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Financial Stability and Payment Systems Report 2009

The Financial Stability and Payment Systems Report (the Report) is an annual publication by Bank Negara Malaysia (the Bank) which highlights the Bank's assessment on the risks and challenges affecting the functioning and stability of the financial system and the capacity of the system in confronting these risks and challenges. The Report also focuses on policy responses and developmental measures undertaken by the Bank in further strengthening the financial and payment systems infrastructure and resilience of the financial sector.

Assessment of Risks and Financial Stability

The Malaysian financial system stability was preserved throughout the year despite the challenging operating environment. The stability and soundness of the financial system and financial institutions were fundamental in assuring that the financial intermediation process, payment and settlement systems continue to function efficiently. Policy responses instituted at the early phase of the global crisis contributed to the stability of the financial system.

Capitalisation and solvency of the financial system strengthened further in 2009. The risk-weighted capital ratio of banks improved to 14.8% as at end-January 2010 (2008: 12.6%), significantly above the minimum requirement of 8%. The amount of excess capital rose to RM60.3 billion as at the end of January 2010 (2008: RM38.7 billion), providing ample financial buffers against potential unexpected shocks. Similarly, the insurance and takaful sector recorded a higher capital adequacy ratio of 230.0% (2008: 187.6%) and a comfortable capital buffer of RM18.6 billion (2008: RM12.3 billion) as at end-2009.

The banking sector recorded unaudited profit before tax of RM17 billion for 2009. This amount was lower than the level recorded in the preceding year as a result of a non-recurring investment impairment by an institution on one of its overseas operations. Excluding this one-off provision, the unaudited pre-tax profit of the banking system recorded a growth of 3.2%. While overall earnings were stronger and registered broad-based improvements, revenue from lending activities softened on subdued demand for financing in the first half of 2009 whilst funding expenses were higher due to the larger deposit base. Meanwhile, the exposure of the banking sector to interest rate risk and foreign exchange risk remained manageable at 5.0% and 4.6% of total capital base respectively.

Total net premiums/contribution of insurers and takaful operators grew by 8.2%, driven mainly by the ordinary life segment for the life and family takaful industry, and a broad-based increase in all classes of business for the general sector. The revival of conditions in the financial markets contributed towards stronger income from investment portfolios and unrealised capital gains for the entire insurance industry. For the general business, improved performance was also achieved on account of lower claims ratio of 60.8% (2008: 62%). Overall, the improved operating conditions have contributed to higher profitability of RM14.5 billion for the insurance industry.

Diterbitkan oleh:
Jabatan Komunikasi Korporat, 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 banking system remained supportive of the financial needs of the domestic economy. Lending and financing activities remained strong throughout the period. Outstanding financing extended by the banking system expanded at an annual rate of 7.8% to RM783.4 billion with a stable approval rate at approximately 70%. The banks' financing portfolio remained concentrated in the retail-based segment with the household and, small and medium enterprises (SMEs) accounting for 55.1% and 15.2% of outstanding financing respectively. Loans to households expanded by 9.4% to RM516.6 billion, with borrowings primarily for the purchase of residential properties. Financing extended to large businesses grew by 7.8% as at end-2009. During the year, over 80% of SME applications were granted new financing. The stable approval rates amidst continued demand for financing have spurred the positive developments in the SME sector particularly towards the end of 2009. In the final quarter of the year, demand for SME financing surged by 37.1% (3Q 2009: -1.7% y-o-y) whilst approvals rose by 8.8% (3Q 2009: -8.1% y-o-y).

Notwithstanding the difficult economic environment, loan quality improved on account of continued recoveries and to some extent loan write-offs. This was further supported by efforts undertaken by the banks in engaging the borrowers early and providing debt management solutions and advice such as restructuring and rescheduling. The net NPL ratio improved further to 1.7% as at end-January 2010, the lowest level since the Asian financial crisis. On a sectoral basis, the banking system gross NPL ratios of large businesses, SMEs and households improved to 4.2%, 5.6% and 3.0% respectively.

The domestic financial markets remained orderly and regained the upward momentum as the year progressed on signs that the slowdown in the domestic economy has bottomed out. This coincided with improvements in the earnings performance of businesses and the more favourable employment prospects, which bolstered the debt servicing capacity of borrowers. The subsequent compression of credit spreads led a turnaround in the bond market, as manifested by the recovery in private debt securities (PDS) issuances, including those by foreign issuers. Ample ringgit liquidity in the

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system also supported the smooth-functioning of the ringgit money market and inter-bank market in 2009.

Both the business and household sectors exhibited high capacity and agility in confronting the challenges that surfaced during the year. This was reflected in the improvements in the quality of their borrowings with the banking system. NPLs of SMEs with the banking system and DFIs rose marginally to 7.6% of gross loans by September 2009 (end-2008: 7.1%) due to the weaker cash flows and subdued business activities. With the economic recovery in the second half of 2009, gross NPL ratio improved to 6.6% as at the end of the year.

The payment and settlement systems remained resilient, contributing to the stability of the financial system. Despite the global financial market turbulence and market uncertainty, the Real-time Electronic Transfer of Funds and Securities System (RENTAS) and the National Electronic Cheque Information Clearing System (eSPICK) continued to operate smoothly without any major disruption, achieving 99.9% system availability throughout 2009. Similarly, the major retail payment systems such as the Malaysian Electronic Payment System (1997) Sdn. Bhd. (MEPS) and Touch ‘n Go Sdn. Bhd. (TnG) remained robust and reliable, with no major disruptions reported during the year. Continued collaboration with the industry players and the relevant authorities has contained fraud in the payment systems and including the payment card and internet banking services at negligible levels.

Development of the Financial Sector and Payment Systems

The focus of financial sector development policies in 2009 was to preserve the soundness and integrity of the financial sector, ensure continued financial intermediation, while forging ahead with longer term initiatives to enhance the capacity and growth potential of the financial sector. New liberalisation measures were introduced in early 2009 to enhance the role of the financial sector in the economy and to strengthen Malaysia’s economic linkages with other economies.

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Ensuring the continued access to financing for all segments of borrowers, the SMEs in particular, remained a high priority area. During the year, a number of measures were introduced towards achieving this objective which includes the establishment of the SME Assistance Guarantee Scheme (SME AGS), the Working Capital Guarantee Scheme (WCGS), and Industry Restructuring Guarantee Scheme, as well as the consolidation of ERF Sdn. Bhd. into Credit Guarantee Corporation (CGC). Both the SME AGS and the WCGS have been fully utilised, whilst more than 400,000 SMEs have benefited from the credit guarantee scheme of CGC.

In facilitating fund raising from the capital market by businesses, Danajamin Nasional Berhad was established with the aim of providing credit enhancements to investment grade issuers with viable businesses to issue bonds at reasonable cost. The Corporate Debt Restructuring Committee recommenced its operations with an expanded mandate to facilitate the restructuring of debts including bonds for businesses. Meanwhile, the eligibility criteria for cases to be handled under the Small Debt Resolution Scheme were revised in 2009 to enable a wider reach of viable SMEs to seek assistance to restructure and reschedule loans under the scheme.

The liberalisation plan that was announced in 2009 encompassed three broad strategies, namely, the issuance of new licenses, increase in foreign equity limits and the granting of greater operational flexibility to incumbent foreign players. During the year, a new commercial bank licence was issued to the largest commercial bank in the People’s Republic of China to promote strategic partnerships and to enhance collaboration and cooperation with the regional economies.

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Initiatives to broaden and deepen the financial markets focused on enhancing the infrastructure and broadening the asset classes, and evolving Malaysia as an international Islamic financial center. The launch of Bursa Suq Al-Sila (formerly known as the Commodity *Murabahah* House), the world's first Shariah-compliant trading platform for commodity *murabahah* transactions marked a major milestone. This platform is expected to further enhance liquidity and facilitate cross border liquidity transactions. The Islamic capital market also achieved significant milestones with the landmark issuance of a foreign currency denominated sukuk by a major corporation which received an overwhelming response by the market. This was followed by a second issuance which was also listed on Bursa Malaysia. This has elevated the status of Bursa Malaysia in terms of value of sukuk program listings in 2009.

In 2010, Malaysia was categorised in the "White List" issued by the Organisation for Economic Cooperation and Development in recognition of the country's strong commitment in observing the international standards on transparency and exchange of information to curb illegal activities. This bodes well for sustaining the overall competitiveness and attractiveness of Malaysia.

On the regulatory front, developments in the global regulatory reform arising from the crisis have sharpened the Bank's focus on delivering a prudential framework which is responsive to the changing environment. While the Bank generally supports the international efforts in regulatory reform, the Bank will carefully evaluate the potential implications of the proposals from different dimensions, particularly to safeguard financial institutions' critical role in supporting sustainable growth of the economy. The emphasis of regulatory initiatives continued to be directed at maintaining an appropriate balance between regulatory prescriptions and supervisory assessment of the risk management quality of a financial institution. Specific consideration needs to be accorded to the regulatory framework that is already in place in the domestic financial system and the extent to which the current framework is adequately delivering the desired outcomes. The focus of regulatory policies in 2009, therefore, has been to further strengthen the oversight capability of

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the boards of financial institutions and improvements in risk management and capital framework.

The implementation of Basel II Framework progressed further in 2009 with the issuance of the guidance on the adoption of the Internal Ratings-Based (IRB) Approach for credit risk. The supervisory review process (Pillar 2) and market discipline (Pillar 3) components of the capital adequacy framework were also taken forward during the year. Meanwhile, the insurance industry transitioned effectively to the Risk-Based Capital (RBC) Framework on 1 January 2009. Significant progress was also achieved on the development of the RBC Framework for takaful operators, with industry consultations and impact assessments to commence in 2010. Enhancements to the Liquidity Framework have also been finalised for implementation in 2010. Further revisions are being considered to take into account the recently released proposals by the Basel Committee on Banking Supervision on the minimum global quantitative standards on liquidity risk management. On accounting standards, the adoption of Financial Reporting Standard 139 for all reporting entities, including financial institutions in Malaysia, took effect on 1 January 2010. Given that developments in provisioning standards remain fluid on the international front, the Bank issued revised guidelines on Classification and Impairment Provisioning for Loans/Financing incorporating a transitional provision in the determination of collective impairment provisions. The transitional provision is intended to reduce significant duplicative costs associated with the impending changes, while aligning provision levels more closely to expected loss considerations.

In the area of Islamic finance, efforts continued to be directed at strengthening Shariah governance, promoting sound business practices and operational efficiencies in the Islamic financial institutions. This resulted in the issuance of the Guidelines of Investment Management, the concept paper on Guidelines on Takaful Operational Framework and the revision to the Rate of Return (ROR) Framework. In addition, a Shariah Governance Framework will be

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issued in 2010 to further enhance Shariah governance of Islamic financial institutions.

The Bank undertook to develop a comprehensive codification of Shariah contracts known as the Shariah Parameters to promote clear understanding and consistent interpretation of Shariah contracts. The first Shariah Parameter on *Murabahah* contract was issued during the year with the Shariah Parameters for contracts on *ijarah, mudharabah, musharakah, istisna'* and *wadiah* expected to be finalised by end-2010. The Bank also entered into strategic bilateral and multilateral cooperation to promote global partnerships and cross-border business ventures in Islamic finance. Two MoUs were signed with the United Kingdom Trade and Investment (UKTI) and the Hong Kong Monetary Authority (HKMA) to promote mutual cooperation in talent development and strengthening of business linkages and infrastructure support for Islamic finance. A new long term brand "Shaping Islamic Finance Together" was also introduced in 2009 to position Malaysia as an international centre for Islamic financial activities that is also supported by a centre of intellectual development in Islamic finance.

The Bank continued to focus on promoting sound corporate governance and risk management practices through the Financial Institutions Directors' Education (FIDE) initiative. Since its launch in late 2008, a total of 131 directors of financial institutions have completed the core programme. Additional specialised and supplementary programmes are being developed to further strengthen the support for boards in providing effective and continuing oversight over financial institutions.

The Bank's surveillance over market practices was intensified during the year in response to the competitive market condition. Thematic examinations focusing on the imposition of fees and charges, credit card promotions, selling of investment-linked and structured products were conducted. This was complemented with the comprehensive disclosure framework for retail financial products that focuses on key product features, risks and benefits,

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and major terms and conditions of the contract. Overall, the intensified market conduct supervision has resulted in improvements in the operational procedures of banks and insurers such as procedures in identifying and resolving cases of replacement of policies.

In the area of payments systems, the transfer of the payment systems, Real-time Electronic Transfer of Funds and Securities System (RENTAS) and National Electronic Cheque Information Clearing System (eSPICK) which were previously operated by the Bank, to Malaysian Electronic Clearing Corporation Sdn. Bhd. (MyClear), a wholly-owned subsidiary of the Bank, was completed smoothly. The robustness and adequacy of the business continuity plans for RENTAS and eSPICK members were also continuously tested during the year to ensure minimal disruption to functioning of these systems.

Accelerating the migration to electronic payments (e-payments) remained a high priority of the Bank. Continuous collaboration and engagement with the Government and private sectors have resulted in significant payoffs. Today, about 96% of Government payments are done via electronic funds transfer, whilst the use of credit transfer facility for payments to the Government grew substantially to RM41.3 million (2008: RM21.9 million). In the securities sector, collaborative efforts were made to facilitate the adoption of e-payments for the sale and purchase of shares and for payment of dividends to be paid directly into investors' bank accounts, namely the e-Dividend initiative.

Policy and Surveillance Focus in 2010

The policy focus for 2010 will be to further reinforce the financial stability framework and to strengthen the contribution of the financial sector to growth.

The focus will include a comprehensive review of all the existing legislations governing financial institutions and payment systems under the Bank's purview. The proposed legislative changes will further reinforce the strengthened financial stability framework in Malaysia following the enactment

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of the Central Bank of Malaysia Act 2009 that came into force on 25 November 2009.

The Bank has also embarked on the development of a new blueprint to further evolve the Malaysian financial sector to support and drive the next phase of the country's economic development. The objective is to elevate the role of the financial sector in the economy, with an enhanced capacity to contribute effectively to the economic transformation process to a high value-added and high income economy. Furthermore, continuous emphasis on promoting awareness and enhancing cooperation of more economic sectors to drive the higher adoption of e-payments will also be a priority for 2010. It will also involve strengthening the trend towards regional and international financial integration.

The Bank will work closely with the Perbadanan Insurans Deposit Malaysia (PIDM) to ensure a smooth transition from the current Government blanket deposit guarantee towards an enhanced guarantee scheme by end-2010. Efforts will be directed towards minimising the destabilising shifts in deposits across institutions and jurisdictions and ensuring continued effectiveness of the deposit insurance scheme. In this regard, the Bank is also working closely with the HKMA and the Monetary Authority of Singapore through the Tripartite Working Group which was established in July 2009 to map out a coordinated strategy for the scheduled exit from the full deposit guarantee in the respective jurisdiction.

The surveillance and supervisory framework of the Bank will continue to be strengthened with an increased focus on the macroprudential orientation for assessment of risk transmissions, both within the financial system and with the economy. Continued focus will also be accorded to more active employment and development of surveillance tools and methodologies, reinforced by greater coordination with other regulatory authorities including authorities across borders.

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The more rapid recovery of the Asian economies has resulted in renewed interest in the region that has begun to draw large capital inflows. The Bank will remain vigilant and maintain heightened surveillance for any emerging signs of excessive risk taking behaviours by financial institutions in this environment. Pre-emptive policy measures will be introduced, where warranted, to prevent such build up of vulnerabilities that could pose threats to the overall financial stability and functioning of the financial markets.

In addition, focus will continue to be directed at ensuring that the financial system remains sound and resilient, and has the sufficient capacity to face future risks and challenges without affecting their capacity to support the economy.

Bank Negara Malaysia
24 March 2010

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