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Bank Negara Malaysia Financial Stability and Payment Systems Report 2016

Risk Developments and Assessment of Financial Stability in 2016

Domestic financial stability was sustained amid bouts of heightened financial market volatility. A subdued economic recovery, geopolitical events, shifting expectations on the pace and timing of interest rate normalisation in the United States and continued volatility in crude oil prices were among the major global themes that drove investor behaviour throughout 2016. Excessive volatility has continued to be largely buffered by the depth of the domestic financial markets and strong domestic institutional investors which supported orderly market conditions. Overall domestic funding conditions were stable, with improvements also observed in the distribution of liquidity across banks. Financial institutions remained well-capitalised and profitable, lending firm support to domestic intermediation activities.

Key potential sources of risks to domestic financial stability continue to stem from high levels of domestic debt, elevated property prices in some segments of residential property and an oversupply of commercial property, and heightened volatility in financial markets. Risks from household lending remained largely contained. Growth in household debt moderated further as households generally scaled back borrowings in line with loan affordability. Total household debt as a proportion of gross domestic product (GDP) was lower at 88.4% (2015: 89.1%), as the pace of moderation in debt slowed below nominal GDP growth for the first time since 2010, potentially marking a turning point for adjustments in household leverage. The debt service ratios of households generally remained within prudent levels and the share of borrowings by vulnerable households reduced further in 2016. Banks have also been gradually increasing the level of provisions and reserves for collective impairments to strengthen buffers against potential loss events. This comes on the back of higher impairments from household lending, albeit from low levels. A broader deterioration in household asset quality is expected to

be reasonably well-contained, owing to macroprudential measures that have been in place since 2012. While these measures are presently judged to be adequate, continued vigilance is required to contain risks from building up again.

The debt burden of households was also eased by the slower growth in average house prices which increased by 5.3%, compared to an average of 9.5% during 2010-2015. The slower growth has been mainly associated with the scaling back of investment purchases, particularly in the higher-priced segments, while demand for affordable housing remained strong. Responsible lending standards have helped to encourage the rebalancing of housing supply towards more affordable segments, but the pace of adjustment continues to be slow with house prices remaining unaffordable for many households. Further price adjustments by private developers will be necessary to meet demand, while contributing to lower household debt.

Risks remained heightened in the office space and shopping complex segments, with new supply outstripping recent historical trends despite signs of softer tenant demand in some sectors. Vacancy rates have continued to rise. Planned additional incoming supply of office and retail commercial space will exert further downward pressure on tenancy and rental rates. Some measures have been taken by authorities to tighten approvals for the construction of commercial buildings. These should continue to be pursued under a carefully designed national planning policy to mitigate risks from oversupply. While banks have small exposures to these property segments, averting deeper imbalances in the commercial property market will be important to contain spillovers to the broader economy.

Business conditions have remained challenging for firms in some sectors. Notwithstanding this, Malaysian firms have continued to maintain reasonably healthy financial positions. Business leverage improved with a slower rate of expansion in both domestic and external business debt. Almost three quarters of external business debt (which comprise inter-company obligations, trade credit and non-resident holdings of ringgit debt bonds and sukuk) present limited funding and currency risks. The debt servicing capacity of businesses continues to be well-supported with a median interest coverage ratio (ICR) of 9.4 times, comfortably above prudent standards. The share of debt that is at risk (defined as debt borne by firms with an ICR of less than two times) remains low at 7.7% (2015: 6.2%) of total corporate debt, mainly attributed to firms in the automotive, real estate and oil and gas (O&G) sectors. Banks have also reduced their credit concentrations to large borrowers.

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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

Malaysia continued to experience two-way portfolio flows during the year. As in previous years, the well-developed financial market with the presence of strong domestic institutional investors continued to provide a stabilising influence for the domestic markets amid significant volatility towards the end of 2016. Ringgit volatility was further exacerbated by speculative activities in the opaque offshore non-deliverable forward (NDF) market and increasing supply and demand imbalances in the onshore foreign exchange (FX) market over the years. Since the implementation of measures announced by the Financial Markets Committee (FMC) in December to deepen and broaden the domestic FX market, ringgit volatility has eased. Aggregate surplus liquidity in the domestic financial system remained supportive of intermediation activities despite declining in line with overall portfolio movements during the year. Banking system liquidity comprising placements, reverse repos and statutory reserves with the Bank remains ample at RM167.4 billion, which can be released to meet liquidity needs. Banks have also increased their capital and long- term funding in recent years, contributing to more stable sources of bank funding.

Net external liabilities of Malaysian banks widened, largely reflecting capital funds maintained by the locally incorporated foreign banks in Malaysia and securities held under custody. Such exposures do not pose significant credit and liquidity risks to the domestic banking system. Domestic banking groups (DBGs) on the other hand continue to maintain a net external assets position, reflecting their expanded overseas operations and centralised liquidity management practices. The overall quality of overseas assets of DBGs remained intact, although higher levels of impairment were recorded from exposures in some lending segments that were more affected by the decline in oil prices and slower economic conditions. This was within expectations. The prospect for non-bank financial institutions, which are not regulated by the Bank and largely unsupervised, to transmit risks and shocks to the financial system also continues to be limited.

In 2017, conditions are expected to remain challenging for some businesses and households. Some deterioration in loan performance is likely, but this is not expected to be broad-based given the generally strong asset quality of banks, stable labour market conditions and continued economic growth. The ongoing low interest rate environment will also increase challenges for life insurers. Based on the most recent stress tests conducted by the Bank, financial institutions are expected to remain resilient to severe macroeconomic and financial strains.

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Banking Sector

Outstanding financing by the banking system expanded by 5.3% to RM1,521.5 billion in 2016, mainly driven by financing to the household sector. Banks continue to lend to small and medium enterprises (SMEs), which grew by 9.2%. Financing by development financial institutions to targeted growth sectors, including the agriculture sector, expanded by 5.7%. To date, RM3.5 billion in financing has been extended to over 200,000 microenterprises under the Skim Pembiayaan Mikro. Also notable has been the performance of agent banks. Transactions conducted through the agent banking network increased to over 100 million transactions valued at RM8.5 billion, performed at more than 7,900 agent banks across the country. Going forward, several key initiatives are being pursued to further improve financing conditions for innovative and new growth businesses. These include lowering entry costs through enabling regulation, leveraging new data sources to reduce information asymmetries, developing a seamless SME financing process and ongoing capacity building programmes to improve the bankability of SMEs. Significant potential also exists to further develop alternative finance in Malaysia to meet an estimated financing gap upwards of RM21 billion through venture capital, leasing and factoring, and crowdfunding solutions.

The profitability of banks improved in 2016, supported by gains from treasury activities and strong financing growth from Islamic banking operations. The wider adoption of technology by banking institutions also continued to deliver efficiency gains and improve customer service experience. Banking transactions conducted through digital channels were more widespread, with mobile transactions in particular, registering a sharp increase in take-up. A number of innovations for onboarding customers, managing customer relationships, facilitating payments and increasing access to banking services for rural communities were also introduced.

The implementation of the Basel III liquidity standards remained a key priority in 2016. Following the finalisation of the Liquidity Coverage Ratio standard in 2015, efforts have shifted towards considering appropriate requirements for banks to comply with the Net Stable Funding Ratio standard. The Bank is also closely monitoring developments on remaining global reforms, as the Basel Committee finalises enhancements to the risk-based capital standards. The Bank is supportive of these changes and will continue to adopt the standards in a manner that is consistent with the risks inherent in the domestic financial system. During the year, the Bank also introduced strengthened standards on credit risk management and stress testing. The management of conduct risks by banking institutions continues to be emphasised, with particular attention to risks associated with the wider adoption of technology in banking services.

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This includes the adequate protection of confidential customer information in a digital environment.

In an important move to professionalise the banking sector workforce, banking institutions committed to support board members and key employees to attain the Chartered Banker qualification awarded by the Asian Institute of Chartered Bankers. This will provide a strong foundation for upholding high standards of professional conduct, ethics and competence in the banking sector.

Regional banking integration further deepened under the ASEAN Banking Integration Framework. In 2016, the Bank entered into bilateral arrangements with Otoritas Jasa Keuangan, Bangko Sentral ng Pilipinas and the Bank of Thailand, paving the way for greater market access and operational flexibilities for qualified ASEAN banks in support of intra-regional trade and investment activities.

Insurance and Takaful Sector

The insurance and takaful sector continued to show positive growth in 2016 supported by strong overall capitalisation. In recent years, medical and health insurance/takaful business has increased as a share of total business, reflecting rising health financing costs. Overall insurance penetration, however, has remained flat within the range of 54% to 56% over the last five years. Affordability and access remain key barriers to higher levels of penetration. This is being addressed through various initiatives, including requirements for life insurers and family takaful operators to make basic protection products available through direct distribution channels beginning from 2017, the development of an Insurance Starter Pack to be rolled out nationally for low-income earners, and further developing alternative distribution channels.

In the general insurance and takaful sector, growth was supported by the fire business which offset the impact from slower growth in the motor and marine, aviation and transit business segments. Domestic capacity to underwrite and retain larger and more complex risks remains underdeveloped - an area that will require greater attention to support the ongoing restructuring of the economy and reduce reinsurance premiums outflows. Overall profitability of insurers and takaful operators improved, although losses on motor Third Party Bodily and Death injury claims continued to exceed premiums by a significant margin. Ongoing reforms that are being implemented in the motor insurance sector to achieve pricing that is more aligned to risk and contain losses remain critical to preserve the industry’s capacity to support motor risks over the longer term.

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The industry moved into the first phase of liberalisation of the motor and fire tariffs from 1 July 2016, where new motor and fire products may be offered at market-based prices while existing motor products under the tariff will continue to be available to the public at prevailing tariff rates. In the second phase which will commence on 1 July 2017, tariffs will be removed for all existing motor products except compulsory motor third party products where tariff rates will be gradually adjusted. This is supported by measures to improve the quality and coverage of data for risk and claims assessments, and safeguards to ensure an orderly transition. The implementation of initiatives under the Life Insurance and Family Takaful Framework also continued to make progress during the year. This will introduce greater flexibility for insurers and takaful operators, and benefit consumers through better control over costs. Additionally, it aims to promote the development of alternative distribution channels and improve the quality of service provided by insurance and takaful intermediaries.

A number of conduct issues continue to receive close supervisory attention by the Bank. Surrender payments over the past four years have increased above the long-term historical average level, raising concerns over sales practices. Escalating healthcare costs have also contributed to more frequent repricing activity for medical and health insurance/takaful products which can increase difficulties faced by policyholders to maintain their policies. Under more challenging investment conditions, revisions to bonus payments under participating life insurance policies have come under closer scrutiny by the Bank. The Bank continued to take firm actions to ensure fair practices by insurers and takaful operators, including requirements for firms to take specific steps to better manage policyholders' expectations. The shift to plain language policies to help consumers better understand the benefits, exclusions and obligations under insurance and takaful policies also gained further traction during the year. By the end of 2017, more than three quarters of insurance and takaful policies for personal lines of business are expected to be simplified using plain language.

Regional insurance integration progressed a step further during the year with the conclusion of the Seventh Package of Commitments under the ASEAN Framework Agreement on Services. Under the Seventh Package, Malaysia has committed to liberalise the cross-border supply of marine, aviation and transit insurance and insurance broking services effective 20 December 2016.

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Islamic Finance Development

The Islamic finance ecosystem has strengthened further towards meeting the evolving needs of the Malaysian economy. Islamic banking and takaful institutions remain resilient, maintaining healthy financial buffers. Investment intermediation activities have seen encouraging growth, with investment accounts (IA) managed by Islamic banks increasing to RM73.7 billion to account for 12.2% of total Islamic deposits and IA within the Islamic banking system in 2016 (2015: RM47.1 billion, 8.6%). The Bank continues to work with the industry and relevant authorities to encourage more innovative applications of Shariah contracts to meet the diverse investment and funding needs of the economy. An important part of this has been the issuance of Shariah standards and operational requirements by the Bank, supported by the adoption of robust capital and liquidity standards to provide a strong regulatory foundation for development. This will be complemented by further efforts to introduce more efficient operational arrangements and facilitative legal, tax and accounting regimes. In the takaful sector, a survey conducted by the Bank indicates significant potential for further growth in commercial takaful product lines, in particular catering to SMEs. This would see the takaful industry expand beyond the current dominant motor, fire and personal accident business segments which are mainly targeted at households.

Over the next two years, the development of the Islamic finance industry will continue to focus on enabling greater business diversification, driven by technology, to sustain its growth trajectory and deliver better customer value. An example of this has been the operationalisation of the Investment Account Platform which has facilitated RM20 million of fund-raising exercises since April 2016 to support a variety of business ventures across different industries. Another important development priority is in the area of trade finance facilitation where the Bank aspires for Shariah-compliant trade financing to support 10% of total trade in the next three years.

Efforts to encourage a stronger focus on value-based intermediation as a core premise of Islamic financial solutions shifted into sharper focus during the year. Greater focus will be given to assessing the economic and social impact of Islamic finance along four dimensions: promoting sustainability, institutional quality, inclusivity and diversity, and efficiency in Islamic financial intermediation. The development of a Corporate Value Intent framework to promote high quality disclosures by Islamic financial institutions and innovative applications of waqf in funding and payment solutions for social welfare purposes are among the measures being pursued to generate greater value for both shareholders and the wider community. This continued to be

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supported by a sustained focus on strengthening arrangements for the development of high quality talent for Islamic finance.

Cross-Sector Developments

Malaysia's debt securities market remains a key source of financing for corporates, rising to account for 37.4% of total corporate financing as at end-2016. New issuances of corporate bonds during the year were led by firms in the finance, insurance and real estate; infrastructure; and electricity, gas and water supply sectors. In the FX market, the implementation of measures by the FMC in December led to improved onshore liquidity and curtailed the disruptive influence on ringgit volatility from speculative transactions in the ringgit NDF market. The measures also reflect a long-standing focus of the Bank on promoting high standards of conduct and transparency in the domestic wholesale financial markets to protect the interests of the general public. The FMC which was established in May has had an important role in providing an inclusive forum to pursue strategies to further develop the domestic financial markets. During the year, the FMC also took further measures to enhance the rate setting methodology for key reference rates and strengthen professional and ethical standards of conduct for wholesale market participants. In addition, the Bank launched the retail Negotiable Instrument of Deposit and Islamic Negotiable Instrument programme in collaboration with the banking industry to encourage retail participation in the domestic financial markets. The programme expands access for retail investors to low-risk money market instruments, thus promoting further depth and liquidity in the domestic financial market.

Local currency settlements in ringgit and renminbi have continued to increase in volume, reducing costs for businesses and contributing to the development of deeper regional financial markets. In 2016, such arrangements were expanded to include ringgit and Thai baht local currency settlements, with preparations underway to implement a similar arrangement for settlements in ringgit and Indonesian rupiah.

The prudential framework was further strengthened with the finalisation of enhanced corporate governance and operational risk management standards which are applicable to financial institutions regulated by the Bank. In the money services industry, the Bank continues to build on successful reforms undertaken since 2011 to further improve the efficiency of money services, encourage the use of authorised channels for remittance services through digitalisation, and promote conditions for an orderly currency exchange market especially during periods of heightened volatility. Further progress was also made on the implementation of action plans under the National Anti-

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Money Laundering and Countering Financing of Terrorism (AML/CFT) Strategic Plan 2015-2020. This was affirmed by a positive follow-up assessment by the Financial Action Task Force which noted considerable improvements in Malaysia's compliance with AML/CFT international standards. Vigilance over the use of the financial system to finance terrorism activities remains high and is supported by active collaboration between the Bank and domestic as well as regional authorities. In addition, strong enforcement actions continue to be taken by the Bank against illegal activities and syndicated crimes, working closely with other enforcement agencies.

The Ombudsman for Financial Services commenced operations on 1 October 2016, further strengthening available out-of-court avenues for financial consumers to resolve disputes relating to financial services and products. The Financial Education Network was also established in November, with members comprising regulators and other key financial education stakeholders, to deliver financial education initiatives with greater impact under a coordinated national strategy. To enhance the legal protection of borrowers in dealings with credit providers, the Bank is working with the Ministry of Domestic Trade, Co-operatives and Consumerism and the Ministry of Urban Wellbeing, Housing and Local Government to formulate a new Consumer Credit Law that will provide more comprehensive protection for borrowers, covering responsible and fair lending practices, debt relief, disclosures and debt recoveries.

To provide a safe and supportive regulatory environment for financial technology (FinTech) innovations, the Bank has established the Financial Technology Enabler Group, tasked to formulate policy measures and strategies for the adoption of technological innovations in the financial services industry. As a key first step, the Regulatory Sandbox was introduced in October, allowing the experimentation of innovative FinTech solutions in a live market environment with appropriate safeguards. Moving forward, the Bank will embark on several priority development areas to further develop the FinTech ecosystem in Malaysia. These include initiatives that will facilitate open application programme interface (API) models, common Know-Your-Customer (KYC) utilities, distributed ledger applications and cloud computing, while strengthening resilience to cyber threats.

Payment and Settlement Systems

The payment and settlement systems in Malaysia remained resilient and continued to operate reliably without major disruptions. Amid the growing threat of cyberattacks globally, effective management of cyber risks was a key focus of the Bank's oversight activities. During the year, the industry took

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additional measures to strengthen existing security controls. The implementation of the new Real-time Electronic Transfer of Funds and Securities System (RENTAS) further improved operational efficiency, risk management and cross-border payment services. In the area of retail payments, fraud losses remained low. Two major initiatives to enhance the payment card infrastructure in Malaysia – the migration from signature to Personal Identification Number (PIN) verification to improve security, and the implementation of Malaysian Chip Card Specifications for domestic debit cards to enhance interoperability – continued to make good progress. Efforts are now being directed to encourage the use of PIN before it is made mandatory on all domestic payment card transactions effective 1 July 2017.

Encouraging progress continues to be made towards achieving the electronic payment (e-payment) targets set out in the Financial Sector Blueprint 2011–2020, driven by increased adoption of credit transfers and payment card transactions. Cheque usage has correspondingly continued to decline. The regulatory measures introduced under the Payment Card Reform Framework, which took effect in 2015, are continuing to have an important effect in lowering transaction costs for e-payments and driving behaviour change. In particular, lower Merchant Discount Rates (MDR) delivered an estimated cost savings of about RM168 million to merchants in 2016, while the establishment of the Market Development Fund in 2015 has encouraged the rapid expansion of POS terminals. Measures taken to improve transparency and choice for merchants have also strengthened competition among debit card networks.

A key strategic priority of the Bank in 2017 will be to facilitate open and fair access to shared payment infrastructures by banks and non-bank payment service providers with the view to create a more competitive payment landscape that fosters continuous improvements in payment services. This includes facilitating interoperability among mobile payment schemes leveraging on common infrastructure for switching, clearing and settlement. This seeks to tap into the significant potential for mobile payments, represented by more than 40 million mobile phone subscriptions in Malaysia, to displace cash and to advance financial inclusion.

Bank Negara Malaysia
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