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PRESS RELEASE

Financial Stability and Payment Systems Report 2008

The Financial Stability and Payment Systems Report 2008 (Report) highlights Bank Negara Malaysia's (the Bank) assessment of the risks and challenges faced by the Malaysian financial sector and key initiatives undertaken by the Bank in preserving market confidence, facilitating continued intermediation function of the financial system and in maintaining overall financial stability. The Report also covers ongoing developmental initiatives taken by the Bank to enhance the role of the financial sector as a driver of growth, while realizing its potential to catalyse growth in the economy moving forward.

Assessment of risks and Performance of Financial Institutions

Throughout 2008, the Malaysian financial sector remained stable and resilient against the backdrop of global economic and financial market turmoil. The impact of the global financial market turmoil on the domestic financial sector remained well contained given the limited direct and indirect exposures to securities and entities linked to the global financial turmoil. Pre-emptive measures taken by the Government and Bank Negara Malaysia during the year preserved confidence and stability in the financial sector. Capitalisation and solvency positions were sustained at strong levels with sufficiently high level of financial buffers, supported by strengthened institutional structures and enhanced governance and risk management practices. The risk-weighted capital ratio (RWCR) of the banking sector was 12.6% at end-January 2009, significantly above the minimum requirement of 8%, with an excess capital position of RM38.4 billion, providing ample buffer against potential unexpected shocks. Profitability of the banking system grew by 8.3% to record an unaudited profit before tax of RM19.2 billion in 2008, partly moderated by lower revenue generated from treasury related and investment activities. Banking sector's exposure to foreign exchange risk was also within manageable limits, with the net open position accounting for 4.6% of total capital base (2007:4.9%). Throughout the year, the banking sector

continued to support the economy's financing needs. Despite a slight moderation in the total approvals granted for new financing, lending and financing activities continued to remain robust, growing at a pace of 12.8% in 2008. The financing portfolio was mainly concentrated in the retail-based sectors and small and medium enterprises (SMEs), which accounted for 53.4% and 17.2% of total outstanding loans and financing respectively. Net non-performing loans ratio (NPL) remained low at 2.2% as at end-January 2009 (2007:3.2%), reflecting the enhanced risk management capabilities of banking institutions. Capital enhancement programmes undertaken or currently being planned by banking institutions would further strengthen the banks' ability to absorb potential risks that may arise from the economic slowdown, and more importantly, to continue to perform the important intermediary role effectively and efficiently.

The insurance and takaful sectors, while recording a stronger solvency position of RM16.6 billion (2007: RM11.7 billion) and attaining a capital adequacy ratio of 187.6%, which is well above the minimum requirement of 100% (2007: 158.4%), faced challenges in maintaining the growth in premiums and contributions from new businesses amidst strong competition in the industry. Total net premium and contribution income of this industry grew by 2.4%, attributed mainly to the expansion in the market share of takaful business. The growth of 5.5% in the general insurance and takaful sectors was driven mainly by the expansion in the fire segment while the modest growth of 1% in the life and family takaful sectors emanated from the weaker demand in investment linked business. Nevertheless, the operating profit of the general insurance and takaful business declined by 44.5% to RM0.7 billion, mainly due to unrealized losses and deterioration in the motor insurance portfolio, as reflected in the higher claims ratio of 84.2% (2007:79.6%).

The domestic financial markets remained orderly, despite higher price volatility, bigger outflows and lower trading liquidity, was well supported by ample ringgit liquidity in the system. Liquidity in the USD market was tighter, mirroring the global tightening of the currency. The corporate sector continued to have access to the bond market to raise long-term funds, with private debt securities (PDS) accounting for 57.8% of total outstanding PDS and banking loans to corporations.

The household and business sectors as a whole demonstrated high degree of capacity and flexibility to adjust to the challenges faced in 2008, having entered the challenging environment from a position of strength and supported by strong financial buffers. Despite revenue challenges and more volatile cost pressures, the debt servicing capacity of corporations was sustained at relatively comfortable levels in 2008. The gross NPL ratio for businesses declined to 6% as at end-2008 (2007:8%), while the gross NPL ratio for SMEs also trended downwards to 6.8% (2007: 9.1%). Businesses continued to receive financing from the banking sector with a total of RM147.9 billion of new loans channeled to businesses in 2008.

The household sector continued to be supported by healthy balance sheets with improved level of indebtedness. Amidst concerns over employment outlook, demand for new financing has declined as households become more conscientious in managing their financial and leverage positions. Household's gross NPL ratio continued to improve to 4.2% as at end 2008 (2007:5.4%).

On the prudential regulatory front, the emphasis of regulatory initiatives continued to be directed at promoting sound corporate governance and risk management practices, and the implementation of more robust capital adequacy regimes across the key sectors of the financial services industry.

The implementation of the Basel II framework remained on track, with 77% of banking institutions having adopted the Standardised Approaches for determining capital requirements with effect from 1 January 2008. The remaining institutions that plan to adopt the Internal Ratings Based (IRB) Approach for credit risk are allowed to remain under the Basel I regime until 2010. A Capital Adequacy Framework for DFIs was also introduced, taking into account the unique mandates of DFIs in economic development. Progress was also made to develop a more robust capital framework for securitization activities and strengthen the Liquidity Framework to support the sound management of foreign currency cash flows. These requirements will be implemented in 2009. The importance of inculcating sound risk management practices in banking institutions was further reinforced by Perbadanan Insurans Deposit Malaysia (PIDM)'s move to implement risk-based premiums for deposit insurance under its Differential Premium System (DPS).

Efforts to strengthen the solvency position of the insurance sector achieved significant progress with the implementation of the Risk-Based Capital (RBC) Framework on 1 January 2009. The framework provides a strong capital foundation for insurance companies to operate at different risk levels that commensurate with the insurers' risk management capabilities. Preliminary groundwork was also laid in 2008 for the development of a similar RBC Framework for takaful operators.

The challenging environment moving forward may likely pose greater revenue pressures and higher delinquencies. However, the series of scenario-based stress tests on credit, market and liquidity risks that were conducted at both the system and institutional levels reaffirmed the capacity of the financial sector to withstand potentially adverse and significant macro-financial shocks. The excess capital position was at RM38.4 billion as at end-January 2009. This compares favourably against the total losses recorded by banking system of RM5.7 billion in 1998 when Gross Domestic Product (GDP) contracted by 7.4%. The potential increase in delinquencies is expected to be manageable, supported by pro-active risk mitigation measures by banking institutions such as engaging and assisting borrowers with potential increased financial strains through restructuring and

rescheduling of existing loans. Although the weaker profits are expected under the more severe economic stress scenario, the availability of strong capital buffers enables the banking system to absorb any potential adverse impact whilst maintaining RWCR and the core capital ratio at a strong level of above 8% and 6% respectively. These stress tests were taken before incorporating 2009 profit performance and the capital enhancement programmes planned or being taken by the banking institutions. Similar stress tests conducted on the insurance and takaful industry revealed that the profitability and capitalisation of some industry players may be impacted under the more adverse scenarios. Nonetheless, the financial system remains in a sound position to support the financial needs of the economy even under a more challenging environment going forward. Internally, the Bank will continue to strengthen macro-prudential surveillance and supervisory activities to enable early detection of emerging risks to facilitate pre-emptive actions. This will be complemented by enhanced engagements and coordination between the Bank and other domestic and international regulators.

A continuing focus on corporate governance was reinforced with the implementation of the Financial Institutions Directors' Education Programme (FIDE) in 2008. Jointly developed by the Bank and PIDM in collaboration with the International Centre for Leadership in Finance, FIDE aims to develop highly effective boards of directors of financial institutions by strengthening their knowledge and skills set to effectively discharge their responsibilities in the more complex financial landscape.

Development of the Financial Sector

The development focus for the year centred primarily on preserving confidence in and resilience of the financial sector, and ensuring that the financial sector continue to perform its financial intermediation function to support economic activities. Efforts were also taken to pursue longer term developmental initiatives aimed towards building a resilient, effective and diversified financial system.

Concerted efforts throughout the year were taken to ensure that businesses continued to have adequate access to financing, in particular the small and medium enterprises (SMEs). The SME Assistance and Modernisation Facilities as well as the SME Assistance Guarantee Scheme were established in 2008 and 2009 respectively for this purpose. Two additional schemes, namely the Working Capital Guarantee Scheme and the Industry Restructuring Loan Guarantee Scheme, were also launched in early 2009 to enhance the avenues for companies to obtain funds for working capital requirements and support long-term investment activities to increase productivity and generate high value-added activities.

Access to financing initiatives was also complemented by enhanced channels to facilitate consumers in obtaining redress, information and advice on matters relating to financial services. The Integrated Contact Centre (ICC) established by the Bank and ABM-Connect set up by the Association of Banks in Malaysia

served as important conduits to strengthen the interface with borrowers. These complemented the already comprehensive institutional framework established to pre-emptively deal with emerging issues in both the retail and business segments. The Small Debt Resolution Scheme (SDRS), which was created in 2003 to facilitate the restructuring and rescheduling of credit facilities for small businesses with non-performing financing of RM3 million or less, will now be expanded to include all viable SMEs with non-performing financing as well as viable SMEs facing financial difficulties with financing from multiple financial institutions. This is to assist viable SMEs to restructure or reschedule debts/financing in the current challenging economic environment. The expanded scope of SDRS will be effective from 30 March 2009. The Credit Counselling and Debt Management Agency (CCDMA), which was established in 2006 to provide credit management counselling services to households, has expanded its branch network throughout the state capitals to better service the needs of households.

Whilst the leverage position and debt servicing capacity of the Malaysian corporations remain at a comfortable level, as a pre-emptive measure to ensure that viable corporations are able to face the current challenging environment, the Bank will reactivate and enhance the Corporate Debt Restructuring Committee. This will complement the various measures that have been put in place to address debt management issues faced by the household and SME sectors, as well as measures to enhance and ensure continued access to financing. The Committee will provide the mechanism for pre-emptive and efficient out-of-court debt resolution for corporations that are viable but may face temporary cash flow constraints given the more challenging environment. This is aimed at pre-empting potential defaults and premature failures of viable corporations, avoiding cross-default and ensuring orderly functioning of the financial system, thereby preserving employment and productive capacity in the economy. The Committee will facilitate the restructuring of corporate borrowings with multiple creditors and debt instruments, including private debt securities.

One of the key measures taken by the Government and the Bank during the year was the provision of a blanket guarantee on all Ringgit and foreign currency deposits placed with financial institutions regulated by the Bank. This measure was taken consistent with regional initiatives to preserve confidence in financial systems during the global financial turmoil, and served as a pre-emptive measure to safeguard stability in the domestic financial sector. The financial safety net was also extended to the insurance and takaful sector by allowing insurers and takaful operators to access the Bank's liquidity facility.

To ensure the continued growth and dynamism of the financial markets and in line with the recommendation in the Financial Sector Masterplan (FSMP), the Government will establish a Financial Guarantee Institution (FGI) to provide credit enhancements to viable corporations to access the bond market. The FGI will facilitate continued access by corporations to the bond market to raise funds,

reduce financing costs, address potential maturity mismatches and also diversify risk and funding sources within the financial system.

In the insurance sector, the Bank continued to pursue consolidation and rationalization exercises to address the fragmentation especially in the general insurance sector. The review for further liberalization of the operating costs control guidelines that would allow for greater cost synergies and product innovation in the insurance industry is also at an advanced stage. Further flexibilities were also accorded to encourage the utilisation of bancassurance as a key distribution channel for insurance companies to further enhance profitability and increase insurance penetration in the country.

In line with the Malaysia International Islamic Financial Centre (MIFC) initiative, further progress was made during the year with the establishment of new international Islamic financial players in Malaysia. One International Islamic Bank licence and one international Takaful Operator licence were granted to foreign financial institutions during the year whilst five domestic and foreign financial institutions were granted approvals to establish International Currency Business Units. The licensing of the world's largest retakaful company in Malaysia in 2008 also marked an important milestone for the development of retakaful in the country. Support for the MIFC initiative is further strengthened with the establishment of the International Shariah Research Academy for Islamic Finance (ISRA) in March 2008 which served to enhance the interaction and exchange of ideas among industry players and scholars. Academic appreciation of Islamic finance was also enhanced through the introduction of the PhD and Masters programmes in Islamic finance by the International Centre for Education in Islamic Finance (INCEIF) in January and June 2008 respectively. Further, the Bank's embarkation on the initiative to develop a comprehensive codification of Shariah contracts, known as Shariah Parameters, would enhance the application of Shariah rules and principles, provide clarity and promote a more consistent application of Shariah contracts within the Islamic financial system.

The strengths in Islamic finance that have contributed to its overall stability are derived from Shariah principles that rested on universal values of good governance, ethics and transparency. Islamic finance requires financial transactions to be supported by underlying productive activities and that funds are channelled into real economic sectors. These reduce Islamic finance transactions from over-exposure to risks associated with excessive leveraging and imprudent risk taking. Such practices, if emulated by all the financial institutions, would lead to improved overall financial system stability.

While financial stability remains the overriding objective, human capital development continue to be an important agenda to support the long-term development and growth prospects of the financial sector. The Bank, jointly with the Securities Commission, established the Financial Services Education Centre (FSEC) in 2008 to promote greater collaboration and efficiencies between the

existing training institutes in the delivery of high quality training solutions for the financial sector.

To enable the Bank to continue performing its role effectively in maintaining financial stability in the years ahead, a more robust legal framework is also being put in place with the proposed Central Bank of Malaysia Act which will provide greater clarity on the Bank's financial stability mandate and in regulating and supervising financial institutions and promoting a sound and progressive overall financial system.

Given the importance of a well functioning payment system towards maintaining financial stability, the promotion of a secure, safe and efficient payment system remained the focus of the Bank, complemented by on-going efforts to enhance and modernize the system to achieve greater efficiency and reliability. Reflecting the effectiveness of the measures that had been undertaken throughout the years, payment system remained resilient and continued to operate smoothly in 2008 without any major disruptions.

During the year, the Bank established a payment subsidiary known as the Malaysian Electronic Clearing Corporation Sdn. Bhd. (MyClear) to operate the Real-time Electronic Transfer of Funds and Securities (RENTAS) and the Cheque Truncation and Conversion System (eSPICK) and spearhead the Bank's migration to e-payments agenda. The establishment of MyClear allows the Bank to focus on oversight responsibilities of RENTAS and eSPICK, thereby facilitating effective surveillance, independent assessment, evaluation and monitoring of the different types of risks on the major payment systems.

As electronic payments have a significant cost advantage over paper-based payment methods, the Bank continued its active role in promoting the greater use of electronic payments. The Government remained committed towards accelerating the pace of migration to electronic payments in the economy, with about 95% of its payments, in terms of volume, made through electronic channels, and 89 of its agencies offering 148 online payment services as at the end of 2008. Key to encouraging public adoption of the wide array of e-Government services offered, is the support from the financial institutions in creating awareness of the branding for Government online payments, "myBayar", and in providing convenient access for the public to undertake these payments. During the year, the Bank also worked with the insurance and securities industries to remove barriers to enable their payments to their payees, such as adjusters, repairers and brokers, and payments of dividend and sale and purchase of shares, to be made via the electronic channels. Bank fees for fund transfers made through the RENTAS system were reduced and the Inland Exchange Commission of 0.03% for funds transfers was waived during the year. Moving forward, focus would be directed towards addressing the price distortion between paper-based payments and electronic payments and having in place effective incentives to drive the migration to electronic payments.

As uncertainties in the global financial environment continue to unfold, the financial sector is expected to face a challenging year ahead. The Bank will continue to focus on reforms and capacity building measures to ensure that the financial system remains resilient and sound while fulfilling its intermediation function. Prudential regulations will also be strengthened to mitigate excessive risk-taking, complemented by enhanced surveillance and oversight functions to ensure emerging vulnerabilities are promptly and pre-emptively addressed. The next phase of development for the financial sector will be spearheaded by the Bank's liberalization roadmap with the strategic aim of enhancing the contribution of the financial services sector to economic growth. The role of the financial sector as an effective growth catalyst will be reinforced while leveraging on Malaysia's competitive advantage in Islamic finance. In pursuing the liberalization agenda, lessons will be drawn from the current global financial turmoil to ensure that the degree of liberalization should be commensurate with the capacity of the financial sector to cope with the consequent changing landscape. To better withstand institutional and systemic risks in the financial sector, the Bank will undertake further enhancements to its surveillance systems, strengthen the institutional arrangements for dealing with emerging threats to the financial system, improve the incentive structure, promote sound corporate governance and risk management practices, and develop the necessary conditions for increased market discipline.

Bank Negara Malaysia
25 March 2009