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Bank Negara Malaysia
Financial Stability and Payment Systems Report 2015

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 2015

Financial market volatility remained elevated in 2015. The prospect of the US Federal Reserve's interest rate normalisation, a weaker outlook for global growth including that for PR China and emerging economies, and the unprecedented slide in crude oil prices were major themes driving investor behaviour for most parts of the year. In the case of Malaysia, portfolio flows were largely driven by a broader retreat of global funds from emerging markets and commodity producing economies, and overseas investments by domestic institutional investors as part of portfolio diversification strategies. As in previous episodes of heightened volatility and large capital flows, the deep financial markets and presence of strong domestic institutional investors in Malaysia continued to support orderly market conditions. While funding conditions were occasionally tighter amid the large volume of portfolio outflows, aggregate surplus liquidity in the domestic financial system placed with the Bank remained high at RM205.1 billion as at end-2015. The provision of liquidity through the Bank's reverse repurchase facilities and, more recently, the lowering of the Statutory Reserve Requirement preserved adequate liquidity conditions and helped smooth out adjustments by individual

banks to heightened deposit competition and the more uneven distribution of deposits across banks.

Domestic banks, insurers and takaful operators continue to remain profitable and maintain strong capital positions. Banks, in particular, have shown a high degree of earnings resilience in spite of more challenging business conditions, allowing them to maintain strong buffers through prudent earnings retention policies. Banks' capital in excess of the minimum regulatory requirement increased further by 9.5% to RM117.3 billion. The aggregate capitalisation of insurers and takaful operators similarly remained strong with excess capital buffers above the regulatory minimum amounting to RM46.0 billion. These factors have continued to firmly support domestic intermediation activities and sustained confidence in the Malaysian financial system.

Risks to domestic financial stability arising from household indebtedness and rising property prices continued to moderate. Outstanding household borrowings from banks and non-banks expanded by 7.3%, extending the slower pace of growth observed since the first implementation of macroprudential measures in 2010. This mainly reflected a sustained slower expansion in financing for personal use while financing for house purchases has remained strong. The level of household debt-to-gross domestic product (GDP) ratio continued to be elevated at 89.1% amid the more moderate growth in nominal GDP in 2015. The capacity of households to service debt has however generally remained firm, supported by a broadly stable domestic employment and income outlook. The share of borrowings by highly leveraged lower income households declined further, reflecting improvements in affordability assessments. Aggregate household financial assets have remained above two times household debt. For some, this has supported adjustments to higher living costs. Among lower income households however, leverage levels remained considerably higher. Lowering the debt levels for these households will continue to be important to provide a buffer against unexpected events and rising costs.

Risks to domestic financial stability from household leverage continue to be largely mitigated by sound credit underwriting standards and risk management practices of banks. Enhancements to lending practices of banks to reflect strengthened processes for assessing affordability are now mostly in place. This has been important to maintain the sound asset quality of banks going forward. The overall quality of banks' housing loans improved further with household impaired loans and delinquencies remaining low across all types of financing facilities. Concerns over the mispricing of risks amid strong competition in the retail financing segment were also assessed by the Bank to have abated as banks took steps to either adjust lending rates to reflect more realistic assumptions of credit and liquidity risks, or increased capital buffers. Based on stress tests conducted by the Bank, risks to financial stability from

household lending continue to be manageable as potential losses even under assumptions of severe stress conditions remain well within banks' excess capital buffers.

In the property market, growth in aggregate house prices appears to have stabilized as house buyers and developers continued to adjust to macroprudential and fiscal measures aimed at curbing excessive speculation and risk-taking. The Malaysian House Price Index (MHPI) has declined from 9.6% registered for the period 2010-2014 to around 8% registered over five consecutive quarters since 2Q 2014. Slower housing transactions mainly in the higher-priced segments, combined with continued strong demand for affordable home units, have encouraged a rebalancing of housing supply. This in turn reduces the risks associated with an unsustainable supply of housing concentrated in specific segments. Given the prevailing acute demand-supply gap in affordable housing, risks of a more generalised correction in house prices are assessed to remain low. An increase in the supply of affordable housing by the Government and private sector remains key to bringing about a further easing of upward pressures on house prices. In the non-residential property segment, risks have heightened in the office space and shopping complex segments. With more challenging business conditions and incoming supply over the next two years adding further to supply pressures, ensuring the effective management of new supply in these segments will be essential. At present, exposures of banks in these segments are limited, with low and stable delinquencies continuing to be observed.

While corporate leverage has increased in the last year, it remains within reasonably prudent levels. The median debt-to-equity ratio of Malaysian non-financial corporations stood at 46.8% as at end-September 2015. Despite lower profitability in some business segments that were more affected by lower commodity prices and softer demand, overall debt servicing capacity of businesses remains sound and continues to be supported by adequate liquidity buffers. At 5.3 times, the median interest coverage ratio of businesses remained comfortably above the prudent standard of two times, while the median ratio of cash-to-short term debt was maintained above one time. This enabled businesses to cope with the more significant movements in exchange rates and commodity prices that were experienced during the year. Furthermore, risks to domestic financial stability from external and foreign currency corporate debt continue to be mitigated by a prudential regulatory approval process that is in place, and financially strong domestic conglomerates (including GLCs) and multinational corporations that account for a significant share of external debt.

The overall quality of business borrowings was thus sustained. While loan performance in some sectors deteriorated in line with economic developments, this had limited impact on overall business loan performance.

Bank exposures to the crude palm oil and oil and gas sectors were small at about 4% and 2% of total credit exposures to businesses respectively. Potential cumulative credit losses from simulated severe shocks on large borrower groups also remained manageable, with excess capital buffers of banks sufficient to cover more than two times the estimated losses. The overall debt servicing capacity of Malaysian corporations is expected to remain broadly intact in 2016 given their stronger fundamentals.

The banking system recorded a slightly higher net external liabilities position of RM138.7 billion (2014: RM131 billion), predominantly attributed to the locally incorporated foreign banks (LIFBs). A significant share of such claims is represented by capital investments in the form of equity and retained earnings of LIFBs with long-established and significant operations in Malaysia, posing limited risks to the Malaysian banking system. The increase in external exposures (both assets and liabilities) of banks has also been the result of centralised liquidity management practices among domestic banking groups (DBGs) that operate across jurisdictions. Such practices must additionally comply with applicable local liquidity regulations in the respective jurisdictions which further mitigate risks associated with claims on Malaysian banks. The overseas operations of DBGs have also continued to perform well, supported by strengthened group-wide risk policies and oversight arrangements.

The Bank will maintain a heightened degree of vigilance over developments in the household, property and business sectors. This will continue to be underpinned by a strong focus on sound lending standards and risk management practices among banks as well as large non-bank lenders. Domestic and external headwinds will continue to challenge businesses and households in the period ahead, making it more important for financial institutions to intensify their risk management and actively identify and manage borrowers that may be affected in this environment. Importantly, the Malaysian financial system is in a much stronger position to cope with these developments and the effects of continued volatility in the global financial system that can be expected ahead. Stress tests conducted by the Bank continue to 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 sector remained on course towards achieving the outcomes outlined in the Financial Sector Blueprint 2011-2020 to support Malaysia's transition to a high income, high value-added economy. Amid a more challenging economic environment, total outstanding financing to the economy has continued to expand at a healthy pace, with efforts to increase access to financial services for the underserved continuing to pay off. Outstanding financing by the banking system expanded by 7.9% to

RM1,445.1 billion, with financing to SMEs increasing by 15% to RM259.7 billion. The expansion of facilities for the financing of new growth areas such as structured trade and commodity finance and green finance also continued to support higher value-added activities.

In the insurance and takaful industry, reforms to the pricing and commission structures that are being progressively advanced will foster greater innovation, promote sustainability and improve choice and value for consumers. This includes the implementation of broader measures of performance to better align the remuneration of insurance intermediaries with the quality of service and advice rendered and the Phased Liberalisation of Motor and Fire Tariffs which will see a gradual move towards pricing of motor and fire policies that is more reflective of risks. The phased liberalisation will commence on 1 July 2016, which will allow for the insurance and takaful industry to offer new products at market rates at the initial phase.

Talent development in the financial sector

Ensuring relevant skills, competencies and a strong ethical foundation for the financial sector workforce remained a key priority of the Bank. This continued to be pursued in close collaboration with key institutions. During the year, several strategic initiatives were progressed to further raise standards of professionalism, ethical conduct and technical competence of the workforce. This included work by the Financial Services Talent Council to formulate strategies to meet the future talent demands of the financial services industry, the publication of a voluntary code of ethics (CoE) by the Financial Services Professional Board which sets a high bar for professionalism and ethics in the financial services industry, and the expansion of high quality programs and qualifications for financial professionals by the key industry professional bodies.

Regional financial integration

Under Malaysia's Chairmanship of ASEAN in 2015, a number of key milestones were achieved in regional financial integration, including the finalisation and launch of the ASEAN Banking Integration Framework to provide greater market access and operational flexibility for Qualified ASEAN Banks. Concurrently, a mutual recognition framework was established to facilitate cross-border offerings of collective investment scheme products within ASEAN, further contributing towards regional capital market development. The Bank also continued to expand central bank arrangements to promote the use of local currencies for trade settlement, the latest being with the Bank of Thailand.

Domestic financial markets

Malaysia's financial markets remained an important avenue for fund-raising and investment activities. Reflecting more bearish conditions during the year,

total outstanding debt securities increased at a slower pace of 5.2% to RM1,175.1 billion. Borrowers and investors nevertheless continued to demonstrate confidence in the resilience of the market, with multi-currency issuances further adding to its depth. Notable issuances during the year included an inaugural issuance of Singapore dollar-denominated bonds and sukuk and the largest corporate dollar bond issuance in Asia by Petroliam Nasional Berhad (PETRONAS) which successfully raised USD5 billion. Revisions made by the Bank to the Repurchase Agreement (Repo) Transactions Policy Document which governs repurchase agreements also served to enhance liquidity in the money market. Efforts continued to be pursued to promote utilisation of the renminbi as a currency of settlement. A key development during the year was Malaysia's admission into the Renminbi Qualified Foreign Institutional Investor (RQFII) programme by PR China in November 2015, with an aggregate investment quota of RMB50 billion allocated to Malaysia for investments of renminbi funds in PR China's financial markets. The RQFII programme is expected to encourage the development of renminbi-denominated financial products in response to growing demand for investment opportunities in PR China. Malaysia is the 14th jurisdiction to be included in the programme.

Islamic finance

Malaysia's position as an international Islamic finance marketplace and leading issuance destination was further strengthened with several landmark issuances in the sukuk market. The issuance of the USD500 million sukuk by the Government marked the longest tenure sovereign sukuk to date and serves as a long-dated benchmark yield curve for other sovereigns. The sukuk was also the first to adopt a structure that utilises non-physical income generating assets in the form of rights to participate in the provision of services. Malaysia also issued the first ever sustainable and responsible investment sukuk under a RM1 billion programme, the proceeds of which will be channelled towards socially and ethically responsible causes, including the financing of educational projects. In addition, the Bank successfully completed the pilot issuance of three-month Islamic Monetary Notes based on the globally accepted *Mudarabah* concept. This issuance is expected to widen the investor base and increase the depth and vibrancy of Malaysia's Islamic financial markets. During the year, the Islamic banking industry completed the successful migration of customers' deposits into Islamic deposits or investment accounts in accordance with requirements under the IFSA. This was further complemented by the launch of the Investment Account Platform in February 2016 which is expected to enhance the role of investment accounts in supporting entrepreneurship by expanding the pool of investors, ventures and banks participating in investment account offerings.

Regulatory and supervisory framework

The Bank continued to strengthen the pillars of a sound prudential framework in 2015. Regulatory and supervisory activities were guided by a domestic focus on ensuring strong governance and appropriate risk-taking by financial institutions in an environment of heightened risks. In addition, the Bank's policy priorities also took into consideration progress made on global regulatory reforms.

The Bank completed a comprehensive review of its corporate governance standards for financial institutions to reflect strengthened practices in the industry as well as evolving global standards and emerging risks, notably from more expansive group activities and interlinkages. The revised standards incorporate strengthened requirements with regard to board composition, compensation structures, corporate culture and group oversight responsibilities. The Bank also completed a review of existing prudential standards on credit risk management which aims, among other things, to further enhance the sophistication of credit risk measurement methods that are employed across the industry. In the insurance and takaful sector, the Bank completed revisions to prudential standards on internal capital management and the role of the appointed actuary to promote the sound management of insurance/takaful and financial risks. In addition, the Bank made further progress on the development of a comprehensive Shariah contract-based regulatory framework that addresses the Shariah parameters and operational requirements.

The final Liquidity Coverage Ratio (LCR) standard for banking institutions, one of the key components of the Basel III regulatory reform package, came into effect on 1 June 2015 for banks in Malaysia. The rules require banking institutions to maintain sufficient liquidity buffers to withstand severe short-term liquidity shocks over a 30-day horizon. As expected, banking institutions transitioned smoothly to the new liquidity requirements with the average LCR of the banking sector at 127%, well above the applicable minimum regulatory requirement of 70% applicable from 1 January 2016.

An important development during the year was the passage of amendments to the Development Financial Institutions Act 2002 (DFIA) which came into effect on 31 January 2016. The amendments further strengthen the regulatory framework for development financial institutions (DFIs) to ensure that the specific mandates entrusted to DFIs are achieved in a financially sustainable manner. To this end, existing provisions in the DFIA on corporate governance, business activities and the scope of the Bank's regulatory oversight have been enhanced. In addition, the amended Act incorporates new provisions for the regulation of Shariah governance and consumer protection, with expanded enforcement tools to ensure compliance.

Efforts to strengthen safeguards against threats of money laundering and terrorism financing (ML/TF) continued to be a key priority for the Bank. In September 2015, the Financial Action Task Force (FATF) published a report on the Mutual Evaluation (ME) of Malaysia's anti-money laundering and countering the financing of terrorism (AML/CFT) framework. The report acknowledged Malaysia's well-developed legal and regulatory arrangements, and strong inter-agency coordination for the supervision of ML/TF. Drawing in part on the recommendations of the ME Report, the National Coordination Committee to Counter Money Laundering has formulated a five-year National AML/CFT Strategic Plan to promote and protect the integrity of Malaysia's financial system over the long term and contribute towards mitigating criminal activity in the country. Based on the commitment demonstrated by Malaysia's action plan and the continuing progress in efforts to improve its AML/CFT programme, Malaysia was granted full membership of the FATF in February 2016.

During the year, enforcement actions continued to be pursued by the Bank to safeguard the integrity of the financial system. The Bank successfully prosecuted 182 criminal offences and obtained six court orders requiring entities and/or individuals to cease operating illegal activities. In addition, RM69.5 million in fines were imposed on licensees for regulatory breaches and 26 new investigations were opened by the Bank during the year into suspected illegal activities and regulatory breaches.

Market conduct and consumer empowerment

The Bank continued to focus on promoting fair, responsible and professional business conduct by financial service providers (FSPs) in 2015. Regulatory and supervisory measures were mainly directed at ensuring that FSPs were adequately assessing the suitability of financial products for consumers, and improving the quality and clarity of information provided to consumers in light of increased competition and heightened volatility in investment performance. The Bank assesses that risks to consumers remain elevated in the near term as operating conditions continue to be challenging for FSPs. A stronger focus among FSPs on strengthening business practices that promote the interests of consumers will therefore continue to play a key role in mitigating these risks.

A number of market conduct standards were strengthened to incorporate requirements that improve fair outcomes for consumers. This included new standards issued by the Bank on the management of participating life business which address practices by insurance companies in the distribution of profits of the insurance fund to policyholders. At the Bank's urging, the banking and insurance industry also continued to promote the use of standardised descriptions of contractual terms and plain language in financial contracts. To date, over two-thirds of the housing loans and home financing

contracts issued by banks have adopted standardised descriptions of key contractual terms, and close to one-fifth of personal line insurance policies are in plain language.

The Bank received fewer complaints against FSPs in 2015, mainly owing to the more proactive management of complaints by FSPs and a sustained supervisory focus by the Bank to address practices that were inconsistent with the fair treatment of financial consumers and responsible business conduct. During the year, supervisory and enforcement actions were pursued against 38 FSPs for failures to comply with various business conduct requirements. On 14 September 2015, the Financial Services (Financial Ombudsman Scheme) Regulations 2015 and Islamic Financial Services (Financial Ombudsman Scheme) Regulations 2015 were brought into force, paving the way for the establishment of a financial ombudsman scheme (FOS) to enhance financial dispute resolution arrangements in Malaysia. Preparations to transform the existing Financial Mediation Bureau into an approved FOS are at an advanced stage with the FOS expected to commence its operations in the second quarter of 2016.

The financial education agenda continued to make progress as a key strategy to empower consumers and promote their financial well-being. The Bank's ongoing collaboration with the Ministry of Education to integrate financial education into the school curriculum continued to gain traction with the goal to complete the process for all primary and secondary school levels by 2021. The Bank also continued to leverage on technological advancements in the design and delivery of financial information and advice, with the development of new mobile applications and a financial education portal among some of the initiatives pursued during the year. In addition, the Bank launched a nationwide Financial Capability and Inclusion Demand Side Survey which will allow the Bank to track the financial literacy levels of Malaysian consumers using a Financial Literacy and Capability Index (MYFLIC) that measures the knowledge, behaviour and attitudes of Malaysians in relation to financial matters.

Payment and settlement systems

The payment and settlement systems in Malaysia remained resilient and continued to operate smoothly throughout the year, contributing to the stability of the financial system. The systemically important payment systems, namely the Real-time Electronic Transfer of Funds and Securities System (RENTAS) and the National Electronic Cheque Information Clearing System (eSPICK) functioned smoothly without any major disruptions during the year. The Bank's oversight activities over these systems and other major retail payment systems continued to focus on the adequacy of risk management and business continuity arrangements, particularly in view of the increasing transaction volumes supported by the systems.

To further elevate the performance of RENTAS, enhancements have also been made to gradually transform RENTAS into a multi-currency system that adopts the Society for Worldwide Interbank Financial Telecommunication (SWIFT) messaging standard, with multiple access channels and added functionalities that will further enhance operational efficiencies and reduce risks for participants. These improvements are expected to be completed by end-2016 and will also facilitate the integration of RENTAS with other regional large value payment systems for seamless, safe and efficient cross-border financial transactions. Fraud losses related to the use of payment cards and online banking remained negligible due to sustained efforts by the Bank and the industry to continuously strengthen risk management and security measures. Efforts to raise public awareness of preventive measures that can be taken to avoid falling victim to fraud attempts were also intensified.

2015 marked the half-way mark of the Bank's 10-year strategic roadmap to accelerate Malaysia's migration to e-payments as outlined in the Financial Sector Blueprint 2011-2020. In the first five years (2011-2015), emphasis was placed on developing an enabling environment by strengthening regulatory frameworks, addressing market distortions and establishing incentive structures. As a result, cheque usage has fallen from 205 million a year to 148 million in 2015, remaining on track to achieve the target of 100 million by 2020. Over the same period, the number of e-payment transactions per capita has almost doubled from 49 to 82. Efforts to displace cash usage with e-payments will further benefit from the implementation of the Payment Card Reform Framework (PCRF) which took effect on 1 July 2015. The regulatory measures introduced under the PCRF have already resulted in a slight moderation in the cost of accepting cards and a tripling of the growth rate of point-of-sale terminals from 4.9% in 2014 to 18.1% in 2015. The industry has additionally committed to investing approximately RM1.1 billion between 2015 and 2020 for enhancements to payment card infrastructure, including its expansion to provide broader coverage of payment transactions.

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