competitive advantage in this area. This is to be realised through efforts that focus on positioning Malaysia as the gateway to tap regional investment opportunities and as a centre of origination, distribution and trading of Islamic instruments and services as well as positioning Malaysia as a centre of excellence in Islamic finance education, training, consultancy and research.

Key measures introduced in 2006 include the formation of the MIFC Executive Committee that acts as the single coordinating committee to oversee the implementation of MIFC policies, issuance of new types of licences, namely International Islamic Banks and International Takaful Operators, and the establishment of International Currency Business Units by Malaysian Islamic institutions.

Given the importance of a well-functioning payment system towards maintaining financial stability, the promotion of a secure, safe and efficient payment system remains the main focus of the Bank.

In November 2006, the Bank in collaboration with the Hong Kong Monetary Authority, successfully implemented the Payment versus Payment (PvP) infrastructure for settling interbank Ringgit US dollar trade transactions. The establishment of the direct link between RENTAS in Malaysia for the settlement of ringgit and the USD CHATS system in Hong Kong for the settlement of the US dollar provides for the simultaneous settlement of ringgit in Malaysia and US dollar in Hong Kong during Malaysian business hours thereby eliminating the settlement risk for ringgit and US dollar FX transactions. Up to December 2006, 44% of the total ringgit-US dollar FX

trades and 86% of ringgit-US dollar transactions between the participating banks were settled through the system.

As operational vulnerabilities can exacerbate various risks in payment systems which may lead to disruptions and affect the stability of the financial markets and undermine public confidence, the Bank continued to place emphasis on operational robustness, security and contingency planning for the systemically important payment systems (SIPS) and other major payment systems. High priority was placed on business continuity planning to ensure the uninterrupted availability of the payment systems through its Disaster Recovery Centre (DRC) for RENTAS and SPICK operations. Market players were also required to take a proactive approach in ensuring that their respective off-site disaster recovery sites are readily available at any time to address any contingency need.

The year also saw the entry of non-bank players in the credit card, electronic money and remittance services sector. This was in response to the Bank's efforts to enhance efficiency and provide greater convenience to the public, in the retail payments arena through increased competition and innovation. To promote the ATM as an electronic payment access point, the ATM network and functionalities were expanded to allow interbank funds transfer on a real-time basis, bill payments via barcode readers installed on the ATMs, Interbank Giro funds transfer to third parties and cross border cash withdrawals in Indonesia, Thailand and Singapore.

With the necessary payment infrastructure in place, supported by the effectiveness of the financial sector as an efficient mobiliser of savings, a major focus of the Bank in the next few years would be to accelerate the migration to electronic payments and act as a catalyst in enabling electronic payments to deliver its full potential of productivity enhancements and cost savings to the country as a whole.

Future Policy Direction

The thrust of policy measures in 2007 will be the reinforcement of the prudential and legal framework for financial institutions, facilitating the emergence of core domestic players and enhancing the level of efficiency within the financial system through deregulation and greater operational flexibility. Continued focus will be given in driving the MIFC agenda and strengthening the role of DFIs and financial market players to contribute towards the economic transformation. Following increasing interest by foreign institutions to take up strategic stakes in domestic financial institutions, the Bank would also continue to have a facilitative role in encouraging the formation of strategic partnerships that aim to bring mutual benefits to the parties involved and the nation generally, whilst preserving financial stability. Additional initiatives will be taken in enhancing consumer awareness and education as part of the Bank's efforts to achieve greater financial inclusion.

Focus of Surveillance in 2007

As the Malaysian economy is expected to be more integrated at the international and regional levels, preserving stability of the financial system will be increasingly more challenging as the country is not insulated from external developments and the risks of contagion. Hence, surveillance efforts in 2007 will be focused on developments in the prospects of global growth, the potential for greater volatility in financial markets, the resurgence in prices of crude oil that could result in renewed inflationary pressures and persistency of capital flows that can result in sudden and sharp reversals in capital flows.

The outlook for the financial system stability remains highly favourable with the increased resilience, and robust financial performance, and strengthened capacity and capability of the financial sector to withstand future disturbances. A more diversified financial infrastructure will also enable a more effective and efficient management of risks in the financial system.

Bank Negara Malaysia
21 March 2007