BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

SIARAN AKHBAR

Ref. No.: 03/15/06

EMBARGO: Not for publication or broadcast before 1800 hours on Wednesday, 11 March 2015

Bank Negara Malaysia
Financial Stability and Payment Systems Report 2014

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 developmental initiatives pursued by the Bank to reinforce the roles of the financial services sector in supporting and contributing to economic growth and the economic transformation process, as well as the regulatory and supervisory measures undertaken by the Bank to ensure continued safety and soundness of financial institutions, protect the interests of financial consumers and promote overall financial and payment systems stability.

Risk developments and assessment of financial stability in 2014

Domestic financial stability continued to be preserved throughout the year. Global events as well as financial and economic developments had a significant impact on regional financial markets, with periods of higher volatility experienced during the year. In the case of Malaysia, portfolio flows were also influenced by concerns over the potential impact of sharply lower oil prices on the domestic economy in the final month of the year. The country's deep financial markets and the presence of strong domestic institutional investors in Malaysia have supported orderly conditions in the markets despite higher net outflows of portfolio funds during the year. Financial institutions also continue to maintain strong capitalisation and financial performance, with stable funding profiles and prudent risk taking. This in turn has ensured that domestic funding conditions, both in the banking system and capital markets, remained favourable and supportive of financing activities of businesses and households.

Risks to domestic financial stability arising from household indebtedness and rising property prices are moderating as a result of the package of measures taken since 2010. The growth in aggregate household debt continued to moderate as intended, expanding by 9.9% in 2014, the slowest pace since the

peak in 2010. Risks associated with the accumulation of unsecured household borrowings receded further as a result of improved assessments by banks and non-bank financial institutions of the ability of borrowers to take on additional debt. This has been accompanied by strengthened pricing and credit risk management practices. At the aggregate level, household financial buffers remain healthy, with the ratio of household financial asset-to-debt sustained at above two times. Stable employment and income conditions have further supported the debt servicing capacity of households. The share of debt attributed to households that earn RM3,000 or less a month continued to decline over the past two years to account for 26.7% of total household debt (2013: 27.3%; 2012:33%). The financial burden of these households eased following the various financial assistance and housing programmes provided by the Government. As a result, the aggregate leverage (measured as ratio of outstanding borrowing to annual income) for this group has not deteriorated further, although lowering the leverage (currently at seven times) to a more comfortable level remains important. Reflecting these developments, household debt-to-gross domestic product (GDP) rose only marginally to 87.9% compared with earlier years.

Importantly, new household borrowings were of higher quality. Among lower income households, the share of new loans approved with a debt service ratio of 60% and below has increased substantially to 91.8% (July 2013: 85.9%). This provides households with more comfortable buffers to weather financial challenges. Higher financing rates following the increase in the Overnight Policy Rate in July 2014 had little impact on households' debt servicing capacity. This reflects on one hand, the substantial share of household borrowings which is based on fixed financing rates, and the building up of stronger financial buffers by households on the other. In the unlikely event of simultaneous and severe default incidents occurring across all the different types of household borrowings, potential losses to the banking system would remain well within the excess capital buffers in the banking system.

Developments in the housing market are reducing risks of a potential sharp correction in house prices as the intended effects from the series of macroprudential and fiscal measures have become more apparent. The Malaysian House Price Index recorded three consecutive quarters of slower growth since end-2013 to 8.4% in 2Q 2014, across almost all house types and major employment centres. Government initiatives to increase the supply of affordable housing have helped to ease pressures on house prices amid prevailing strong demand for affordable houses which continues to outstrip supply. The gap between demand and supply will, however, take some time to narrow. Risks to household finances and domestic financial stability from a house price correction continue to be mitigated by: (i) the subdued speculative purchases in the property market; (ii) prudent valuation and credit risk management practices, with improved loan affordability assessments, by banks; and (iii) the sound quality of the housing loan portfolio. In the non-residential property sector, conditions have remained broadly stable and are improving in some segments.

Diterbitkan oleh:
Jabatan Komunikasi Strategik, Tingkat 14, Blok B, Bangunan Bank Negara Malaysia,
Jalan Dato' Onn, 50480 Kuala Lumpur, Malaysia.
Telefon: +60(3) 2698 8044 Faksimili: +60(3) 2693 6919
Web: www.bnm.gov.my

The overall leverage of businesses, though marginally higher with a debt-to-equity ratio of 42.7% (2013: 40%), remains comfortably within prudent levels. External borrowings by businesses recorded a negligible growth of 0.05% (2013: 22.6%). This has supported the debt servicing ability of businesses, including large borrowers from the banking system, despite the more significant movements in exchange rates and commodity prices that were experienced during the year. The quality of business loans in the banking system remains sound, with broad-based improvements observed in delinquency and impairment trends across most economic sectors.

Financial institutions continued to demonstrate strong financial performance and capitalisation, underpinned by sound governance and risk management practices. As at end-2014, the Common Equity Tier 1, Tier 1 and Total Capital Ratio of the banking system stood at 12.6%, 13.3% and 15.2% respectively. Sustained improvements in operational efficiency, observed over several years now, have also contributed to the positive performance. Continued profitability and generally conservative earnings retention policies further increased banks' capital buffers in excess of the minimum regulatory requirement which stood at RM97.4 billion as at end-2014. The strong buffers support the ability of banks to comply with minimum capital requirements (which are also being progressively strengthened) under a range of adverse conditions. The capitalisation of the insurance industry also strengthened, with the aggregate capital adequacy ratio improving to 253% (2013: 246.1%) and excess capital buffers amounting to RM30.2 billion.

The historically low delinquency levels across major financing segments and already high loan loss coverage ratio continued to lend support to banks' net interest margins which improved during the year. At current levels, margins are fairly thin and it is therefore important that banks continue to observe sufficient rigour in their pricing and provisioning practices. The performance of the life insurance and family takaful sector similarly improved in 2014, having recovered from significant investment losses incurred in 2013. General insurers remained profitable and have been recording improving loss ratios in the fire and motor sectors over the last three years. Stress tests conducted by the Bank affirm the strong capacity of financial institutions, both at the system and institutional levels, to withstand severe macroeconomic and financial strains.

Development of the financial sector

The financial intermediation process has remained supportive of the financing needs of the economy. New financing extended by the banking system continued to grow by 13.3%. Over 70% of loans disbursed were channelled to businesses, of which 30.4% were loans extended to small and medium enterprises. Despite greater volatility in the financial markets, orderly conditions continued to support fund raising activity. Issuances of new debt securities continued to grow during the year, totalling RM505.9 billion. Greater collaboration between the Bank, the financial industry, businesses and relevant government agencies is helping to address the issues that constrain

Diterbitkan oleh:
Jabatan Komunikasi Strategik, Tingkat 14, Blok B, Bangunan Bank Negara Malaysia,
Jalan Dato' Onn, 50480 Kuala Lumpur, Malaysia.
Telefon: +60(3) 2698 8044 Faksimili: +60(3) 2693 6919
Web: www.bnm.gov.my

bank financing to businesses in new growth industries. This includes bridging information gaps on the commercial potential of innovative industries, building capabilities within financial institutions to value these businesses, providing advisory support in financial management, and increasing awareness of alternative forms of financing that are more suited to the nature and maturity of the businesses. Further progress in these areas will enable financial institutions to play a larger role in supporting the financing needs of new growth industries without inappropriately increasing risks to depositors.

In the insurance and takaful sectors, reforms to promote competition, address pricing distortions and improve value to policyholders continued to be a priority. These reforms will further contribute towards the long-term sustainability of the industry while encouraging more Malaysians to secure the insurance/takaful protection that they need. A major component of the reforms is the Life Insurance and Family Takaful Framework. Following extensive consultations with the public and industry, the Bank will implement the Framework in phases beginning in 2015. The near term benefits to the public will include wider access through direct channels to compare and purchase life/family takaful products, a larger pool of financial advisers who are qualified to provide independent financial advice, and improved incentive structures for insurance intermediaries that have a stronger focus on professional conduct and service quality in the interests of consumers. Another major reform initiative is the implementation of the New Motor Cover Framework. This initiative continued to deliver significant improvements in the motor claims settlement process which are also helping to contain insurance losses – an important outcome to ensure that motor insurance remains viable for insurers and affordable for consumers. Plans remain on track to gradually abolish motor tariffs from 2016 and move towards a pricing mechanism that is more reflective of risk. This will enable policyholders with better risk profiles to benefit from lower premiums, while ensuring that premiums will be adequate to cover losses. In 2015, a detailed roadmap which sets out the approach towards full market-based pricing will be announced.

Domestic financial markets

The domestic financial markets continued to develop as an important avenue for fund raising, investment and risk management activities. Total outstanding debt securities expanded by 8.2% in 2014 to RM1,117 billion (2013: RM1,032.5 billion). At 104.4% of GDP, Malaysia's debt securities market remains the largest in Southeast Asia. Malaysia also continued to be a preferred destination for global sukuk issuances, with over 60% of new global issuances worth USD77.9 billion originated out of Malaysia in 2014. The year also saw the first yen-denominated sukuk issued out of Malaysia, and the largest renminbi bond issuance by a Malaysian corporate to date. Reflecting the increased cross-border demand for sukuk, Malaysian Government Investment Issues (GII) will be included in the Barclays Global Aggregate, Asian Pacific Aggregate and EM Local Currency Government indices starting 31 March 2015. The inclusion would enable the GII to be marketed to a larger international investor base. These developments continue to add to the

Diterbitkan oleh:
Jabatan Komunikasi Strategik, Tingkat 14, Blok B, Bangunan Bank Negara Malaysia,
Jalan Dato' Onn, 50480 Kuala Lumpur, Malaysia.
Telefon: +60(3) 2698 8044 Faksimili: +60(3) 2693 6919
Web: www.bnm.gov.my

breadth and depth of the Malaysian bond market, particularly in terms of the diversity of its currency and investor base. In the foreign exchange market, the market infrastructure continues to be modernised by leveraging on electronic channels for transactions in the interbank market. Proposals were also advanced to enhance the oversight, integrity and transparency of the Kuala Lumpur Interbank Offered Rate (KLIBOR) setting process in line with international standards.

Initiatives to facilitate the wider use of regional currencies were intensified during the year to support growing intra-regional trade and investment activities. Facilities for banks to manage short-term renminbi liquidity were expanded. A notable development was the appointment of a renminbi clearing bank in Malaysia – the first in an emerging economy in Asia outside China – which will enable domestic financial institutions to source renminbi funds directly from the onshore Chinese financial market at competitive rates. In addition, the passage of the Netting of Financial Agreements Bill 2014, which affirms Malaysia's status as a "netting-friendly jurisdiction" will contribute towards enhancing overall liquidity in the derivative market and substantially lower the costs of derivative transactions.

Advancing the financial inclusion agenda

Advancing the financial inclusion agenda remained an important focus of the Bank in 2014. Agent banking which was introduced in Malaysia in 2012 has continued to expand its reach across the country. The number of financial institutions and agents that are part of agent banking networks increased during the year along with an expanded range of services offered through the agent banks. In three years, the number of sub-districts (*mukims*) that have a banking presence has more than doubled to 95% of all 872 sub-districts in Malaysia, from just 46% in 2011, largely due to the presence of agent banks. As a result, 99% of the population in Malaysia currently has access to banking services, either through a bank branch, an agent, or both. Micro enterprises have also continued to be supported with greater access to financing under the *Skim Pembiayaan Mikro*. Total outstanding financing under this scheme has continued to grow to RM863.2 million as at end-2014, with a total of RM2.7 billion in financing extended to more than 168,000 micro-enterprise accounts since its inception in 2006. New financing, savings and insurance/takaful products, catering specifically to the needs and financial circumstances of micro enterprises and lower income households, were also developed during the year. Globally, the Bank has continued to be a strong advocate of inclusive financial development. The establishment of the headquarters of the Alliance for Financial Inclusion in Malaysia reflects the commitment of the country to support initiatives to expand financial inclusion at a broader level. Work is also underway to establish the Global Financial Inclusion Knowledge Exchange as a central repository for policymakers involved in financial inclusion.

Diterbitkan oleh:
Jabatan Komunikasi Strategik, Tingkat 14, Blok B, Bangunan Bank Negara Malaysia,
Jalan Dato' Onn, 50480 Kuala Lumpur, Malaysia.
Telefon: +60(3) 2698 8044 Faksimili: +60(3) 2693 6919
Web: www.bnm.gov.my

Islamic finance

The Islamic finance industry continued its growth momentum in 2014. Islamic banking assets grew by 12.0% and now account for 25.6% of total banking system assets. Foreign currency assets also increased to RM27.7 billion (2013: RM19.3 billion), reflecting the growing importance of cross-border transactions in Islamic finance. The issuance of the Investment Account Framework in 2014, and the launch of an Investment Account Platform expected in 2015, will expand the offering of investment accounts as a new Shariah-compliant asset class and source of funding. The Bank also made further progress towards putting in place a comprehensive Shariah contract-based regulatory framework. This is supported by operational standards that are being introduced to ensure end-to-end compliance with Shariah principles in the offering and management of Shariah contract-based products.

Regional financial integration

Financial integration in the region will be advanced further with the conclusion of the Sixth Package of Financial Sector Commitments under the ASEAN Framework Agreement on Services. Together with this package, the ASEAN Banking Integration Framework (ABIF) will be finalised, paving the way for deeper regional banking integration. ABIF is built on principles which accord priority to the outcome of promoting greater regional economic growth, and emphasise inclusiveness, transparency and reciprocity taking into account the readiness of individual member countries to pursue greater liberalisation of their financial sectors. Under ABIF, Qualified ASEAN Banks will be accorded greater access and flexibilities to expand into regional markets, consistent with the aim of enlarging their role in facilitating intra-regional trade and investment. In anticipation of this, the Bank, Bank Indonesia and Otoritas Jasa Keuangan signed a Heads of Agreement in December which identifies measures to facilitate market access and operational flexibilities that would be accorded in Malaysia and Indonesia to Qualified ASEAN Banks from both countries. Regulatory and supervisory arrangements will also be strengthened to ensure that domestic and regional financial stability is preserved.

Talent development in financial industry

The Bank has continued to invest in the development of a sustainable talent pipeline for the financial industry. The establishment of the Financial Services Talent Council and the Financial Services Professional Board during the year further complements the institutional arrangements for talent development that have been put in place over the years. This includes the repositioning of the Institute of Bankers Malaysia to form the Asian Institute of Chartered Bankers and the establishment of the Asian Banking School. These arrangements now cover a full range of solutions that are required to meet the growing challenge of producing sufficient high quality talent for the current and future needs of the financial services industry.

Regulatory and supervisory framework

The regulatory and supervisory framework continued to be strengthened, driven both by the global reform agenda as well as domestic priorities. The

Diterbitkan oleh:
Jabatan Komunikasi Strategik, Tingkat 14, Blok B, Bangunan Bank Negara Malaysia,
Jalan Dato' Onn, 50480 Kuala Lumpur, Malaysia.
Telefon: +60(3) 2698 8044 Faksimili: +60(3) 2693 6919
Web: www.bnm.gov.my

domestic implementation of the Basel III regulatory reforms focused on finalising the Liquidity Coverage Ratio (LCR) standards. This is now almost completed with final rules expected to be issued in March 2015 for effective implementation from 1 June 2015. Having built strong liquidity buffers and supported by sound liquidity risk management practices, banking institutions are expected to meet the minimum liquidity requirements with relative ease. The Bank continues to closely monitor the impact of the LCR standards on financial markets and credit conditions, particularly in the present environment of increased volatility in the financial markets and greater competition for deposits from alternative savings and investment avenues.

The development of a regulatory framework for financial groups was also an important priority for the Bank in 2014. The Bank is in the final stages of approving financial holding companies (FHCs) under the Financial Services Act 2013 (FSA) and the Islamic Financial Services Act 2013 (IFSA) which will be required to comply with prudential standards applicable to the group. As at end-January 2015, ten companies have been approved as FHCs, including eight which were identified prior to the enactment of the FSA and IFSA. During the year, the Bank completed initial consultations with the industry on the proposed capital standards for banking groups which will be the first set of prudential standards to be issued for application to FHCs.

Enhancing corporate governance and risk management practices also continued to be a key focus of the policy agenda. The Bank concluded a broad review of the corporate governance framework for financial institutions and will publish proposals within the first half of 2015, focusing in particular on strengthening requirements to help boards perform their role more effectively. The Bank also consulted with the industry on new standards on operational risk management and compliance. Work is also in progress to update existing prudential frameworks on outsourcing which aims to clarify the boundaries within which financial institutions can continue to leverage on outsourcing arrangements without materially increasing risks in the operations of financial institutions. In the insurance and takaful sectors, requirements on the preparation of the financial condition report and the management of participating life policies were also strengthened.

The regulatory framework for development financial institutions is also being further developed and strengthened to better support the specific mandates of these institutions in promoting more inclusive and sustainable growth. The Bank is working closely with relevant Ministries on proposed amendments to the Development Financial Institutions Act 2002, which would be tabled to Parliament in 2015.

As Chair of the National Coordination Committee to Counter Money Laundering (NCC), the Bank continued to play a central role in coordinating nationwide efforts to strengthen the anti-money laundering and countering the financing of terrorism (AML/CFT) regime in Malaysia. In 2014, the NCC completed a number of key initiatives which included strengthening the

Diterbitkan oleh:
Jabatan Komunikasi Strategik, Tingkat 14, Blok B, Bangunan Bank Negara Malaysia,
Jalan Dato' Onn, 50480 Kuala Lumpur, Malaysia.
Telefon: +60(3) 2698 8044 Faksimili: +60(3) 2693 6919
Web: www.bnm.gov.my

supporting legislation, developing the National Risk Assessment to identify key vulnerabilities and money laundering and terrorism financing threats, and formulating the National AML/CFT Strategic Plan to comprehensively address these threats. An evaluation exercise was undertaken by international assessors to determine Malaysia's compliance with the International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation. Pending the outcome of the review which will be known in 2015, Malaysia has been accorded an Observer status by the Financial Action Task Force, paving the way towards becoming a full member which will enhance international confidence in the integrity of the domestic financial system.

A strengthened enforcement framework was put in place to preserve strong oversight and objectivity of enforcement actions taken by the Bank. During the year, a total of 1,104 charges brought by the Bank were convicted by the court. The Bank also initiated 42 investigations and pursued 119 criminal charges against entities and individuals operating illegal schemes and activities. In addition, 536 offences were identified against licensees for non-compliance with laws and regulatory requirements.

Market conduct and consumer empowerment

The Bank continued to foster fair, responsible and professional business conduct of financial service providers (FSPs) and enhance the protection of financial consumers in 2014. A key focus of the Bank has been on monitoring compliance with responsible financing practices and supporting targeted education programmes for financial consumers, in line with measures to prevent the excessive indebtedness of households. Improvements were also made to the disclosure and advisory regime to provide an appropriate counterbalance to increasingly competitive conditions and the unrelenting pace of financial innovation. This is reinforced by the Bank's ongoing monitoring activities which resulted in a range of actions taken where FSPs failed to comply with requirements to ensure that information provided to consumers is not misleading. The Bank will be taking further measures to increase public awareness and the use of product disclosures by FSPs to communicate key product information to consumers.

The implementation of more balanced pre-contractual disclosure obligations and proportionate remedies in relation to insurance/takaful contracts came into effect on 1 January 2015. This will afford better protection to insurance policyholders and takaful participants against the risk of claims being rejected due to innocent and unintentional misrepresentations. Business conduct standards for payment cards were also enhanced to strengthen safeguards against payment card fraud, improve important disclosures and prohibit excessive charges and penalties. During the year, FSPs were required to refund over RM238,000 in fees and charges that were imposed for various financial products and services in breach of guiding principles issued by the Bank on fair and reasonable charges. The Bank also intensified its review of re-pricing practices by insurers for medical and health insurance products

Diterbitkan oleh:
Jabatan Komunikasi Strategik, Tingkat 14, Blok B, Bangunan Bank Negara Malaysia,
Jalan Dato' Onn, 50480 Kuala Lumpur, Malaysia.
Telefon: +60(3) 2698 8044 Faksimili: +60(3) 2693 6919
Web: www.bnm.gov.my

which had become more prevalent due to increasing medical costs. The reviews aimed to ensure that any pricing adjustments are consistent with the portfolio experience, reflect proper underwriting, and are carried out in a way that would reasonably allow existing policyholders to adjust to higher premiums and continue their insurance coverage.

An important initiative taken by the Bank in 2014 to protect financial consumers was the strengthening of redress mechanisms. This involved transforming the existing Financial Mediation Bureau which currently operates as a voluntary arrangement, into a full-fledged financial ombudsman scheme (FOS). The Bank published its proposals during the year on the governance and operational arrangements of the FOS, including its scope. Following broad support for the proposals, plans are well advanced for the FOS to commence operations in the second half of 2015. In addition to the FOS, the Bank through BNMLINK and BNMTELELINK provides assistance to financial consumers to resolve issues with FSPs. A total of 7,381 complaints against FSPs were lodged with LINK in 2014, a 9.7% reduction from the 8,171 complaints lodged in 2013.

Efforts to promote financial capability from an early age are on track with the progressive incorporation of financial education into the school curriculum for Primary Four and Primary Five, in collaboration with the Ministry of Education. This is supported by the ongoing training and engagements with teachers, headmasters and other school administrators to ensure the effective delivery of financial education to students. For adults, the Bank, in collaboration with the Credit Counselling and Debt Management Agency (Agensi Kaunseling dan Pengurusan Kredit, AKPK), introduced a new POWER! (Pengurusan Wang Ringgit Anda) financial education programme for individuals already in the workforce. The programme builds on the success of the first POWER! Programme, which primarily targets university students and young adults, as part of the overall initiative to help Malaysians make better informed financial decisions. The Bank also intensified its outreach programmes in 2014 to educate the public on financial scams, while continuing to work with government agencies to eradicate scams and prosecute the perpetrators.

Payment and settlement systems

Payment and settlement systems in Malaysia remained resilient and continued to operate reliably during the year, with no major disruptions experienced. The Bank continued to direct efforts towards strengthening the business continuity and contingency arrangements for Malaysia's large value and major retail payment systems to provide further assurance of their resilience. Investments in system upgrades for the retail payment systems were also made to cater to the anticipated growth in transaction volume, improve performance and enhance operational reliability. Collectively, these developments have further reduced systemic risk.

The Bank and the industry remain committed to achieving the ambitious targets set for the migration to electronic payments (e-payments) which will

Diterbitkan oleh:
Jabatan Komunikasi Strategik, Tingkat 14, Blok B, Bangunan Bank Negara Malaysia,
Jalan Dato' Onn, 50480 Kuala Lumpur, Malaysia.
Telefon: +60(3) 2698 8044 Faksimili: +60(3) 2693 6919
Web: www.bnm.gov.my

enhance Malaysia's competitiveness and growth potential. In 2014, the use of e-payments continued to rise, with the total number of e-payment transactions increased to 2.2 billion from 1.2 billion in 2010. Pricing reforms implemented since 2013 have encouraged the strong growth of Interbank GIRO transactions which increased in volume by 36.2% in 2014 (2013: +19%) to 113.6 million transactions, while the number of cheques issued declined by 10.1% (2013: -3.3%) to 177.1 million cheques. The number of e-payment transactions per capita increased to 72 during the year, up from 43 in 2010. Ongoing measures by banks and payment instrument issuers to regularly review and update security arrangements for the provision of online banking and payment instruments have also continued to contain the incidence of payment fraud at a low level.

Greater transparency in e-payment services was provided with the requirement for all banks to publish information on fees, crediting times and transaction limits at bank branches and websites. The e-Payment Incentive Fund (ePIF) framework was introduced to require banks to channel the fees that they collect from processing cheques to fund incentives for customers to adopt e-payments. The Payment Card Reform Framework, implemented in January 2015, will further foster an efficient, transparent and competitive payment card industry by addressing indiscriminate increases in interchange fees and other market distortions. Together, these reforms will further accelerate the migration to e-payments, offering the public cheaper and efficient payment alternatives.

Bank Negara Malaysia
11 March 2015

Diterbitkan oleh:
Jabatan Komunikasi Strategik, Tingkat 14, Blok B, Bangunan Bank Negara Malaysia,
Jalan Dato' Onn, 50480 Kuala Lumpur, Malaysia.
Telefon: +60(3) 2698 8044 Faksimili: +60(3) 2693 6919
Web: www.bnm.gov.my