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CENTRAL BANK OF MALAYSIA

SIARAN AKHBAR

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Financial Stability and Payment Systems Report 2012

The Financial Stability and Payment Systems Report is an annual publication by Bank Negara Malaysia (the Bank) which highlights the Bank's assessment of risks and challenges faced by the Malaysian financial system and the capacity of the system to sustain its financial intermediation role in the economy. It also reports the regulatory and supervisory measures undertaken by the Bank to ensure continued safety and soundness of financial institutions and promote overall financial and payment systems stability, as well as the developmental initiatives pursued by the Bank to reinforce the roles of the financial services sector in supporting and contributing to economic growth.

Risk Developments and Assessment of Financial Stability in 2012

Domestic financial stability was preserved and overall confidence in the financial system remained strong throughout 2012, ensuring that financial intermediation continued to function efficiently to support the growth of the Malaysian economy. The Malaysian financial system continued to demonstrate a high degree of resilience amid persistent uncertainties in the global economy and financial markets. This is supported by well-capitalised financial institutions, orderly conditions in the domestic financial markets and ample liquidity in the financial system. The assessment of Malaysia under the Financial Sector Assessment Program (FSAP) conducted by the International Monetary Fund and World Bank in 2012 further reaffirmed the resilience of the domestic financial sector to macroeconomic and financial stresses.

Financial institutions continued to record strong capital positions and financial performance amid continuing improvements to operational and risk management practices. The banks' risk-weighted capital ratio and core capital ratio stood at 15.2% and 13.4%, respectively as at end-2012, with financial buffers in excess of RM80 billion. With a significant proportion of the capital in the form of equity capital, banks are well placed to meet new capital requirements under Basel III that are being phased in from January 2013. The common equity tier 1 capital ratio, tier 1 capital ratio and total capital ratio were at 12.1%, 13% and 14.5%, respectively as at end-January 2013. The insurance industry also remains well-capitalised with the capital adequacy ratio of the general and life insurance industry unchanged at 222.3%. In addition to continued discipline in lending, financial institutions have taken measures to manage exposures to market risk, insurance risk and displaced

commercial risks. These strategies have further improved the resilience to a range of economic and market shocks.

Credit quality of the Malaysian financial sector also remained sound, with risks to financial stability from credit exposures to households and businesses largely unchanged. The financial condition of businesses has been healthy and generally improving, while income growth and stable employment prospects generally have continued to support the debt servicing capacity of households. Overall growth in household lending was slower at 13% for the second consecutive year, largely on account of slower growth in bank lending to households. Personal financing nonetheless expanded strongly by 30% during the year, driven mainly by expansion in such lending by non-bank financial institutions. Although the majority of these borrowers are those who earn a monthly income of below RM3,000, the credit risk is well mitigated as about 80% of these borrowers have stable jobs and regular salary, and the loan repayment is deducted automatically at source. These developments are nonetheless being closely monitored particularly in light of recent innovation observed on the product offering by the non-bank financial institutions. Bank underwriting practices and risk management control functions were further strengthened. Following the implementation of the Guidelines on Responsible Financing during the year, banks are also more thorough in assessing borrower affordability with more prudent buffers allocated in the computation of debt service ratios, improved processes and documentation in income verification. Impairment trends continued to improve almost across the board. As at end-2012, the gross impaired loans ratio of the banking system improved to 1.5% for the household portfolio, 2.9% for large businesses and 3% for small and medium enterprises (SMEs).

In the property market, pre-emptive macroprudential and fiscal measures undertaken have had a moderating effect on investment activities involving the purchase of residential property. However, overall house prices have continued to increase at a strong pace, driven mainly by macroeconomic, rather than financial factors, as the supply of houses remains insufficient to meet genuine demand for new homes. Additional measures taken by the Government, including that to increase the supply of affordable houses, are aimed at mitigating such further price increases. Risks to financial stability from these developments, however, remain well contained, mainly on account of continued discipline in lending standards and further improvements in the risk management practices by banks. Exposures of financial institutions to the non-residential property segment are also low.

Exposures of Malaysian financial institutions to counterparties in Europe remained low, while global reinsurance conditions have improved considerably, reducing the risks associated with foreign reinsurance placements. Malaysia remains well placed to cope with the effects of potential deleveraging activities by European financial institutions, with the domestic institutions and other foreign banks in Malaysia in a position to replace any lost capacity. The continued regional expansion by Malaysian banks has been at a relatively moderate pace and is commensurate with the greater capacity of the banks to manage risks on a group-wide basis.

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The payment and settlement systems in Malaysia remained resilient in 2012 and supportive of financial sector and economic activities. The Real-Time Electronic Transfer of Funds and Securities System (RENTAS) continued to operate at a high level of compliance with international standards, while major retail payment systems operated reliably without any major disruptions.

Regulatory and Supervisory Framework

The enactment of the Financial Services Act 2013 (FSA) and Islamic Financial Services Act 2013 (IFSA) marked another significant milestone in modernising Malaysia's financial sector laws to reinforce the Bank's mandate to safeguard financial stability. The new laws significantly strengthen the foundations for a regulatory and supervisory framework that is effective, transparent and that contributes to an efficient financial system that is resilient to future stresses. The new laws also strengthen the oversight on the market conduct of financial service providers, promote effective oversight of payment systems and payment instruments, and support preconditions for the development of the financial sector.

Malaysia's regulatory and supervisory system received a positive review under the FSAP, with a high level of compliance observed for the domestic regulatory and supervisory frameworks for the banking and insurance sectors, the deposit insurance system and the financial market infrastructure with international standards. Key recommendations made by the International Monetary Fund and World Bank will be addressed with the enhanced legal framework provided by the FSA and IFSA.

The domestic implementation of the Basel III global regulatory reform package progressed with the publication of final rules that will significantly raise the level and quality of banks' regulatory capital. The new requirements are being phased in from January 2013 to December 2018 in line with globally determined timelines. Malaysian banks are in a strong starting position to meet the higher standards, and the extended transition period allows ample room for banks to gradually build up the required buffers. In the takaful industry, the final Risk-Based Capital Framework for Takaful Operators was issued to significantly strengthen the prudential framework for takaful operators to be on par with standards applicable to the insurance industry, with full compliance taking effect from 1 January 2014.

Further enhancements were made to prudential standards that promote effective risk governance and prudent management of single counterparty risk exposures. Moving forward, the Bank will provide an appropriate level of oversight over financial holding companies to ensure that the activities of financial groups do not pose undue risks to the safety and soundness of financial institutions. This includes setting prudential standards for financial holding companies, conducting ongoing supervision on a consolidated basis and requiring corrective actions by financial holding companies to address identified risks.

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In the area of market conduct, the Bank's priorities in 2012 have been on implementing an enhanced market conduct supervisory framework and strengthening the insurance intermediaries. Improvements were observed in the attention accorded by financial service providers to market conduct issues. Disclosures made in the sales and marketing materials of financial service providers have also been more balanced in presenting risks and returns, while the use of plain language has been extended to a wider range of financial contracts. During the year, the Bank strengthened existing requirements on product advice in the life insurance and family takaful sectors and imposed requirements on all Islamic banks to grant *ibra'* (rebates) to customers upon the early settlement of financing contracts. Moving forward, an inter-agency platform will be established to conduct a comprehensive review of the gaps in the existing regulatory regime for credit providers, with the view to develop a comprehensive consumer credit law that will provide a more cohesive legal framework for regulating consumer credit activities in Malaysia.

Efforts to prevent the financial sector from being used for illegal activities were also intensified in 2012. The Bank undertook a re-licensing exercise for the money services business industry, which substantially improved the financial and operational capacity of licensed money changers and remittance service providers, and strengthened controls against risks associated with financial crime. In total, the number of money services business licensees declined to 515 from 839 at the end of December 2011 following the re-licensing initiative. During the year, the legal framework for countering the financing of terrorist activities was further strengthened to include an expanded scope of predicate offences, while work has commenced to further review the existing anti-money laundering and counter financing of terrorism framework to take into account revised international standards issued in February 2012 by the Financial Action Task Force.

To ensure effective oversight over the financial system as regional and international linkages continue to expand, the Bank further strengthened its cooperation arrangements with other central banks and supervisory authorities. Domestic arrangements for cooperation between the Bank and other authorities in Malaysia which contribute to financial stability, notably the Malaysia Deposit Insurance Corporation and Securities Commission Malaysia, have also been further enhanced.

In the area of payment and settlement systems, several enhancements to the operations, systems and risk mitigation measures were implemented during the year to ensure RENTAS continues to meet high international standards. Greater focus was also directed at strengthening the security standards for payment instruments and ensuring the operational reliability of the retail payment systems. Losses due to retail payments fraud remained negligible in 2012.

Development of the Financial Sector

Policy initiatives in 2012 focussed on harnessing Malaysia's long-term growth potential by promoting sound conditions for the intermediation of funds to new

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growth areas and strengthening Malaysia's interlinkages with regional and international economies.

Financial intermediation activities continued to be well supported by the financial sector. Total outstanding banking sector financing increased by 10.4% to RM1,108 billion as at end-2012, with financing to SMEs accounting for RM189 billion or 40.5% of total business financing. Financing to micro-entrepreneurs via the Pembiayaan Mikro scheme amounted to RM870.3 million, which was channelled to more than 68,000 microfinance accounts. More flexible financing products for micro-enterprises were introduced, while further progress was also achieved to develop the credit assessment and risk management capabilities of banks in providing financing for green technology ventures.

The debt securities market remained an important source of funding for corporations, breaching RM1 trillion (or 110% of GDP) in 2012 in terms of total outstanding value of debt securities issued. The increased capital allocation by the Government to Danajamin Nasional Berhad will further enhance the capacity of Danajamin in improving cost-efficient access to the bond market for issuers seeking to raise longer-term funding. In the money market, the Bank continued to introduce new products to facilitate more efficient liquidity management by Islamic financial institutions. As concerns increased globally over rate-rigging practices in relation to financial market benchmark rates, the Bank and the financial industry took additional measures to preserve the credibility of key domestic benchmark rates and reinforce the confidence of market participants in the use of these rates. In efforts to further deepen the foreign exchange market, an immediate focus has been to improve the access to, and availability of a broader range of hedging instruments. To this end, the foreign exchange administration rules were further liberalised to encourage greater innovation in foreign exchange product offerings and demand for more efficient foreign currency management solutions.

Domestic banking groups continued to extend their regional footprint, with overseas operations in 21 countries. Efforts to deepen regional financial integration also gained further momentum, with ASEAN member countries in the final stages of launching a banking sector integration framework that will support a more dynamic and meaningful role of qualified ASEAN banks in the region. The launch of a pilot platform for the cross-border investment and settlement of debt securities in Malaysia and Hong Kong, as well as the adoption of a new roadmap by ASEAN+3 member countries pursuant to the Asian Bond Market Initiative are both anticipated to contribute towards the further deepening of the Asian bond markets. The preparedness of the region to respond to crises has also been further strengthened, following enhancements to the Chiang Mai Initiative Multilateralisation Agreement and continuing work to strengthen existing arrangements for crisis management and resolution within the grouping of the Executives' Meeting of East Asia Pacific Central Banks.

The Islamic financial sector continued its growth trajectory, with robust growth recorded in Islamic banking assets, takaful assets, sukuk, and foreign

currency business. The Islamic banking sector recorded a double-digit growth of 13.8% in total assets, to account for 23.8% of total assets in the overall banking system (including DFIs), while total assets of takaful funds grew by 12.4% to RM19 billion, with total takaful contributions accounting for 13.6% of total premiums and contribution in the insurance and takaful industry. Malaysia remains a key marketplace to support the internationalisation of Islamic finance and for sukuk issuances globally, with sukuk issuances in Malaysia accounting for 74% of total global sukuk issuances. In supporting effective end-to-end Shariah governance and compliance in the Islamic financial sector, a contract-based regulatory framework has been put in place which aligns legal and regulatory principles with Shariah precepts, and will serve as a useful benchmark for evolving a more comprehensive regulatory framework. This has been complemented by continued innovations in the sukuk market, a strong focus on research, and ongoing efforts to develop a deep pool of talent to meet the growing needs of the global Islamic financial industry.

Measures of financial inclusion showed improvement in terms of access to deposit accounts, while access to financing accounts remained at high levels. During the year, two key initiatives to widen the outreach of financial services in Malaysia were undertaken, with the implementation of the agent banking framework and the MyMobile platform. Since the introduction of agent banking, findings by the Bank showed that 75% out of 837 *mukims* (sub-districts) with a population of more than 2,000 have at least one financial access point, a significant increase from only 46% in 2011. The total number of transactions conducted through agent banks have also exceeded three million, with a total value of more than RM446 million.

The Bank continued in 2012 to advance financial capability and education initiatives to empower Malaysians to build, manage and protect their personal wealth. An immediate focus has been to promote financial capability skills from an early age through the school curriculum and to roll out financial capability programmes based on life event models for adults. More than 117,000 individuals benefited from the POWER! Programme in 2012, which provided young adults and first-time borrowers with practical lessons and tools for effective debt and cash flow management, while a customised financial capability programme was delivered to more than 1,500 1AZAM participants, helping such individuals to better manage cash flows and encourage good savings habits.

Further progress was achieved during the year towards encouraging the wider use of electronic payments (e-payments), with a marked increase in the adoption of e-payments in the recent two years. Pricing reforms will be undertaken to address existing price distortions between paper-based payments and e-payments and allow the pricing of payment services to better reflect the cost of production. The implementation of the pricing framework will be carefully coordinated to ensure wide access and convenience, while providing sufficient time for the public and businesses to adjust to e-payment alternatives that are more cost-effective.

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The implementation of the Financial Sector Blueprint 2011-2020 is on track. 76 initiatives representing 35% of the total number of initiatives have been completed or are being implemented on an ongoing basis. This includes the enactment of FSA and IFSA, development of agent banking framework, and allowing greater foreign participation in onshore interest rate derivatives market.

Outlook and Priorities for 2013

The outlook for domestic financial stability in 2013 remains positive, supported by strong fundamentals in the Malaysian financial system. While the external environment is expected to remain challenging, potential risks to domestic financial stability will mainly be from a general weakness in the external economic conditions which is transmitted through the trade channel. The Malaysian financial sector is well placed to cope with such adverse external developments given the strong financial buffers of financial institutions, comprehensive institutional arrangements in place for responding to system-wide risks, and most importantly, the sound and continuous improvements in credit, market and operational risk management practices of banks. Liquidity and funding conditions in 2013 are also expected to remain supportive of domestic intermediation. In 2013, macrosurveillance and supervisory activities will continue to focus on the business expansion and lending activities of non-bank financial institutions, the high leverage of the lower-income households, and developments in the property market.

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