BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

LETTER OF TRANSMITTAL

Yang Amat Berhormat Dato' Sri Mohd Najib bin Hj. Tun Abdul Razak,
Prime Minister/ Minister of Finance,
Malaysia.

YAB Dato' Sri,

In accordance with section 56 of the Takaful Act 1984 and section 192 of the Insurance Act 1996, I have the honour to submit for presentation to Parliament, reports on the administration of the Takaful Act 1984 and Insurance Act 1996, and other related matters for the year ended 31 December 2010 which are incorporated into this Financial Stability and Payment Systems Report 2010.

Respectfully submitted,

Zeti Akhtar Aziz
Governor
23 March 2011

PREFACE

The Financial Stability and Payment Systems Report 2010 outlines Bank Negara Malaysia'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 and promote overall financial and payment systems stability.

This publication is intended to promote greater understanding on issues and developments affecting financial stability, including policy directions of the Bank.

The Financial Stability and Payment Systems Report is available in PDF format at www.bnm.gov.my

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GOVERNOR'S STATEMENT

The financial stability of the Malaysian financial system continued to be sustained in 2010. This has allowed the financial sector to provide important support to the economy, despite the challenging conditions arising from global developments that occurred during the course of the year. The financial sector was supported by strong fundamentals including enhanced financial buffers, high asset quality and sound risk management. The soundness of the financial sector has not only contributed towards the efficient functioning of the financial intermediation process, but it has ensured the orderly response to shocks to the financial system. Conditions in the financial markets and the payment and settlement systems also remained orderly and efficient, facilitating the increase in external trade and domestic economic activities.

With the coming into force of the Central Bank of Malaysia Act 2009 (CBA), Bank Negara Malaysia has in 2010 further strengthened the governance and accountability arrangements in the management of financial stability. Within the Bank, the Financial Stability Policy Committee which has been in place since 2004, has the responsibility for the deliberation of risks to financial stability and the formulation of policy responses to manage such risks. Recognising the relationship between financial stability and monetary stability, a joint meeting of the Financial Stability Policy Committee and the Monetary Policy Committee was established this year to provide a forum for the effective deliberation and consideration of macroprudential measures to safeguard financial and macroeconomic stability. Pursuant to the CBA, the Financial Stability Executive Committee has also been operationalised with the mandate to approve proposals by the Bank to take actions to avert a risk to financial stability where it concerns entities not regulated by the Bank or for the resolution of systemically important financial institutions.

Supervisory activities in 2010 remained focused on bolstering the capacity of financial institutions to anticipate and respond to emerging risks, and ensuring that identified risks both to individual institutions and the system as a whole are well managed. The focus was directed in particular at promoting effective governance, and more robust stress testing and capital management processes by the financial institutions to ensure their continued resilience under a range of economic and financial scenarios. This was complemented by the continuing review of prudential standards to take into account both global and domestic developments. The Bank has also strengthened its surveillance of the growing activities of non-bank entities to ensure that any potential risks to financial stability will be managed at an early stage.

While household indebtedness has increased in the recent years, it has continued to be supported by strong financial buffers at the aggregate level. Income growth, the high savings rate and favourable employment conditions have contributed to supporting the debt servicing capacity of households. To ensure that this does not become a source of financial instability, a comprehensive series of policies were introduced during the course of the year. These include prudential policies applied in the residential property sector, new credit card measures and strengthened requirements for banks to adopt prudent and responsible lending practices. This was reinforced by more intensive supervisory oversight of financial institutions with respect to the management of household lending portfolios. More targeted financial education programmes as well as advisory and support arrangements have also served to promote responsible borrowing by households. These pre-emptive and more holistic measures also aim to contribute towards further strengthening the resilience of the household sector.

The overall performance of the insurance industry has been positive even though conditions have remained challenging under a low interest rate environment, rising claims costs and more volatile financial markets. The industry as a whole is more resilient to these challenges given its sound capital position and the efforts directed at promoting further improvements in capital and risk management. Moving forward, as Malaysia transitions into a high value-added and high income economy, the market potential for the insurance and takaful industry will be significant. A key priority therefore lies in enhancing the capacity of the industry to support the new and larger demand for insurance and takaful solutions. As part of this evolution, the further consolidation and rationalisation of the general insurance sector will continue to be encouraged, while broader structural issues in the motor insurance segment will be addressed with the implementation of a new motor cover framework.

In Islamic finance, the foundations for financial stability have also been further strengthened with the implementation of prudential standards issued by the Islamic Financial Services Board in both the Islamic banking and takaful sectors. On the international front, the requisite building blocks as recommended by the Islamic Finance and Global Financial Stability Report have set out the key priorities in the agenda to promote the stability of the global Islamic financial system. Among the important global institutional arrangements in support of these priorities is the establishment of the Islamic Financial Stability Forum to deliberate the risks to financial stability and the International Islamic Liquidity Management Corporation which commenced operations early this year to facilitate liquidity management across borders.

The more diversified and matured financial system that has evolved over this recent decade has provided a stronger foundation for financial stability with strong domestic banking institutions operating at its core. Moving forward, the focus is to build on these foundations to support its continued resilience to withstand potential shocks or disruptions in the financial system and the broader economy. The further development of the financial system also aims to position the financial sector to effectively support Malaysia's economic transformation into a high value-added, high income economy, while further promoting financial inclusion and regional financial integration. The new financial sector blueprint to be released by the Bank later this year will outline strategies to achieve these objectives.

The functioning of the financial system during the year has continued to be well supported by the payment and settlement systems infrastructure. With the increased sophistication in the financial system and the growth in cross-border trade and financial flows, these infrastructure have continued to be modernised. An important focus, amongst others, is the regional effort to establish a common platform for Asian post-trade processing infrastructure. This will integrate the Malaysian real time gross settlement system, RENTAS, with the international clearing and settlement systems such as Euroclear as well as global securities depositories such as the International Central Securities Depository. On the domestic front, the migration to e-payments has gained further traction, supported by greater collaboration between the Government, Securities Commission, Bursa Malaysia and the financial services industry players.

The expansion of the Malaysian financial sector over the recent decade has seen our financial institutions venture beyond our borders, in particular to the Asian region. It has also seen the entry of new foreign players establishing their presence in both the conventional and Islamic finance sectors in the Malaysian financial system. The entry of these new foreign players will not only add to the capacity of the domestic financial sector to support the development of new growth industries, but will also further enhance Malaysia's international linkages. Greater supervisory cooperation and coordination domestically and across borders have consequently become more important to support the effective supervisory oversight of financial institutions and overall management of financial stability. Towards this agenda, the Bank has and will continue to pursue new and enhanced collaborative arrangements with other national and foreign regulatory authorities to further reinforce cooperation in cross-border banking supervision, capacity building and other initiatives to achieve greater regional financial integration.

Zeti Akhtar Aziz
Governor
23 March 2011

2010

EXECUTIVE SUMMARY

Risk developments and assessment of financial stability in 2010

The Malaysian financial system remained stable and supportive of economic growth in 2010 despite the continuing uncertainties and challenges in the operating environment. During the year, financial intermediation remained efficient and broad-based, supported by the orderly functioning of financial markets. Strong fundamentals of the domestic financial system, coupled with an ample liquidity environment, have provided the necessary conditions for the orderly exit of the temporary blanket deposit guarantee by the Government on 31 December 2010.

The household debt level continued to rise, but remained manageable. This has been supported by the sound financials of the household sector underpinned by income growth, further accumulation of financial assets, favourable employment conditions and a high level of savings. The debt coverage ratio of households (measured as the ratio of financial assets to total debts) was in excess of two times, thus providing households with the flexibility to adjust to changing economic and income conditions while preserving their debt servicing capacity. The strength of the household sector is also evident with the continued improvement in the household delinquency trend. With increased competition among financial institutions in serving the retail segment, supervisory attention remained focused on promoting responsible lending practices and conduct of financial institutions in their dealings with consumers. This was complemented by increased surveillance on the lending activities of non-bank entities to gauge the extent of any over-borrowing by certain segments within the household sector. Pre-emptive and targeted measures have been undertaken by the Bank to ensure effective management of debts by banks and households.

The increased and more volatile portfolio investments into the Asian region, including Malaysia, has prompted heightened surveillance of risk accumulation in the financial system and asset markets. Despite the magnitude of the portfolio flows, implications to financial stability remained contained as risk-taking behaviours of Malaysian financial institutions, businesses and households did not change materially. Orderly conditions in financial markets were also maintained and the increased volume and movements of such portfolio flows were intermediated through a diverse range of asset classes.

The contagion risks arising from external developments, largely stemming from fiscal and banking developments in Europe and geo-political tensions in the Middle East, were well contained and had negligible impact on the financial sector in Malaysia due to the low and mostly indirect exposures of financial institutions to counterparties in these regions. Any potential credit losses in the event of widespread sovereign defaults would therefore be limited. The expansion of Malaysian banking groups in the Asian region in recent years has further deepened financial linkages and while this has increased the potential for cross-border risk transmission, adverse spillovers from overseas operations are assessed to be immaterial. Credit risk to the banking system emanating from overseas operations remained manageable given the strong economic performance of countries in the region. This is further reinforced by the strong balance sheet fundamentals and risk management capacity both at the overseas entity and group levels. In addition, measures have been taken by a number of jurisdictions in the region to curb excessive asset price appreciation.

Profitability of the banking sector improved further in 2010, largely driven by higher net interest income and lower provisioning for impairment. The banking sector remained well-capitalised, reinforced by the high quality of capital, which is predominantly in the form of common equity and reserves. The aggregate risk-weighted capital ratio (RWCR) and core capital ratio (CCR) were 14.8% and 13.0% respectively, well above the current regulatory minimum levels, as well as the higher requirements under Basel III. Similarly, the insurance and takaful sectors registered stronger results backed by sustained demand for savings and protection products and the improved performance of the equity market. The capitalisation of the insurance industry remained strong with a capital adequacy ratio

(CAR) of 224.6%. The risk-bearing capacity of the financial system to withstand extreme macroeconomic and financial conditions was reaffirmed by stress tests carried out on the banking and insurance sectors, at both the aggregate and institutional levels.

The Islamic banking system continued to remain resilient throughout 2010, supported by high capitalisation, improved asset quality and sustained profitability in an environment of ample liquidity. Prudent administration of the profit equalisation reserves by the Islamic banks has contributed towards the effective management of displaced commercial risk. Islamic banking institutions have also been actively managing re-pricing gap risk that arises from the fixed rate nature of the financing portfolio with Islamic profit rate swaps. In reducing the concentration to fixed rate financing, Islamic banking institutions have also increasingly been focusing on variable rate Islamic financing products in the form of *musharakah mutanaqisah* (diminishing partnership) and *ijarah* (leasing).

The outlook for domestic financial stability in 2011 remains positive supported by underlying strengths of the Malaysian financial system. Key challenges to financial stability in 2011 are likely to be largely externally driven, as global economic conditions remain uncertain. Shifts in global liquidity will continue to pose challenges to the region, including Malaysia, whilst developments in commodity and energy prices will affect costs of living, particularly for average Malaysians living in urban areas. The growing influence and significance of non-bank lenders will also need to be managed to avoid an excessive build-up of leverage among certain segments in the household sector. While Malaysia's financial system is well-placed with the capacity and flexibility to respond to emerging risks to preserve financial stability, the Bank will remain vigilant to these potential sources of risk.

Development of the financial sector

Policy measures to develop the financial sector remained supportive of macroeconomic stability and the growth momentum of the economy, while advancing longer-term initiatives to enhance the potential capacity and resilience of the Malaysian financial sector. Initiatives were also directed towards strengthening Malaysia's inter-linkages with the global economy and cementing its position as an international centre for Islamic finance, alongside measures to raise the level of financial inclusion to all consumer segments.

The financial safety net was further strengthened with the coming into force of the new Malaysia Deposit Insurance Corporation (PIDM) Act 2011 on 31 December 2010. The new legislation extended and increased the coverage of the deposit insurance system. In addition, PIDM now has a broader range of intervention and resolution tools that can be deployed in the unlikely event of a member institution's failure. A new financial safety net framework for the insurance and takaful sectors has also been introduced with the implementation of the Takaful and Insurance Benefits Protection System (TIPS), which will provide better protection for insurance policyholders and takaful participants.

In raising the capacity and resilience of the insurance sector, the Bank continued to promote consolidation, particularly in the general insurance industry. Significant resources involving collaboration with multiple stakeholders have been directed towards addressing the structural weaknesses in the motor insurance sector. The new motor cover framework will provide better third party coverage, while paving the way for a gradual and smooth transition towards the removal of tariff in the motor sector.

The prompt policy measures undertaken by the Bank in 2008 and 2009 to provide a conducive enabling environment for business and household sectors to deal with their debt difficulties during this period, and to ensure continued credit flows to the economy, have enabled financial intermediation to continue smoothly and efficiently. Total outstanding financing to both businesses and households recorded robust growth of 9.4% and 13.4%, respectively. The environment for financing to small and medium enterprises (SMEs) continued to improve with continuous efforts to put in place a comprehensive institutional framework for SMEs. This included the creation of additional platforms for outreach and the provision of support and advisory services to SMEs, as well as collective measures by financial institutions to expedite the approval and disbursement of loans to SMEs. Such initiatives continue to provide essential support for SMEs to advance and transform to become larger and more competitive.

The Malaysian financial markets remained vibrant and supportive of corporate funding and international trade, with strong growth in both the ringgit and non-ringgit fund raising activities in the bond and sukuk markets. The foreign exchange market also saw increased breadth and liquidity as a result of the development of new financial instruments, the gradual liberalisation of foreign exchange administration rules and further flexibility accorded to foreign money brokers to increase the competitiveness, efficiency and transparency of the money and foreign exchange markets.

Initiatives to support the development of the Islamic finance sector continued to be an important agenda for the Bank, focusing in particular on capacity building, infrastructure and talent development. The Bank participated in the establishment of the International Islamic Liquidity Management Corporation (IILM) in October 2010 which would form part of the international Islamic infrastructure to support the liquidity needs of the global Islamic financial system. A high-level Law Harmonisation Committee was also set up during the year to develop recommendations to improve the certainty and enforceability of Shariah contracts in Malaysia. Malaysia continued to advance initiatives to deepen Shariah understanding in the industry, while elevating the Shariah advisory profession. This was complemented by more accommodative immigration policies introduced to attract talent into the Islamic finance industry and the continued advancements by the International Centre for Education in Islamic Finance (INCEIF) in the field of higher education in Islamic finance, both of which have enriched the available pool of talent to support the industry's growth. The issuance of four new family takaful licences to joint ventures between global and regional players and strong domestic entities has further reinforced Malaysia's position as a global hub for Islamic finance.

In line with Malaysia's commitment towards gradual liberalisation, five new commercial banking licences were also issued to foreign institutions with new expertise, global networks and strong value propositions to contribute positively to the Malaysian financial system and economy. These institutions are expected to add further diversity to Malaysia's financial system, support new areas of growth and facilitate international trade and investment flows. Existing locally-incorporated foreign banks (LIFBs) were also given greater operational flexibility during the year to establish new branches.

With the rapid expansion of Malaysian banking groups within the region and Islamic finance becoming an integral part of the global financial system, bilateral relationships and cooperation with central banks from around the region and beyond were strengthened. The framework for bilateral relationships and cooperation with central banks continued to be enhanced with the formalisation of a number of memorandums of understanding (MoUs), covering a broad range of areas related to cross-border banking supervision, economic integration, capacity building and strategic developments in both conventional and Islamic finance. A key cooperation initiative was the implementation of the Chiang Mai Initiative Multilateralisation Agreement involving a currency swap agreement for all ASEAN countries, the People's Republic of China, Japan and Korea to further strengthen regional capacity to deal with risks to financial stability.

Financial inclusion represented another area of high priority on the Bank's developmental agenda in 2010. Efforts were advanced during the year to improve the outreach of financial services nationwide, with plans progressed to establish the presence of financial institutions in the remaining unserved districts in Sabah and Sarawak. Greater flexibility has also been accorded for banking institutions to leverage on shared banking service platforms in collaboration with third parties to provide wider access to basic financial services to the public. Access to financing without collateral has seen significant growth since the implementation of the framework for *Pembiayaan Mikro* in 2006, with total outstanding micro financing amounting to RM776 million as at end-2010. This is further complemented by the 1Malaysia Micro Protection Plan (1MMPP), which is being finalised by the insurance and takaful industry to provide a financial safety net for micro enterprises and individuals. Ongoing efforts by the Bank to empower consumers through financial information, education and assistance were sustained, and further intensified through strategic collaborations with consumer associations to conduct financial literacy programmes for communities and youths in both urban and non-urban areas nationwide.

National efforts to curb money laundering and terrorism financing activities were enhanced with the implementation of a National Anti-Money Laundering and Counter Financing of Terrorism

(AML/CFT) Strategic Plan 2010–2012 to deliver high impact outcomes, more optimal resource allocations and improved monitoring of AML/CFT measures. This was supplemented by a comprehensive review of the legal and regulatory regime for the money changing and remittance services industry to elevate and modernise the industry, while further strengthening its defences against illicit activities.

Moving forward, key developmental priorities will be focused on the implementation of a new financial sector blueprint, which aims to enhance the capacity and capability of the Malaysian financial sector to serve the needs of a high-value added and high income economy. Among the basic thrusts of the plan are to reinforce the position of Malaysia as a global hub for Islamic financial services, support the holistic review of the pension and social security system given the demographic and social trends in Malaysia and further deepen Malaysia's inter-linkages with regional and international economies through facilitating further growth of cross-border financial transactions.

Regulatory and supervisory framework

Given the changing landscape and an increasingly integrated global financial system, the financial stability policy framework adopted by the Bank has sharpened its focus on the complementary roles of microprudential and macroprudential policy framework as well as market conduct regulation and supervision.

Global reform initiatives by the Basel Committee on Banking Supervision (BCBS) made significant progress during the year with the release of the new capital and liquidity standards in September 2010. The focus now is to complete the calibration of the remaining parts of the proposals and to coordinate global implementation. Based on preliminary assessments conducted by the Bank, banking institutions in Malaysia are well-positioned to meet the higher capital standards supported by their strong capital positions, continued profitability and prudent risk taking strategies. While the implementation of the new global liquidity standards will be more challenging primarily due to the structural characteristics of the domestic funding market, the extended timeframe and observation period provided by the BCBS will enable the Bank to make further impact assessments prior to implementation.

The implementation strategy for the local adoption of the new international standards will be further detailed in 2011. This will involve a careful assessment of the potential impact on the economy, the overall readiness of the financial system and the benefits that will be gained from strengthening the resilience of the financial system to future shocks.

Global initiatives to strengthen the resilience of the Islamic financial system were also taken forward during the year. The Task Force on Islamic Finance and Global Financial Stability published the Islamic Finance and Global Financial Stability Report which highlighted eight key building blocks for a sound and resilient Islamic financial system in the more challenging global environment. Malaysia is now at an advanced stage in developing these key building blocks as efforts to develop the Islamic financial sector have moved in parallel with the conventional financial system over the recent decade.

The migration of 11 banking institutions to the Internal Ratings-Based (IRB) approach for credit risk and the implementation of the Guideline on Internal Capital Adequacy Assessment Process (ICAAP) – the Pillar 2 component of Basel II – completed Malaysia's transition to Basel II. In addition, further enhancements were also made to prudential standards on corporate governance to promote more effective assessments of the fitness and propriety of persons in responsible positions within financial institutions.

Concurrently, the regulatory framework for the Islamic financial system was further strengthened with the development of a more robust solvency framework, enhanced regulatory framework for the management of takaful funds and Shariah governance standards for Islamic banks and takaful operators. The capital adequacy requirements for takaful operators were further defined, building on the parameters earlier established under the proposed Risk-Based Capital Framework for takaful operators (RBCT) and incorporating risk charges that are calibrated to reflect the underlying differences of business models in takaful operations.

Supervisory activities in 2010 remained focused on shoring up financial institutions' capacity to anticipate and respond to emerging risks as well as ensuring that identified vulnerabilities and weaknesses were followed up on and effectively rectified. The focus was directed in particular at promoting more robust stress testing and capital management processes to ensure the continued resilience of financial institutions under a range of economic and financial scenarios. Thematic supervisory reviews were also conducted to examine board practices among banking institutions as well as to assess the effectiveness of AML/CFT measures implemented by financial institutions. The outcome of these supervisory activities and reviews has enabled the Bank to respond pre-emptively to the vulnerabilities identified with the appropriate supervisory actions.

The Bank also heightened its surveillance of market conduct practices in view of the more intense competition in the retail segment. While banking institutions have generally continued to observe prudent underwriting standards, the rigour of standards applied for assessing the suitability and affordability of products offered to consumers varied considerably. In light of these observations, the Bank considered it appropriate to set clear expectations of responsible behaviour for financial institutions in the conduct of business in retail financing. The new Credit Card Guidelines have also been issued to enhance the security features of the credit card infrastructure, strengthen the protection of consumer's interests and mitigate the potential for fraud risk.

In the area of AML/CFT compliance, substantive improvements, including a higher level of awareness and technical capability, use of more sophisticated and discerning customer acceptance and due diligence practices, as well as more extensive use of centralised transaction monitoring models, have been observed across the industry. To support more effective monitoring and surveillance of any money laundering and terrorist financing activities, the Bank's supervisory assessment framework for AML/CFT has been further enhanced to provide additional guidance for supervisors in conducting AML/CFT assessments to ensure the integrity of the financial system.

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 and maintenance of public confidence. The focus of supervisory oversight during the year was to ensure the continuous availability of the systemically important payment systems (Real-time Electronic Transfer of Funds and Securities System, RENTAS), with progressive efforts being undertaken to enhance and modernise the systems to achieve greater efficiency and reliability. Greater attention was also directed at ensuring the operational reliability and robustness of the major retail payment systems such as those operated by the Malaysian Electronic Payment System Sdn. Bhd. (MEPS) and Touch 'n Go Sdn. Bhd. (TnG). During the year, measures were undertaken to strengthen regulatory requirements for retail payments to promote the safe conduct of electronic banking services by financial institutions.

The Bank intensified its efforts to achieve greater penetration of electronic payments in targeted sectors. The implementation of electronic share payment and electronic dividend initiatives during the year increased efficiency in the capital market, while providing greater convenience and faster access to funds for investors. Work also progressed to create an open and interoperable mobile banking and payment ecosystem which would promote the wider use of mobile banking and payment channels in the country.

Collaborative efforts among central banks in the ASEAN region and regional industry players in respect of regional integration of payment systems were also intensified to achieve an ASEAN Economic Community by 2015.

RISK DEVELOPMENTS AND ASSESSMENT OF FINANCIAL STABILITY IN 2010

OVERVIEW

Domestic financial stability was preserved throughout 2010 providing support for the strong growth of the Malaysian economy. The domestic financial system demonstrated a high degree of resilience against the key sources of risks, as highlighted in the *Financial Stability and Payment Systems Report 2009*. Financial intermediation was broad-based and functioned efficiently; the financial markets remained orderly; and confidence in the financial system was maintained throughout the year. This was reinforced by the strong fundamentals of the financial system and an ample liquidity environment, which ensured conditions for the efficient exit from the blanket guarantee on deposits by the Government on 31 December 2010 without event.

Profitability of the financial institutions recorded a strong recovery, on account of higher interest and fee income for the banks, and investment performance for the insurers and takaful operators. This reinforced the strong aggregate capitalisation of the financial sector, both in terms of the level and quality of capital under normal as well as stressed conditions. Amidst more buoyant financial market conditions arising from capital flow movements, risk-taking by financial institutions remained well-managed, with stress tests affirming the capacity of financial institutions to withstand extreme market volatility and conditions associated with reversals of portfolio flows.

While the household debt level continued to expand, the aggregate financial position of the household sector remains sound, supported by income growth, favourable employment conditions and a high level of savings. Close monitoring was accorded to financial management and lending practices that may place households in a vulnerable position moving forward. In addition, attention was also accorded to lending activities of non-bank entities, which mainly focused on the retail segment, to gauge the extent of over-borrowing by any segment within the household sector. Pre-emptive and targeted measures by the Bank have therefore been directed towards addressing this risk.

Deliberations of these risks and the ensuing policy responses were undertaken by the Financial Stability Policy Committee. This high-level forum is responsible for the assessment of risks to financial stability arising from both system-wide and institutional developments, and decisions on the appropriate policy responses. In arriving at these decisions and in designing the specific policy responses, the Financial Stability Policy Committee would take into account the potential trade-offs and spillovers of such actions to the wider economy as well as any longer-term consequences to the financial system. Policy deliberations for macroprudential responses that can have a wider impact on macroeconomic and monetary conditions are jointly deliberated with members of the Monetary Policy Committee of the Bank.

Risks to domestic financial stability in 2011 are expected to be largely externally driven, with significant uncertainties associated with the uneven global recovery and geo-political tensions. This could affect domestic conditions through the potential build up of asset prices, financial market volatility and rising costs of living. As regional and global financial systems become more integrated with a substantial and growing presence of Malaysian financial institutions in the region, the potential for risk transmission and contagion across borders will also be higher, both in terms of speed and magnitude. While Malaysia's financial system is well placed with both the capacity and flexibility to respond to preserve financial stability, the Bank's surveillance and supervisory functions will remain vigilant to these potential sources of risk.

MANAGING RISING HOUSEHOLD DEBT LEVEL

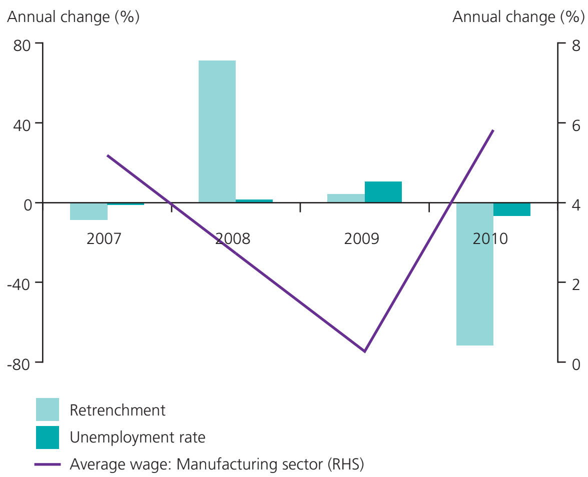
Sound financials enabled households to weather rising prices and higher borrowing costs in 2010

In 2010, households continued to exhibit a strong aggregate financial position, supported by income growth and improved employment conditions. The strong recovery of the domestic economy saw more new job positions created, while unemployment rate continued to improve

(Chart 1.1). This allowed the majority of households to adjust to the rise in food prices, transportation costs and borrowing costs, while preserving their debt servicing capacity (Chart 1.2). Meanwhile, the household debt level continued to expand at a faster pace of 12.5% in 2010, reflecting a rebound in consumer sentiment. The ratio of household debt-to-GDP remained almost unchanged at 75.9% (Chart 1.3). While higher in comparison with other regional economies (Chart 1.4), risks of financial stress in the household sector remain limited at present, as the debt level is comfortably supported by a

Chart 1.1

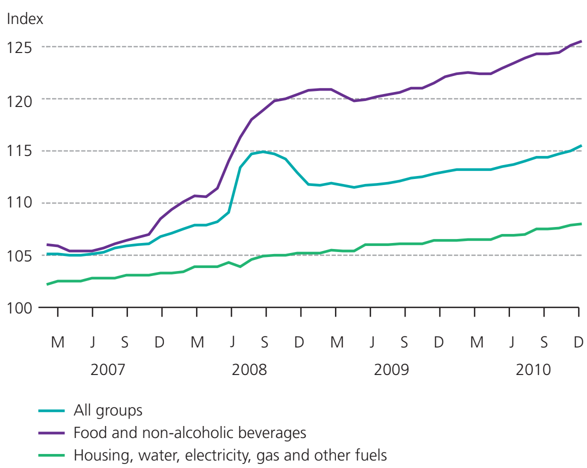
Labour Market Conditions



Source: Department of Statistics, Malaysia

Chart 1.2

Consumer Price Index



Source: Department of Statistics, Malaysia

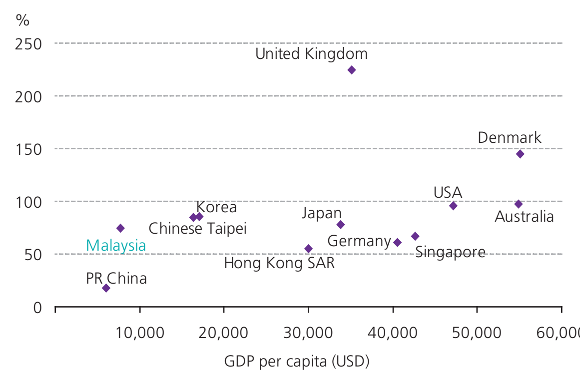
Chart 1.3

Household Debt-to-GDP Ratio

Source: Bank Negara Malaysia and Department of Statistics, Malaysia

Chart 1.4

Country Comparison: Household Debt-to-GDP Ratio

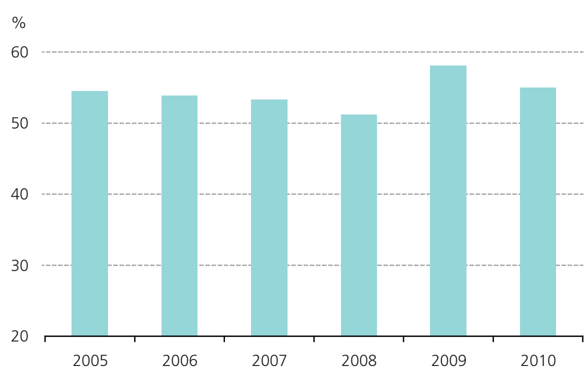


Note: Australia (Q2 2010), Denmark (Q1 2010), Germany (2010), Hong Kong SAR (2009), Japan (Q3 2010), Korea (2009), PR China (2008), Singapore (Q3 2010), Chinese Taipei (2009), United Kingdom (Q1 2009) and USA (Q1 2010)

Source: Bank Negara Malaysia, Department of Statistics, Malaysia; National Authorities and International Monetary Fund

Chart 1.5

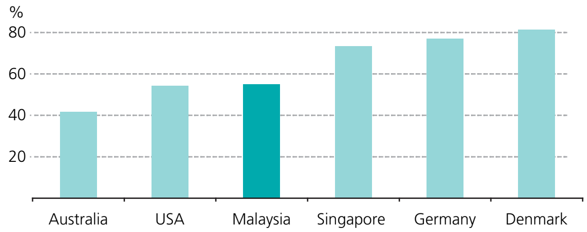
Household Deposit-to-GDP Ratio



Source: Bank Negara Malaysia and Department of Statistics, Malaysia

Chart 1.6

Country Comparison: Household Deposit-to-GDP Ratio

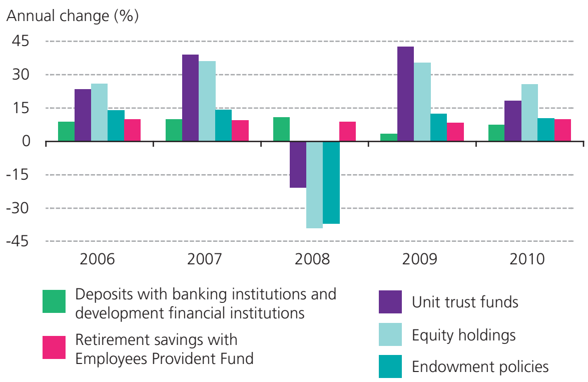


Note: Australia (2009), Denmark (2009), Germany (2009), Singapore (Q3 2010) and USA (2009)

Source: Bank Negara Malaysia, National Authorities and International Monetary Fund

Chart 1.7

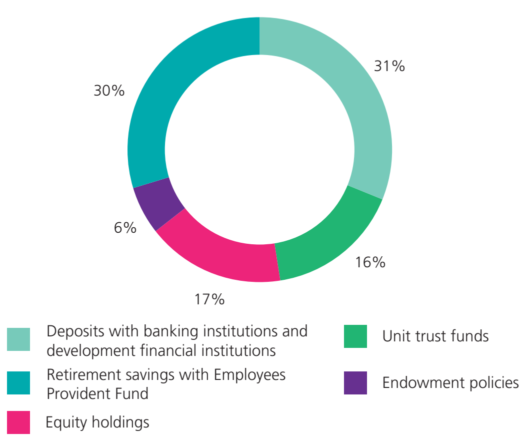
Household Financial Asset



Source: Bank Negara Malaysia, Employees Provident Fund, Securities Commission Malaysia and internal computation

Chart 1.8

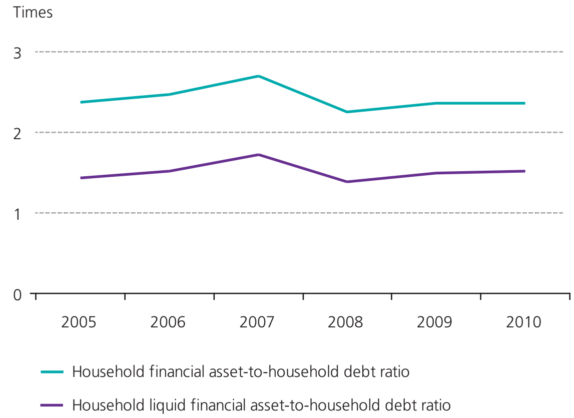
Composition of Household Financial Asset



Source : Bank Negara Malaysia, Employees Provident Fund, Securities Commission Malaysia and internal computation

Chart 1.9

Household Financial Asset-to-Household Debt Ratio



Source: Bank Negara Malaysia, Treasury Housing Loans Division, Employees Provident Fund, Securities Commission Malaysia and internal computation

high level of deposits (Chart 1.5 and Chart 1.6) and other forms of savings (Chart 1.7 and Chart 1.8). Debt coverage, as measured by the household financial asset-to-debt ratio, is more than two times of household debts (Chart 1.9). Delinquency rate is also low at 2.3% of total banking system household financing and has been on a sustained improving trend over the recent decade.

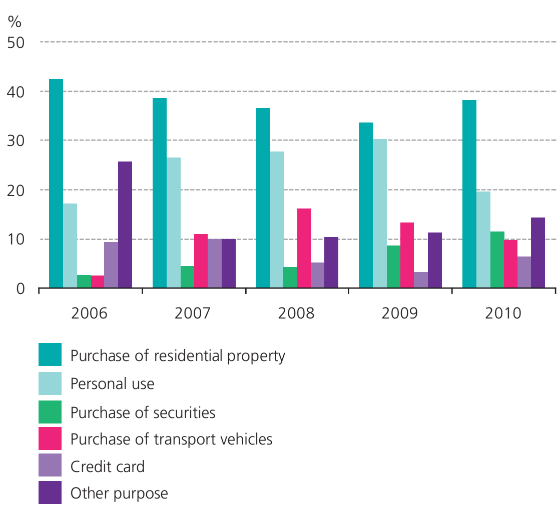
Financial assets of households expanded at 13.1% (2009: 14.9%) for the year. The growth in household financial assets was mainly attributed to the strong performance of the equity market, which bolstered market valuations and holdings of equity by households. With one third of household financial assets in the form of equity, households are susceptible to volatile swings in equity prices as observed in 2008, when a 39.3% fall in the FBM KLCI precipitated a decline in household financial assets. This in turn, may subject household financial position to the vagaries of the equity market. The impact from valuation movements in the equity investments of households is mitigated by a substantial and almost equivalent proportion of household financial assets represented by deposits with financial institutions, which continue to provide a comfortable buffer to support households' debt servicing ability. As at end-2010, the ratio of financial asset-to-debt remained relatively unchanged at 238.4%, with more than 60% of the financial assets held in the form of highly liquid assets (Chart 1.9).

Rising household indebtedness was mitigated by more than two-fold of financial assets buffer. The strong buffer provides a comfortable cushion for households to adjust to the higher cost of living and potentially borrowing costs

Liabilities of households expanded at a slower rate relative to financial assets in 2010. The growth was led mainly by financing for the purchase of properties and for personal use (Chart 1.10 and Chart 1.11). The pace of growth however, was higher than the previous year (12.5%; 2009: 9.4%) (Chart 1.12), although this has largely been offset by a corresponding increase in personal disposable income at the aggregate level. With the continued emphasis of banking institutions on the retail segment (Chart 1.13) and given the rise in household indebtedness, supervisory activity in 2010 remained focused on the robustness of banks' risk underwriting and management practices, as well as the practices and conduct of banking institutions in their dealings with retail customers.

Chart 1.10

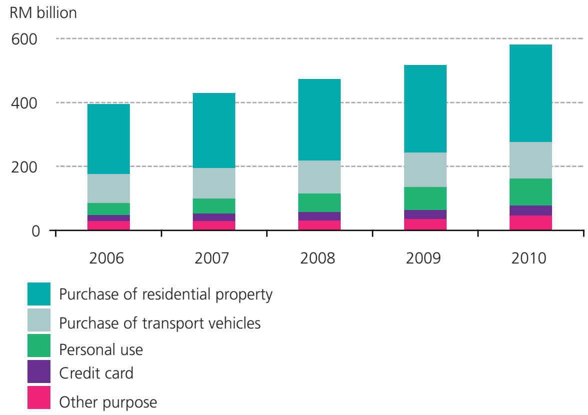
Contributors to Growth of Household Debts



Source: Treasury Housing Loans Division, Bank Negara Malaysia and internal computation

Chart 1.11

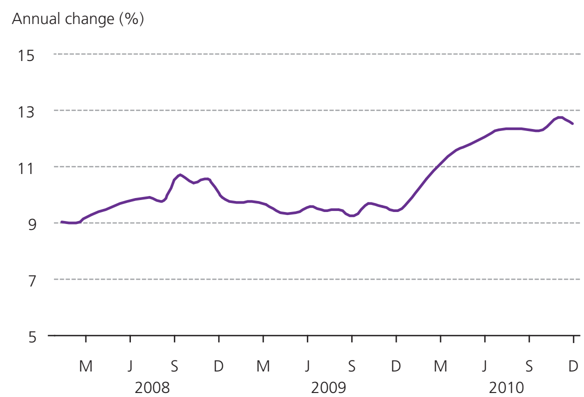
Composition of Household Debts by Purpose



Source: Treasury Housing Loans Division and Bank Negara Malaysia

Chart 1.12

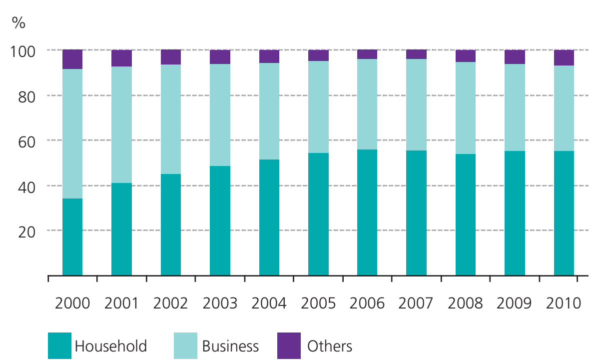
Household Loans Outstanding



Source: Bank Negara Malaysia

Chart 1.13

Proportion of Banking System Loans by Sector



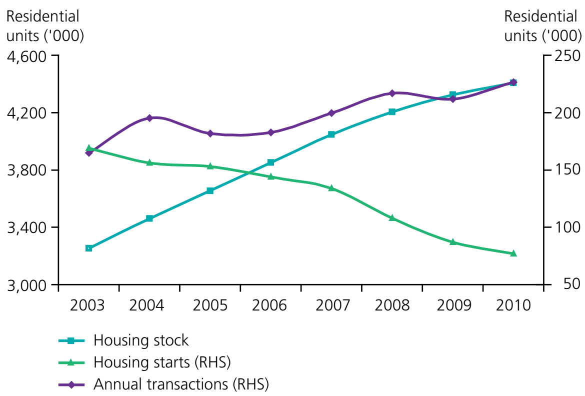
Source: Bank Negara Malaysia

Assessments on banks' underwriting practices so far indicate that the extension of financing on competitive terms such as below base lending rate (BLR) financing rates and extended tenures, have largely been confined to customers that met stringent internal credit standards including those with good financial track records. Such practice therefore ensures that banks' credit risk exposures associated with such financing are contained. In addition, banks also employ other form of safeguards for such financing, which includes the requirement for borrowers to open bank accounts with the lending banks, in order to better monitor payment trends. Credit checks through the Central Credit Reference Information System (CCRIS) ensure comprehensive assessment of borrowers' aggregated debt repayment obligations and credit worthiness. These practices support the continued and improving low delinquency rate for financing to households for the purchase of property which stood at 3.2% of housing loans extended by the banking system (2009: 4.3%).

The residential property market has been experiencing an upturn since the fourth quarter of 2009 as demand rebounded by 7.1% (2009: -2.3%) following improved consumer sentiments. Meanwhile, the increase in housing stock moderated in 2010 as housing starts extended a declining trend (Chart 1.14). The widening gap between supply and demand has kept property prices elevated, although at the national level, the Malaysian House Price Index rose only moderately by 6.2% up to third quarter of 2010 (Chart 1.15). Substantial increases in house prices have been observed in selected locations

Chart 1.14

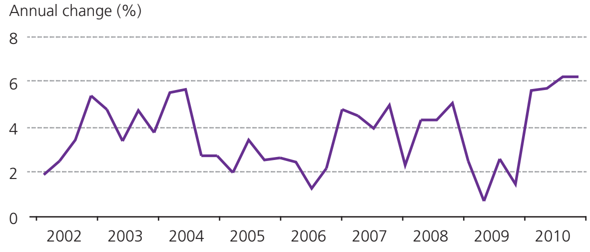
Supply of and Demand for Residential Properties



Source: National Property Information Centre (NAPIC) and internal estimation for 2010

Chart 1.15

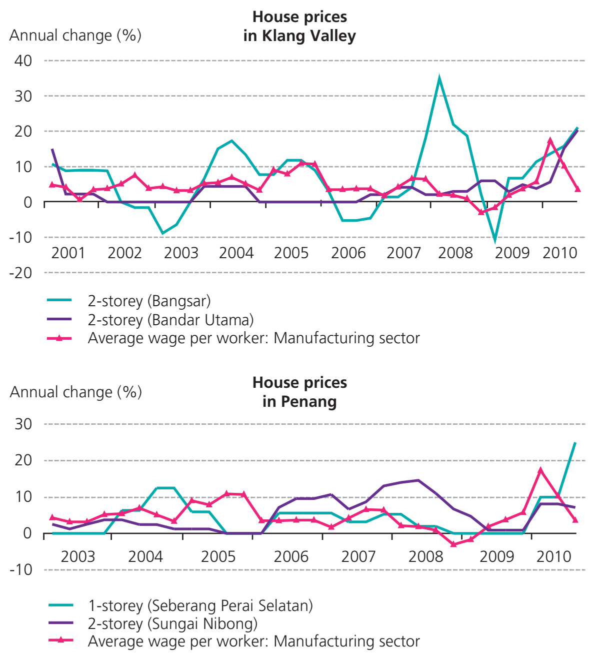
Malaysian House Price Index



Source: National Property Information Centre (NAPIC)

Chart 1.16

Property Prices in Selected Prime Locations

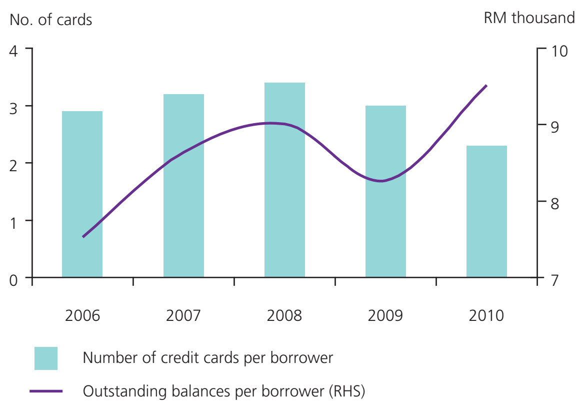


Source: The EDGE and Department of Statistics, Malaysia

within and surrounding the urban areas where price increases were up to four times higher than the national house price index (Chart 1.16). Price increases in these locations have in turn resulted in prices of properties in the surrounding locations to increase, making homeownership increasingly less affordable for average Malaysians. There have also been incidents of applications for financing of multiple residential units within a single development project from a single borrower. To address this development, while safeguarding the risk profile of banks' house financing portfolios, borrowers are subjected to a loan-to-value (LTV) ratio of 70% for the third and subsequent house financing facilities with effect from 3 November 2010. This measure aims to promote a stable and sustainable property market by deterring speculative activity through higher equity requirements for transactions of these nature, without affecting genuine home owners who would continue to be able to obtain financing at the prevailing LTV levels applied by financial institutions based on their internal credit policies. In January 2011, the Bank revised the risk weights applied under the capital adequacy framework from 75% to 100% for housing loans with LTVs exceeding 90% to further reinforce prudent underwriting practices.

Chart 1.17

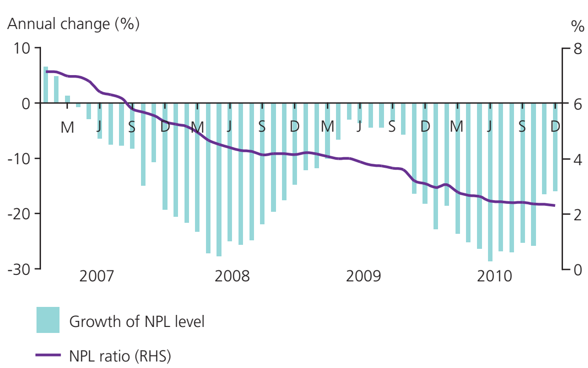
Credit Cards per Borrower



Source: Bank Negara Malaysia

Chart 1.18

Banking System: NPL of Household Sector



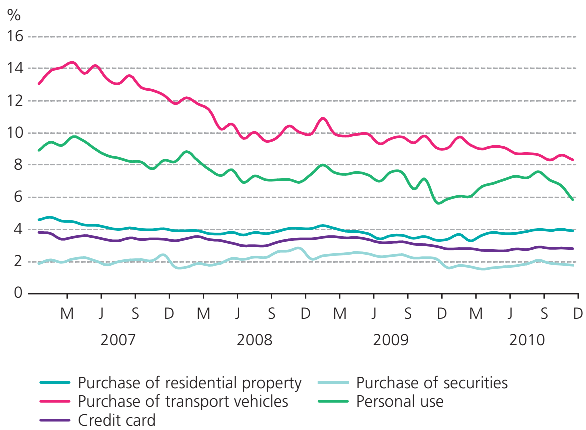
Source: Bank Negara Malaysia

While a large fraction of household borrowings is collateralised (45.3% was for the purchase of residential properties), personal financing has increased significantly in recent periods. In 2010, outstanding personal financing grew by 17.5% to account for 14.6% of household debt (2006: 9.6%). Development financial institutions (DFIs), cooperatives and building societies accounted for the bulk of this growth, with almost 80% granted under salary deduction schemes. Given the salary deduction feature, credit assessments by these institutions are mostly limited to a reliance on incomplete computations of debt-servicing ratios, which are applied for the purpose of qualifying for the salary deduction facility. The absence of robust credit and affordability assessments will result in households being more at risk of becoming over-indebted, while the risk of defaulting on financing obligations, including those obtained from other banking institutions, will be higher for borrowers who have over-borrowed. Excluding the DFIs, personal financing exposures of commercial banks increased at a lower rate of 13% to account for 8.6% of banking system household loans. Sound underwriting standards have largely been maintained by banks in terms of financing limits, tenures and pricing for these exposures.

The higher household debt level is also partially attributed to increases in credit card transactions. Despite a reduction in the number of cards owned by households following the imposition of a RM50 fee by the Government on credit cards in 2010, outstanding credit card balances increased by 15.2% to RM30.8 billion as at end-2010 to account for 5.3% of household debts. Similarly, outstanding balances per credit card holder rose by 15.1% to RM9,516 as at end-2010 (Chart 1.17). The number of credit card holders with revolving balances (excluding defaulters) accounted for 47.9% of total credit card holders. More than half of credit card holders with revolving balances were those earning an annual income of RM36,000 and below. Meanwhile, the level of non-performing loans (NPLs) ratio for credit cards issued by banks and non-banks remained low at 1.7%. To ensure that credit card debts are maintained at manageable levels, a number of pre-emptive measures have been introduced, including raising minimum income eligibility, limiting the number of credit card ownership and aggregate credit limit for those with annual income of RM36,000 and below.

Chart 1.19

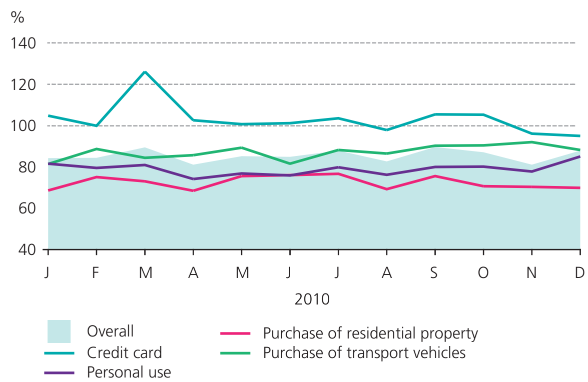
Banking System: Loans-in-Arrears Ratio of Household Sector by Purpose



Source: Bank Negara Malaysia

Chart 1.20

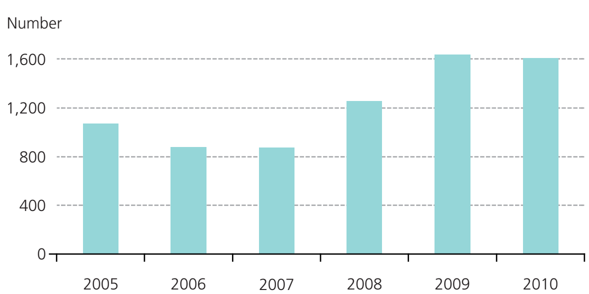
Banking System: Household Debt Repayment-to-disbursement Ratio



Source: Bank Negara Malaysia

Chart 1.21

Number of Bankruptcies



Source: Malaysia Department of Insolvency

Aggregate debt repayment capacity of households remained intact throughout the period of economic contraction in 2009 and has continued to be sustained in 2010. NPLs improved further during the year, both in terms of amount and ratio, underpinned by the relatively stable incidence of new delinquencies (Chart 1.18). Similarly, loans-in-arrears across most categories of household debts remained stable, while loans-in-arrears for personal financing, which drifted upwards in the early part of the year, started to come down in the fourth quarter of 2010 (Chart 1.19). As at end-2010, the NPL ratio for household loans was 2.3%. The ratio of household loan repayment-to-disbursement increased marginally to 87.8% (Chart 1.20). There has been little evidence of an across the board deterioration in underwriting standards and practices to date. Lending decisions have continued to be well supported by the strengthened credit information and the risk management infrastructure put in place by banking institutions. For the isolated instances of a loosening in underwriting practices by individual institutions, the Bank has taken firm supervisory actions. The adoption of Basel II, which became effective in 2008, has also further supported and strengthened risk management practices among the financial institutions.

While aggregate indicators suggest that household financial positions remain sound, the highly competitive environment and the increased indebtedness of households have called for pre-emptive measures to preserve the resilience of the household sector going forward. While the number of personal bankruptcies and relapse rate among borrowers under AKPK's Debt Management Programme has been manageable, it has been on the increase since 2007 (Chart 1.21). Important in taking on increased debts by the households is their capacity and capability to more effectively manage their financial positions.

In response to these developments, a number of initiatives were implemented during the year to ensure the continued resilience of the household sector. These include the introduction of the POWER! Programme, to educate younger and first time borrowers on responsible borrowing, tighter standards for credit cards and enhanced requirements on the conduct of business by financial institutions in retail financing. See box article on *"Pengurusan Wang Ringgit Anda (POWER!) Programme"*. Under the new measures introduced for credit cards, individuals with an

Pengurusan Wang Ringgit Anda (POWER!) Programme

The *Pengurusan Wang Ringgit Anda* (POWER!) Programme was launched in January 2011 as part of the agenda to improve the financial capability of Malaysian financial consumers. It complements the *bankinginfo* and *insuranceinfo* initiatives as the key platforms through which the Bank, in collaboration with its partners, works to support better financial decisions among the adult population.

With more intense competition in the financial sector and increasing complexity of financial product offerings, the ability of consumers to better understand the implications of their financial choices is vital to ensure that they can adapt to unexpected changes in their circumstances, and avoid falling into financial hardship. The young adult population in particular is facing a more demanding environment in which less than optimal financial decisions can have significant longer-term consequences in terms of their ability to meet future expenditures, weather unexpected changes in income levels and provide sufficiently for retirement. Against this backdrop, the POWER! Programme aims to help consumers achieve their financial goals and protect themselves from falling into over-indebtedness through better borrowing decisions. In addition, the programme will empower financial consumers to engage more effectively with financial service providers when making their financial choices and in resolving any debt problems that may arise. Equally significant are the wider benefits to the economy and society that will accrue from financially resilient households, sustainable consumption growth and a strong safety net.

The POWER! Programme is targeted primarily for young individuals and new borrowers to equip them with practical financial knowledge and skills on money and debt management as well as decision-making tools to make sound and responsible financial decisions. The half-day voluntary programme covers six modules delivered in a highly interactive, relevant and creative manner. The modules address topics that will confront most young adults in the management of their financial affairs such as how to analyse and manage personal or household cash flows, maintain manageable debt levels, and the key considerations and processes that a potential borrower should understand when obtaining financing for house and vehicle purchases, or credit card facilities for personal use. The programme uses financial toolkits and focuses on practical applications of financial decisions and their consequences in real life situations that will create a direct and immediate impact in making responsible financial management a way of life among Malaysia's young adults.

The programme is managed and delivered by Credit Counselling And Debt Management Agency (AKPK) in collaboration with banking institutions. Participation in the programme is free of charge and individuals can register for the programme directly with AKPK or through their banking institutions. Meanwhile, work has advanced to develop a wide range of interactive learning and online tools to supplement the POWER! Programme. Through these facilities, participants will be able to simulate their financial affordability, cash flow and financial net worth, engage in discussion forums on financial management and obtain financial tips and advice.

Employers and members of the public can obtain more details of the programme in the websites of AKPK (www.akpk.org.my), *bankinginfo* (www.bankinginfo.com.my) or *insuranceinfo* (www.insuranceinfo.com.my). Interested parties can also contact AKPK at their toll-free number 1-800-88-2575 or Bank Negara Malaysia TELELINK at 1-300-88-5465.

Table 1

Overview of the POWER! Programme

No.	Module	Key contents
1.	Cash Flow Management	• Smart living: identify needs and wants • Develop personal budget and cash flow/net worth statement • Knowing financial position and net worth
2.	Borrowing Basics	• Common sources of personal credit and key features of credit facilities • Key lending criteria • Cost of borrowing and setting own debt limit • Rights and responsibilities of a borrower
3.	Using a Credit Card	• Different types of cards i.e. debit card, credit card and charge card • Understanding the terms and conditions of credit cards • Using credit cards wisely • Responsibility to protect credit cards
4.	Buying a Car	• Factors to consider when buying a car, including affordability, maintenance and other recurring expenses • Terms and conditions of hire purchase agreement, including term charges, early settlement and repossession
5.	Buying a House	• Factors to consider when buying a house, including affordability, types of house ownership, location, cost and maintenance • Understanding the terms and conditions of housing loans/house financing • Understanding the rights and responsibilities of a borrower • Consequences of default
6.	The Importance of Managing Your Debts	• Factors contributing to indebtedness • Consequences of unmanageable debt • Importance of building and maintaining good credit history • Advisory and redress services available to assist in better debt management

annual income of RM36,000 and less will be limited to owning credit cards from not more than two issuers and an aggregate credit limit of not exceeding two times the individual's monthly income per issuer. The minimum income eligibility criterion for credit card applications has also been strengthened to RM24,000 per annum from RM18,000 previously. This is supplemented by new guidelines to be issued by the Bank on the conduct of business in retail financing, which set the minimum standards (including on affordability and suitability assessments), to deliver a more responsible approach to lending by the financial institutions. The guidelines have recently undergone a consultation process with the industry and will be issued in April 2011. Details of the measures are highlighted in box article *"Consumer Protection, Market Conduct and Financial Stability"*.

FINANCIAL STABILITY IMPLICATIONS OF VOLATILE CAPITAL FLOWS

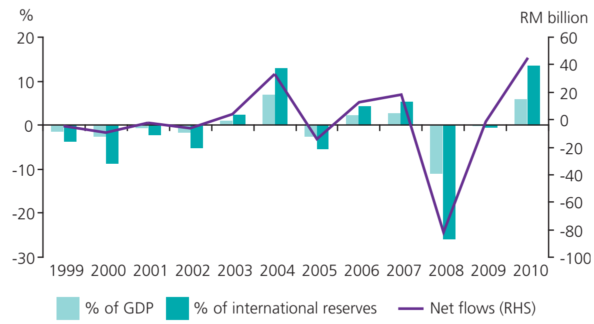
Financial stability implications from volatile portfolio flows remained manageable

The resumption of inflows of portfolio investments into the Asian region, including Malaysia, since the second half of 2009 gained further momentum in 2010. The surge of such flows has posed challenges to the management of liquidity and monetary policy operations in the regional economies, prompting heightened surveillance by authorities for signs of accumulation of excessive risk in the financial system and in the asset markets. A number of the regional economies have introduced measures to manage the surge and volatility in portfolio inflows in order to preserve stable conditions in the domestic markets, including for when the trend reverses. While Malaysia experienced a similar magnitude of portfolio flows, this has not materially altered the risk-taking behaviours of financial institutions, businesses and households. Financial markets in Malaysia have also remained orderly and exhibited an enhanced capacity to intermediate the increased volume and movements of the portfolio flows.

The resurgence in portfolio flows into Malaysia became more evident from the third quarter of 2009 amid better economic growth prospects in the region, including Malaysia, and improvements in the international financial market conditions. Given Malaysia's increased integration with the global financial system, the magnitude and

Chart 1.22

Net Portfolio Flows



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

volatility of the two-way flows have been more pronounced in periods of heightened uncertainty such as that experienced at the height of the global financial crisis and during the financial turmoil in the European sovereign debt markets in mid-2010. For the year as a whole, net portfolio flows were positive, amounting to RM44.9 billion (2009: net outflow of RM1.7 billion) to account for 5.9% of GDP (Chart 1.22).

Portfolio investment flows into the country are now being channeled into more diversified asset classes. In the first half of 2010, the inflows were largely concentrated in the public debt market, in particular, the Malaysian Government Securities (MGS) and Bank Negara Monetary Notes (BNMN), causing MGS yields to decline. As investors' risk appetite improved and search for yields re-surfaced, the positive outlook for the domestic economy drew more funds into the equity and futures markets. This contrasts with the period of large portfolio capital inflows during 1992-1993, when inflows were heavily concentrated in the equity market, which resulted in the exceptionally bullish performance of the Kuala Lumpur Stock Exchange in 1993.

Reflective of these developments, changes in foreign participation in the capital markets during the year were more evident in the public debt securities market. Non-resident holdings of MGS, as at end-2010, rose by 64.2% to RM74 billion to account for 28.3% of outstanding MGS. Holdings of BNMN by non-residents were slightly higher at 32.8% of outstanding BNMN for the same period. While holdings of short-term securities by non-residents increased during the year, longer-tenured securities continued to represent

Consumer Protection, Market Conduct and Financial Stability

The regulation and supervision of the conduct of financial institutions towards consumers has traditionally served mainly to protect individuals from unfair, abusive and predatory practices by financial institutions. More recently however, regulations that protect financial consumers (or market conduct regulations) have also received greater global attention as having an important complementary role to prudential regulation and supervision in protecting the overall financial system from **systemic risk**. This article elaborates the link between market conduct practices of financial institutions and the build-up of systemic risk drawing on observations from the global financial crisis, and provides an insight to the market conduct regulatory and supervisory regime in Malaysia including the focus of current and future initiatives to mitigate systemic risk.

Observations from the financial crisis

From a market conduct perspective, a confluence of several notable developments contributed to events that culminated in the financial crisis:

- The decade predating the financial crisis saw a dramatic increase in subprime mortgage lending which was partly fuelled by a period of substantive deregulation of the features and terms of consumer loans. In particular, the Depository Institutions Deregulation and Monetary Control Act of 1980 which lifted state-regulated interest-rate caps is widely credited with spurring the growth of subprime lending in the United States (US);

- The rapid pace of financial innovation and growing complexity of financial products also significantly widened the information gaps between financial institutions and consumers, in turn rendering ineffective much of the disclosure-based regulations that had replaced the regulation of the terms of consumer loans. Mortgages and consumer credit products offered by financial institutions in the US have evolved to include complex terms that allowed lenders to reset interest rates or charge heavy fees and penalties that were not apparent or adequately explained to consumers. This in turn led to poor and uninformed financial decisions where borrowers were unrealistically led to believe that they could depend on a perpetual rise in house prices to meet potentially onerous financial obligations;

- In an environment of intense competition, misaligned incentive structures in the credit and sales processes also worked against the interests of consumers. Compensation structures were biased towards encouraging lenders and intermediaries to push products that generated the highest profit or commission, with little or no regard for the suitability of the product to a borrower's particular financial circumstances. Incentive schemes that linked commissions to sales volume or particular credit products expectedly reduced incentives for intermediaries to ascertain the customer's financing needs or capacity to repay the debt over the longer term without substantial hardship; and

- The advent of securitisation enabled lenders to easily offload credit risks and generate cash flows (and lucrative servicing fees) that allowed **and** incentivised them to further increase lending exponentially to the subprime segment. Investors in securities that were backed by subprime credits also suffered major losses which were widely blamed on the misrepresentation of securitisation products as low-risk alternatives to deposits. Subsequent regulatory reviews, including in Asia, of market conduct practices in the offering and sale of securities linked to subprime mortgages revealed mis-selling by sales representatives who were ill-equipped to properly explain the risks associated with the products, and failed to establish the suitability of the products for the investors to whom the products were being sold.

These developments had important and ultimately disastrous consequences for the stability of the overall financial system. They contributed towards significantly increasing leverage in the system as a whole as financial institutions, borrowers and investors collectively miscalculated and failed to properly take account of the risks that they were exposed to. When concessionary interest rates on adjustable rate mortgages were reset to market rates and house prices eventually corrected, borrowers defaulted in large numbers, triggering a series of events that would threaten the livelihoods of indebted borrowers, the soundness of financial institutions and ultimately, impair the ability of the financial system to perform its intermediation function. Widespread foreclosures further depressed house values, feeding into a vicious cycle that significantly impeded recovery efforts. This was further compounded by regulatory findings of improper foreclosure practices by some financial institutions which further stalled recoveries that were critical to restore the balance sheets of financial institutions and revive lending to the economy. Continuing allegations of pervasive misconduct on the part of lenders, arrangers and brokers both in the mortgage and securitisation markets saw the widespread erosion of confidence in financial institutions and markets which severely affected the functioning of funding markets during the crisis, and continues today to cast a shadow over the firm recovery of financial institutions which remain exposed to financial losses from legal and regulatory sanctions.

In the wake of the financial crisis, financial regulators in a number of countries have since moved to strengthen existing institutional arrangements and regulations in the area of market conduct. Most notably, authorities in many jurisdictions have introduced higher standards on fair and responsible lending practices, particularly in lending to households and small businesses. These standards have substantially raised the bar on practices by financial institutions in ensuring that credit products offered to individuals are both affordable and suitable for their needs. Other significant developments have included extending the existing consumer credit law to regulate the emergence of a wider array of players in the consumer credit market, the establishment of new agencies and enactment of new legislation to support a stronger focus on consumer protection. This requires significantly higher standards of competency of sales intermediaries and a return to stronger regulatory prescriptions on terms and conditions of credit and circumstances under which complex products may be offered to individuals.

Market conduct regulation and supervision in Malaysia

The financial consumer protection framework in Malaysia for which Bank Negara Malaysia is primarily responsible, comprises five main strands which may be described as follows:

- Regulating and supervising the market conduct practices of financial institutions. This focuses on addressing information asymmetries between financial institutions and consumers, and setting clear expectations on fair, responsible and transparent practices by financial institutions in their dealings with consumers;

- Empowering consumers to make sound and well-informed financial decisions through a comprehensive and sustained financial education programme;

- Providing a comprehensive supporting credit infrastructure that promotes a sound credit culture among consumers and robust credit assessments by financial institutions;

- Setting and enforcing qualification and competency standards for sales and marketing personnel/ agents and other intermediaries such as insurance brokers and financial advisers; and

- Providing effective and expedient redress and support arrangements for financial consumers, including complaints and mediation channels, financial counselling services and debt management programmes.

In an environment of increasingly intense competition, the search for yield among investors, and the globalisation of financial institutions with operations in multiple jurisdictions, Malaysia benefited in particular from several notable elements of the financial consumer protection framework that has been put in place in averting the widespread market conduct failures which were revealed in some jurisdictions at the height of the financial crisis.

Under the framework applied by the Bank for the regulation of financial products, banking institutions were required until 2007 to obtain the Bank's approval for any new financial product prior to offering the product for sale in the market. This allowed the Bank to review the capacity of the financial institution to effectively manage the risks associated with the product, both to the institution itself and the consumers to whom the products would be sold. As part of this process, the Bank can prohibit a financial institution from offering any product, or require the institution to vary the product (including related disclosures to consumers) to address any regulatory concerns. With strengthened risk management frameworks in place within financial institutions, the product approval regime has since been gradually replaced by a notification requirement which improved the time-to-market of new product offerings, while effectively preserving the ability of the Bank to conduct timely regulatory reviews of significant new products. Supervisory actions by the Bank were also expanded to include requiring financial institutions to recall misleading or high-risk products and provide restitution to affected consumers. Further, the Bank has preserved the requirement for financial institutions to obtain the Bank's prior approval of products that are new to the domestic market. Given the expectations under this framework for a financial institution to be able to demonstrate to the Bank its ability to adequately safeguard the interests of consumers and internally manage the risks associated with any new product, financial institutions in Malaysia largely avoided involving themselves in offering the complex securitisation products that had led to significant losses experienced by financial institutions and investors in several countries during the crisis.

Financial institutions are also required to observe requirements to actively consider and properly advise consumers on the suitability of products for their needs. For the introduction of new financial products, in particular sophisticated investment products, financial institutions are required to establish customer suitability procedures that include processes to clearly describe the types of consumers that a product would generally be suitable for, clear lines of authority for approving transactions with customers that do not meet generic customer suitability profiles and the effective oversight of sales personnel. To establish customer suitability, financial institutions must obtain and document relevant information from a prospective customer to determine the financial circumstances, needs and objectives of the customer as a basis for recommending a particular product.

Financial institutions must further comply with specific disclosure requirements that are designed to ensure that disclosures (including product names and descriptions) are not confusing and presented in plain language, and that the key risks of financial products are highlighted in a prominent manner to consumers. The disclosures must also clearly illustrate in defined terms the financial impact to consumers of changes to key variable features of products. Financial institutions must provide relevant disclosures to consumers before and at the point of entering into a financial contract, as well as during the contract.

Another significant element has been the development of a strong national credit infrastructure in Malaysia that is instrumental in financial institutions' management of credit risk. The comprehensive national Central Credit Reference Information System (CCRIS) which has been acknowledged as among the best by the World Bank for its scope, accessibility and quality of credit information, has now been operational for 10 years. The system captures details of all outstanding credit facilities and the month-by-month repayment track record of any individual or company with a credit facility from banking institutions. The system figures prominently in financial institutions' credit scoring systems and assessments of the creditworthiness of prospective borrowers, and thus plays an important role in mitigating the risk of a system-wide deterioration in underwriting standards among financial institutions such as was observed in some markets in the period dealing up to the crisis.

Moving forward

The main strands that characterise Malaysia's consumer protection framework work together to protect consumers from predatory practices and excessive risk, as well as the financial system from systemic risk. In mitigating systemic risk however, the focus is on addressing **collective action failures** by financial institutions or borrowers that can lead to systemic risks. In this respect, current and future initiatives to further strengthen the existing consumer protection and market conduct regime to address systemic risk are focused on:

- addressing specific expectations on responsible conduct by financial institutions in the retail financing segment. This aims in particular to promote more rigorous and consistent practices by financial institutions in considering the factors that should be taken into account in conducting assessments of whether a financing product is affordable and suitable given a borrower's financial circumstances;
- further refining disclosure requirements where appropriate to encourage consumers to focus on key risks (e.g. by using more illustrative disclosures, greater standardisation of how key terms are presented to consumers, or through the more effective use of default and opt-in provisions for more complex or higher-risk product features);
- strengthening institutional arrangements for the regulation and supervision of market conduct. This includes enhancing existing inter-agency coordination arrangements to promote consistent approaches to the regulation and supervision of retail financing activities;
- conducting thematic and focused supervisory reviews of market conduct practices of financial institutions in selected areas to identify behavioural biases that can increase systemic risks. This will include industry-wide assessments of retail financing practices, covering incentive systems, the terms of consumer lending and retail investment products, and the manner in which such products are presented and sold to consumers;
- intensifying consumer financial education efforts to promote responsible borrowing decisions on the part of consumers through the nation-wide roll-out of the POWER! Programme and supplementary financial toolkits for consumers; and
- further developing and leveraging on the credit infrastructure to promote a healthy credit culture among borrowers.

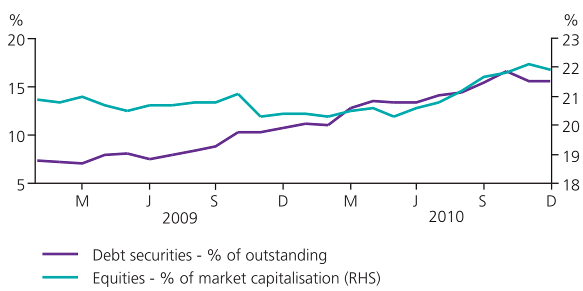
the bulk of their investments, accounting for 73% of total non-resident holdings of domestic debt securities. In the private debt securities (PDS) market, non-resident holdings of PDS remained small and stable at 5% of outstanding PDS. In the equity market, non-resident holdings rose only marginally by 1.5 percentage points to account for 21.9% of market capitalisation as at end-2010 (2009: 20.4%) (Chart 1.23). These holdings however remained lower than the previous peak of 26.2% of market capitalisation in 2007. In the futures market, non-resident holdings of KLCI and crude palm oil futures rose to 39% and 26% respectively of the total number of contracts as at end-2010 (Chart 1.24).

While resurgence in portfolio inflows led to some asset price appreciation, resilience of domestic financial markets was well preserved

The inflows of portfolio investments combined with positive prospects of economic performance contributed to the bullish sentiment in the financial

Chart 1.23

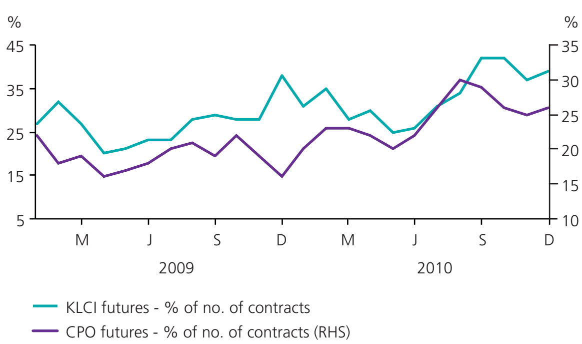
Foreign Holdings of Equities and Debt Securities



Source: Bank Negara Malaysia and Bursa Malaysia

Chart 1.24

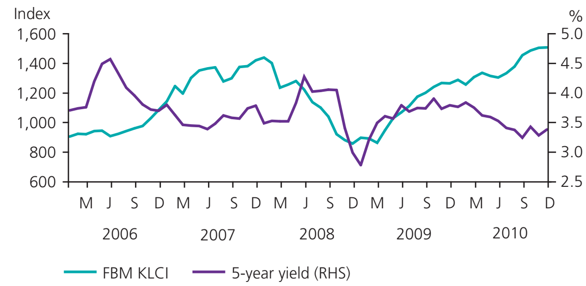
Foreign Holdings of KLCI and CPO Futures



Source: Bursa Malaysia

Chart 1.25

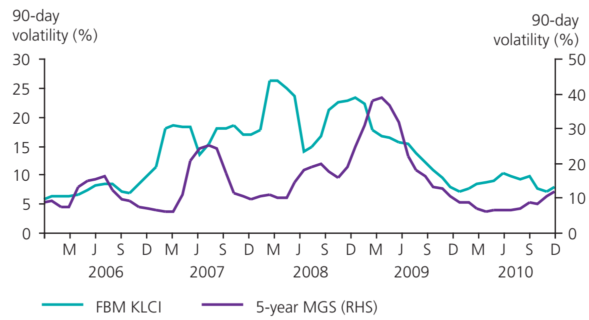
FBM KLCI and MGS Yield



Source: Bank Negara Malaysia and Bloomberg

Chart 1.26

Volatility in FBM KLCI and MGS



Source: Bloomberg

markets and higher prices of financial assets. In the government bond market, the strong demand by non-residents amid lower supply caused MGS prices to rise, suppressing yields in the medium to longer end of the spectrum (Chart 1.25). The average bid-to-cover ratio for MGS auctions rose to 2.12 times in 2010 (2009: 1.77 times), while the yield curve flattened between January and September despite the 75 basis points increase in the overnight policy rate (OPR) during the year. The trend subsequently reversed in October following the release of the Government's budget allocation for 2011, which indicated a potentially higher issuance of MGS. Volatility in MGS (5-year) yield eased, averaging 8.2% for the year (2009: 24.5%) (Chart 1.26). Trading liquidity was favourable with the average monthly turnover ratio for MGS rising to 11.6% (2009: 10.4%) while the average bid-ask spreads for benchmark MGS remained stable at 12 basis points. This reinforced the continued resilience of the government bond market, as reflected in the relatively stable and low ratio of returns to turnover in MGS (2010: 0.04, 2009: 0.06) (Chart 1.27).

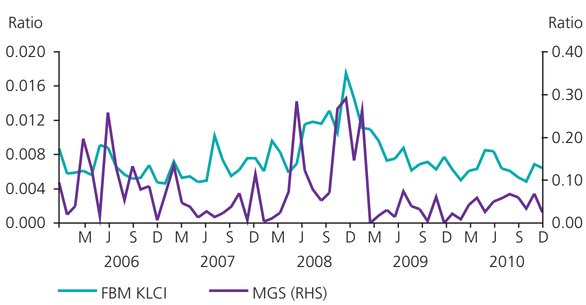
Similarly, domestic equity prices generally trended upwards during the year, driven mainly by favourable corporate earnings, the renewed focus on economic reforms, which further boosted the long-term growth prospects for the economy, as well as market expectations of a stronger ringgit. These favourable developments more than offset externally induced uncertainties associated with the elevated sovereign risks in Europe and policy tightening measures by various economies in the Asian region. The benchmark FBM KLCI gained 19.3% (2009: 45.2%) to reach a historical high of 1,528 points in November while average volatility declined to 8.6% (2009: 15.1%) (Chart 1.26). This gain was more modest in comparison with several other equity bourses in the region, which experienced gains in excess of 30% for the year. The rally in the domestic equity market since 2009 has also not caused excessive valuations, with the average price earnings ratio for FBM KLCI remaining relatively stable at 18.3 times (2009: 18.6 times). Market liquidity remained healthy with average bid-ask spreads tightening to 46.9 basis points (2009: 68.4 basis points) whilst the FBM KLCI average monthly turnover ratio was 42.5% (2009: 49.8%). The ratio of returns to turnover generally trended lower throughout the year, denoting the resilience of the domestic equity market (Chart 1.27).

Favourable financial market conditions, coupled with ample domestic liquidity, did not translate into significant changes in risk-taking behaviour of financial institutions

The trading portfolio of the banking system increased by 49.2% in 2010 after a sluggish trading year in 2009 as risk aversion abated. This led to higher net trading and investment gains, which posted an overall growth of 4% for the

Chart 1.27

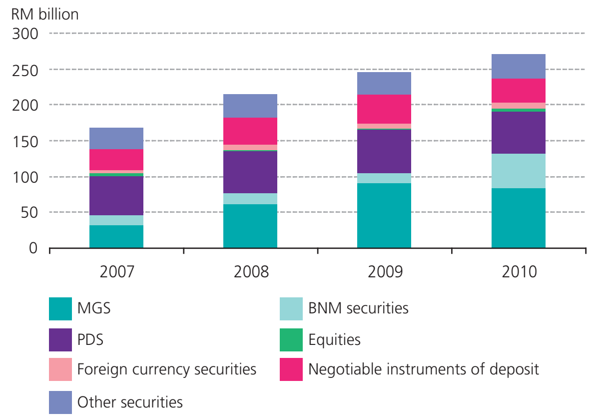
Returns-to-turnover Ratio for FBM KLCI and MGS



Source: Bloomberg, Bank Negara Malaysia, RAM quant shop and internal computation

Chart 1.28

Banking System: Composition of Securities Portfolio



Source: Bank Negara Malaysia

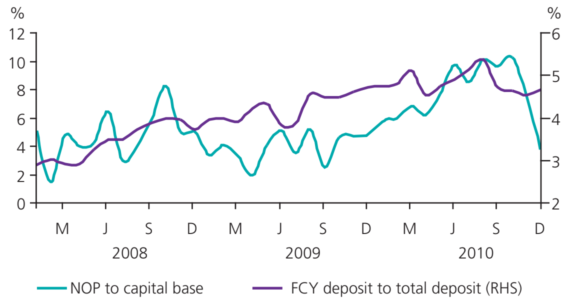
year, to account for 15.4% of the total income of banking institutions (2009: 16.6%). Despite more buoyant conditions in the financial markets and continued surplus liquidity, treasury assets of banks did not change materially in terms of the composition (Chart 1.28). This is reflected in the aggregate interest rate exposure of the banking system, as measured by the duration-weighted position, which remained stable at 4.9% of capital base (5% as at end-2009).

Overall foreign currency exposures of banks, as measured by the net open position (NOP) was at 3.8% of capital base as at end-2010 (2009: 4.4% of capital base). This was primarily attributed to an increase in foreign exchange forward transactions entered into with domestic corporations, as a result of more active hedging activities by businesses in view of the strengthening trend of the ringgit. A small number of banks, which recorded large increases in NOP were brought under closer supervision by the Bank to ensure that the related risks were being properly monitored and effectively managed.

Other foreign currency exposures in the form of foreign currency deposits and foreign currency denominated securities drifted higher but remained small in proportion to total deposits (4.7%) and securities (3.5%) respectively. Deposit flows have continued to witness two-way movements – placement of deposits abroad by Malaysian banks and placement of deposits with Malaysian banks by non-residents. Deposits by non-residents rose slightly, but remained relatively stable as a proportion of the deposit base, at 2.4% and

Chart 1.29

Banking System: Foreign Currency Net Open Position (NOP) and Foreign Currency (FCY) Deposit



Source: Bank Negara Malaysia

10.6% for ringgit and foreign currency deposits respectively (Chart 1.29). Overall, ringgit deposits continued to be the main source of funding for Malaysian banks, accounting for 81.3% of total funding.

Direct exposures of banks to foreign currency asset-liability mismatches remained low, at less than 1% of total assets of the banking system. In terms of indirect exposures emanating from open positions, mainly to corporations in the export-oriented resource-based industries that have maintained unhedged positions, the banking system's credit exposures to these sectors are small at less than 5% of outstanding business loans.

In the insurance and takaful sector, investment portfolios moved into higher yielding assets in tandem with the improved performance of equity market. Equity holdings by insurers grew marginally to account for 16.5% of insurance industry assets, compared to 13.5% in 2009. This was accompanied by additional capital set aside by insurers for market risk, which accounted for 32.5% of total capital required (2009: 29.5%) or RM7.9 billion (2009: RM6.5 billion) as at end-2010 (Chart 1.30). The high capital charge for equity has acted to effectively contain overly aggressive rebalancing by insurers into equity.

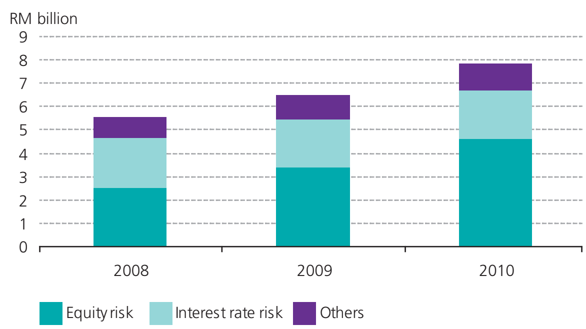
Meanwhile, holdings of long-term PDS remained almost unchanged to account for 38.6% of insurance industry assets, the bulk of which was concentrated in high investment grade papers (AA-rated and above). Holdings of relatively lower yielding assets such as MGS and fixed deposit placements declined to account for 15.5% and 11.2% of total assets respectively as at end-2010 (2009: 15.1% and 13.9% respectively) (Chart 1.31).

Historically low yields have continued to exert pressure on life insurers' asset-liability positions. This was partly eased by the temporary flexibility accorded to insurers to apply the average yields observed over eight preceding quarters (instead of prevailing spot yields) in the valuation of liabilities. This flexibility, which was put in place since April 2009, expired on 31 December 2010. While the reversion to spot yields will result in higher liability valuations, the impact on capital is expected to be manageable given the industry's strong capital buffers and earlier upward adjustments in MGS yields since October 2010.

During the year, a number of new structured products linked to foreign currencies and

Chart 1.30

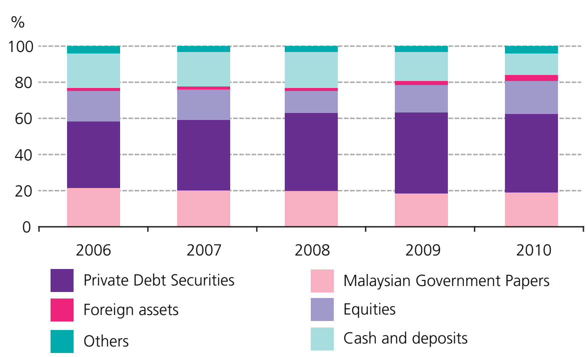
Components of Market Risk Exposures of Insurance Industry



Source: Bank Negara Malaysia

Chart 1.31

Composition of Insurance and Takaful Industry Assets



Source: Bank Negara Malaysia

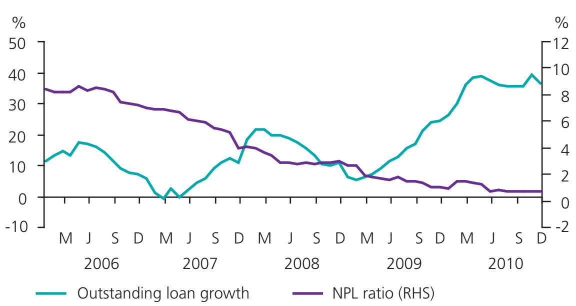
commodities were introduced by financial institutions. These products were mostly simple variations of existing products that are already being offered to corporations, institutional investors and high net worth individuals. Similarly, demand for and the offering of investment-linked products by life insurers also rebounded strongly in line with the equity market performance. With the revival in demand for such products, greater supervisory attention has been directed since the early part of the year towards ensuring that financial institutions take adequate steps to establish that products sold or recommended are suitable, and that customers are clearly and fully informed of the nature and risks associated with those products.

While there was an increased demand for higher-yielding assets by households, risks to the banking system remained well-contained. Despite an increase in trading activity, domestic retail investors' participation in the equity market was relatively stable at 21.2% of total trades in 2010. New loans approved for the purchase of securities amounted to RM13.1 billion, an increase of 39.9% over the preceding year's level (Chart 1.32). Bulk of the new approvals was for the purchase of unit trust funds. Outstanding loans for purchase of securities remained small at only 3% of banking system loans. Combined with the low incidence of delinquency (NPL ratio: 0.7%), the credit exposures of banks associated with such financing are thus limited.

The prevailing market conditions also saw moves by institutional investors, primarily provident and pension funds, to rebalance their investment portfolios towards equity. The provident and

Chart 1.32

Household Sector: Outstanding Loans Growth and NPL Ratio for Purchase of Securities



Source: Bank Negara Malaysia

pension funds form the largest non-bank institutional investors in the capital market, with portfolio investments accounting for 14% of the market capitalisation of Bursa Malaysia and 28% of total outstanding debt securities as at end-2010. Notwithstanding the sizeable exposures, these institutions have considerable flexibility to manage the impact of any increase in asset price volatility on their profitability and cash flow positions. The flexibility is attributable to their low leverage, constant stream of flow of funds from pension contributions and generally non-callable nature of withdrawals of contributions before retirement.

MANAGING EXTERNAL CONTAGION

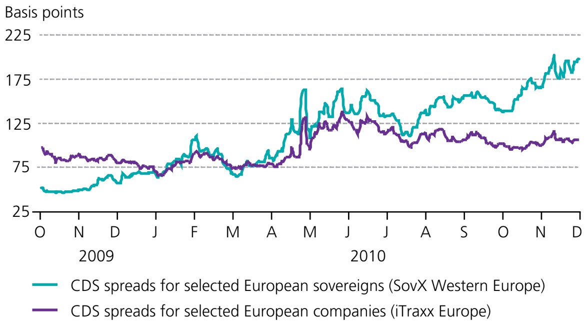
Contagion from external adverse developments was well-contained given the limited exposures of Malaysian financial institutions

Heightened external contagion and counterparty concerns largely emanated from developments in Europe

Unprecedented financial sector support and fiscal stimuli to mitigate the recessionary impact of the global financial crisis have significantly intensified market scrutiny of the fiscal position and sustainability of public debt levels in the advanced economies. Premiums demanded to insure against default for a number of European sovereigns rose sharply and have remained elevated on concerns of sovereign and banking risks (Chart 1.33). Spreads on credit default swaps (CDS) for financial institutions domiciled in the more affected jurisdictions (Greece, Ireland, Italy, Portugal and Spain – GIIPS) also experienced similar upward pressures, renewing the concerns of financial spillovers to major European economies through the close financial linkages in the European banking system (Chart 1.34 and Chart 1.35). Markets remained concerned with the large, concentrated holdings of sovereign debt by financial institutions in these jurisdictions and the lack of progress in implementing fiscal reforms, which would constrain policy options to support economic recovery in the

Chart 1.33

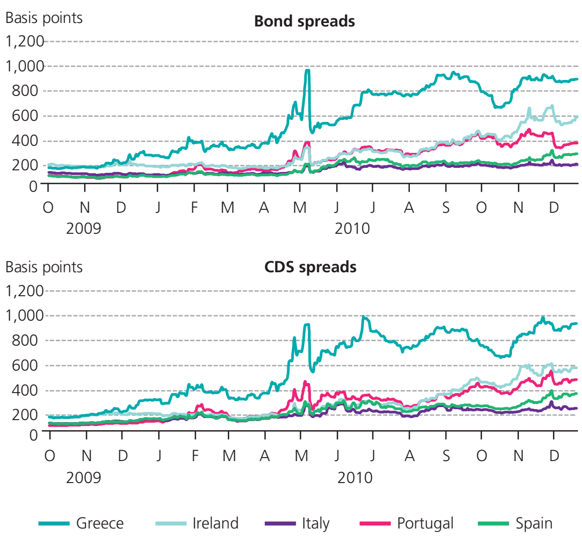
CDS Spreads for European Sovereigns and Companies



Source: Bloomberg

Chart 1.34

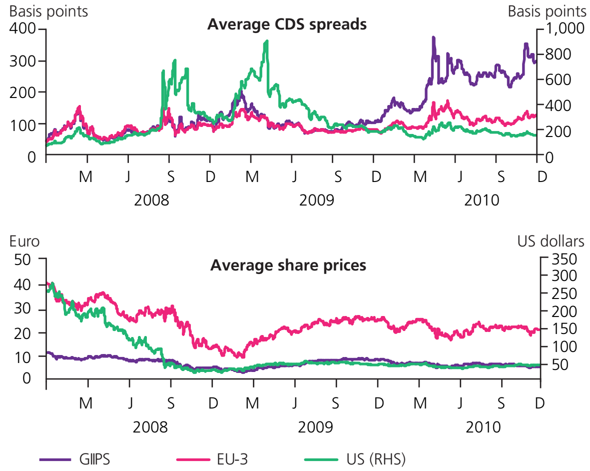
Bond Spreads and 5-year CDS Spreads of GIIPS



Source: Bloomberg

Chart 1.35

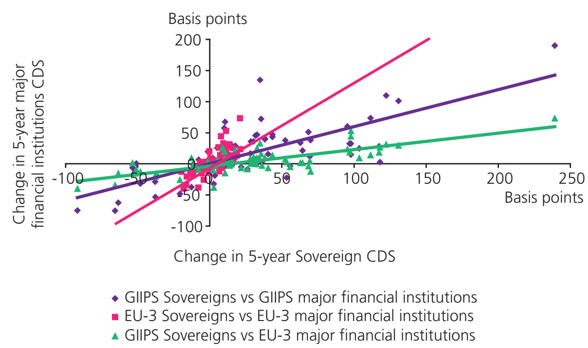
Average CDS Spreads and Share Prices of Major Financial Institutions



Source: Bloomberg

Chart 1.36

Change in 5-year Sovereign CDS vs Change in 5-year Major Financial Institutions CDS



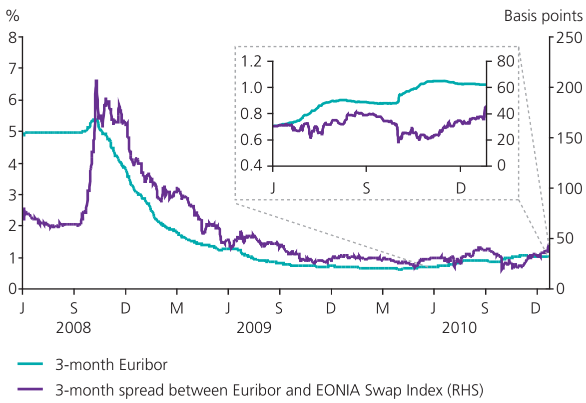
Source: Bloomberg

event that the debt crisis worsens (Chart 1.36). With inadequate transparency on the size of sovereign debt holdings and intra-European exposures, counterparty risks and funding costs of European banks increased considerably. The consequential widespread dislocations in the euro area wholesale funding markets quickly spread into the market for commercial papers, which constitutes an important source of dollar funding for most European banks (Chart 1.37). While funding conditions eased during the second half of 2010 following multi-pronged measures by the authorities[1], banking institutions in the euro area continued to be confronted with the higher risk of loan losses as a result of the continued weakness in the employment and property market.

[1] With reduced access to private capital markets and high reliance on short-term wholesale funding, European banks increasingly tapped on funding from the European Central Bank (ECB) through its monetary policy operations and liquidity facilities, including the reactivation of US dollar swap line with the US Federal Reserve and the expansion of euro lending facility in terms of maturity and size. Other measures include a new €440 billion loan facility for the euro area economies, the European Financial Stability Facility, and an expansion of the existing lending facility by the European Commission in May 2010 that amounted to €60 billion. The ECB also initiated the outright purchase of euro area government bonds to address strains in the sovereign debt markets.

Chart 1.37

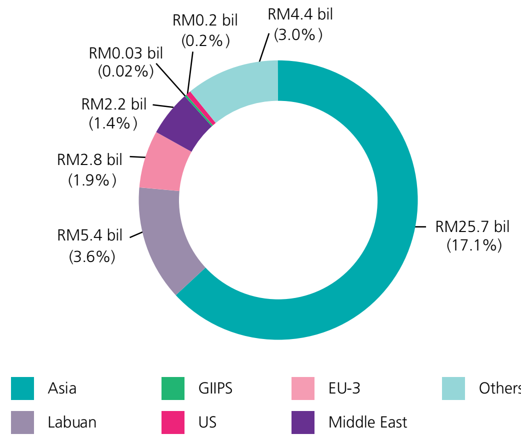
3-month Euribor and Spread between Euribor and EONIA Swap Index



Source: Bloomberg

Chart 1.38

Banking System: Composition of External Exposures by Region or Country (as % of Capital Base)



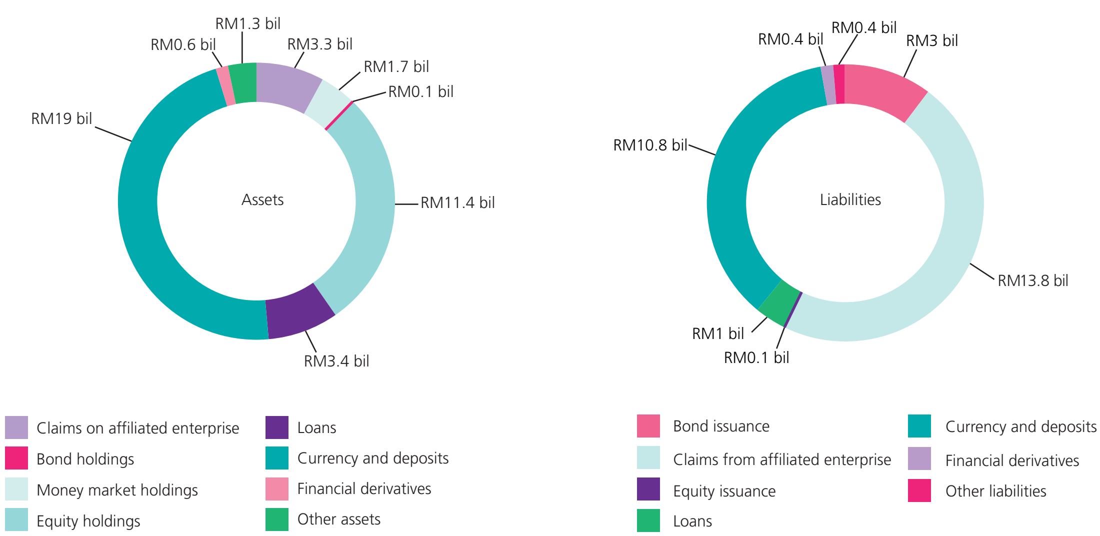
Source: Bank Negara Malaysia

Minimal direct and indirect impact from developments in Europe and the Middle East

Developments in Europe and the Middle East had negligible impact on banks in Malaysia. This was due to limited direct exposures to these economies and the private counterparties domiciled in these jurisdictions, which accounted for 18.3% of total external exposures or 5% of the banking system's capital base as at end-2010 (Chart 1.38). Of this, banking system exposures to GIIPS only accounted for 0.02% of capital base or 0.1% of total external exposures. Holdings of such sovereign papers were mostly in the banking book, thus further limiting the financial impact of movements in market valuations (Chart 1.39). Foreign currency denominated assets held by banking institutions for trading and investments, including securities denominated in euro, were

Chart 1.39

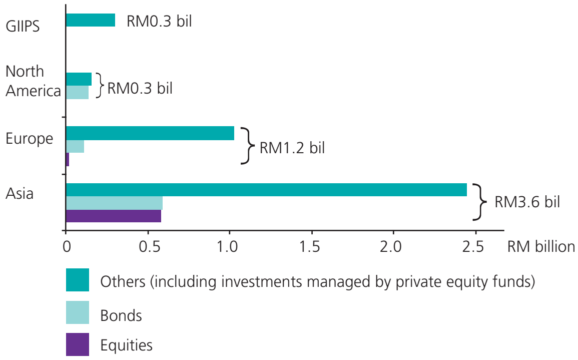
Banking System: Composition of External Exposures by Type of Transactions



Source: Bank Negara Malaysia

Chart 1.40

Insurance Sector: External Exposures by Type of Investments



Source: Bank Negara Malaysia

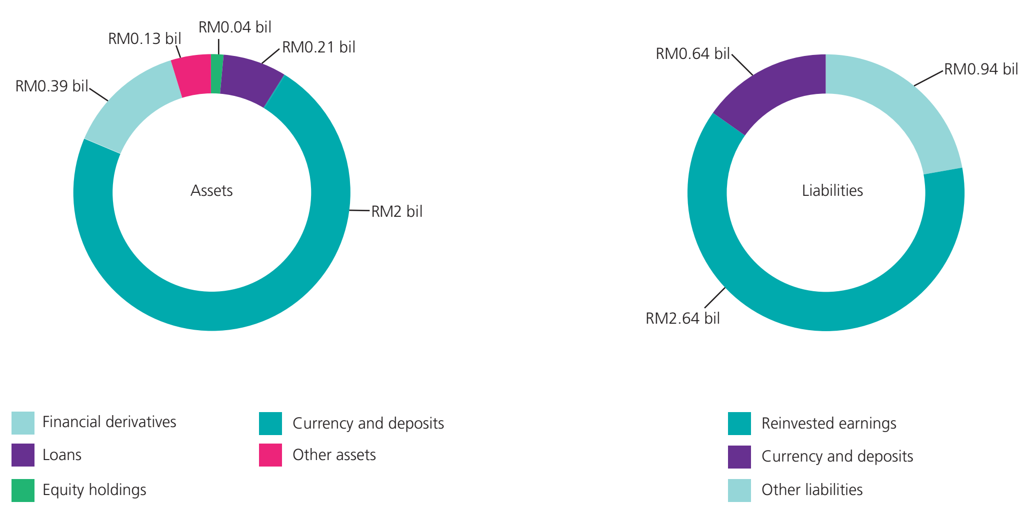
similarly small at 0.6% of total assets and 6.5% of capital base as at end-2010. The bulk of foreign currency denominated external exposures was in US dollar, Australian dollar and euro, which amounted to RM24.2 billion or 16.2% of capital base. Direct exposures of Malaysian insurers and takaful operators (both referred to as insurers hereafter) to Europe and the Middle East amounted to only RM1.45 billion or 27.1% of total foreign exposures, mostly comprising investments that are managed by European-based private equity funds. Exposures to GIIPS were small at 5.6% of total foreign assets. In an unlikely scenario of widespread sovereign defaults by the peripheral euro economies, the potential credit losses would be below 0.05% and 0.0006% of capital buffers of the banking and insurance sectors respectively (Chart 1.40).

Indirect contagion via exposures to other European economies, particularly those with considerable foreign claims to the affected countries, also remained small. While financial institutions in the rest of the euro area are highly interconnected with the peripheral euro economies through various credit and funding channels, the credit risk of Malaysian banks to the rest of Europe remained manageable at 12.9% of total external exposures and 3.5% of capital base. More than half of these direct European exposures were with the EU-3 countries (Germany, France and the UK). Apart from holdings of highly-rated debt securities, parent-subsidiary interbank transactions and derivatives contracts predominantly interest-rate swaps formed a substantial portion of banking system external exposures with major European economies (Chart 1.41). Meanwhile, insurers' investments in the rest of Europe (excluding GIIPS) were negligible at 0.8% of total industry assets.

There were no adverse spillovers from interbank funding strains in the euro area that affected the availability of funds in the domestic money market or to foreign banks in Malaysia with parents headquartered in major European countries. Like their domestic peers, ringgit

Chart 1.41

Banking System: Composition of External Exposures to EU-3 by Type of Transactions

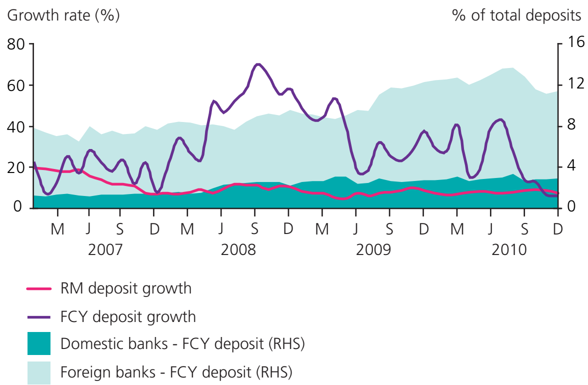


Source: Bank Negara Malaysia

deposits represented the primary funding source for foreign banks' operations (Chart 1.42). In addition, all banks continued to operate under ample domestic liquidity conditions and are required to comply with regulatory standards on liquidity. Domestic interbank rates continued to remain stable across all maturities throughout the year (Chart 1.43). Cross-border financing to Asia by foreign banks domiciled in other jurisdictions was also largely unaffected, with financing to borrowers in Malaysia from banks domiciled in foreign jurisdictions recording a growth of 13.7% in 2010. As at end-September 2010, borrowings by residents from overseas banks amounted to RM90.9 billion. In the event of cutbacks in cross-border lending, particularly by distressed European financial institutions, excess liquidity in the banking system as measured by net interbank placements with the Bank totalling RM131.7 billion is more than sufficient to meet the borrowing requirements of residents.

Chart 1.42

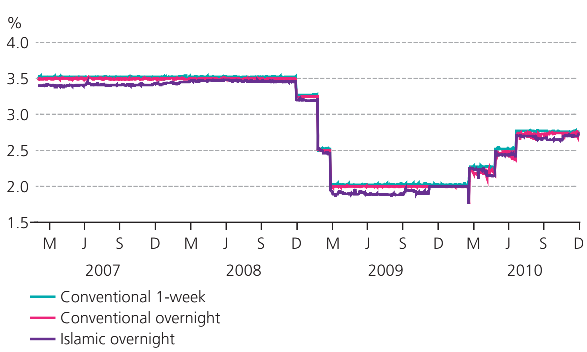
Banking System: Ringgit and Foreign Currency Denominated (FCY) Deposits



Source: Bank Negara Malaysia

Chart 1.43

Banking System: Conventional and Islamic Interbank Rates



Source: Bank Negara Malaysia

While intensification of regional expansion by the Malaysian banks and the entry of new foreign banks have increased the potential for contagion risks, the impact is well-managed given the strong capital buffers and the favourable prospects for the region

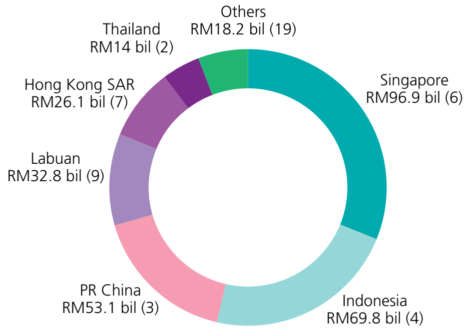
Limited external spillovers from overseas banking operations, underpinned by improved asset quality and profit contribution

Economic and financial integration in Asia has been supported by the continued development of regional capital markets, more integrated financial infrastructure, as well as the growing prominence of regional financial institutions. During the year, Malaysian banking groups further expanded their regional footprint through branch and subsidiary set-ups, particularly in the emerging South East Asian economies. While this has led to the more efficient intermediation of regional financial flows and greater diversification of risks and revenue, the deepened financial linkages have also increased the degree, channels and dynamics of potential cross-border risk transmission.

Adverse spillovers from overseas operations were immaterial throughout the year, due primarily to the strong balance sheet fundamentals and risk management capacity at both the overseas entity and group levels. As at end-2010, Malaysian banking groups had over 50 establishments across 19 countries abroad. The asset size of overseas operations of domestic banking groups expanded to RM311 billion, accounting for 20% of total domestic assets as at end-2010. While several large domestic insurers also expanded their overseas operations, particularly in Indonesia and Singapore, this remained small, accounting for only 0.2% of total

Chart 1.44

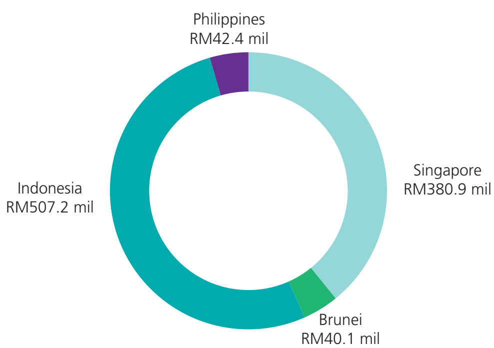
Banking System: Asset Composition of Overseas Operation (and Number of Establishments)



Source: Bank Negara Malaysia

Chart 1.45

Insurance Sector: Overseas Operation by Country and Total Asset Size



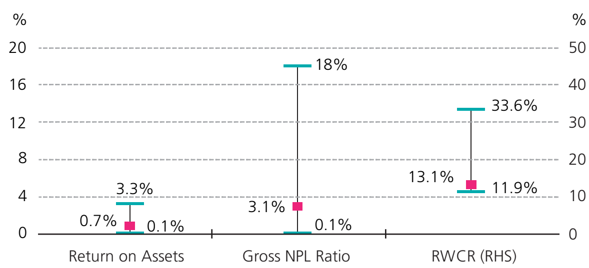
Source: Bank Negara Malaysia

domestic assets (Chart 1.44 and Chart 1.45). Major overseas operations of domestic banking groups continued to record strong profits and higher returns on assets. This has contributed to an increasing portion of the banking groups' profitability, ranging between 0.1% and 33.7%, coming from overseas operations. The earnings capacity of overseas operations also supported the independent generation of capital by foreign subsidiaries of domestic banks. The risk-weighted capital ratios (RWCR) for major foreign subsidiaries of the domestic banks, computed based on Basel II requirements for respective domestic banking groups, were sustained between 12.4% and 33.6% at end-2010, thus providing strong buffers against adverse external developments (Chart 1.46). As with the domestic operations of these banking groups, lending activities in host countries are largely funded through local currency deposits as reflected in the stable loan-to-deposit ratios maintained by foreign subsidiaries. With the low reliance on wholesale funding markets for domestic and overseas operations of Malaysian banking groups, the potential for external liquidity shocks to propagate through cross-border banking operations is thus well-contained (Chart 1.47).

The credit risk emanating from overseas operations remained manageable throughout the year given the strength of banks' risk management capacity. This is further reinforced by favourable factors that influenced debt servicing capacity, including improved economic performance in the region (Chart 1.48). Gross non-performing loans of major overseas subsidiaries, on aggregate, remained stable at 3.3% of total loans. However, the regional operation of domestic banking groups may be affected by the increased capital flows into the Asian region. To cool overheating pressures,

Chart 1.46

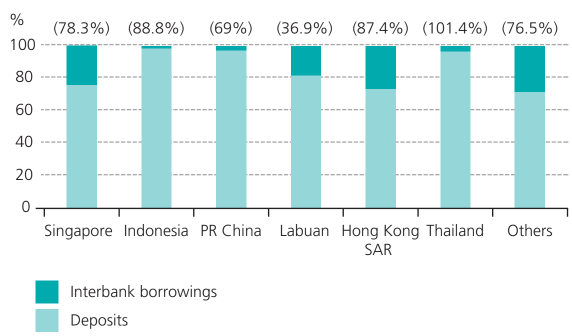
Range of Key Financial Soundness Indicators for Major Overseas Operations



Source: Bank Negara Malaysia

Chart 1.47

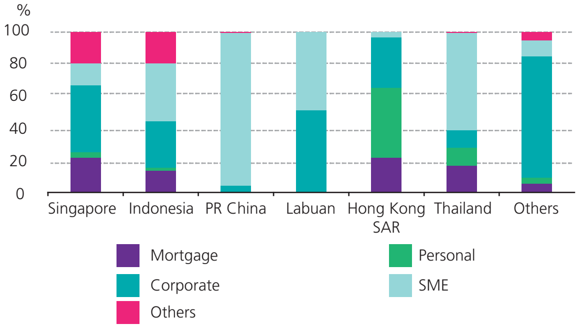
Funding Structure of Overseas Operations (and Loan-to-Deposit Ratio)



Source: Bank Negara Malaysia

Chart 1.48

Loan Composition of Overseas Subsidiaries by Type and Country



Source: Bank Negara Malaysia

notably in the property market, a number of regional jurisdictions have introduced property-related measures to curb the emergence of price bubbles. While these measures may result in some moderation of loan growth and earnings capacity of operations abroad, this is not expected to materially affect the financial position and profitability of the domestic banking groups.

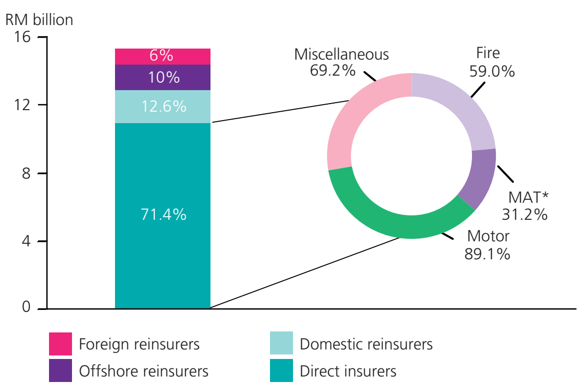
Limited risk from counterparty exposures to European reinsurers

In the insurance industry, a key risk monitored by the Bank was the exposures of Malaysian general insurers to reinsurance claims on European insurers and reinsurers. In addition to the protracted low yield environment, which continued to bear down on underwriting and investment income, estimated insured losses from more than 300 catastrophic events globally, which are expected to reach USD38 billion, will exert further downward pressures on the profitability of these insurers and reinsurers. Meanwhile, contagion risk from the public debt crisis remained elevated due to the large government bond holdings and significant exposures of insurers and reinsurers in the euro area to the vulnerable European banking sector.

Risks to the Malaysian insurance sector arising from the inability of major European reinsurers to honour reinsurance obligations are, however, well-contained. Domestic capacity remains adequate to support the bulk of Malaysian risks, with a net retention ratio of 71.4% (Chart 1.49). The balance of the industry's capacity needs is met by foreign insurers and reinsurers that are rated at least 'A' and above. Total reinsurance exposures to European reinsurers, measured in terms of reinsurance claims outstanding, accounted for 11.9% of total reinsurance recoveries or RM248 million (2009: RM1.25 billion). This represented only 8.5% of total capital available of the general insurance industry as at end-2010, well within prevailing capital buffers maintained by the industry. The risks to capital from potential downgrades of European reinsurers, remain limited amid their improved financial performance during the year. This is further supported by the CDS of the major European reinsurers, which remained below the peak level observed during the global financial crisis (Chart 1.50 and Chart 1.51). Negative spillovers from adjustments in reinsurance rates have also,

Chart 1.49

Insurance Sector: Distribution of Gross Premium Income and Retention Ratio by Major Business Classes

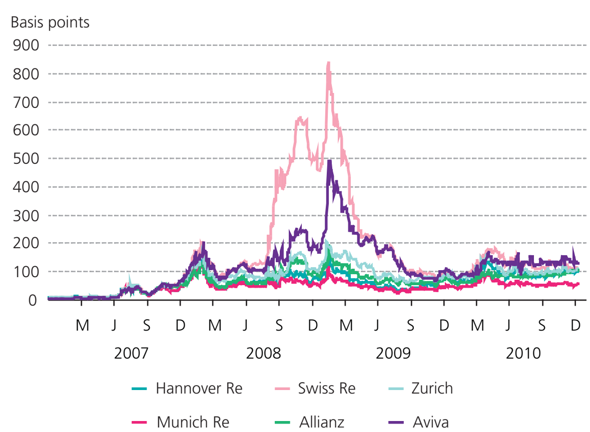


*MAT: Marine, aviation & transit

Source: Bank Negara Malaysia

Chart 1.50

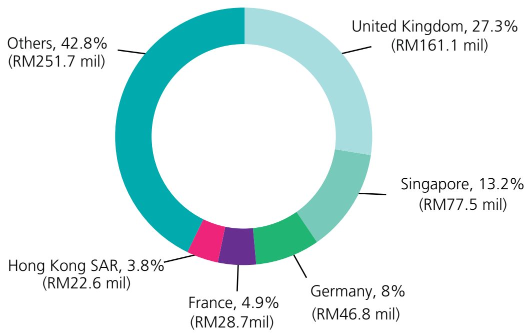
CDS Spreads of Major European Insurance and Reinsurance Companies



Source: Bloomberg

Chart 1.51

Insurance Sector: Composition of External Exposure in terms of Claims Outstanding by Country



Source: Bank Negara Malaysia

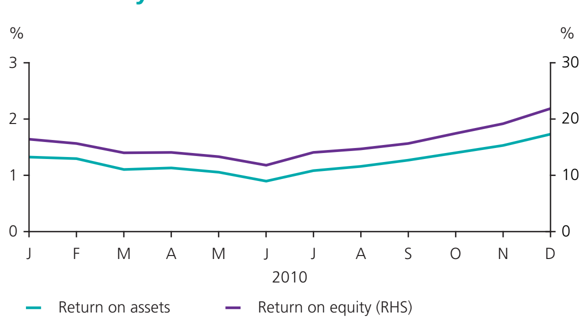
thus far, not been evident. Global reinsurance rates continued to soften for renewals in 2010, supported mainly by the prevailing excess global capacity. This in turn, has preserved cost efficiencies for Malaysian corporations that are highly dependent on insurance for their operations.

MANAGING RISKS PECULIAR TO ISLAMIC BANKING SYSTEM

The Islamic banking system continued to remain resilient throughout 2010 supported by high capitalisation (RWCR: 14.9%) and improvement in asset quality with non-performing financing at 2% in an environment of ample liquidity and improved economic conditions. In terms of profitability, Islamic banking institutions registered a steady and sustained income, thereby improving returns on assets and equity (Chart 1.52).

Chart 1.52

Profitability Ratio



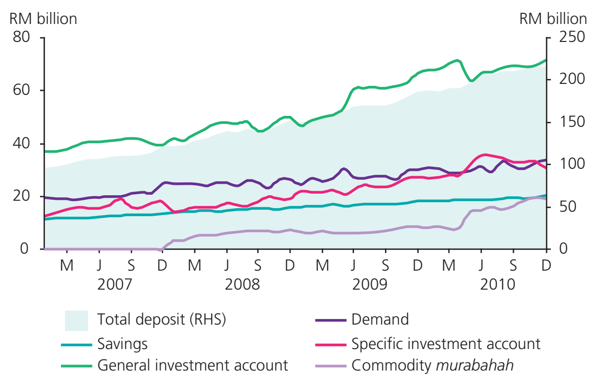
Source: Bank Negara Malaysia

The encouraging profitability recorded has enabled Islamic banking institutions to provide competitive returns to their depositors, thus enabling Islamic banking institutions to continue to attract additional deposits (Chart 1.53). As at end-2010, total deposits of Islamic banking institutions increased by 15.7% to RM218.4 billion.

Almost half of the deposits is in the form of *mudharabah* (profit-sharing and loss bearing) contracts (Chart 1.54). Of this, about 70% was in the form of General Investment Account (GIA) where the depositors have expectations on the protection of their principal investments and certainty of the returns. Given these expectations, Islamic banking institutions have been actively managing their asset portfolio to generate

Chart 1.53

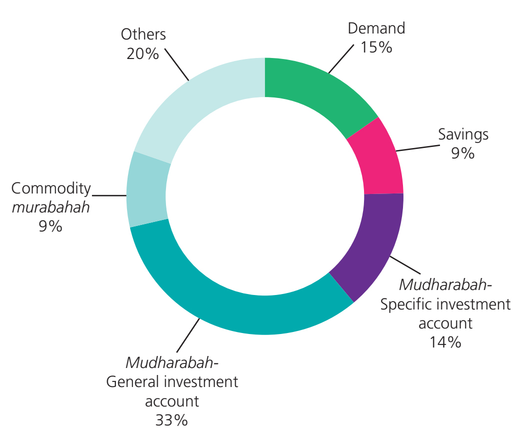
Islamic Deposit



Source: Bank Negara Malaysia

Chart 1.54

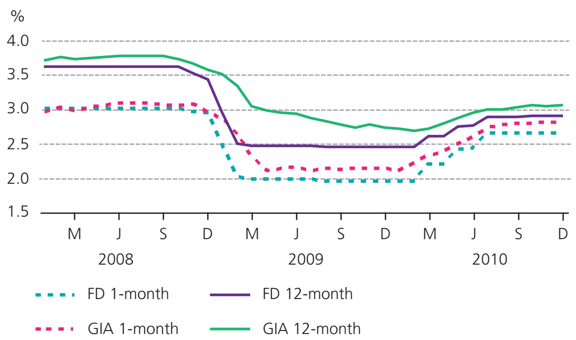
Composition of Islamic Deposit



Source: Bank Negara Malaysia

Chart 1.55

Quoted FD Rates and GIA Rates



Source: Bank Negara Malaysia

sufficient returns to mitigate the displaced commercial risks (DCR). Managing DCR therefore becomes more apparent in a dual banking system environment where rates on fixed deposit and GIA are positively correlated (Chart 1.55). In managing DCR, Islamic banking institutions employ measures such as profit equalisation reserves (PER) that enabled them to provide competitive rate of returns to depositors.

PER would normally be accumulated during periods when the underlying assets generate higher income than the returns expected by *mudharabah* depositors. In situations where the returns on underlying assets are lower or insufficient to meet the depositors' expectations, the accumulated PER will be utilised. This was observed in the second half of 2009 following the slowdown in economic activities. The drawdown in PER continued in the early part of 2010 in response to upward adjustment in conventional rates (Chart 1.56). As economic conditions improved, Islamic banking institutions re-commenced the accumulation of PER for the remaining period of the year. The prudent administration of PER by Islamic banking institutions have enabled the effective management of the DCR. In addition to PER, the purchase of Islamic house financing and hire purchase debts by Cagamas Berhad, the National Mortgage Corporation, while small at this juncture, offers another avenue for Islamic banking institutions to effectively manage DCR.

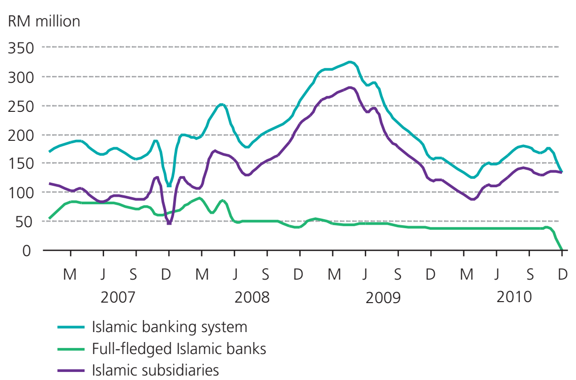
The remaining 30% of *mudharabah* deposits was in the form of Specific Investment Accounts (SIA). In contrast to GIA deposits, investment risks associated with SIA deposits are borne by the investors. The investors' willingness to assume these risks is supported by the requirement for an agreement on the investment mandate and timely disclosure of the risks and performance of the investment to the investors. As at end-2010, total SIA deposits increased by 14.8% to RM31 billion (Chart 1.53 and Chart 1.54).

Meanwhile, approximately 63.8% of Islamic banking assets are contracted on a fixed rate basis. These are predominantly structured using *murabahah* contract, which accounted for 48% of total financing (Chart 1.57 and Chart 1.58).

The fixed rate nature of such financing gives rise to re-pricing gap risk due to mismatch between the returns earned on assets and re-pricing of liabilities. To mitigate the re-pricing gap risk, Islamic banking institutions have increasingly

Chart 1.56

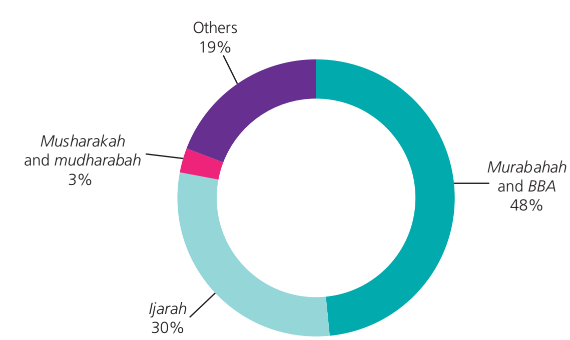
Profit Equalisation Reserves



Source: Bank Negara Malaysia

Chart 1.57

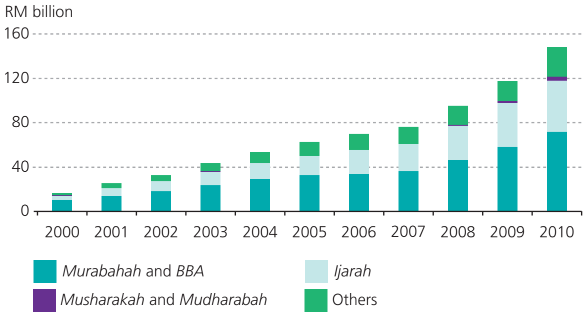
Composition of Financing by Islamic Contract



BBA: *Bai Bithaman Ajil*
Source: Bank Negara Malaysia

Chart 1.58

Financing by Type of Islamic Contract



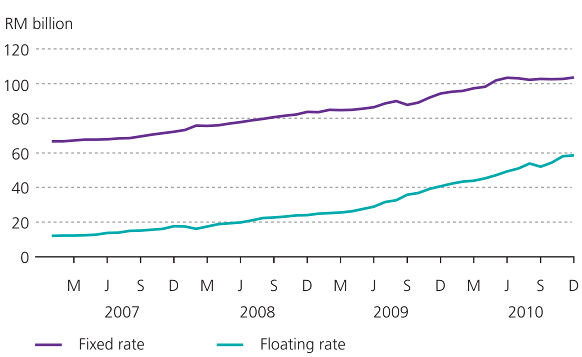
BBA: *Bai Bithaman Ajil*
Source: Bank Negara Malaysia

been utilising hedging instruments such as Islamic profit rate swaps (IPRS) which provide Islamic banks with the flexibility to swap fixed rate receivables with floating rate receivables. In 2010, the notional amount of outstanding IPRS increased to RM2.5 billion. Efforts are being intensified to deepen the liquidity of the IPRS market. These include the development of a *tahawutt* (hedging) Master Agreement, which enables more effective management of counterparty risks, thereby increasing the attractiveness of IPRS market.

There has also been higher volume of variable rate Islamic financing products in the form of *musharakah mutanaqisah* (diminishing partnership) and *ijarah* (leasing) contracts that provide Islamic banking institutions with the avenue to diversify their asset base, hence reducing concentration to fixed rate financing. Such financing increased by 44.1% during the year to amount to RM58.6 billion as at end-2010 (Chart 1.59).

Chart 1.59

Fixed Rate and Floating Rate Financing



Source: Bank Negara Malaysia

OTHER DEVELOPMENTS AND RISK AREAS

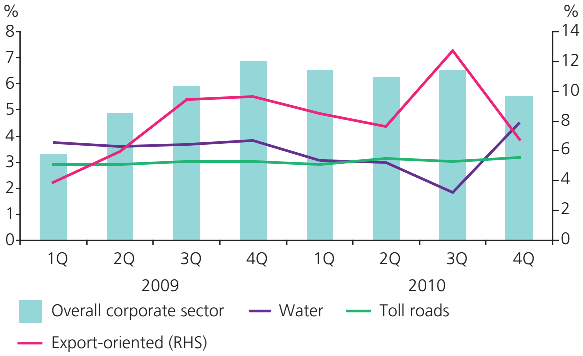
Financial stability remained intact throughout 2010 supported by strong capitalisation and liquidity conditions of financial institutions. Stress test results reaffirmed the capacity of the financial system to absorb potential shocks even at worst case macro economic scenarios

Other external developments such as international regulatory reforms and the series of climate-related events as well as geo-political tensions in the Middle East and North Africa (MENA) region were also closely monitored by the Bank. While these events caused brief periods of increased market volatility and uncertainty, the financial markets and system continued to remain orderly throughout the year.

Favourable conditions in the PDS market continued to facilitate fund raising by corporations particularly from mid-year onwards. For the year, new PDS issuances amounted to RM82.3 billion. Rating actions during the third quarter on debt securities issued by entities involved in the distribution and treatment of water in Selangor had only a limited and temporary impact on market activity. In June, these entities were placed on negative watch by the domestic rating agencies in view of the uncertainty surrounding the protracted restructuring exercise of the state's water industry. Trading liquidity in the secondary market following this rating action was only briefly affected and market conditions remained largely orderly throughout this period even following the downgrade of these debt securities in September. This was due in part to the small size of the issuances, which on aggregate accounted for less than 3% of outstanding PDS. Reflective of the better credit and economic conditions in 2010, credit quality, as measured by the downgrade-to-upgrade ratio improved to

Chart 1.60

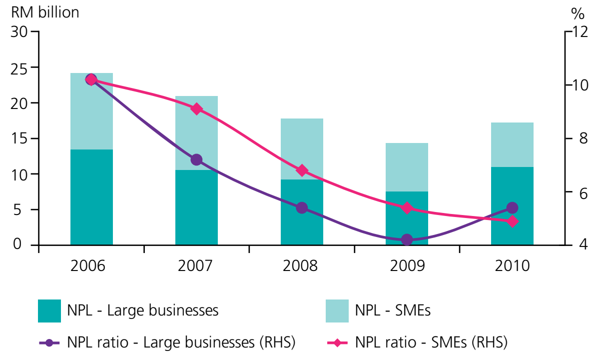
Interest Coverage Ratio for Selected Industries



Source: Bloomberg and internal computation

Chart 1.62

Banking System: NPL for Large Businesses and SMEs

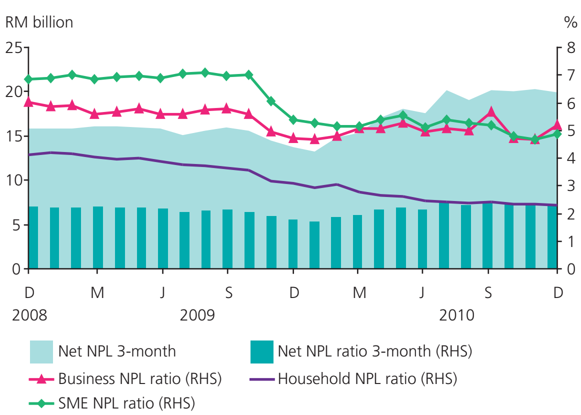


Source: Bank Negara Malaysia

1.47 times (2009: 2.09 times). Improved economic conditions have further bolstered the debt servicing capacity of businesses despite greater exchange rate volatility and higher borrowing costs, thus sustaining the quality of banks' loan portfolios. While the strengthened ringgit resulted in lower export proceeds for businesses in the export-oriented industries, the impact was offset by sustained external demand and relatively cheaper imported raw materials. Meanwhile, corporations with foreign currency borrowings benefited from the strengthening of the ringgit through lower debt servicing costs (Chart 1.60). Developments in exchange rates have also encouraged the more active management of foreign currency exposures by businesses

Chart 1.61

Banking System: NPL[1] Level and Ratio



[1] Beginning January 2010, includes impaired loans based on Financial Reporting Standards (FRS) 139

Source: Bank Negara Malaysia

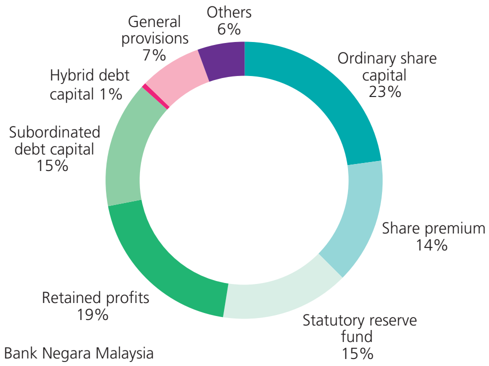
through the use of hedging instruments such as forwards and swap transactions. Businesses continued to maintain a relatively low leverage position, a condition that has prevailed since the Asian Financial Crisis. This has accorded businesses with greater flexibility to cope with rising production and borrowing costs without adversely impacting their debt servicing capacity. As at end-2010, gross NPLs for the business portfolio of banks increased to RM17.2 billion (2009: RM14.3 billion) or 5.2% of outstanding business loans (Chart 1.61 and Chart 1.62). The marginally higher NPLs level is attributed to the adoption of impairment methodology following the coming into effect of the financial reporting standards requirement, FRS 139, since the financial year beginning 2010. Meanwhile, growth in total loans (including loans to households) of 12.7% outpaced the annual expansion in deposits of 7.3%.

Profitability of the banking sector improved further in 2010 to register a return on equity of 16.5% (2009: 14%). Pre-tax profits for the year increased by 34% to RM22.8 billion. The robust performance was partly driven by higher net interest income, which grew at an annual rate of 15.1%, and slightly wider net interest margin of 0.61 percentage points. Fee and other income, which grew by 11.3% and 4% respectively, as well as further decline in impairment charges (-9.1%) also contributed to the increase in profitability.

The capitalisation of the banking sector continued to remain sound with strong financial buffers against potential losses. This is reinforced by the high quality of capital, with 70% of

Chart 1.63

Banking System: Composition of Capital



Source: Bank Negara Malaysia

total capital in the form of common equity and reserves (Chart 1.63). The aggregate risk-weighted capital ratio (RWCR) and core capital ratio (CCR) was 14.8% and 13% respectively, well above the current regulatory minimum levels, as well as the higher requirements under Basel III. See box article on *"Basel III and its Potential Implications on Malaysia and the Financial System"*.

In the insurance and takaful sectors, sustained domestic demand for savings and protection products and the improved performance of the equity market supported stronger results for the year. Business growth was primarily driven by a strong recovery in demand for investment-linked products, and higher demand for ordinary life protections as well as motor and fire insurance. Payout of benefits and claims as a percentage of premiums increased slightly to 58.1% for the life business and 62.3% for the general business. Meanwhile, the motor portfolio continues to pose a drag on overall performance given the substantially higher loss ratio of 79.5% (Chart 1.64).

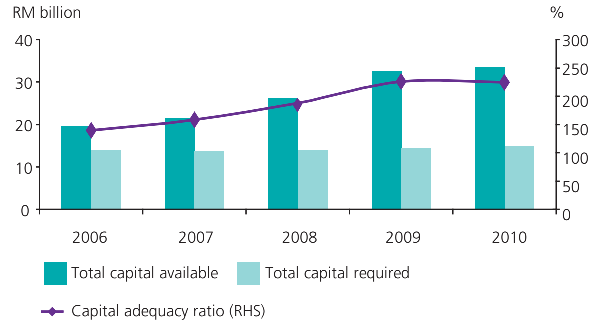
Chart 1.64

General Insurance and General Takaful Businesses: Claims Ratio

Source: Bank Negara Malaysia

Chart 1.65

Insurance Sector: Capital Adequacy Ratio



Source: Bank Negara Malaysia

For the year as a whole, aggregate excess income over outgo for the life and family takaful industry improved to RM14.1 billion (+12.1%) whilst the general sector recorded operating profits of RM2.2 billion (+3.5%). Capitalisation of the insurance industry remained strong with a capital adequacy ratio (CAR) of 224.6% (2009: 225.7%) (Chart 1.65). While the strong equity market performance has bolstered the overall profitability of insurers, the persistent low interest rate environment continues to present challenges to life insurers in their management of asset-liability mismatches and meeting policyholders' expectations.

The risk-bearing capacity of the financial system to weather extreme macroeconomic and financial conditions was reaffirmed by the regular stress tests carried out on the banking and insurance sectors, at both the aggregate and institutional levels. The scenario-based stress tests, covering both market and credit risk exposures, assume a simultaneous materialisation of major downside risks to the Malaysian financial system under varying stress circumstances. These stress parameters are also further calibrated to capture institution-specific risk profiles based on supervisory assessments of key risk drivers, detailed default history and loss rates, quality of assets and the risk absorbing capacity of capital, as well as the strength of risk management and governance controls.

Potential shocks to financial institutions' interest rate risk positions were simulated based on the historical worst-case experience for Malaysia to account for varying degrees of (i) steepening of the MGS yield curve; (ii) widening credit spreads between highly-rated corporate debt securities and MGS; and (iii) higher basis risk to reflect larger differentials between interest rate swaps and MGS yields. For foreign currency denominated exposures, shocks reflected the potential sharp volatility of six major currencies against ringgit, namely the US dollar, Singapore dollar, euro, pound sterling, Hong Kong dollar and yen. Stresses on equity risk were calibrated using extreme declines in the FBM KLCI, which are comparable to the Asian Financial Crisis.

The stress test assumptions for credit risk exposures were largely premised on a weaker-than-expected economic growth in Malaysia, due largely to spillovers from the sluggish economic performance of the advanced economies and major trading partners. While the concerns surrounding a double-dip recession have receded and the multi-track global recovery is expected to continue, the resilience of Malaysia's financial sector against extreme credit losses emanating from a prolonged global and domestic economic slowdown were nevertheless put to test. Under the worst macroeconomic scenario, severe shocks applied on the debt servicing capacity of households and businesses were reflective of the large loan losses experienced during the Asian Financial Crisis.

Both the RWCR and CCR of the banking system post-stress remained above 9% even after having to absorb substantial losses under the most severe economic contraction and extreme financial market volatility. Overall potential cumulative losses from credit shocks far exceeded those from market risk shocks, which accounted for 61.6% and 19.7% of excess capital respectively. This is due primarily to the conservative loan loss provisioning rates assumed, which do not take into account the value of underlying collateral, and is reflective of the large financing composition in banks' balance sheets. The largest potential losses from extreme financial market conditions mainly emanated from banks' interest rate risk exposures, which constituted 78.5% of total market risk losses, followed by losses from the foreign exchange and equity portfolios, which accounted for 14.9% and 6.6% of total market risk losses respectively.

Similarly, the stress test conducted on the insurance industry affirmed the resilience of insurers under adverse and extreme scenarios. In addition to market and credit risk stress scenarios, stress factors were also applied to the insurance risk components to reflect the risk of under-estimation of insurance liabilities and adverse claims experience. The post-stress CAR of the industry remained close to 130%, albeit with an uneven impact among individual insurers.

OUTLOOK FOR FINANCIAL SYSTEM STABILITY AND FOCUS OF SURVEILLANCE IN 2011

The outlook for domestic financial stability in 2011 remains positive supported by underlying strengths of the Malaysian financial system. Financial institutions have accumulated strong financial buffers totaling RM81.4 billion to withstand external risks and domestic challenges, even under extreme scenarios of credit and market stress. This, in turn, will support the continued functioning of intermediation activities by the financial system.

Key challenges to financial stability in 2011 are likely to be largely externally driven, as global economic conditions remain fragile. While expected to be more moderate than in 2010, domestic growth will continue to be underpinned by strong economic fundamentals and further expansion in consumption and investment, although developments in commodity and energy prices will affect cost of living, particularly for average Malaysians living in urban areas.

Shifts in global liquidity will continue to pose challenges to the region, including Malaysia. The global search for higher yielding assets and expectations for the ringgit, alongside other regional currencies, to appreciate will continue to exert upward pressures on the prices of financial assets domestically. While the domestic property market has not experienced a significant broad-based increase in prices as a result of capital inflows, domestic financial markets are likely to remain volatile and impacted by developments on the external front. Financial asset prices and exchange rates remain susceptible to large and volatile portfolio inflows as well as the potential sharp reversals. The pre-emptive measures taken to ensure that risk-taking behaviours by financial institutions continue to remain prudent and measures that aim to create greater financial awareness among households, as well as hedging activities of businesses to manage exchange rate fluctuations, will collectively contribute towards mitigating these risks. This is further reinforced by the robust financial conditions of financial institutions.

Financial institutions will continue to face pressures to generate returns under the ample domestic liquidity conditions. The enforcement of responsible lending practices will act to counter overly aggressive behaviours by financial institutions. Nonetheless, the growing influence and significance of non-bank lenders will need to be managed to avoid excessive build-up of leverage among certain borrower segments.

Given that the recent trend of rising commodity and oil prices is expected to contribute to higher cost of living and cost of inputs for production, it will be particularly important for financial institutions to monitor risk developments in these segments, and to act pre-emptively to assist affected borrowers. This will also contribute towards preserving the overall quality of the banks' loan portfolio. In addition, the existence of the AKPK to facilitate individual borrowers in managing their debts and finances will provide additional support to households.

Moving forward, the Bank will focus on the following strategies to ensure that domestic financial stability continues to be preserved:

- *Ensuring prudent and responsible risk-taking by financial institutions* – The supervisory activity including on-site examination will remain focused on financial institutions' risk-taking behaviours as well as the effectiveness of their risk management and control functions. This will also be complemented by continuous assessment of financial institutions' resilience to credit and market risk shocks. The market competitiveness will also require continuous monitoring by the Bank on business and pricing practices, as well as conduct of financial institutions in their dealings with customers;
- *Ensuring sustainable household consumption and debt repayment capacity* – Emphasis will continue to be placed on inculcating responsible borrowing behaviours by raising the level of financial literacy as a means to promote sound financial and debt management, and hence contain credit risk in the banking system within prudent levels. Such responsible behaviours will also prevent excessive accumulation of debts by households outside the formal financial system. The Bank will also closely monitor the growing presence of, and coordinate with relevant agencies responsible for non-bank financiers, to ensure that their activities do not substantially increase household leverage;
- *Strengthening the risk capture and assessment on entities with systemic implications in the financial system* – To further enhance the Bank's assessment of risks to financial stability, efforts will be focused to better capture and manage contagion risk within and to the financial system. In addition, the Bank will continue to monitor developments in the activities of entities that are not regulated by the Bank;
- *Understanding and assessing the impact of changes in regulatory and accounting environment* – This will include ongoing assessments of the impact to financial stability and behaviours of financial institutions from the enhanced capital and liquidity requirements under Basel III and changes to international financial reporting standards;
- *Strengthening the regulatory laws and prudential guidelines* – The existing legislations will be reviewed to further strengthen the Bank's regulatory and supervisory framework. This will be complemented by enhancements to the governance framework and solvency standards as well as ensuring the smooth implementation of the new financial reporting framework. In the area of Islamic finance, the regulatory framework will be further strengthened to reflect the unique attributes of Islamic financial contracts. This will also include the development of Shariah parameters. Details of these enhancements are contained in Chapter 3 on "Regulatory and Supervisory Framework"; and
- *More active and closer domestic, regional and global cooperation and coordination* – The Bank will continue to pursue cooperation with other supervisory authorities, and through established multi-lateral platforms and bilateral arrangements, in order to effectively identify, and further strengthen the Bank's readiness, to deal with emerging risks to financial stability.

2010

DEVELOPMENT OF THE FINANCIAL SECTOR

Policy measures to develop the financial sector in 2010 remained supportive of macroeconomic stability and growth momentum of the economy, while advancing longer-term initiatives to enhance the potential capacity and resilience of the Malaysian financial sector. Malaysia's inter-linkages with the global economy and position as an international centre for Islamic finance were further strengthened. This was achieved with a continued focus on elevating financial inclusion levels and ensuring a strong foundation for financial stability. Going forward, the financial sector is also being positioned to take on an enhanced role in supporting Malaysia's transition to a high value-added and high-income economy, underpinned by growth that is both sustainable and inclusive.

PRESERVING SOUNDNESS AND CONFIDENCE IN THE FINANCIAL SECTOR

Over the years, banking institutions in Malaysia have built up strong capital and provisioning buffers, with improvements in underwriting and risk management practices as well as strengthened governance structures. In 2010, the preconditions for further growth were considerably enhanced and the enabling environment continued to improve in support of productive competition and innovation.

The financial safety net was significantly strengthened with the coming into force of the new Malaysia Deposit Insurance Corporation (PIDM) Act 2011 on 31 December 2010, incorporating substantial enhancements to the consumer protection framework. The new legislation widens the existing coverage under the deposit insurance system with an increased coverage limit of up to RM250,000 per depositor per member institution (from RM60,000). Coverage is also now extended to foreign currency-denominated deposits. PIDM's powers to minimise risk in the financial system have also been enhanced to support its role in safeguarding public confidence in the Malaysian financial system and the intervention and resolution of non-viable financial institutions.

Specifically, the new legislation empowers PIDM to utilise a wider range of tools and measures, including enhancing protection limits, extending coverage to a non-member institution and designating a bridge institution to temporarily assume the commitments of a non-viable institution as a resolution option.

The Bank continued in parallel to pursue initiatives to enhance the resilience of Malaysia's insurance industry. These initiatives focused in particular on enhancing the capacity of insurance companies to provide protection to consumers, addressing structural weaknesses in the industry, and strengthening the financial safety net to safeguard the interests of policyholders.

The financial safety net was significantly strengthened with the coming into force of the new Malaysia Deposit Insurance Corporation (PIDM) Act 2011

In the general insurance industry, fragmentation and the lack of scale among the general insurers remained a key challenge to realising the long-term growth potential of the sector and its ability to support the growing needs of the economy for risk protection solutions. Out of the 30 insurers represented in the general insurance industry, 20 of the smaller players account for a combined share of only 38% of total gross premiums. Moving forward, demand for increasingly sophisticated insurance products and protection mechanisms will rise as the economy advances to become a high-income nation and new economic growth sectors assume a more important role in the economy. With this in view, the Bank continues to promote consolidation and rationalisation within the industry with the objective of developing strong general insurers with sufficient capacity and scale to contribute meaningfully to the broader economy. Notable progress has been made thus far; where in addition to the successful rationalisation schemes of three general insurers approved by the Bank in 2010, a number of promising negotiations are in the pipeline. The impetus for continued consolidation and rationalisation is further driven by the more liberal foreign equity participation limits, strengthened capital requirements and enhanced supervisory expectations on the insurers.

Efforts to address structural weaknesses in the motor insurance sector were taken forward during the year. This has been key to putting the general insurance and takaful industry on a firmer foundation to support the requirements of Malaysian households and businesses given that more than 47.5% of total general premiums and contributions are concentrated in the motor sector. Motor insurance business represents the dominant portfolio for 18 general insurers, with shares ranging from 24.3% to 87.3% of total premiums underwritten by these insurers. In recent years, it has become increasingly difficult for the general insurance and takaful industry to continue supporting motor insurance and takaful business on a commercially sustainable basis, leading to a significant withdrawal by insurers from underwriting motor policies (especially Third Party policies). The holistic review of the existing motor insurance framework focusing on coverage for third party bodily injury aims to preserve access to affordable motor insurance cover for the public, while ensuring its sustainability over the longer term. A more detailed description of the underlying issues, challenges and the outcome of this review is provided in the box article ``Towards a More Effective and Efficient Motor Cover Framework´´.

The safety net for insurance policyholders was significantly strengthened with the implementation of the Takaful and Insurance Benefits Protection System (TIPS) on 31 December 2010. The TIPS replaces the Insurance Guarantee Scheme Fund (IGSF) for the insurance industry which has been in place since the 1970s to meet the claims of policyholders of failed insurance companies using funds pooled from the insurance industry. Since its establishment, the IGSF has been utilised to facilitate the payouts of three failed general insurance companies. Moving forward, TIPS will assume this role, with an improved level of protection to insurance policyholders and takaful participants and the broader mandate under the administration of PIDM to resolve insurance companies or takaful operators that have ceased to be viable or which the Bank considers likely to become non-viable, in a manner that minimises cost to the financial system. A more detailed explanation of this system is provided in the box article ``Introduction of Takaful and Insurance Benefits Protection System in Malaysia´´.

ENSURING CONTINUED ACCESS TO FINANCING

The prompt policy measures undertaken by the Bank in 2008 and 2009 to ease the strains faced by the business and household sectors and to support continued credit flows to the economy have enabled financial intermediation to function smoothly and efficiently. As at end-2010, total outstanding banking system financing increased by 12.7% from the previous year to RM883.3 billion or 115.3% of gross domestic product (GDP). Total outstanding financing to both businesses and households recorded robust growth of 9.4% and 13.4% respectively.

The improved environment for financing to SMEs is attributed to the development of a comprehensive institutional framework including support and advisory services, and pre-emptive measures by financial institutions to assist viable SMEs

As a key engine of growth in the economy, the small and medium enterprises (SMEs) continue to draw support from the financial sector to meet their financing needs, with outstanding financing to SMEs from banking institutions and development financial institutions (DFIs) reaching RM141.1 billion or 37.6% of total business loans as at end-2010. The number of SME cases received by the Bank's Integrated Contact Centre in relation to access to financing issues reduced significantly by 38% from 2009 to 327 cases. This reflects an improved environment for financing to SMEs, attributed in large part to the development of a more comprehensive institutional framework including support and advisory services for SMEs as well as pre-emptive measures by financial institutions to assist viable SMEs facing temporary financial difficulties and expedite the approval and disbursement of loans. These include

Towards a More Effective and Efficient Motor Cover Framework

Challenges facing the insurance and takaful industry in motor underwriting and impact on motor vehicle owners

Under the Malaysian road transport legislation, it is a mandatory requirement for all Malaysian motor vehicle owners to purchase an insurance policy or takaful certificate (collectively referred to as insurance policies) to cover against liabilities arising from bodily injury including death, to any third party. This is to provide for compensation to members of the public who suffer injury or loss of life arising from a road accident caused by a vehicle owner.

In Malaysia, motor insurance premiums (including contributions in the context of takaful) and the scope of coverage under motor insurance policies are determined by the Malaysian motor tariff (Tariff). The Tariff has not been revised since 1978 to take into account the changing profile of risks associated with motor insurance and takaful coverage (subsequent reference to insurance cover includes takaful cover), including the increased frequency and escalating costs of motor accidents.

Among the motor accident-related expenses borne by the insurers and takaful operators, costs relating to bodily injury and death constitute the largest component. Over the years, the claims experience of the Third Party Bodily Injury and Death component of motor insurance policies has progressively deteriorated with claims ratios exceeding 200% since 2006. In 2010, for every ringgit of Third Party Bodily Injury and Death premiums received, insurers and takaful operators paid out RM2.82 and RM2.25 respectively in claims, before factoring in other related costs such as management and acquisition expenses.

The growing gap between premiums collected and claims paid out by the industry has contributed to the displacement of Third Party motor insurance covers as more insurers and takaful operators are not able to sustain such business on a financially viable basis. As a result, some motor vehicle owners have had to purchase their motor policies from the Malaysian Motor Insurance Pool (MMIP), which was originally set up by the general insurance industry in 1992 to act as an insurer of last resort for high motor risks such as buses as well as vehicles carrying hazardous materials. This led to a sharp increase in the number of motor policies issued by the MMIP which increased from 5,897 in 2007 to 128,058 in 2009. Policies insured by the MMIP are subject to additional premium surcharges and stricter underwriting rules to reflect the higher risk of the policies covered. The increased displacement of motor policies into the MMIP has, however, disproportionately affected these vehicle owners through substantially increased insurance-related costs and reduced access to motor insurance protection. While the vehicles underwritten by MMIP account for only 2% of the total number of vehicles insured in Malaysia, immediate review of the rules of MMIP will be undertaken to ensure that these motor vehicle owners that are not deemed as high risk will have greater access to motor protection at a lower premium.

Holistic review of the motor cover framework

Recognising the difficulties faced by vehicle owners with respect to motor insurance, the Bank initiated a holistic review of the motor insurance framework with the primary aim of addressing the issue of access to affordable motor insurance protection. The goal is to ensure that the public is afforded easy access to adequate insurance and takaful protection at a reasonable premium at all times, and that such protection is provided in a commercially sustainable manner over the longer term. In undertaking the review, the Bank was mindful that while a review in the premium rates would address the pricing misalignment in the short term, this must be accompanied by more fundamental structural adjustments to the entire motor claims value chain to arrest the continuing trend of escalating claims costs in the longer term. The resulting proposed new motor cover framework therefore significantly improves on the existing tort-based unlimited liability system through pervasive efficiency enhancements to contain the cost of claims that result from leakages, misaligned incentives and claims fraud.

Feedback from public engagements

Engagements with key stakeholder groups and the public at large have indicated broad support for motor insurance protection to continue to be provided by the existing insurers and takaful operators due to the ease of access and better service levels that would be promoted as a result of competition. The majority of respondents also supported maintaining the existing scope of coverage for various types of bodily injury claims with a reasonable overall limit on compensation paid out. Feedback received further suggested a high degree of acceptance by the public to a reasonable and gradual premium adjustment to address the pricing misalignment in view that the Tariff has not been revised for more than 30 years. However, the expectation was for this to be accompanied by a significantly more efficient claims settlement process that would also effectively control cost leakages along the entire claims settlement chain. Preserving the role of the court system as an avenue for redress was also favoured to ensure the adequate protection of claimants' interests.

Towards a new motor cover framework

Taking into consideration the feedback obtained from the public engagement process, the new framework focuses on two areas, namely enhancing efficiency in the claims settlement process and the introduction of a gradual premium adjustment to bring premiums more in line with the general motor claims experience.

The formulation of efficiency enhancement measures has been achieved in close consultation and collaboration with the relevant government agencies as well as selected private institutions involved in the claims settlement chain. These include the Royal Malaysian Police, the Ministry of Health (hospitals), the Judiciary, the Attorney General's Chambers, the Malaysian Bar Council, and the insurance and takaful industry, which have provided their commitment to support the realisation of more efficient, fair and transparent claims settlements that most importantly safeguard the interests of motor vehicle accident victims. The identified efficiency initiatives include:

- the establishment of a call centre to provide immediate support assistance to road accident victims;
- enabling hospitals to assist road accident victims in submitting claims notifications to insurers;
- shorter timelines to produce police and medical reports to facilitate early processing of claims;
- a more simplified claims notification process; and
- a review of lawyers' fees for bodily injury and death cases.

Steps by various parties to implement the identified efficiency measures will commence immediately. The effective implementation of these measures is expected to reduce the time taken to settle motor insurance and takaful claims significantly from the current average duration of one to five years to six to 18 months moving forward. The improvement measures are overseen by a joint working committee chaired by Bank Negara Malaysia, and comprising representatives from the Ministry of Finance, the Ministry of Health, the Judiciary, the Attorney General's Chambers, the Malaysian Bar Council, the Royal Malaysian Police, the insurance and takaful industry and the consumer and transport associations. The committee's mandate is to drive and ensure the successful implementation of the various efficiency enhancement measures which the relevant agencies and private institutions have committed to undertake. The first meeting of the committee will be held in April 2011.

In parallel with the efficiency improvement measures, reasonable premium adjustments will be introduced gradually over a period of four years beginning 1 January 2012. The premium adjustments are guided by the following key principles:

- The adjustment will be gradually phased in to mitigate its impact and coincide with enhancements to the Malaysian transportation system;
- The premium adjustment will not have a material impact on the lower income group; and
- Premium adjustments will be more closely aligned with the risk profile of vehicle categories, so that those with good claims experience will benefit from a lower adjustment or a premium reduction consistent with risk-based pricing.

The new motor cover framework strives to converge the long-term interests of both the insuring public and the insurance and takaful industry as well as promote a good and safe driving culture. Its effective and timely implementation is critical to secure the long-term availability of reasonably priced motor insurance protection offered by insurers and takaful operators, with competitive and efficient service levels that will deliver better outcomes for consumers.

Introduction of Takaful and Insurance Benefits Protection System in Malaysia

The recent financial crisis has prompted regulators around the world to reassess the robustness and adequacy of the safety net arrangements in their own countries to safeguard the public when failures of financial institutions occur. The initiatives taken include a review of the scope and level of coverage of existing arrangements as well as the consideration of new arrangements to provide effective protection for the broad range of financial consumers.

In Malaysia, the safety net arrangement within the financial sector was further strengthened with the introduction of the Takaful and Insurance Benefits Protection System (TIPS) by the Malaysia Deposit Insurance Corporation (PIDM) on 31 December 2010, to complement the existing deposit insurance system (DIS) introduced in 2005 for the banking system. TIPS, which replaces the existing Insurance Guarantee Scheme Fund (IGSF) administered pursuant to the Insurance Act 1996, operates as an **explicit compensation scheme** to protect consumers of the insurance and takaful industry in the event of a failure of an insurer or takaful operator (hereinafter collectively referred to as institutions). By alleviating the potential financial loss to policyholders (including participants in the context of takaful) in the unlikely event of the failure of an institution, TIPS will further strengthen the consumer protection framework in Malaysia, thereby promoting public confidence in the industry.

Mandate of PIDM

The Malaysia Deposit Insurance Corporation Act 2011 provides that PIDM's mandate shall include administering TIPS. This will further enhance PIDM's role as an important component of the financial safety net, while leveraging on PIDM's capacity, competencies and institutional framework which have been developed and strengthened to manage financial sector resolutions. Similar to the DIS, PIDM is required to carry out its mandates under TIPS in a manner that minimises cost to the financial system.

Public policy objectives of TIPS

The primary objective of TIPS is to protect the interests of policyholders and preserve public confidence in the insurance and takaful industry. Most individual and small policyholders would find it difficult to ascertain the financial soundness of institutions given the significant information asymmetries that exist between policyholders and institutions. This is further compounded by the technical complexity and long term nature of insurance and takaful business. The vast majority of policyholders would have neither the resources nor incentives to monitor the performance of institutions and exercise informed consumer choices. Under these circumstances, the reasonable protection of policyholders serves not only to safeguard the interests of policyholders of an institution that may become insolvent, but it is also important to avert a widespread erosion of confidence in the industry at large which could have detrimental consequences for economic activity, individual welfare and the development of the industry.

A key feature of TIPS, in comparison with the IGSF, is the explicit level of protection provided under TIPS. The IGSF previously provided compensation up to 90% of the benefits in the event of a failure of an institution. This level in practice has varied between 55% and 70% of the benefits depending on the availability of the fund. In contrast, under TIPS, the maximum level of protection is predetermined to provide greater certainty, assurance and importantly, full protection to the vast majority of insured individuals and small businesses. The explicit protection under TIPS, which has existed under the DIS since 2005, will also provide for the consistent treatment between savings instruments offered in the banking and insurance/takaful industry to reflect the growing convergence of products within the financial sector and provide equivalent protection for depositors and policyholders.

The protection of policyholders will also be further enhanced under TIPS with broad powers provided for PIDM to be able to intervene and resolve troubled institutions which have ceased to be viable or which the Bank considers likely to become non-viable, in the best interest of policyholders. PIDM's intervention and resolution powers include arrangements to transfer policies/certificates to another institution in order to preserve the continuity and value of investments and protection afforded under existing insurance policies and takaful certificates.

A further objective of TIPS is promoting and strengthening incentives for sound risk management by institutions. This will be achieved through the implementation of a differentiated premium structure which will reflect the risks posed by individual institutions to the compensation fund. Under this structure, institutions with strong financial standing and risk management will contribute a lower rate of premium to the fund. This will complement and reinforce the supervisory role of the Bank through strengthened incentives for institutions to adopt and implement sound risk management practices commensurate with their risk profiles. This contrasts with the IGSF where all institutions contribute the same rate of premium to the IGSF regardless of their risk profiles.

Membership

Membership in TIPS is compulsory for insurers licensed under the Insurance Act 1996 and takaful operators registered under the Takaful Act 1984. Reinsurance companies, retakaful operators, international takaful operators, Danajamin Nasional Berhad and intermediaries such as insurance/takaful agents, brokers and adjusters are excluded from membership.

Funding

TIPS will be funded from annual premiums assessed against member institutions based on the level of coverage for each individual institution. PIDM maintains and administers separate funds under TIPS respectively for:

- conventional life policies;
- conventional general policies;
- family takaful certificates; and
- general takaful certificates.

The clear segregation of funds promotes equity, transparency and accountability in the management and usage of the funds, as each fund is built up from premium funded from the respective types of insurance/takaful business for the benefit of its respective policyholders. The segregation between conventional and takaful TIPS funds also ensures compliance with Shariah principles.

Coverage

TIPS provides coverage for ringgit-denominated policies issued in Malaysia. Where a member institution is unable to meet its obligations to its policyholders, PIDM is required to reimburse the policyholders in respect of the covered benefits up to the specified maximum limits provided under TIPS. The maximum coverage limits vary for the different types of protected benefits, ranging from up to RM10,000 per month for disability or annuity income benefits, to an amount of up to RM500,000 on death or property damage claims. Any premiums paid in advance will also be refunded in full. The limits are generally adequate to protect the vast majority of policyholders in full, while retaining sufficient incentives for policyholders of high-value policies with substantial benefit levels to be more vigilant in selecting the institutions from which coverage is obtained. Further details on the coverage provided by TIPS can be accessed at www.pidm.gov.my.

Collaboration and coordination

Bank Negara Malaysia remains responsible for the regulation and supervision of insurers and takaful operators as part of its mandate for maintaining overall stability of the Malaysian financial system, while PIDM administers both the DIS and TIPS in a manner that contributes towards promoting public confidence in the financial system. The close collaboration and coordination between the Bank and PIDM ensures the effectiveness and efficiency of the financial safety net.

This is achieved through a strategic alliance agreement (SAA) between the Bank and PIDM, which was established during the inception of the DIS and which has now been expanded to include TIPS. The SAA clearly sets out how the two organisations will collaborate and coordinate their activities to preserve the integrity of the financial safety net and minimise duplicative regulatory costs and burdens on the industry. In particular, the arrangements provide for the coordination of risk assessments, resolutions of member institutions as well as requirements on regulatory reporting. It also establishes protocols for regular consultation and exchange of information concerning developments in the industry to promote optimal financial stability outcomes.

collaborative efforts in 2010 to establish SME Financing Help Desks that are well-equipped to provide advisory services at SME associations and business chambers nationwide, as well as the Association of Banks in Malaysia's (ABM) ``PARTNER´´ initiative to streamline and simplify loan application procedures for SMEs. Such efforts over the years have contributed towards the advancement and transformation of SMEs which saw more than 4,600 SME accounts with a combined financing value of RM14.9 billion upgraded to become large enterprises during the year.

While financing remains largely ample to support the present needs of the Malaysian economy, proactive measures were taken to cater to the new financing requirements of the economy. Three special funds were established by the Government in 2010, namely the RM200 million Creative Industry Fund and RM1.5 billion Green Technology Financing Scheme in support of the development of new growth areas, and the RM20 billion Facilitation Fund to support the financing of large-scale and high-impact development projects by the private sector. The Creative Industry Fund aims to spur commercialisation activities in the creative field, including assistance to companies that export high-tech multimedia content and that contribute to economic activity through the promotion of the nation's rich heritage of arts and culture. An important area for further growth is the adoption of environmentally-friendly technological solutions, including renewable energy and energy efficiency enhancements, to promote and sustain the competitiveness of Malaysian companies in the face of rising energy costs and greater social awareness of the critical need to preserve the environment. This is also consistent with the broader goal of achieving long-term growth that is economically and environmentally sustainable. The RM1.5 billion Green Technology Financing Scheme is targeted at companies which are producers and users of green technology in the energy, building, water and waste management, and transportation sectors. The Facilitation Fund represents the Government's continued commitment towards supporting public-private partnerships as a means of effective risk-sharing and in providing a long-term sustainable solution to the financing of large-scale and high-impact development projects. In ensuring that the three special funds meet their objectives and benefit the respective industries and the economy at large, proactive measures were undertaken to improve the utilisation of these funds, including promoting awareness and understanding, enhancing the fund disbursement framework such as certification requirements, and conducting training programmes for relevant stakeholders.

The coverage of the Corporate Debt Restructuring Committee (CDRC), which recommenced operations in July 2009, was expanded in 2010 to enhance CDRC's role in assisting distressed corporations. The eligibility criteria were revised to allow a larger pool of companies to benefit from CDRC's assistance where there are prospects for companies to remain viable post-restructuring. With improved economic conditions and pre-emptive measures by financial institutions in the restructuring and rescheduling of credit facilities, Malaysian corporates were largely well-supported to continue remaining in business without the need to avail of CDRC's assistance. In 2010, CDRC received only 13 applications for assistance from distressed corporations with a total debt value amounting to RM2.2 billion.

Since its establishment in 2009, Danajamin Nasional Berhad (Danajamin) has continued to play an important role in assisting corporations to raise funds from the bond market at a reasonable cost, particularly in an environment of more cautious investor sentiment. As at end-2010, Danajamin has approved RM4.6 billion worth of guarantees. Danajamin's longer-term objective is to support sustainable access to the bond market for a diverse range of issuers, thus contributing to the further development of a vibrant and comprehensive domestic capital market. In this effort, Danajamin also participates in risk-sharing arrangements under syndicated facilities with banking institutions, with Danajamin guaranteeing instruments with longer tenures whilst the banks address the medium-term funding requirements. Credit enhancements provided by Danajamin in 2010 have benefited a diverse set of issuers covering a wide range of industries and sectors, including the property, infrastructure, plantation, oil and gas, construction, manufacturing, aviation and energy sectors.

DEVELOPING THE FINANCIAL MARKET

The deep and vibrant Malaysian bond market remains an important source of funding for corporations, with the bond market growing significantly from an outstanding value of RM306.8 billion in 2001 to RM782.4 billion or 102.1% of GDP in 2010. This has contributed towards more diversified sources of financing for the Malaysian economy, with the corporate debt securities and sukuk market now accounting for 58.5% of total corporate financing as at end-2010. In 2001, the corporate debt securities and sukuk market supported 46.4% of total corporate financing. Wide-ranging initiatives to develop the bond market since the 1980s, coupled with measures taken in the aftermath of the 1997 Asian financial crisis, have established Malaysia's bond market as the largest in South-East Asia.

In complementing the bond market, greater focus has been directed at the development of a comprehensive and well-functioning money and foreign exchange market. Being a highly open economy with aspirations for deeper regional integration and expansion, prospects for further growth and development in the Malaysian foreign exchange market, in particular, are promising to promote trade, support more effective and efficient risk management, and enhance the contribution of the financial sector to economic growth.

The average daily turnover including swap transactions in the foreign exchange market grew by 49.6% since 2007 to reach USD6.9 billion in 2010. The increased breadth and liquidity of the foreign exchange market can be attributed to the development of new financial instruments, the gradual liberalisation of foreign exchange administration rules to promote greater efficiency in the conduct of international trade and to facilitate the use of domestic currency in the settlement of trade, and the admission of new entrants into the market with the capacity to contribute towards further developing the foreign exchange market. During the year, flexibility was given for foreign electronic brokers to establish electronic broking platforms for wholesale interbank trading in Malaysia as part of efforts to increase the diversity, dynamism and competitiveness of the foreign exchange market. Electronic broking platforms will enhance transparency, improve market efficiency and lower transaction costs for market participants. This flexibility, coupled with the entry of new global financial market players established as commercial banks in Malaysia will contribute towards the development of a more vibrant and dynamic foreign exchange market to support Malaysia's economic transformation.

On the international front, Malaysia remained the global leader in sukuk issuances, capturing 66% or USD94 billion of total global sukuk outstanding as at end-2010. Bursa Malaysia is currently the largest sukuk listing exchange in the world with a value of USD27.7 billion as at end-2010, exceeding that of any other leading international financial centre. The global dimension of Malaysia's sukuk market is reinforced by the continued presence and interest of foreign issuers and investors, which saw four successful issuances of foreign currency-denominated sukuk amounting to USD1.85 billion and SGD1.50 billion in 2010.

The global inter-linkages of Malaysia's Islamic financial markets were further boosted by the establishment of the Bloomberg-AIBIM-Bursa Malaysia Sovereign Shariah Index (BMSSI) in February 2011 as a benchmark to measure the performance of ringgit-denominated Shariah-compliant government securities. Jointly developed by the Association of Islamic Banks in Malaysia (AIBIM), Bursa Malaysia and Bloomberg, the index will promote more efficient price discovery for investors seeking exposure to Shariah-compliant financial instruments, thereby stimulating product innovation and the further development of the Islamic financial markets.

ENHANCING CONTRIBUTION OF ISLAMIC FINANCE AND MALAYSIA AS AN INTERNATIONAL ISLAMIC FINANCIAL CENTRE

Islamic finance in Malaysia continued to register strong growth during the year. Total assets of the Islamic banking sector (including DFIs) amounted to RM350.8 billion as at end-2010, increasing by 15.7% from end-2009. The Islamic banking sector now accounts for over 20% of the overall banking system in terms of assets, financing and deposits. In the takaful sector, assets increased by 17.8% from 2009 to reach RM14.7 billion as at end-2010. Takaful assets now account for 8.7% of the total assets in the insurance and takaful industry.

Strategies to spur the development of Malaysia's Islamic finance industry continued to focus on developing the players, infrastructure and expertise required to meet the needs of the growing economy, and reinforcing Malaysia's position as a leading international centre for Islamic finance.

During the year, the Bank granted four new family takaful licences to joint ventures between global and regional players and strong domestic entities. This was an increase from the earlier announced issuance of two new family takaful licences in 2009. The decision to increase the number of licences took into account the overwhelming interest received in the new licences offered and the large untapped growth potential within the takaful sector. Given Malaysia's demographic profile, the realisation of this potential is especially important to enhance the insurance and takaful penetration rate. All four new family takaful operators offer strong value propositions that are expected to significantly grow the family takaful industry and further entrench Malaysia's position as the global hub for Islamic finance.

The formation of a high-level Law Harmonisation Committee in 2010 to review, harmonise and further strengthen the legal infrastructure to facilitate the conduct of Islamic finance reinforces Malaysia's leadership role in building and maintaining a solid foundation for the development of Islamic finance. The committee is headed by Tun Abdul Hamid Mohamad, the former Chief Justice of Malaysia, and has a diverse membership drawn from the Government, regulatory authorities, experienced Islamic finance practitioners and Islamic finance scholars. The committee has a mandate to recommend legal reforms that will advance the development of Islamic finance and achieve greater certainty and enforceability of Islamic finance contracts domestically. It is expected that this in turn will position Malaysia's laws as the law of choice for international Islamic finance transactions and settlement of disputes relating to cross-border Islamic financial transactions.

An important breakthrough in meeting the global liquidity management requirements of Islamic financial institutions was achieved with the establishment of the International Islamic Liquidity Management Corporation (IILM). This initiative marked the successful collaboration of 12 central banks and regulatory agencies, and two multilateral institutions to form a corporation that would be part of an international Islamic infrastructure to issue high quality instruments to support the liquidity needs of the global Islamic financial system. IILM was established in October 2010 during the second Global Islamic Finance Forum (GIFF) hosted by the Bank, which has become a key international event in the calendar of Islamic finance, bringing together regulators, Shariah scholars and financial market participants who are key drivers in shaping Islamic finance globally. A more detailed explanation of IILM is provided in the box article ``International Islamic Liquidity Management Corporation (IILM): Enhancing Global Islamic Liquidity Management".

Strategies continued to focus on developing the players, infrastructure and expertise required to meet the economy's needs, and reinforcing Malaysia as a leading international centre for Islamic finance

Over the years, the Bank has pursued various initiatives to deepen the industry's Shariah understanding as well as address issues in the application of Shariah in Islamic finance. This includes the establishment of the Fund for Shariah Scholars in Islamic Finance amounting to RM200 million in June 2005. In 2010, the fund supported talent enrichment, research and Islamic finance knowledge enhancement activities, which included the provision of scholarships for furthering Islamic finance studies. The fund also supported efforts to translate selected papers and international *fiqh muamalat* publications with the aim of deepening knowledge and expertise in the field of Islamic finance. During the year, the Islamic Banking and Finance Institute of Malaysia (IBFIM), with the support of the fund, published the English translation of *Qawa'id al-Ahkam fi Islah al-Anam* (Rules of the Derivation of Laws for Reforming the People) which serves as one of the main references in Shariah jurisprudence. The issuance of Shariah Parameters continued to serve as guidance and reference in Shariah best practices for various Islamic finance transactions. In 2010, two concept papers for *mudharabah* and *musharakah* contracts were issued as part of this initiative. The second edition of Shariah Resolutions in Islamic Finance, which documents all Shariah rulings made by the Shariah Advisory Council between 1997 and 2010, was published as part of the Bank's efforts to promote deeper understanding of the Shariah rulings. It is envisaged that all these initiatives will

International Islamic Liquidity Management Corporation (IILM): Enhancing Global Islamic Liquidity Management

Current challenges in Islamic liquidity management

The recent global financial crisis has underscored the critical importance of robust liquidity risk management practices by financial institutions and a sound financial market structure that is able to support the aggregate liquidity needs of the financial system.

For institutions offering Islamic financial services (IIFS), the limited availability of Shariah-compliant instruments in many jurisdictions continues to present substantial challenges for efficient and robust liquidity management. As demand for these instruments continues to outstrip supply, both at the national and global levels, the secondary market trading of the instruments involves high transaction costs and wide bid-ask spreads, while the trading has remained shallow. Even standard instruments for liquidity management such as that based on commodity *murabahah* are considered illiquid given the difficulty of converting the underlying commodity trade into cash before the maturity of the instruments. This has resulted in additional commodity brokerage costs associated with short-term liquidity transactions. In most markets where IIFS operate, the supply of tradable and sovereign instruments that can be held for liquidity purposes has also been limited. The combination of supply and cost considerations has resulted in unnecessarily large holdings of cash by most IIFS to meet their short-term liquidity needs and mitigate liquidity mismatch risks. As Islamic finance grows to become a more significant component of the global financial system, addressing the limitations that constrain effective liquidity management practices will be critical not only to support the further development of Islamic finance, but more importantly to promote global financial stability.

The establishment of Bursa Suq Al-Sila` in Kuala Lumpur in August 2009 as an international commodity *murabahah* platform was a key initiative to strengthen the Islamic liquidity management infrastructure. It is the world's first, end-to-end Shariah-compliant multi-currency commodity trading platform specifically dedicated to facilitating commodity-based Islamic financing and investment transactions in the Islamic money market. This will ultimately enhance the liquidity and risk management capacity of participants in the international Islamic financial markets.

Besides mitigating relevant legal, market and counterparty risks, the Bursa Suq Al-Sila` provides industry players with additional instruments to manage their assets and liabilities as well as to facilitate the development of new financing and investment products that are globally accepted.

Establishment of the International Islamic Liquidity Management Corporation

At the global level, the development of Islamic liquidity management infrastructure has been further strengthened with the setting up of the International Islamic Liquidity Management Corporation (IILM). This arose from the recommendation of the High Level Task Force on Liquidity Management that was established by the Islamic Financial Services Board Council in March 2009.

The formal establishment of the IILM on 25 October 2010 represents a major breakthrough in the development of global Islamic finance industry given its pivotal role in facilitating cross-border Islamic liquidity management. Its significance in the global Islamic financial landscape is further underscored by the close collaboration among central banks behind the operations of the IILM to address key fundamental issues facing the industry namely the lack of short-term liquid instruments for IIFS and the absence of a robust liquidity management infrastructure. The current members of the IILM comprise 12 central banks and regulatory authorities, and two multilateral development institutions. Membership in the IILM is open to central banks, monetary authorities, financial regulatory authorities, government ministries or agencies that have regulatory oversight on finance, and relevant multilateral organisations.

The IILM will enhance cross-border liquidity management among IIFS through the regular issuances of short-term high quality Shariah-compliant financial instruments in major reserve currencies in a cost efficient manner. The ultimate objective is to facilitate greater international integration of the Islamic money and capital markets, while improving the efficiency of the cross-border intermediation of funds. A range of high-grade Shariah-compliant interbank instruments and the supporting liquidity management platform will be established to facilitate the domestic and global development of Islamic liquidity management in the different jurisdictions. The IILM will also be equipped to render technical advice and support in the development of Islamic liquidity management capabilities among IIFS and member countries, and thus enhance the ability of IIFS to participate in international liquidity management operations.

Backed by the strength of the IILM's shareholders, instruments issued by the IILM will also contribute towards expanding the pool of eligible collateral for interbank transactions and/or central bank financing; as well as for secondary market trading among IIFS within and across different jurisdictions. Over the medium term, this is expected to catalyse the development of infrastructure at the international level for collateralised borrowing and lending, and the development of standardised documentation to facilitate trading of these instruments. Furthermore, with the enhanced capacity of IIFS to manage liquidity shocks over time, the significant potential reduction in cash holdings by IIFS would also contribute towards improving returns to investors.

In addition to encouraging more efficient cross-border intermediation of funds and improved liquidity risk management practices among IIFS, the IILM will provide a platform for interaction and engagement among central banks and regulatory authorities on developments and evolving practices in Islamic liquidity management. This will in turn foster greater regional and international cooperation in supporting further development of the Islamic financial markets.

Malaysia, as the host country for the IILM, has enacted a dedicated legislation for the establishment of the IILM that accords the entity with privileges and immunities granted to supranational organisations. This stature strengthens the prospects for the IILM to assume a key role in the development of Islamic finance as an important and viable component of the international financial system. The IILM will have an important role in shaping the future landscape of the global Islamic finance industry through its contribution to the development of more efficient and vibrant Islamic financial markets across borders, and overall financial stability.

contribute towards reinforcing Malaysia's role as a global Shariah reference point in Islamic finance in defining the practices of Islamic financial transactions internationally.

Efforts were also made to strengthen the Shariah advisory profession during the year. The International Shariah Research Academy for Islamic Finance (ISRA) is in the midst of setting up the Association of Shariah Advisors (ASAS), which will be the body that regulates the conduct and establishes the ethical code for Shariah advisors. ASAS is also expected to take on the role of accreditating Shariah advisors and enhancing public confidence in the qualification and professionalism of Shariah advisors. ISRA also continues to pursue initiatives to enhance collaboration amongst Shariah advisors and scholars beyond national borders, towards mutual recognition of Shariah opinions so that international Islamic finance activities can be harnessed further.

The International Centre for Education in Islamic Finance (INCEIF), Malaysia's global university of Islamic finance, continued to supply qualified Islamic finance professionals during the year 2010 with 74 students from 10 countries including Afghanistan, India and the United Kingdom obtaining the Chartered Islamic Finance Professional (CIFP) qualification, and seven students from countries including India, Indonesia and Nigeria receiving the inaugural Masters in Islamic Finance degree. Given the global nature of Islamic finance, INCEIF has over the years strengthened its collaboration with foreign and domestic institutions, including entering into memorandums of understanding (MoUs) with four institutions of higher learning from Jordan and Indonesia in 2010. With INCEIF having sealed over 50 collaboration arrangements with various institutions globally, the enhanced collaboration and cross-leveraging of respective areas of strengths among education and training providers at the domestic and international levels are expected to enhance the supply of high quality researchers and practitioners in Islamic finance across jurisdictions. These human capital development efforts were complemented by initiatives taken to encourage the entry of expatriates that have sound knowledge of Islamic finance to contribute to the development of the Islamic financial industry. Through the collaboration by the Bank, Ministry of Home Affairs and Immigration Department of Malaysia, a special employment pass for Islamic finance expatriates was introduced in September 2010, providing longer tenures and distinct flexibilities with the two-pronged objective of attracting foreign Islamic finance talent into Malaysia and enabling the Malaysian Islamic finance industry to better utilise such talent.

ENHANCING MALAYSIA'S INTER-LINKAGES WITH REGIONAL AND INTERNATIONAL ECONOMIES

Malaysian financial institutions continued to expand their regional footprint in 2010. Six domestic banking groups currently have operations in 19 countries worldwide, contributing RM250 billion in total assets and almost RM2 billion in profits as at end-2010. The recent years have also seen nine Malaysian stand-alone investment banks, insurance and reinsurance companies and takaful operators expand abroad through acquisition or the establishment of subsidiaries or joint ventures as part of longer-term growth strategies to diversify their sources of income and tap new business opportunities. Several Malaysian financial institutions have successfully emerged as leading regional players with an important role in contributing to the overall development of the countries in which they are present. In line with the more significant presence of Malaysian banks within the region, the Bank further strengthened its bilateral relationships with central banks around the region. New MoUs with Bank Indonesia, National Bank of Cambodia and State Bank of Vietnam were signed during the year. The Bank also entered into bilateral MoUs with the Australian Treasury, Banque de France, Central Bank of Nigeria and Bank of Mauritius to foster long-term strategic developments in both conventional and Islamic finance between Malaysia and these economies. These bilateral arrangements reinforce the Bank's expanding framework of cooperation with the regional and other foreign regulatory authorities which spans cooperation in cross-border banking supervision, regional financial integration, development of financial market infrastructure, capacity building and human capital development. Moving forward, as Malaysian banks enhance their presence in regional markets and global advancements in Islamic finance become more pronounced, such cooperation is expected to continue to strengthen.

A key development in 2010 was the implementation of the liberalisation plan that was announced in April 2009 which offered new commercial banking and family takaful licences to qualified players. Following a rigorous evaluation process, five new commercial banking licences were accorded to foreign financial institutions with the expertise, global network and strong business capacity to contribute to the future growth and diversity of Malaysia's financial system, support new areas of economic growth and facilitate international trade and investment flows. Of the 20 foreign commercial banks including the new entrants in Malaysia, over half now originate from Asia, signifying the growing importance of Asia in the global economic landscape. Existing locally-incorporated foreign banks also benefited from the increased operational flexibility granted to establish new branches in Malaysia, with four foreign banking institutions obtaining approval to establish 12 new branches nationwide thus far. These developments have contributed towards further expanding the breadth and depth, and enhancing the competitiveness of the Malaysian financial sector.

Several Malaysian financial institutions have successfully emerged as leading regional players with an important role in contributing to the overall development of the countries in the region

As the region becomes increasingly integrated, strong regional frameworks for cooperation in the areas of surveillance, supervision, policy and crisis management have become more important. The Chiang Mai Initiative Multilateralisation Agreement, a multilateral currency swap arrangement which covers all ASEAN member states, the People's Republic of China, Japan, Korea and Hong Kong SAR came into effect on 24 March 2010 with the aim of providing financial support to address balance of payment and short-term liquidity difficulties in the region through prompt and simultaneous currency swap transactions among the participants. The agreement is supported by an independent regional surveillance unit that will be established, demonstrating the strong commitment of its members to further enhance the region's capacity to respond to downside risks and challenges in the global economy while preserving financial stability.

CONTINUED DEVELOPMENT OF HUMAN CAPITAL

Promoting strong institutional arrangements to meet the human capital development needs of the financial sector remained a key priority in 2010.

Since its establishment in 2007, the Financial Sector Talent Enrichment Programme (FSTEP) has played an important role in supplying the financial services industry with graduates who are equipped with the necessary competencies and skill sets to perform within the industry through a combination of classroom teaching and practical training in financial institutions. To ensure that the programme remains relevant and takes into account the evolving nature of the financial services industry, FSTEP's revised syllabus and programme design and delivery was launched in July 2010. The enhanced programme will enable participants to have a deeper practical understanding of the financial industry and its operations, thus enhancing their ability to assume meaningful roles in the industry. To date, 784 participants have benefited from FSTEP, with an employment success rate of over 99%.

The Asian Institute of Finance (AIF) made further advancements in 2010. Established in 2009, AIF aims to complement and enhance the capacity of the financial sector training institutes in elevating the competency and skills of professionals in the banking, insurance, securities and Islamic financial services industries to meet the demands of the more challenging and complex operating environment. During the past year, AIF's efforts were focused on providing key capacity building support systems, executing capacity building initiatives, facilitating the adoption of higher standards for learning programmes, establishing shared learning infrastructure, and promoting AIF and the training institutes as leading providers of comprehensive training solutions for the financial services industry. Continuous improvements to programme quality and design were promoted through the development of a learning programme assessment and accreditation framework and implementation of quality assurance processes. The positioning of AIF as a leading human capital development institute in the region was further enhanced through strengthened collaboration with domestic and international institutes and research centres.

For directors, the Financial Institutions Directors' Education (FIDE) programme continued to provide a strong foundation for building more effective boards and promoting better governance practices across the financial industry. Further information on this programme is provided in the box article ``Financial Institutions Directors' Education under the ICLIF Leadership and Governance Centre´´ in Chapter 3.

Whilst human capital development initiatives for the financial services industry are imperative, the continuous enhancement of the regulatory community's capabilities in keeping pace with advancements in the financial sector is equally crucial. The South-East Asian Central Banks (SEACEN) Research and Training Centre, located in Kuala Lumpur, plays a critical role in providing capacity building programmes that have practical applications in central banking, including programmes that are targeted at regulators. In line with the centre's vision of becoming the regional learning hub for central banks in the Asia Pacific region, the centre aims to promote the participation of central banks both within and beyond the region in its learning and networking platforms, and foster greater collaboration and deliberation on central banking issues to build regional views. In January 2011, the People's Bank of China became the 17th member of the SEACEN grouping, reinforcing the identity of SEACEN as the most inclusive central banking grouping in the region.

PRESERVING THE INTEGRITY OF THE FINANCIAL SYSTEM

Malaysia's anti-money laundering and counter financing of terrorism (AML/CFT) regime is characterised by a robust legal and regulatory framework that is consistent with international standards, preventive measures applied to financial institutions and designated non-financial businesses and professions, a comprehensive financial intelligence infrastructure to support analysis and investigations, and strong domestic and international inter-agency cooperation arrangements to support capacity building, surveillance and enforcement.

Since the establishment of the AML/CFT framework in Malaysia, efforts have been ongoing to ensure that the framework remains effective against evolving money laundering and terrorism financing threats. During the year, initiatives were taken to further strengthen the implementation and strategic focus of AML/CFT efforts. This aims to support high impact outcomes, more optimal resource allocation and improved monitoring of AML/CFT measures. The National AML/CFT Strategic Plan 2010-2012 will serve as a strategic tool to promote focused implementation of AML/CFT efforts through outcome-based initiatives in six areas of focus: (i) effective implementation of preventive measures for reporting institutions, (ii) timely resolution of money laundering and terrorism financing investigations and prosecutions, (iii) strengthened legal framework, (iv) larger pool of specialist AML/CFT practitioners, (v) effective management of seized and forfeited assets, and (vi) increased visibility and awareness of AML/CFT initiatives domestically and regionally. The core thrust of the strategic plan is the mutual agreement of relevant stakeholders to support the areas of focus through well-coordinated efforts and alignment with the overarching objective of safeguarding the integrity of the financial system.

The National AML/CFT Strategic Plan 2010-2012 focuses on well-coordinated efforts among the relevant stakeholders and alignment with the overarching objective of safeguarding the integrity of the financial system

A major reform of the legal and regulatory regime governing the money changing and remittance services industry was also undertaken to promote the orderly development and modernisation of the industry and strengthen its defences against illicit activities. The proposed legislation, which has been finalised, will be tabled to Parliament this year. More details on the reform and the envisioned new landscape of the money changing and remittance services industry can be found in the box article `Modernisation of the Money Changing and Remittance Industry´.

PROMOTING AN INCLUSIVE FINANCIAL SYSTEM

Financial sector development policies have facilitated the nation's balanced growth by recognising the social and economic benefits of financial inclusion. This commitment to financial inclusion is embedded in the Central Bank of Malaysia Act 2009, which includes promoting a sound, progressive and inclusive financial system among the primary functions of Bank Negara Malaysia. The Bank's financial inclusion agenda is delivered through five key components – extensive financial access and outreach, micro financing to enable participation in productive economic activities, financial tools to cope with daily necessities, financial protection mechanisms to cope with emergencies, and avenues for consumer information, education and assistance.

Improving the outreach of financial services nationwide by overcoming geographical barriers to financial access represents an important outcome of the Bank's financial inclusion agenda. In particular, the wider presence of financial institutions in remote and non-urban locations is key to ensuring that all segments of society are able to participate in the formal financial system and conduct financial transactions in a safe, secure and convenient manner. Efforts were advanced during the year to provide banking services in every district in Malaysia, with commitments made by financial institutions to establish a presence in the remaining unserved districts in Sabah and Sarawak. These plans are in progress and will deliver essential financial services to all districts in Malaysia in 2011. Greater flexibility was also accorded for banking institutions to leverage on the outreach of third parties to provide basic financial services. To date, two banking groups have entered into strategic arrangements with Pos Malaysia Berhad to provide banking services, including cash deposits and withdrawals, loan repayments, opening of savings account and remittances, to the public through the extensive postal service network nationwide.

Over 300 locations have been targeted for the roll-out of such shared banking services over the course of 2011.

The *Pembiayaan Mikro* framework that was introduced in 2006 to provide micro entrepreneurs with access to financing without collateral has seen significant progress over the years. *Pembiayaan Mikro* is currently offered by 10 participating financial institutions with total outstanding micro financing amounting to RM775.9 million, benefiting more than 66,000 customers as at end-2010. Market research surveys conducted in 2010 will support more targeted and effective promotional efforts to heighten awareness among micro entrepreneurs to avail of financing facilities under *Pembiayaan Mikro*.

> The Bank's financial inclusion agenda is delivered through extensive financial outreach, micro financing, financial tools to cope with necessities and emergencies, and avenues for consumer information, education and assistance

To complement the *Pembiayaan Mikro* framework, the 1Malaysia Micro Protection Plan (1MMPP) is being finalised by the insurance and takaful industry to provide a financial safety net for micro enterprises and individuals operating small businesses against unexpected events, such as the death or disability of a breadwinner, and damage or loss of property due to accidents, floods and fires. As a start, the 1MMPP will provide insurance and takaful coverage for death and disability, personal accident, hospitalisation and protection of property against natural disasters. Accessibility to the scheme will be promoted through simple underwriting standards and processes, an extensive outreach via banks and DFIs, and affordable rates starting at less than RM20 per month.

Ensuring access to affordable housing has become increasingly challenging with the higher pace of urbanisation and higher cost of living in urban centres. The challenge is particularly acute for the urban poor segments who spend the greater part of their incomes on

Modernisation of the Money Changing and Remittance Industry

Aided by rapid technological advancements, the money changing and remittance industry globally has seen significant growth over the last decade in terms of size, sophistication and number of players with global linkages and advanced operations. Domestically, the volume of money changing and remittance transactions has similarly increased significantly in tandem with the expansion in economic activity. This in turn has driven demand for and access to money changing and remittance services while increasing the need for operators to ensure safety, security and integrity of these activities.

In line with these developments, Bank Negara Malaysia has initiated a comprehensive review of the legal and regulatory framework for the money changing and remittance services business in Malaysia, with the view to modernising and elevating the current status of the industry. The review is also aimed at ensuring that the necessary safeguards are in place and operating effectively to protect the integrity of the industry from the risk of money laundering, terrorist financing and illegal activities.

As an outcome of the review, a new industry landscape is envisaged to promote the orderly and professional development of the money changing and remittance industry in Malaysia under a more cohesive framework, while rationalising the regulatory regime applicable to the money changing, remittance and foreign currency wholesale businesses which is currently provided in three separate legislations, namely the Money Changing Act 1998, the Payment Systems Act 2003 and the Exchange Control Act 1953. This will pave the way for a more dynamic and effective industry to evolve with the following features:

- Greater business flexibilities for qualified players in the industry, including the ability to carry on multiple business activities within a single entity, thus promoting greater synergies between these activities and economies of scale;
- Differentiated regulatory requirements according to the nature, scale and complexity of an entity's business; and
- Strengthened safeguards to promote the professional and sound management of the industry.

Greater business flexibility

In line with the objective of fostering greater effectiveness and efficiency in the money changing and remittance business as well as to facilitate their orderly expansion, qualified players will be given greater flexibility to provide both money changing and remittance services within a single entity. This recognises the synergies between the money changing and remittance businesses and is expected to not only broaden the revenue base of operators, but also to encourage the use of formal channels for remittances by allowing existing money changers to also provide remittance services. Consideration is also being given to allow qualified wholesalers to conduct retail operations, thus enabling them to derive greater synergies from upstream and downstream activities. The existing foreign currency holding limit and remittance limits imposed on money changers and remitters respectively are also being reviewed to allow well-managed players to achieve greater scale and expand their product offerings. Such added flexibility to be accorded to eligible players that fulfill preconditions, will enhance the capacity of the industry to complement the banking sector in providing a broad range of comprehensive services to customers in the long run.

Differentiated regulatory requirements

The proposed new framework will provide flexibility under a more proportionate and differentiated regulatory and supervisory regime which provides for compliance with regulatory requirements according to the nature, scale and complexity of an entity's business. Consistent with such a regime, wider enforcement powers are envisaged for the Bank to promote sound and responsible practices by players in the industry and to support early actions against non-compliances or breaches of regulatory requirements that may undermine the integrity and confidence in the industry.

Strengthened safeguards to promote sound and professional management

Central to an effective and dynamic industry will be enhanced oversight arrangements that are underpinned by effective governance, operational and control requirements for the sound conduct of the business. This is essential to provide a strong foundation for the modernised and more vibrant landscape for the money changing and remittance businesses. Consistent with other regulated industries within the financial sector, rigorous fit and proper requirements and assessments will be introduced for shareholders, directors and managers, to ensure that only people of high integrity, competency and experience are allowed to operate in the industry. A key focus will be on establishing the financial capacity and capability of players in the industry to put in place and effectively implement sound governance and operational arrangements, as well as internal control mechanisms, in particular for compliance with AML/CFT.

Conclusion

The new landscape for the money changing and remittance industry will provide a stronger foundation for the orderly growth and further development of the industry. Importantly, this will be supported by a more robust and responsive regulatory and supervisory framework that will safeguard the integrity of Malaysia's financial system from money laundering and terrorist financing threats, while improving the efficiency and quality of services provided to the public at large. The enabling legislation which will pave the way for these changes is expected to be put in place in 2011.

residential rent. In response to this challenge, the Government launched the My First Home Scheme under the 2011 Budget as a means of facilitating first-time home ownership among the young adult population. The scheme alleviates the financial strains faced by individuals in sourcing for funds to meet the down payment for a house. Under the scheme, first-time home buyers can obtain 100% financing from financial institutions, with the support of a guarantee granted by Cagamas Berhad (Cagamas) on 10% of the loan value. The guarantee granted by Cagamas is backed by the Government. The financial support provided under the scheme not only enables young Malaysians in urban centres to own a place of their own, but also contributes towards their asset accumulation, thus enhancing their welfare over time.

Ongoing efforts by the Bank to empower consumers through financial information, education and assistance have continued to pay off. Established by the Bank in 2006, the Credit Counselling and Debt Management Agency (AKPK) extended financial management advice and counselling services to over 30,000 consumers in 2010, of which over 15,000 consumers received assistance under AKPK's Debt Management Programme. The Bank's Integrated Contact Centre, established in 2008, also remained an important platform for consumers to source information and seek assistance on financial matters. In 2010, almost 300,000 individuals and businesses sought assistance from the centre, mainly to obtain information and financial advice. This represented a 15.6% increase in consumers seeking the centre's services compared to 2009 and is indicative of greater awareness and initiative on the part of consumers to avail of such platforms to seek assistance and enhance their knowledge on financial matters. To complement existing channels offered by the Bank's branches nationwide, mobile counter services were set up in November 2010, starting with Selangor, to enhance public accessibility to financial assistance in the non-urban areas. Public awareness was also enhanced through the Bank's strategic collaboration with consumer associations to conduct financial literacy programmes for communities and youths in both urban and non-urban areas nationwide. The multi-pronged approach taken by the Bank to promote consumer education and protection critically supports the development of a more competitive financial sector with enhanced access to a broad range of financial products and services reinforced by empowering consumers to make informed and responsible financial decisions.

KEY PRIORITIES MOVING FORWARD

The successful outcomes achieved over the years in financial sector development have largely been attributed to the comprehensive approach taken to develop the financial sector. Most segments of society today have broad access to financial services at reasonable cost. Moving forward, in order to support Malaysia's transition to a developed nation, the role of the financial sector will need to evolve further. Towards this end, the Bank is at the advanced stages of finalising a financial sector blueprint, which aims to enhance the capacity and capability of the Malaysian financial sector to best serve Malaysia's needs as a high value-added and high-income economy by 2020. It is envisioned that the structure of the Malaysian financial system will evolve to become more diverse in terms of institutions and arrangements to support an effective and efficient financial intermediation function in the new economy, with improved productivity, responsible innovation and greater support for the formation of businesses. The transformation of the financial sector will be accelerated by the continued process of financial integration and increased connectivity within the region, continued gradual and sequenced liberalisation of the financial sector, integration of payment and settlement systems, and greater cross-border cooperation in maintaining regional financial stability. This will be achieved with a continued focus on financial inclusion, and a strengthened surveillance, consumer protection and prudential regulatory framework which will provide the core foundations for sustainable growth with financial stability.

The financial sector blueprint aims to enhance the capacity and capability of the Malaysian financial sector to best serve Malaysia's needs as a high value-added and high-income economy by 2020

In the area of Islamic finance, Malaysia's position as the global hub for Islamic finance will continue to be reinforced, supported by a diverse set of institutions, deep, liquid and efficient financial markets, vibrant ancillary and support services including consultancy and advisory services as well as a highly competent and skilled talent pool. This will also contribute to and complement identified strategies to promote the more efficient mobilisation of funds through the financial markets. The blueprint which will articulate the Bank's vision, strategies and recommendations will be released in 2011.

The Bank will continue to contribute actively to the holistic review of the pension and social security system spearheaded by the Government. The focus is to ensure that the pension and social security system is robust and sustainable in light of demographic and social trends in Malaysia. In addition to enhancements to the existing pension framework, an important outcome will be the development of a voluntary private pension industry to complement the mandatory retirement savings scheme and old age welfare scheme. Banking institutions and insurance companies will have an important role in this development.

Efforts will also be enhanced to deepen Malaysia's inter-linkages with international economies. It is envisaged that as Malaysia becomes more integrated with the regional economies, cross-border cooperation in areas of financial sector development, financial regulation and supervision, and crisis management and resolution will become increasingly important. In this respect, the Bank will continue to proactively seek to open up opportunities abroad for Malaysian financial institutions through bilateral and multilateral agreements that provide optimal benefits to the economy at large, while ensuring the preconditions and safeguards are in place to mitigate any adverse effects to the financial sector and economy as a whole.

2010

REGULATORY AND SUPERVISORY FRAMEWORK

INTRODUCTION

Bank Negara Malaysia's regulatory framework and supervisory oversight continued to support the overall development of the domestic financial system and financial system stability in 2010. With volatility in global financial markets remaining elevated and more intense domestic competition, the Bank's regulatory and supervisory activities remained focused on promoting sound risk management and effective board oversight functions in financial institutions to ensure that risk-taking activities are prudent, sustainable and subject to effective controls. This was supported by rigorous and sustained stress tests by both the Bank and financial institutions, and the ramping up of the Bank's market conduct surveillance and supervisory activities in the retail segment of the financial system. The Islamic financial system was also further strengthened, with the development of a more robust solvency framework and Shariah governance standards for Islamic banks and takaful operators.

As financial conglomeration and convergence continued to shape the domestic financial landscape, policy initiatives also served to bring about greater consistency in the treatment of similar risks between the banking and insurance sectors, and between the conventional and Islamic financial sectors. This builds on the Bank's significant cumulative efforts over the years to develop a better understanding of the underlying business and risk models in the various financial sub-sectors, and the interlinkages between them.

The Bank's regulatory and supervisory activities remained focused on promoting sound risk management and effective board oversight functions in financial institutions

INTERNATIONAL AND DOMESTIC REGULATORY DEVELOPMENTS

International regulatory initiatives in response to the global financial crisis progressed significantly in 2010 with agreement reached by the Basel Committee on Banking Supervision (BCBS) in September 2010 on key elements of the reform package (better known as Basel III), mainly in respect of capital adequacy and liquidity standards.

Quantitative assessments carried out by the BCBS on the financial and economic impact, including the long-run economic benefits and costs, of the reform proposals under Basel III suggest that banks should be able to meet the higher capital requirements through relatively modest earnings retention and capital raising, while remaining supportive of lending to the economy. This is affirmed by assessments carried out by the Bank on the impact of the new capital measures on banking institutions as illustrated in Table 3.1.

Table 3.1

Impact Assessment of Global Reforms on Capital on Banking Institutions

	Common Equity Ratio	Tier-1 Capital Ratio	Total Capital Ratio	Leverage Ratio
Minimum requirement	4.5%	6.0%	8.0%	3.0%
Conservation buffer	2.5%	2.5%	2.5%	–
Minimum requirement plus conservation buffer	7.0%	8.5%	10.5%	–
Current Basel II position	12.3%	13.0%	14.8%	–
Estimated Basel III position	9.5%	11.1%	14.8%	5.9%

Source: Bank Negara Malaysia and internal computation

The liquidity standards however will likely pose greater challenges for banks in Malaysia given the structure of the domestic funding market. While banks in Malaysia are already accustomed to complying with liquidity requirements that are conceptually consistent with the Liquidity Coverage Ratio, the dominant role of the Employees Provident Fund in mobilising domestic savings and the lack of sufficient eligible liquid assets will substantially constrain banks' ability to capture more stable retail deposits and bolster their liquidity buffers in order to comply with the new liquidity standards under Basel III. Further details on the proposed reforms and their implications can be found in the box article ``Basel III and its Potential Implications on Malaysia and the Financial System´´.

The Bank intends during the course of 2011 to issue an implementation strategy for the incorporation of the enhanced capital and liquidity rules into the domestic regulatory framework. This will take into account, where appropriate, the need to provide more granular parameters under the new rules to reflect the specific characteristics of the domestic market and relevant transitioning arrangements. Work will also be directed towards operationalising an objective and robust framework for the implementation of the counter-cyclical capital buffers required under Basel III.

Global initiatives to strengthen the resilience of the Islamic financial system were also taken forward during the year. In April 2010, the Task Force on Islamic Finance and Global Financial Stability (a joint collaboration between the Islamic Development Bank and the Islamic Financial Services Board (IFSB)) published the Islamic Finance and Global Financial Stability Report that examines in greater depth the conceptual elements inherent in Islamic finance and identifies priorities for the development of an international Islamic financial system that will further enhance prospects for greater global financial stability. Drawing on lessons from the recent crisis which highlight the fragilities inherent in the global financial system, the report identified eight key building blocks to provide a solid foundation for a sound and resilient Islamic financial system in the more challenging global environment.

These building blocks include: (i) the global implementation of IFSB prudential standards; (ii) the development of a systemic liquidity management infrastructure; (iii) the establishment of strong financial safety nets; (iv) the institutionalisation of an effective crisis management and resolution framework; (v) enhancements to the accounting, auditing and disclosure standards for Islamic financial institutions as well as governance arrangements; (vi) the development of an effective macroprudential surveillance framework; (vii) strengthening of the rating processes for Islamic financial institutions and instruments; and (viii) increased intensity in capacity building and talent development to keep pace with the rapid growth of Islamic finance. The development of these building blocks in Malaysia is already well-advanced as a result of concerted efforts to promote the orderly expansion of Islamic finance in parallel with the conventional financial system over the last decade. The focus going forward will be to reinforce these foundations through the promotion of globally consistent applications and practices. In addition, further efforts are needed to develop more robust rating processes for Islamic financial institutions in order to support its rapid growth and expansion.

The Bank intends during the course of 2011 to issue an implementation strategy for the incorporation of the enhanced capital and liquidity rules into the domestic regulatory framework

Following a key recommendation of the report, the Islamic Financial Stability Forum (IFSF) was established in April 2010 to provide a global platform for cross-border cooperation and dialogue with a view to promote the effective and timely exchange of information on developments in the Islamic financial system and their implications for national and global financial stability. In addition, the IFSF is also intended to support the coordinated implementation of policies to prevent, contain and manage emerging risks in Islamic finance.

The review of the international financial reporting standards also progressed during the year. In October 2010, the International Accounting Standards Board (IASB) completed

Basel III and its Potential Implications on Malaysia and the Financial System

Basel III and the global financial reforms

In September 2010, the Basel Committee on Banking Supervision (BCBS) endorsed a package of reforms to strengthen global capital standards and introduce global standards for liquidity – now collectively referred to as Basel III. The reforms which represent the core components of the global financial reform agenda aim to improve the banking sector's ability to absorb financial and economic shocks, thus reducing the risk of spillover from the financial sector to the real economy. This article discusses the implementation of the Basel III capital and liquidity reforms for banking institutions in Malaysia.

Table 1

Elements of the Basel III reform package

Areas	Reform measures
Capital	• Raise the quality, consistency and transparency of the capital base so that banks are better able to absorb losses on both a going concern and a gone concern basis. • Strengthen capital requirements for counterparty credit risk exposures arising from derivatives and securities financing activities. • Raise the level of minimum capital requirements, particularly for Tier-1 capital and common equity. • Incentivise the conservation of capital through the build-up of capital buffers above the minimum requirement which can be drawn down by individual banks as losses are incurred. • Promote the build-up of counter-cyclical capital buffers at the system level to protect the banking sector from periods of excessive credit growth and thus maintain the flow of credit in the economy during a downturn. • Introduce a non-risk-based leverage ratio to reinforce risk-based requirements and constrain the build-up of leverage, thus mitigating the effects of excessive deleveraging in the banking system during distressed periods.
Liquidity	• Introduce a Liquidity Coverage Ratio (LCR) to ensure that banks have sufficient high quality liquid resources to survive an acute stress scenario lasting a month. • Introduce a Net Stable Funding Ratio (NSFR) to promote resilience over a longer-term horizon by creating incentives for banks to fund activities with more stable sources of funding on an ongoing basis.

Implementation of Basel III in Malaysia

Banking institutions in Malaysia will be able to transition into Basel III from a position of strength owing to the extensive reform initiatives undertaken by the Bank and the industry following the Asian financial crisis. All major elements of the Basel II capital framework – including the Internal Ratings-Based approach for credit risk as well as the Pillar 2 and Pillar 3 components – have been put in place. Explicit liquidity requirements which ensure that banking institutions hold adequate high quality liquid resources to survive acute stress situations, consistent with the objectives of the LCR introduced by the BCBS, have also been in place for over a decade. With minimal exposures to complex and high-risk off-balance sheet activities which are mainly targeted by the reforms, strong starting capital positions (common equity and reserves currently contribute towards approximately 70% of the banking system's total capital) and leverage levels in line with that permitted under Basel III (the banking system leverage is 5.9%, against the minimum 3%), the need for substantial structural adjustments in the Malaysian banking system will be less significant than those of advanced economies.

The implementation of Basel III in Malaysia will further reinforce these foundations, while reducing procyclicality and contagion within the financial system. With their greater regional presence, Malaysian financial institutions can also expect to be held up to greater scrutiny by investors, analysts and market participants in respect of their compliance to global standards. For these reasons, the Bank has already initiated work to develop strategies for Basel III implementation in Malaysia and will begin consultations with industry players in 2011 on specific enhancements to the existing capital and liquidity frameworks required to give effect to the requirements of the global reform package. The sequencing and timelines of implementation of these enhancements will also be determined as part of this process.

While the BCBS has outlined an extended time frame until 2018 for the implementation of the new requirements to provide continued support for the global economic recovery process, the positive outlook maintained for Malaysia as well as the strong capital positions of banking institutions allow considerable flexibility for certain elements of the package to be implemented on an accelerated basis. Any decision to fast-track implementation in Malaysia will consider the need to ensure that the standards are implemented at a speed and manner that does not disproportionately impact individual components of the financial system or sectors of the economy. The Bank also aims to coordinate implementation with other countries within the region to avoid any material market distortions. However, this will be carefully weighed against the clear benefits of moving the domestic banking system to a higher degree of resilience in a timely fashion.

Implications on the economy and the financial intermediation process

The main concerns expressed at the international level with Basel III have been the potential impact of the reforms on the cost and availability of financial services due to the need for banks to realign business strategies and restructure balance sheets, including through the build-up of larger liquidity buffers, and the raising of longer-term debt and high quality capital. The extended implementation time frame provided by the BCBS serves to mitigate the risk of resulting constrictions to the supply of credit particularly given the fragile pace and extent of global economic recovery. Based on a joint assessment by the Financial Stability Board and the BCBS released in 2010, given the reasonable implementation time frame, the transition to stronger capital and liquidity standards will likely only have a modest impact on global economic growth. It is estimated that if higher capital requirements are phased in, the annual growth rate in gross domestic product would be reduced by an average of only 0.04% over a period of four and a half years.

In Malaysia, banking institutions are already largely operating at capital adequacy and leverage levels consistent with the requirements and targets set under Basel III, thus the impact of the new capital standards on the real economy will likely be modest. Preliminary assessments by the Bank indicate that the current reported common equity ratio of the banking system, adjusted for Basel III requirements, would be approximately 9.5%, well above the minimum common equity ratio of 7% (including the capital conservation buffer). Internal capital management strategies by banking institutions to maintain comfortable buffers over the new regulatory minimums are also expected to be easily met through the retention of earnings, obviating the need for large-scale capital raising activity. This is supported by the prudent earnings retention practices of banking institutions in Malaysia over the last decade, with 57.5% of new capital of banking institutions attributable to increases in reserves and retained earnings.

Meeting the Basel III liquidity requirements will however be considerably more challenging. Based on self-assessments conducted by a number of banking institutions in 2010, the LCR under Basel III for most banking institutions is expected to range between 60-80% (against the required 100%). Reflecting the higher assumed sensitivity of wholesale funding to changes in interest rates and perceived credit risk, the new liquidity rules apply run-off rates on wholesale funding that are significantly higher than for retail deposits, and higher than that observed by distressed banking institutions in Malaysia during the Asian financial crisis. While this may incentivise banking institutions to source more stable retail deposit funding, the ability of the Malaysian banking sector as a whole to mobilise greater amounts of retail deposits in the short run is constrained by the dominance of other pensions and investment schemes (notably the Employees Provident Fund and Permodalan Nasional Berhad) that account for a significant share of household savings. Perversely, heightened competition for retail deposits may also result in banking institutions offering and potentially mis-selling complex and opaque structured investment products which may not be suitable for the general public. While other avenues such as the issuance of long-term senior debt exist for banking institutions to shore up their liquidity positions and to diversify their funding sources, this is likely to be more costly than raising retail deposits.

In view of the wider implications of the Basel III liquidity rules, the Bank intends to use the observation period[1] provided by the BCBS to perform further analyses of the implications of the standards for domestic financial markets and credit extension. This will leverage on data currently submitted to the Bank under the existing Liquidity Framework and additional data as may be required to facilitate the Bank's analyses. A key focus will be on monitoring the behaviour of wholesale funding sources. The outcome of this assessment will form the approach to the implementation of the LCR in Malaysia.

The need for banking institutions to shore up their capital and liquidity positions may however encourage the development of new classes of financial instruments in Malaysia. This includes covered bonds which qualify as liquid assets under Basel III and new forms of hybrid instruments which meet the more stringent criteria set by the BCBS, including contingent capital. While these instruments have been held out as cost-effective means for banks to meet the standards, they will require supporting legal, regulatory and institutional arrangements to be put in place to ensure that these instruments will perform as envisaged in a crisis, and gain acceptance among market participants. As an example, institutional investors will have to also evaluate the extent to which their investment objectives can continue to be met through investments in debt instruments that convert more easily to equity, and this in turn would depend on the defined triggers for conversion applied to such instruments. The Bank will continue its engagement with market participants and other relevant authorities on these developments during the observation period, with early attention given towards the prospects of developing a covered bond market which could qualify under Basel III.

Remaining concerns

Two other areas of the reform package will require a more cautious approach to implementation. The first relates to the way in which total exposures are determined for the purpose of complying with the leverage ratio which requires banking institutions to hold the same amount of capital for a majority of on- and off-balance sheet exposures regardless of their inherent risks. The Bank shares concerns expressed by a number of countries that this could inappropriately disincentivise the provision of credit to low-risk and economically productive activities, such as trade financing. The second concerns the strong incentives created by the NSFR to avoid long-term financing which would affect the banking system's critical role in maturity transformation. Given the potential for unintended consequences which can harm the broader economy, particularly emerging and highly open economies, it is crucial that a careful appraisal be made of the likely effects of these measures during the observation period and appropriate adjustments incorporated prior to their full implementation. In this regard, the Bank welcomes the commitment by the BCBS to use the observation period to assess whether the proposed design and calibration of these measures are appropriate to achieve their intended objectives while avoiding economic dislocation.

Conclusion

On balance, the implementation of Basel III is expected to deliver long-term benefits to the overall economy and financial system, with a much strengthened banking system operating as its core. With a more resilient banking system, the likelihood and severity of future banking crises will be reduced, as will the need for large-scale government interventions to support the economy and to stabilise the financial system during crises. Moreover, elements of the reform package that reduce procyclicality and promote counter-cyclical buffers will ensure that the banking sector has the capacity to support lending activities during economic downturns, thus reducing the amplitude of the business cycle. On issues that remain open in respect of specific components of the reform package, the observation period will be critical to allow a more complete assessment of the proposals and refinements to be made as appropriate to address any unintended consequences.

[1] For the LCR, the BCBS has provided for an observation period beginning 2011 to end-2014 where national supervisors and the BCBS will monitor the impact of the standards on the financial systems and economies throughout the world prior to its full implementation in 2015.

the classification and measurement phase of its project to replace the existing international accounting standards for financial instruments, International Accounting Standard (IAS) 39. This marked a significant step in international efforts to reduce the complexity of accounting standards for financial instruments. The new requirements will make it easier for users of financial statements to assess the amounts, timing and uncertainty of cash flows arising from financial assets by aligning the measurement of such assets with the way the entity manages these assets (its `business model´) and with their contractual cash flow characteristics. Limited changes were also made to the measurement of financial liabilities to address widely expressed concerns with earlier provisions which allowed companies to record gains as a result of a deterioration in their own credit risk. The second and third phases of the IAS 39 replacement project that addresses accounting for the impairment of financial assets and hedge accounting are scheduled to be completed in June 2011. Proposed measurement standards on accounting for insurance contracts were also issued by the IASB in July 2010. The proposals would provide a more consistent basis of accounting for insurance contracts, thus enhancing comparability across entities, jurisdictions and capital markets. These standards are at a consultation phase in Malaysia and have been subject to a sustained engagement programme by the Bank and the Malaysian Accounting Standards Board (MASB) with the industry to prepare for their adoption while contributing meaningfully to the international standard setting process. Given Malaysia's commitment towards convergence with international financial reporting standards, it is important that financial institutions leverage on these engagements to understand and assess the implications of the new standards for policies, systems and processes within their organisations.

The following sections provide greater details on key developments in the domestic regulatory and legal framework in 2010.

Capital adequacy

Following two years of intense efforts by banking institutions to enhance their internal rating models and processes, 11 banking institutions completed the transition to the Internal Ratings-Based (IRB) approach for credit risk under Basel II in 2010. With their transition, all banks in Malaysia now comply with the Basel II capital standards.

A significant benefit from the adoption by banking institutions of more advanced approaches to regulatory capital under Basel II has been the corresponding improvements made to internal processes and information technology systems which have promoted a deeper and more complete understanding among senior management about the risk drivers behind the bank's business strategies. This allows for more informed decisions, better risk management and the ability to respond more effectively to changes in market conditions.

In December 2010, the Bank issued Guidelines on the Internal Capital Adequacy Assessment Process (ICAAP) which set out the Bank's approach to Pillar 2 (Supervisory Review Process). Under Pillar 2, banking institutions are required to assess the adequacy of capital relative to their overall risk profile, including risks which are not covered or fully captured under Pillar 1 (such as interest rate risk in the banking book and credit concentration risk). The ICAAP assessments overlay the minimum capital requirements determined under Pillar 1, with banks required to maintain capital levels above the Pillar 1 standards consistent with their individual risk profiles and objectives. The Bank's current supervisory process and practices for reviewing the capital adequacy of banks under the risk-based supervisory framework (RBSF) are broadly consistent with Pillar 2 principles. The ICAAP assessments required under Pillar 2 are therefore expected to complement this process in two particular respects:

- by providing additional input from a bank's own internal processes to better inform the Bank's assessment of the institution's inherent risks under the RBSF; and
- by encouraging the integration of a bank's capital management practices with its business processes, thus strengthening the link between the Bank's assessment of an institution's significant activities and its capital adequacy.

As part of the ICAAP, banking institutions are expected to develop appropriate strategies for maintaining capital at a level consistent with the institution's risk profile. The Bank's supervisory activities in 2011 will be directed at reviewing and monitoring the progress of banking institutions' Pillar 2 initiatives and understanding the approaches used by banks to allocate capital to key business risks. Particular emphasis will be given to the extent to which banks integrate their ICAAPs into their internal processes for business planning and forecasting, risk mitigation, governance and control, pricing and performance management. In anticipation of the implementation of the higher capital standards, including additional capital conservation buffers under Basel III, supervisory reviews of banking institutions' ICAAPs will also consider relevant strategies by banks to meet higher future capital levels, including through reasonable earnings retention and capital raising policies. Greater scrutiny will also be undertaken of banks' capital disclosures under Pillar 3, which were further enhanced during the year for Islamic banks and banking institutions adopting the IRB approach.

The Bank's supervisory activities in 2011 will be directed at reviewing and monitoring the progress of banking institutions' Pillar 2 initiatives and understanding the approaches used by banks to allocate capital to key business risks

The Risk-Based Capital (RBC) Framework for insurers continued to provide a sound foundation for the continuous strengthening of insurers' capital positions. As at end-December 2010, the industry-wide capital adequacy ratio stood at 224.6%. Improvements continued to be observed in insurers' risk management practices, with the development and wider adoption of more systematic approaches to assessing and managing risk exposures. The Bank intends to update the RBC Framework in 2011 to take into account international developments towards establishing a globally consistent solvency framework for insurers which is being advanced by the International Association of Insurance Supervisors (IAIS), lessons from the crisis and developments in accounting standards for insurance contracts. Specific areas under consideration for review include the valuation methodology for life insurance liabilities, recognition of reinsurance arrangements, and the capital definition. During the year, the Bank also withdrew the temporary flexibility accorded to life insurers for the valuation of certain life insurance liabilities introduced in response to developments arising from the global financial crisis. Life insurers were able to adjust to the withdrawal with no material impact to their capital positions, demonstrating their continued resilience.

The Bank has further detailed the specific components of the Risk-Based Capital Framework for takaful operators (RBCT), building on the conceptual parameters established for RBCT in 2009. This includes the determination of the capital adequacy formula and specific capital risk charges which reflect the fundamental differences between the business models that underpin the insurance and takaful industries. The RBCT additionally addresses the need for takaful operators to adhere to Shariah requirements. Consultations with the industry on the RBCT and impact assessments will commence in the second quarter of 2011.

Corporate governance

As part of continuing efforts by the Bank to promote more effective and engaged boards of financial institutions, further clarity was provided by the Bank on the position of board members with executive roles within a group context. This follows and further entrenches the essential principle of preserving a clear separation between the oversight and management functions within a financial institution, in particular by ensuring an adequate balance of members on the board who are truly independent from management. More specifically, an individual employed by a financial group who assumes management or control responsibilities within the group, shall generally be regarded as an executive director of the financial institution. Such an individual may not be appointed Chairman of the board of the financial institution. Where more than two executive members are represented on the board, the Bank may direct financial institutions to put in place compensating measures which may include appointing additional independent directors on the board to strengthen the independence of the board from management.

The issuance of the Guidelines on Fit and Proper for Key Responsible Persons in March 2011 will further complement the corporate governance framework. The guidelines require financial institutions to establish policies and processes for assessments of the fitness and propriety of key persons in responsible positions within a financial institution on an ongoing basis, including members of senior management, and persons primarily responsible for key control functions (which includes appointed actuaries). The guidelines also address the factors that should be considered in determining a responsible person's fitness and propriety, and actions for dealing with persons found to be no longer fit and proper.

> The issuance of the Guidelines on Fit and Proper for Key Responsible Persons in March 2011 will further complement the corporate governance framework

On Islamic finance, the Bank finalised and issued the Shariah Governance Framework for Islamic Financial Institutions (the Framework) in October 2010 to strengthen the accountability and responsibilities of the board, the Shariah Committee and the management of Islamic financial institutions in relation to Shariah matters. The Framework supports more effective Shariah audits and Shariah compliance and research functions within Islamic financial institutions. In ensuring that the operations and business activities of the Islamic financial institutions are consistent with Shariah principles at all times, the role of the Shariah Committee has been elevated from that of an advisory nature to one with a higher degree of authority and clear accountability for decisions on Shariah matters. The Framework takes effect from 1 January 2011.

The Financial Institutions Directors' Education (FIDE) programme continued to serve as the core training programme for directors of financial institutions, with over 200 directors of banking institutions, insurers and takaful operators having completed the core programme since its launch in November 2008. Further enhancements were made to the programme during the year, supported by existing and new faculty members who are experts in the field of governance and risk management. The Information Technology (IT) Governance and Risk Management Programme for directors was introduced from September 2010, bringing the total complement of specialised programmes offered together with the core programme to five.

> The role of the Shariah Committee has been elevated from that of an advisory nature to one with a higher degree of authority and clear accountability for decisions on Shariah matters

Further enhancements to the FIDE programme which are planned for 2011 include new programmes for the boards of insurance companies and additional technical complements in areas such as corporate finance, strategic marketing and cross-border investments. FIDE is managed and delivered by the International Centre for Leadership in Finance (ICLIF) under its newly formed Governance Centre. Further details are provided in the box article ``Financial Institutions Directors' Education under the ICLIF Leadership and Governance Centre´´.

Financial reporting standards

For financial years beginning 1 January 2010, financial institutions have been required to adopt Financial Reporting Standard (FRS) 139 Financial Instruments: Recognition and Measurement in the accounting for financial instruments and impairment of loans/financing. The majority of banking institutions applied the transitional provision allowed by the Bank for the determination of collective impairment provisions pending the finalisation of the new impairment standard which is currently under review by the IASB. With the new basis adopted by banks for impairment under FRS 139, a key supervisory focus has been on ensuring that loss estimates by banks are determined at a sufficiently prudent level to absorb the inherent credit losses in the loan portfolio. An important benefit observed from the adoption of FRS 139 has been the corresponding improvements made to the credit review process of loans that are individually assessed for impairment. As a result, impairment provisions increased, but were more reflective of a broader range of both quantitative and qualitative

Financial Institutions Directors' Education under the ICLIF Leadership and Governance Centre

The Financial Institutions Directors' Education (FIDE) programme, introduced by the Bank and the Malaysia Deposit Insurance Corporation (PIDM) in November 2008, is now being offered under the International Centre for Leadership in Finance (ICLIF) as of September 2010. FIDE was developed with the aim of promoting high-impact boards in financial institutions by strengthening board competencies in dealing with corporate governance, risk management and strategic issues in the financial sector. Emphasis is placed on important current issues confronting the financial industry, drawing from the Bank's supervisory observations and global and domestic developments affecting financial institutions. Directors will have the opportunity to debate these issues at an intellectual level and examine their practical implications in the context of the environment they operate in. This is achieved through the extensive use of case studies and simulations developed based on real experiences in the financial sector. FIDE thus aims to equip directors with practical tools and knowledge to provide effective oversight on managements of financial institutions.

Over the two years since its launch, the FIDE programme has been continuously refined and enhanced to reinforce its key strengths, namely:

(i) a unique and singular focus on governance within financial institutions which allows in-depth discussions to take place among like-minded directors on specific issues that they face on the board. It also facilitates the customisation of key modules such as that on risk management to address the different business considerations in banking, insurance and Islamic finance;

(ii) the pooling of the extensive wealth of knowledge and practical insights of experienced directors who participate in the programme to provide an environment where directors learn from each other. This experience is carried over outside the classroom through ongoing support and tools provided to directors to maintain contact after the programme;

(iii) a strong and diverse faculty consisting of thought leaders and practitioners drawn from various backgrounds, with vast experience in financial services and adult learning; and

(iv) the extensive involvement of regulators and supervisors in providing content input and reinforcing the lessons learnt through the supervisory interactions with financial institutions. This ensures that education is translated into better board practices and preserves a strong link between the programme and desired financial stability outcomes.

The FIDE initiative which started with the core modular-based programme has also been expanded in response to strong interest from financial institutions' directors for further training. FIDE now provides, in addition to the core programme, training in a range of specialised and technical areas to cater for specific board roles (such as the audit committee, risk management committee and nominating committee) and the interest among directors to deepen their knowledge of particular aspects of their business (e.g. in information technology and Islamic finance). Since 2010, programmes were also provided for new directors to enhance their knowledge of basic banking and insurance business. FIDE is also supplemented by a series of talks and special lectures by renowned speakers and leading industry experts on topical issues which enable directors to keep abreast with current developments.

To date, more than 230 Malaysian financial institutions' directors have benefited from the FIDE programme, resulting in a significant strengthening of boardroom practices in the financial institutions. FIDE's success as well as a heightened awareness globally of the importance of governance and the need for effective boards to strengthen the resilience of financial institutions and promote long-term financial stability has attracted increasing interest from directors of financial institutions from around the region to participate in the programme. In response to this interest and as part of efforts to deepen cross-border cooperation in promoting financial stability, FIDE's outreach has been expanded to make the programmes available to directors of financial institutions in the Asia Pacific, Middle East and African regions beginning from 2011. ICLIF will serve as the platform to manage, adapt and deliver the FIDE programme offering to the regions. As part of this move, ICLIF has established a Governance Centre and was renamed the ICLIF Leadership and Governance Centre to reflect its wider mandate.

The move will enable FIDE to leverage on ICLIF's core strength in developing leadership competencies to further enrich FIDE and complement FIDE's faculty with leadership and governance experts in ICLIF from world leading institutions. FIDE's commitment to lifelong learning and building an effective support network for directors of financial institutions will also be preserved and further reinforced. There will be enlarged resources dedicated under ICLIF to research, the development of new programmes and case studies, and the provision of a broad range of advisory services for directors.

To ensure the practical relevance of the programme to the industry and to take into account changes in the financial landscape, there is continuous interface with the industry so as to provide leading edge education for directors in the financial sector. Further information on FIDE can be obtained from its website at www.fide.org.my.

FIDE Programmes

CORE PROGRAMME

At the end of the four modules, participants will have:

- a greater understanding of the role of the board and the fiduciary responsibilities of individual directors to stakeholders, including depositors and policyholders
- a heightened awareness of the changing legal, regulatory and business environment, and reflect on its immediate and long-term implications for board practices
- the capacity to assume more active roles in articulating a dynamic vision for the institution, establishing a strong ethical culture and promoting a right balance between risk controls and entrepreneurship
- the ability to design and evaluate appropriate organisational structures for stronger risk management
- an increased understanding of the key issues in financial reporting and ensure the integrity of financial reports
- an increased appreciation of how they can better contribute towards the overall effectiveness of boards and committees

PROGRAMMES FOR SPECIFIC BOARD ROLES

- Audit Committee Programme
- Risk Management Committee Programme
- Nomination and Remuneration Committee Programme*

TECHNICAL PROGRAMMES

- Banking Insights
- Insurance Insights*
- Risk Management in Islamic Finance
- IT Governance and Risk Management
- Risk Management in Takaful*

Special board simulation

* To be introduced in 2011

credit information used in banks' provisioning methodologies. To minimise the divergence in practice under more principle-based FRSs which would reduce the comparability of financial statements between financial institutions, additional guidance was issued to individual institutions to promote more consistent applications, particularly in defining impaired loans and providing for non-performing loans which are individually insignificant.

Financial reporting practices for the insurance and takaful industries were also brought closer in line with applicable accounting standards, namely the FRS 139 and FRS 4 Insurance Contracts, with amendments to the existing Guidelines on Financial Reporting for Insurers and the Guidelines on Financial Reporting for Takaful Operators issued by the Bank in July 2010. Based on prudential considerations and given the ongoing policy consultations on the measurement and presentation of the insurance contracts at the international level which may result in substantive changes to FRS 4, two departures from FRS were preserved. These are the requirement that life insurance contracts be presented as liabilities (instead of equity) in the insurers' statement of financial position and the non-deferment of acquisition costs for life insurers whereby such costs would continue to be accounted for as and when they are incurred. The guidelines also specify expectations that must be met by insurers in the use of the fair value option for financial assets as well as additional guidance on the measurement of *qard* and impairment methodologies to promote consistency and comparability among takaful operators.

Other aspects of the prudential framework for Islamic finance

In the Islamic banking industry, developments in the prudential regulatory framework responded to the increased scale and diversity of Islamic banking activities. The Guidelines on Property Development and Property Investment Activities by Islamic banks, first issued in 2007, were revised in March 2010 to strengthen the Bank's expectations in relation to requirements for Islamic banks to have in place a robust governance framework and effective internal controls that promote prudent business practices. While involvement in property development and property investment activities by Islamic banks in Malaysia is currently not significant, regulatory measures have been progressively put in place to mitigate the risks arising from the cyclical effects of the real estate market and activities related to asset-based financing operations of Islamic banks. The enhanced supervisory expectations include requirements for key functions to be installed by Islamic banks to support sound technical assessments, research and asset valuations in their property development and investment units.

A review of the Rate of Return (ROR) framework was also undertaken to strengthen the operational aspects of the framework in keeping with the enlarged and diversified scope of Islamic banking institutions' business, which includes real estate and property investment, leasing, structured products and equity-based transactions. The ROR framework protects the interests of investment account holders under contractual relationships with Islamic banks, particularly in respect of *mudharabah* contracts. The Bank will issue a concept paper on proposed revisions to the framework in the third quarter of 2011. The revisions will cover, among other things, strengthened requirements for segregation in the management of *mudharabah* and other types of funds in order to prevent the commingling of returns and losses between these funds.

In connection with the review of the ROR framework, the Bank conducted a separate consultation with the industry on proposals to strengthen governance and transparency in the application of profit equalisation reserves (PER) by Islamic banking institutions. PER is an important tool in managing displaced commercial risk, which refers to the risk that Islamic banking institutions will have to forgo part of its share of profit in order to provide market rate of returns to investment account holders. In addition to further detailing the Bank's supervisory expectations in the management of PER, the review also sought to clarify the accounting treatment for PER within the framework of approved FRS established by the MASB and the regulatory capital treatment applicable to PER.

The regulatory framework for the takaful industry was also substantially strengthened in 2010. A central component of the regulatory framework was completed with the issuance of the Guidelines on Takaful Operational Framework (TOF) in December 2010. The TOF addresses requirements for the establishment and management of takaful funds that include principles relating to asset, liability and surplus management, as well as the rectification of deficits in the takaful funds. It also prescribes broad disclosure requirements to enhance transparency in takaful operations. Consistent with the Bank's approach in regulating Islamic financial services, strict requirements are upheld in respect of Shariah compliance in takaful operations while allowing flexibility for individual takaful operators to decide the appropriate Shariah contracts to apply in their operations, as approved by their respective Shariah committees. The TOF is supported by Guidelines on Valuations for Takaful Liabilities which were issued in December 2010 to ensure adequate provisions (or reserves) for takaful benefits that are commensurate with the product features and underlying risks. The TOF comes into effect on 1 October 2011.

Consumer and market conduct

Consumer and market conduct issues have drawn significant attention globally in the aftermath of the global financial crisis. While the focus of the Bank's regulatory and supervisory activities in the area of market conduct were largely driven by domestic considerations, international developments served to inform the Bank's work, particularly in the retail financing segment. With intense competition in the retail segment showing no signs of abating during the year, the Bank heightened its scrutiny of the practices of financial institutions in acquiring new customers. In general, the Bank found that banking institutions observed prudent underwriting standards, but varied considerably in the rigour of standards applied for assessing the suitability of products given the needs and circumstances of prospective customers to whom the products were offered. Some practices observed also contributed towards inappropriately increasing the debt burden borne by consumers against their long-term interests. As a result of these observations, a concept paper on the Conduct of Business for Retail Financing and a revised Credit Card Guidelines were issued to enhance the protection afforded to consumers and promote responsible credit behaviours among financial institutions. Given the nature and intensity of competition in the retail space which can work against the interests of consumers, the Bank has taken a more prescriptive approach in these guidelines in order to safeguard the interests of more vulnerable consumers. The Bank expects to finalise these guidelines in the second quarter of 2011 after resolving implementation issues identified during the consultation process.

During the year, the Bank also initiated a review of existing guidelines on late payment charges by Islamic banks. The proposed revisions which were exposed to the industry in September 2010 include enhanced methodologies to calculate late payment charges and improved governing processes for administering the *gharamah* (penalty) and *ta'widh* (compensation) payments. The concept paper also addresses minimum standards for the financial reporting and disclosures of late payment charges as well as appropriate appeal mechanisms for the consideration of cases of late payments with mitigating circumstances. The Bank has further outlined proposals to provide for more equitable mechanisms in the granting of *ibra*' (rebate) by Islamic banking institutions. These aim to address issues relating to the inconsistency in practices and application in terms of the eligibility of *ibra*' for customers in sale-based contracts (such as *murabahah* and *bai' bithaman ajil*).

In the area of investor protection, the Bank in consultation with the Securities Commission Malaysia, issued the Guidelines on Investor Protection in December 2010 which are applicable to financial institutions carrying out permitted capital market activities that are deemed as `registered persons´ under the Capital Markets and Services Act 2007 (CMSA). The guidelines provide for the application of all relevant investor protection provisions under the CMSA to registered persons and ensure that the employees carrying out permitted capital market activities on their behalf are fit and proper, thus affording equivalent standards of investor protection to customers of financial institutions as that provided to customers of other capital market intermediaries.

In the insurance and takaful sectors, substantive revisions were made to the investment-linked guidelines to provide insurers and takaful operators with greater flexibility in the design and offering of investment-linked insurance and takaful products. This acknowledges the increased demand for such products since their introduction to the Malaysian market more than a decade ago and the enhanced capacity and sophistication of consumers to manage their finances using a broad array of savings and investment plans combined with life protection. The added flexibility provided to insurers and takaful operators is accompanied by enhanced disclosures and strengthened internal oversight arrangements for the management and control of investment-linked business.

The industry associations continued to play an important role in fostering fair market practices. The Life Insurance Association of Malaysia (LIAM) is close to finalising an industry framework for treating customers fairly in the provision of life insurance services, building on principles for the fair treatment of consumers under the guidelines issued by the Bank. This is expected to guide life insurers in the operationalisation of regulatory requirements for treating customers fairly. In addition, LIAM members passed a resolution to disallow insurers from using the doctrine of privity of contract to deny the rights of individual borrowers/life assured to bring actions against insurers under individual and group mortgage reducing term assurance policy contracts between insurers and financial institutions. In the general insurance sector, Persatuan Insurans Am Malaysia is currently working with the relevant stakeholders involved in motor insurance claims to improve the efficiency of claims settlement practices. Initiatives that are being advanced include measures to curb unreasonable practices by insurers in imposing across-the-board trade discounts on repair estimates, improving the professionalism of panel repairers through a `tiering system´ as well as reducing subjectivity in the determination of the market value of vehicles. These initiatives will contribute towards improving the quality of motor repairs, the time taken to settle claims, and the overall public perception of the insurance industry.

Reforms to financial services legislation

Proposed legislative changes to amalgamate and modernise the existing financial services legislation under a new omnibus law governing financial institutions, payment system operators and payment instruments issuers, as well as market intermediaries licensed and supervised by the Bank, progressed further during the year. The new legislation aims to promote the continuing ability and effectiveness of the Bank in discharging its regulatory and supervisory mandate taking into consideration the more complex nature of financial services, and commensurate approaches to regulation and supervision required to preserve financial stability and the protection of consumers. Major pieces of the proposed new legislation have been developed through an extensive process that took into account both domestic and international developments, and the cumulative body of supervisory knowledge and experience residing within the Bank. The international dimension of prudential regulatory developments however remains fluid, notably in relation to the shape and detail of new and revised core principles for effective banking and insurance supervision being contemplated by the BCBS and IAIS. Additional regulatory and supervisory requirements to deal with systemically important financial institutions have also yet to be detailed by the international standard setters. The Bank will also be seeking to engage where appropriate with the international standard setting community to take into account the likely direction of international standards. This will be pursued through the Bank's direct representation on several committees of the BCBS and IAIS, as well as through regional groupings that contribute to the reform process.

The new legislation aims to promote the continuing ability and effectiveness of the Bank in discharging its regulatory and supervisory mandate taking into consideration the more complex nature of financial services

SUPERVISORY ACTIVITIES

The Bank's supervisory activities continued to be directed at the early identification of key risks facing the individual financial institutions as well as broader system-wide issues that could give rise to risks to financial stability. The main focus of supervisory activities in 2010 was on: (i) bolstering the capacity of financial institutions to anticipate and respond to emerging risks; (ii) ensuring that identified vulnerabilities and weaknesses are followed up on and effectively rectified; and (iii) promoting responsible and fair practices toward consumers in the light of more intense competition.

Through its supervisory activities, the Bank has observed a general strengthening of risk management practices among banking institutions. More specifically, there has been an increased focus on risk issues at the board level and boards have become more informed and participative in risk discussions, with more constructive challenge of senior management on risk issues taking place. Improvements have also been observed in the quality of risk reports to the board, with greater alignment within banks between risk appetite, business strategy and resources available (e.g. capital, skills and technology). The articulation of risk appetite statements by banking institutions have also improved with the use of a combination of quantitative and qualitative elements to express risk appetites. A further observation has been the increased use of historical data by some institutions to produce more credible risk estimates which serve to better inform key risk decisions by the board and senior management.

In the area of capital management, the Bank's supervisory reviews identified scope for further improvements in processes currently adopted by banks to ensure that capital levels remain above the minimum regulatory capital at any stage of the business cycle. While forward-looking stress tests have increasingly become an integral part of capital planning activities, the severity of the scenarios adopted by banking institutions varied considerably. In addition, most institutions were observed to only consider immediate capital needs in their capital management plans rather than the capital required over a medium-term horizon as reflected in their business plans. Some progress was however observed among the larger banking institutions to move towards the use of more sophisticated capital measurement tools that integrate their capital management with the risk measurement and analysis processes. With capital management becoming a prominent agenda at the board and senior management level, influenced by regulatory requirements under Pillar 2, the Bank expects to see even more progress among banks across the industry in the coming year towards achieving more integrated approaches to capital planning, risk measurement and business strategy. The Bank further expects that this process will support the development of more robust approaches to the measurement of risks that are not easily quantifiable such as liquidity risk.

Improvements have also been observed in the quality of risk reports to the board, with greater alignment within banks between risk appetite, business strategy and resources available

During the second half of the year, a thematic review was conducted to examine board practices among domestic banking institutions. While improvements in the governance practices of these institutions continued to gain traction with boards displaying a good understanding of the business and providing a stronger check and balance for management, the review identified several areas in which the domestic banking institutions could further strengthen the foundations for more effective governance. These include: (i) enhancing the mix of appropriate experience and expertise on the board, particularly in the areas of risk management and financial reporting; (ii) more active participation and challenge by independent directors; (iii) reducing the burden on board members with overlapping membership in multiple board committees so as to allow for more focus on the key responsibilities of each committee; (iv) implementing a sustained programme of continuing education for board members to keep abreast with best practices and developments in the industry; and (v) putting in place more rigorous internal processes for evaluating the performance of directors and ensuring a proper succession plan for the board.

During the year, the Bank continued to conduct reviews on products under the `launch-and-file´ regime. In general, the Bank found that banking institutions had in place adequate internal processes to address financial risks to the institution from new product offerings. Further improvement was also seen in the adoption of enterprise-wide risk assessment approaches (as opposed to a silo approach) to ensure that all risks and the interplay between different risks are promptly identified, assessed and effectively controlled. For Islamic products, the board and senior management of the Islamic banking entity have a further responsibility to ensure that the risks unique to Islamic products are also well-understood and effectively managed.

In light of more intense competition in the retail segment, the Bank heightened its surveillance of market conduct practices. More than 270 advertisements and promotional materials were reviewed by the Bank during the year, resulting in 30 incidents whereby financial institutions were directed to withdraw or modify misleading information/disclosures. The Bank also continued to monitor fees and charges imposed by financial institutions on retail consumers and small and medium enterprises to ensure that these are appropriate, reasonable and fair. Enforcement actions by the Bank resulted in a refund of RM23 million to customers of financial service providers for prohibited fees and charges imposed, and premiums charged for optional insurance products that were misrepresented as mandatory or packaged products.

The Bank's supervisory assessment framework for anti-money laundering and counter financing of terrorism (AML/CFT) was enhanced during the year to provide additional guidance for supervisors in conducting AML/CFT assessments under the RBSF and to capture new money laundering and terrorist financing trends and modus operandi due to increasing innovations in product/service offerings and advent of new technologies. The enhanced framework was applied to assess AML/CFT risks under the AML/CFT thematic reviews performed by the Bank during the year on the majority of banking and development financial institutions, and selected insurance companies.

In the area of AML/CFT compliance, substantive improvements have been observed across the industry, in line with international standards and practices and consistent with the higher expectations set by the Bank. Underpinning these improvements are a higher level of awareness and technical capability among financial institutions, developed mainly through an increased emphasis on training. Financial institutions have also graduated to more sophisticated and discerning customer acceptance and due diligence practices, leveraging on the more extensive use of IT systems and management information systems to support the effective monitoring and management of money laundering and terrorist financing risks. More financial institutions have also moved towards a centralised transaction monitoring model as compared to decentralised monitoring by business units and branches as previously observed. Governance and oversight by management however, can be further improved to ensure the robustness of AML/CFT risk management moving forward.

Close cooperation and coordination with international supervisors continued to be pursued to support the Bank's supervisory activities. These efforts were intensified during the year to enable the Bank to identify and respond in a timely manner to emerging risks as domestic financial institutions expanded their operations abroad and vice versa. The Bank participated in two supervisory colleges and bilateral meetings held outside Malaysia and hosted two supervisory colleges as home supervisors for Malaysian financial institutions with cross-border operations. These engagements covered assessments of the economic and financial conditions in the home and host countries, sharing of respective countries' supervisory frameworks, exchange of supervisory concerns and actions, and areas for future collaboration. While experience with such supervisory colleges remains relatively new in Malaysia, the Bank is confident of evolving a more robust process for the conduct of supervisory colleges as more experience is gained. It is also expected that supervisory colleges will play an instrumental role in supporting effective mechanisms for cross-border resolutions of systemically important financial institutions going forward. Such initiatives will become increasingly important to promote domestic and regional financial stability.

The Bank's internal supervisory capacity continued to be strengthened. During the year, work commenced on the development of a micro-surveillance system with improved functionalities and data capture to support the Bank's risk analyses. The Bank also intensified its development of a strong supervisory talent pool to support the performance of the Bank's supervisory functions in the more complex environment. These include the recruitment of additional staff with relevant experience and competencies, as well as valuable experience gained by current supervisors through attachment arrangements with international financial organisations and other supervisory authorities.

2010

PAYMENT AND SETTLEMENT SYSTEMS

The oversight of the payment and settlement systems by the Bank continued to focus on systemic risk reduction, promoting an efficient payment and settlement infrastructure to cater for both domestic as well as cross-border payments and improving efficiency in the provision of payment services. With a view to accelerate the adoption of electronic payments (e-payments), the Bank has intensified its efforts to achieve greater utilisation of electronic means of payments in targeted sectors including initiatives to provide wider and more convenient access to payment systems and payment services. The major payment systems in Malaysia remained resilient and operated without any material disruption throughout 2010, thus ensuring the timely settlement of both systemically important high-value transactions and retail transactions.

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DEVELOPMENTS IN PAYMENT AND SETTLEMENT SYSTEMS

RENTAS

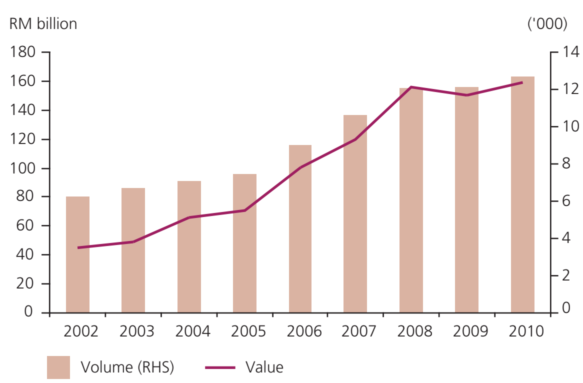
The Real-time Electronic Transfer of Funds and Securities System (RENTAS) which provides real-time gross settlement (RTGS) of transfers between members for high-value payments as well as Delivery versus Payment (DvP) securities settlement is now operated by the Bank's wholly-owned payment subsidiary, Malaysian Electronic Clearing Corporation Sdn. Bhd. (MyClear). RENTAS continued to register increases in the daily average value of transactions settled in 2010, mainly involving foreign exchange settlements, reflecting the pick up in business and financial transactions as confidence in the global economy improved. The value of foreign exchange transactions settled through the Payment versus Payment (PvP) link between RENTAS and the USD Clearing House Automated Transfer System (USD CHATS) in Hong Kong SAR registered a significant increase of 41.3%. The total value of transactions settled through RENTAS represents 51.5 times Malaysia's gross domestic product (GDP) while the daily average turnover of RENTAS recorded an average annual growth of 18.9% in the past five years.

Modernising RENTAS

Apart from facilitating the effective execution of monetary policy, RENTAS plays a pivotal role in enhancing the efficiency of the financial system and the economy as a whole. The convenience and speed of executing and receiving payment transactions through RENTAS has a direct bearing on the operational efficiency of the financial institutions, corporates and businesses. In the light of the significant payment flows passing through the system and as Malaysia's financial sector expands and integrates with regional and global markets, the efficient functioning of RENTAS and its ability to cater for cross-border payments were given greater focus by the Bank during the year.

Chart 4.1

RENTAS : Daily Average by Value and Volume



Source: Bank Negara Malaysia

In April 2010, the Bank announced its participation in the pilot implementation of a common platform for the Asian post-trade processing infrastructure. This is a collaborative initiative among several central banks and central securities depositories in the region together with Euroclear, an International Central Securities Depository (ICSD), under the Pan-Asian Central Securities Depository Alliance (the Alliance). The Alliance is a regional task force formed to facilitate the development of the Asian bond market by promoting efficient and cost-effective post-trade settlement and processes for the Asian capital market. The initiative will link RENTAS with Euroclear thus allowing MyClear to provide custodian services for securities denominated in any currency. In addition, the link would provide seamless accessibility to securities and sukuk issued and deposited in Malaysia by international investors. The pilot which is planned for implementation in the second half of 2011 will further strengthen Malaysia's position as the world's largest securities depository for sukuk instruments. To complement this, RENTAS would be enhanced to allow multi-currency settlements.

Developments are also underway to enhance RENTAS to adopt the international messaging standard i.e. the Society for Worldwide Interbank Financial Telecommunication (SWIFT) standard. The adoption of the SWIFT messaging standard will allow Malaysian banks and corporates to streamline their domestic and international treasury operations to improve operational efficiency and lower payment infrastructure cost.

In the light of the significant payment flows passing through the system and as Malaysia's financial sector expands and integrates with regional and global markets, the efficient functioning of RENTAS and its ability to cater for cross-border payments were given greater focus by the Bank during the year

Given the complexity of the initiative, the implementation of the SWIFT messaging standard will be carried out on a staggered basis to minimise operational risks and is targeted for completion in 2014.

Table 4.1

Major Retail Payment Systems in Malaysia

System	Description	Operator
National Electronic Cheque Information Clearing System (eSPICK)	An image-based cheque clearing system where the cheque image and magnetic ink character recognition (MICR) code line data are captured and transmitted electronically to facilitate clearing.	MyClear
Interbank GIRO (IBG)	An interbank funds transfer system that facilitates payments of up to RM500,000 per transaction.	Malaysian Electronic Payment System Sdn. Bhd. (MEPS)
Shared ATM Network (SAN)	A network switch which enables bank customers to access their funds from any of the participating banks' automated teller machines (ATMs). There are currently two networks i.e. MEPS SAN and HOUSe. MEPS is owned by all domestic commercial banks, two Islamic banks and one development financial institution, while HOUSe is owned by four locally incorporated foreign banks.	MEPS and HOUSe
e-Debit	A switching network which enables participating banks' ATM cards to be used to pay for purchases at point-of-sale (POS) terminals at all participating retail outlets.	MEPS
Financial Process Exchange (FPX)	An Internet-based multi-bank payment platform that leverages on the Internet banking services of banking institutions to offer online payment for electronic commerce (e-commerce) transactions.	MEPS
MEPS Direct Debit	An interbank collection service for regular and recurring payments enabling automated collection directly from a customer's bank account at multiple banks with a single authorisation.	MEPS

Source: Bank Negara Malaysia

Retail payment systems

The retail payment systems include systems that process smaller-value payments such as cheques, electronic funds transfer, that is, the debit and credit transfers and Electronic Funds Transfer at Point of Sale (EFTPOS) transactions (see table 4.1 for a summary of the retail payment systems operating in Malaysia). While cash continues to be an important payment method, non-cash payments made via the various retail payment systems have increased significantly. This reflects a positive shift in consumer preferences towards payment methods which are largely driven by considerations of convenience, speed with which payments are processed, the reliability and security of the payment method and the fees charged by the financial institutions in providing the payment services.

Trends in retail payments

On average, 44 e-payment transactions per capita were made in 2010 compared to 29 in 2006. The increase is mainly attributable to the usage of credit cards, electronic money (e-money) and Internet banking while the usage of ATM (excluding cash withdrawals), debit cards and IBG are increasingly gaining wider acceptance.

Cash and cheques

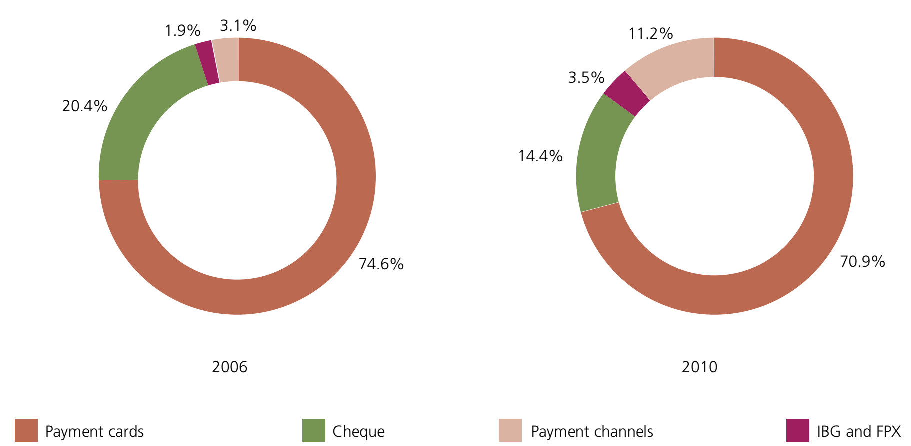
The ratio of cash in circulation (CIC)-to-GDP declined slightly to 6.2% in 2010 from 6.4% in 2009. However, cash remains a significant payment method particularly for small-value payments. The average value of cash withdrawals at the ATM was higher, increasing from RM470 in 2009 to RM492 in 2010, while the total value of cash withdrawals rose by 8.1%, faster than the 7% growth in consumption spending. The increasing importance of Internet banking and the ATM have to some extent displaced the use of cheques. Its share of total non-cash retail payments has declined both in terms of volume and value. Corporates issued 40.3% of the total volume of cheques, followed by individuals at 20.2% and sole proprietors at 17.4%. Nearly 90% of the cheques are for payments of RM10,000 and below. Although cheques remain a convenient and flexible means of payment, moves to progressively reduce the inefficiencies that exist in the payment systems are likely to result in upward adjustments in the pricing of cheques to reflect the high costs of processing cheques currently borne by financial institutions.

Payment cards and e-money

The higher adoption of Internet banking and the ATM has also contributed to some displacement in the use of payment cards. Its share of total volume of non-cash retail payments declined from 74.6% in 2006 to 70.8% in 2010. In the payment cards market, e-money continues to dominate, accounting for 68.7% of the total number of payment card transactions in 2010. The bulk of the e-money transactions valued at RM2.7 billion in 2010 was attributable to payments in the transportation sector using the Touch 'n Go card. Credit card transactions continued to grow despite a 21% reduction in the number of credit cards in circulation in 2010,

Chart 4.2

Share of Non-Cash Retail Payments By Volume



Source: Bank Negara Malaysia

mainly due to the imposition of the Government service tax since 1 January 2010. Whilst the number and value of debit card purchases remained much lower than credit card, debit card usage has increased more than four-fold from 2006 to 2010, reflecting consumers' increased preference for the `pay now´ method. The awareness and promotional activities rolled out by debit card issuers, such as reward programmes, cash rebates and discounts, had also contributed to the higher usage.

Electronic channels and other electronic funds transfer systems

Internet banking continued to register strong growth in the past year, accounting for 8.4% of the total number of non-cash retail payments in 2010 compared to 2.9% in 2006. Internet banking transactions grew by 34.8% with transaction value amounting to RM1 trillion in 2010 as compared to RM699.9 billion in 2009. The growth is mainly attributed to the increase in salary payments and funds transfer performed by corporates and the increase in the number of Internet subscribers from 8.1 million as at end-2009 to 9.8 million subscribers as at end-2010.

The ATM has come a long way since its introduction in the 1980s. From facilitating cash withdrawals and balance enquiry, its functionalities have since been expanded to provide a suite of payment services that have made it an increasingly popular payment channel in the country. Both the volume and value of non-cash transactions conducted via ATMs have risen to 38.8 million and RM31.3 billion respectively, compared to only 1.8 million and RM2.1 billion in 2006. In response to the high acceptance of the ATM as a convenient e-payment access point, the domestic SAN of MEPS has been enhanced to facilitate interbank credit card and loan repayments as well as bill payments for utilities since 2009. Such facilities are currently available at more than 2,000 ATMs of participating banks nationwide.

Mobile banking and payment transactions remained low. The number of mobile banking subscribers in 2010 registered an increase of 35% but mobile banking transactions declined both in volume and value. Mobile banking is mainly used for mobile prepaid top-ups and funds transfers, while corporates use the service to make payments to suppliers. In 2010, 4.9 million mobile payment transactions valued at RM529.6 million were recorded. This represents a decline in transaction volume by 35.6%, but a four-fold increase in transaction value, contributed mainly by the high number of mobile remittance transactions which accounted for 70% of the total transaction value. To drive the development of mobile banking and payments in the country, an industry initiative to build a mobile banking and payment ecosystem was launched in April 2010.

Mobile payment transactions riding on the Near Field Communication (NFC) technology was introduced for commercial use last year. However, it is still at an infancy stage and its adoption is very much dependent on the availability of contactless infrastructure at the merchants and number of NFC-enabled mobile devices in the market.

Improving the efficiency of retail payments

In pursuit of the Bank's mandate to promote the efficiency of the payment system of the country, the Bank continued to work extensively with the banking industry, and other relevant stakeholders to enhance the payment infrastructure to offer faster payment services and easier and more convenient access to payment services. Apart from assisting important stakeholders to overcome the obstacles faced in their transition from paper-based payments to e-payments, the Bank also worked with MEPS and the financial institutions to improve the efficiency of payments via the IBG and FPX systems and introduce new payment offerings that would offer greater customer access, lower cost of access and improved user payment convenience. These efforts to advance the e-payments agenda at the national level are important to boost productivity and contribute towards raising Malaysia's competitiveness.

IBG and FPX systems

To promote the greater use of the IBG and FPX systems as an alternative to cheques, the IBG system has been enhanced to accept payments with value of up to RM500,000, with effect from 22 November 2010. This took into account the current profile of cheques which showed that more than half of the total value of cheques issued annually are for values above RM100,000. However, banks may impose a lower limit for IBG transfers made via online channels such as Internet banking to mitigate risks associated with these channels. Recognising that funds availability is also an important consideration in the choice of payment method, the IBG system has also been enhanced to provide faster funds availability. Users can now enjoy same-day funds availability if the transaction is effected before 10 a.m. In addition, the days taken to notify IBG users of unsuccessful transactions have been reduced. Work is also in progress on improving the processes relating to the FPX system to allow banks to offer improved customer services. This includes the development of a centralised web-based direct debit authorisation document management system to automate the processes undertaken by banks to verify and authorise direct debit applications from their customers.

Establishment of a national mobile ecosystem platform

Malaysia's highly-banked population and the availability of 32 million mobile phone subscriptions present immense opportunities and benefits for the financial institutions and other mobile service providers to leverage on the mobile phone to offer new products and services and reach a wider customer segment in a more cost-effective manner. A significant step forward for mobile banking and payments in Malaysia was taken with the formation of a working group in early 2010 chaired by the Bank which included representation from key stakeholders namely the Ministry of Finance (MOF), Malaysia Administrative Modernisation and Management Planning Unit (MAMPU), Malaysian Communications and Multimedia Commission (MCMC), MEPS, mobile network operators and banks to create an ecosystem that offers compelling user and merchant experience and cost efficiency to the industry.

The working group has agreed on a shared integrated platform to be operated and maintained by MEPS based on a standard mobile banking application and common security standard which will be piloted in the first half of 2011. The platform would enable merchants and service providers to tap on the multi-bank and mobile network neutral infrastructure to market their products and services to a wide customer segment. Meanwhile, consumers will be able to undertake a whole range of payment transactions to the Government, utility service providers and others, anytime and anywhere using their mobile phones. This represents a fundamental transformation from the current proprietary arrangements where a bank customer has less flexibility in selecting the mobile operator of his choice.

A significant step forward for mobile banking and payment in Malaysia was taken with the formation of a working group in early 2010 to create an ecosystem that offers compelling user and merchant experience and cost efficiency to the industry

The ecosystem will provide banks with the option of maintaining their existing mobile banking and payments infrastructure and complementing it with the new mobile ecosystem platform that offers wider network access, or alternatively migrating to the new and open mobile ecosystem platform. Banks which have yet to offer mobile banking and payment services can also benefit from the opportunity to launch services to their customers at a lower investment cost and faster time to market. However, the benefits of a common mobile banking and payment ecosystem can only be realised if it receives widespread support from banks, telecommunication companies, Government agencies and other service providers to achieve the critical mass of users. A key priority going forward is therefore to develop a coherent strategy to create awareness particularly among merchants and users of payment services about the opportunities and benefits provided by the ecosystem. All stakeholders have a critical role to play and common interest in making the initiative a success given the considerable social benefits that it would generate.

OVERSIGHT OF THE PAYMENT AND SETTLEMENT SYSTEMS

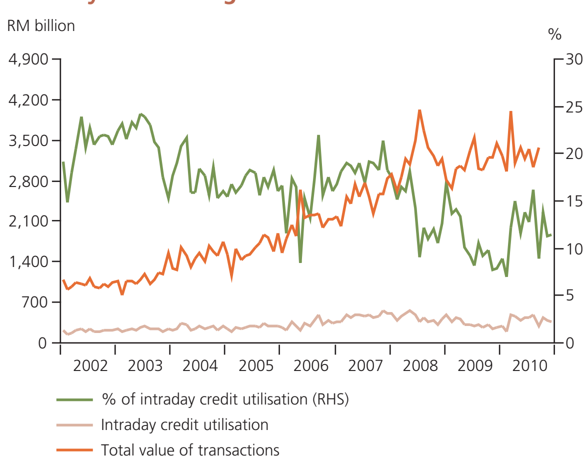
The RENTAS and eSPICK systems are designated payment systems under the Payment Systems Act 2003, reflecting their extensive use and criticality to financial stability and the smooth functioning of the economy. Oversight activities undertaken by the Bank were accordingly focused on MyClear, the operator of the two systems, and its observance of the supervisory expectations issued by the Bank. In assessing the performance and resilience of the designated payment systems, the Bank is guided by international standards for payment systems, specifically the Core Principles for Systemically Important Payment Systems (CPSIPS) and the Recommendations for Securities Settlement Systems, issued by the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organisation of Securities Commissions (CPSS-IOSCO). Compliance with these standards are reflected in the supervisory expectations issued by the Bank. In line with the Bank's supervisory expectations, MyClear further strengthened its operational arrangements and risk management practices during the year to ensure that the RENTAS and eSPICK systems remain robust. This included reviewing its participation and operation rules and business continuity arrangements to ensure comprehensiveness, relevance and transparency to provide participants of the systems with a clear understanding on the risks involved. No major outage or disruptions were encountered by RENTAS and eSPICK, and the systems operated smoothly achieving 99.9% availability throughout the year.

Liquidity risk

While gross settlement in RENTAS eliminates the credit and settlement risks inherent in a deferred net settlement system, the trade-off is higher liquidity requirements and cost to the participants of RENTAS. A participant's failure to manage intraday liquidity effectively could result in its inability to meet its payment obligations within the expected timeline, thereby affecting its own liquidity position and that of other participants. The recent global financial crisis in 2008 had shown how quickly interbank liquidity can dry up, underscoring the paramount importance of effective liquidity risk management, both at the system level as well as by the individual participants, in view of the systemic repercussions of a liquidity shortfall at a single institution.

Chart 4.3

Intraday Credit Usage



Source: Bank Negara Malaysia

Reflecting the ample liquidity in the market, payment and settlement patterns remained stable during the year

To effectively minimise potential gridlock due to intraday liquidity constraints, the Bank provides a collateralised, interest-free intraday credit facility to eligible participants to ensure that the system has enough liquidity throughout the day. Despite the increase in RENTAS transactions in 2010, the demand for intraday liquidity was minimal as there was ample liquidity in the market. Notwithstanding the intraday credit facility made available by the Bank, each participant is expected to actively manage its intraday liquidity positions to meet payment and settlement obligations on a timely basis.

In the wake of the global financial crisis, additional guidance on managing intraday liquidity is being established under the Bank's liquidity framework for banking institutions, consistent with the Principles for Sound Liquidity Risk Management and Supervision issued by the Basel Committee on Banking Supervision in September 2008.

Reflecting the ample liquidity in the market, payment and settlement patterns remained stable during the year. On average, RENTAS participants settled 50% of the value of payments before 12 p.m. and 70% before 3 p.m., which is in line with international best practices. The Bank's and MyClear's monitoring of the behaviour of RENTAS participants also did not reveal any liquidity stress in the system.

Operational risk and business continuity

Ensuring business continuity and the uninterrupted availability of the RENTAS and eSPICK systems continued to receive high priority by MyClear. Monthly disaster recovery live runs as well as regular extended live runs conducted in 2010 affirmed the operational capability and reliability of contingent arrangements to sustain operations for a prolonged period, without major issues. MyClear also undertook measures to ensure operational reliability and readiness of the participants' business continuity arrangements. In July 2010, MyClear successfully coordinated an industry-wide Disaster Recovery live run in which all RENTAS and eSPICK participants were required to operate from their Disaster Recovery Centres (DRCs) and connect to the RENTAS and eSPICK host systems at the Bank's DRC. MyClear also provides a second level back-up facility which can be used by the participants in the event that both RENTAS members' production and DRC sites are down. In 2010, the facility was activated twice to facilitate payments and settlements of affected participants due to system and power failures.

Public confidence in retail payments

The Bank's role in promoting safe and reliable payments in the retail payments space has become more challenging in view of the changing retail payments landscape and rapid technological advancements. The Bank adopts a balanced regulatory approach that promotes payment systems efficiency, innovation and competition whilst ensuring the safety of the payment systems. This is achieved in close collaboration with industry players and relevant authorities to address emerging risks in retail payments with the ultimate objective of maintaining public confidence in the use of retail payment systems.

During the year, the Bank's oversight activities in the retail payments space were focused on the retail payment systems operated by MEPS and Touch 'n Go Sdn. Bhd. (TnG). MEPS' systems namely the SAN, domestic personal identification number (PIN)-based ATM card or e-Debit, IBG, FPX and Direct Debit processed approximately 251.2 million transactions amounting to RM193.8 billion in 2010. TnG processed over 684.6 million transactions amounting to RM2 billion, which accounted for 97.9% and 74.5% of total e-money transactions in terms of volume and value respectively. Both these significant systems did not experience major disruptions during the year. As part of its oversight, the Bank nevertheless followed through on requirements for both MEPS and TnG to further strengthen measures to ensure the reliability and uninterrupted availability of their payment systems in line with international practices. This saw MEPS implement several system improvements to enhance the quality of its service to customers and to strengthen its payment infrastructure. The completion of the FPX and Direct Debit system disaster recovery (DR) setup also significantly reduced the Recovery Time Objective (RTO) from five days to only four hours, thus achieving a higher level of business continuity for the two systems, which is now in line with the IBG and SAN systems. In addition, to minimise operational risk in its services, MEPS successfully conducted two disaster recovery exercises for its core systems. TnG, the sole e-money issuer and electronic payment system provider in the transit sector and tollways is similarly undertaking several measures to further enhance its system robustness to improve its operational reliability and efficiency.

The Bank's oversight and surveillance activities were also centred on payment instruments such as e-money and payment cards as well as payment channels to maintain public confidence and to address fraud in the retail payment systems. As at end-2010, there were 20 approved non-bank e-money issuers compared to only six in 2005. The use of e-money is predominantly in the transportation sector and for online purchases of goods and services.

The growing popularity of online payments coupled with the advancement in mobile technologies has motivated payment service providers to introduce innovative online payment services in the Malaysian payment landscape. Such payment services, offered by mobile and Internet based e-money issuers, not only provide users with the convenience of being able to conduct real-time and cross-border transactions, but has also facilitated virtual commerce activities via various social networking platforms. Although still in its infancy, the use of e-money to pay for virtual goods and services over the social media, is growing rapidly. Social networking sites today offer various virtual applications including an online marketplace which sells virtual contents, as well as online gaming. With the increasing use of e-money in the virtual space, the need for adequate safeguards against vulnerabilities to criminal activities such as money laundering and terrorist financing have correspondingly increased. Given that virtual activities are being operated without geographical boundaries and may be unregulated, particular focus needs to be directed towards safeguarding consumers' interest in using the payment services. In response to these developments as well as the emerging trends and risks, the Bank is currently reviewing the e-money regulatory framework. The level of innovation in payment services offered by the non-bank players requires a differentiated regulatory approach by the Bank which appropriately reflects the business dynamics and operational arrangements of the players.

Collaborative efforts by the Bank together with industry players and stakeholders were intensified to avert emerging fraudulent acts

Managing fraud risk

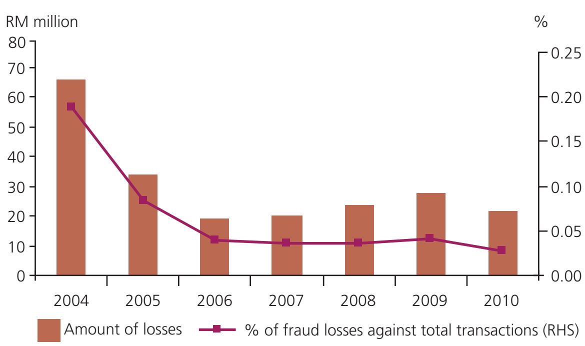
Following the industry wide Europay-Mastercard-Visa (EMV) chip migration in 2005, Malaysia had significantly reduced the incidents and losses from the usage of counterfeited cards in the country from 97,285 cases valued at RM63 million in 2004 to 2,286 cases valued at RM2.3 million in 2010 respectively. While the success of the EMV migration has achieved a significant reduction in counterfeit card fraud domestically, cross-border counterfeit fraud remains a concern. This is mainly attributed to the inconsistent deployment of EMV globally, resulting in the continued incidences of the usage of counterfeit Malaysian cards in countries that are still riding on the less secure magnetic stripe technology. The different pace in timing and progress of each country in migrating to the EMV standard has somewhat constrained efforts taken to reduce overall fraud due to counterfeit cards, in particular for cross-border transactions. At the same time, the tremendous decline in counterfeit cards has shifted the fraud trend to other forms of payment card fraud, mainly associated with lost and stolen cards as well as card-not-present (CNP) transactions that do not require the presence of physical cards, e.g. for purchases made over the Internet or mail and telephone orders.

Recognising this development, collaborative efforts by the Bank together with industry players and stakeholders were intensified to avert such emerging fraudulent acts. This has contributed to the decline in total fraud losses for credit card in 2010, mainly associated with the effective reduction of CNP fraud cases. The efforts by the card industry to reduce the level of fraud have been intensified, including industry-wide merchant education programmes which have helped to create greater awareness of fraud activities and support for the effective implementation of pre-emptive measures (including more proactive monitoring and mitigating measures) to combat fraud. In October 2010, a nationwide education campaign by the National Cards Group (NCG) and the Association of Banks in Malaysia (ABM) was also launched to educate cardholders and inculcate responsible credit card usage among consumers.

Measures were also undertaken by the Bank to strengthen the regulatory requirements for the credit card industry following the growing importance of credit cards as a payment

Chart 4.4

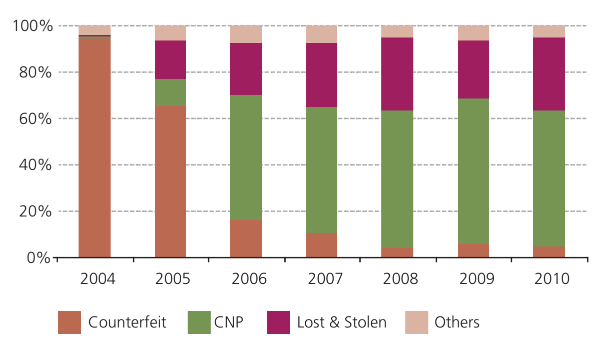
Credit Card Fraud



Source: Bank Negara Malaysia

Chart 4.5

Credit Card Fraud Modus Operandi



Source: Bank Negara Malaysia

instrument. In this regard, the Bank completed a review of the Credit Card Guidelines, with the aim of further enhancing the security features of the credit card infrastructure, strengthening the protection of consumers and introducing specific risk management requirements to mitigate emerging fraud risk.

While transactions conducted through Internet banking has increased significantly, Internet banking fraud cases and losses remain negligible. Phishing continued to be the main threat to the Internet banking industry, accounting for 98% of Internet banking fraud cases reported. Phishing involves the sending of fake e-mail or short message service (SMS) to lure victims to divulge their PIN and passwords. The industry continued to undertake measures to increase consumer awareness on fraud tactics and the importance of keeping customer information confidential via the mass media and the banking institutions' websites. Members of the public are advised to protect their personal credentials and not fall prey to SMS scams and phishing e-mail requesting the public to update their profile for the purpose of account activation. To further strengthen the regulatory requirements for the safe conduct of electronic banking (e-banking) services by financial institutions, the Bank issued the Guidelines on the Provision of Electronic Banking Services by Financial Institutions in March 2010 setting out the minimum operational requirements for e-banking services. The Guidelines outline the broad principles that should be adopted by financial institutions when offering e-banking services and stipulate the minimum requirements that should be observed for e-banking services in accordance with their associated risk levels.

SECTORAL MIGRATION TO ELECTRONIC PAYMENTS

The Government continued to play a crucial role in supporting the national agenda of migrating to e-payments on a national scale. Having migrated 97% of Government payments to electronic payment modes, measures are being actively pursued to migrate the remaining payments to the electronic channel by 2011. At the same time, the Government has embarked on initiatives to increase the use of e-payments for collections, including collections for 281 online services offered by 116 Government agencies. E-payments made to the Government agencies through the FPX system have increased from 113,833 transactions amounting to RM41.3 million in 2009 to 187,958 transactions valued at RM70.9 million in 2010. Payments through payment cards totalled 1.7 million transactions amounting to RM907.9 million in 2010 as compared to 1.9 million transactions worth RM787 million in 2009. A new platform, *myGovXchange*, was launched in July 2010 with the aim of providing a single convenient access point for Malaysian citizens and business communities to make electronic submissions and payments to the Government agencies.

Building on the success of the electronic share payment and electronic dividend initiatives, plans are in the pipeline to expand the adoption of e-payments to other areas in the capital market

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A consultative group comprising the financial institutions, ABM, MEPS and the Association of Islamic Banking Institutions Malaysia was also formed in August 2010 to pursue opportunities and ways to promote the greater adoption of e-payments. The quick wins identified by the group to be implemented by participating institutions include ceasing the issuance of cheques for payments among them and encouraging customers to make credit card and loan repayments via electronic channels. The Bank is also working with the insurance industry to migrate the large number of cheques issued annually for insurance premium and claims/benefit payments. This will be complemented by more concerted efforts to raise consumer and merchant awareness of e-payment options and create the `e-payment habit and experience´.

To enhance the penetration of e-payments in the capital market, the electronic share payment (ESP) and electronic dividend (e-Dividend) initiatives were launched during the year, allowing investors to enjoy same-day crediting of share sales proceeds and dividend income. Investors can also initiate payments to their stockbrokers via electronic channels for share purchases or they opt for more convenient auto-debit facilities by authorising their banker to debit their designated bank account directly. These services are offered free of charge and eliminate the need for investors to deposit and collect cheques. The successful launch of these initiatives were the result of collaborative efforts by the Bank, Securities Commission Malaysia, Bursa Malaysia, MEPS, banking institutions and stockbroking firms. Responses to both the ESP and e-Dividend initiatives have been very encouraging. To date, more than one-third of the Central Securities Depository (CSD) shareholders have signed up for e-Dividend since registration opened in April 2010. This represents an important development with prospects for a total of RM20 billion to RM25 billion in dividend payments to be made via e-Dividend instead of cheques annually.

Building on the success of these initiatives, plans are in the pipeline to expand the adoption of e-payments to other areas in the capital market such as sale and purchase of unit trusts, subscription of rights issues and refund of unsuccessful Initial Public Offering (IPO) applications made via the electronic subscription service.

Promoting electronic commerce

Increasing the uptake of e-commerce has been identified as another key strategy to spur the adoption of e-payments. To build user trust and confidence to transact online with the electronic businesses (e-businesses), the Bank proposed the idea of a national trust mark scheme for Malaysia to accredit e-businesses reliability. The scheme has been approved by the Government in November 2010 and is expected to be operational in 2011. Under the scheme, online businesses which have obtained certification from the appointed trust mark scheme operator may display the trust mark logo on their website which signifies fulfillment with the stringent code of practices set. The trust mark logo would assist consumers in identifying online businesses that have been accredited to exercise fair business practices, thus boosting consumers' confidence in online shopping.

REGIONAL PAYMENT SYSTEM INTEGRATION

Efforts to integrate payment systems in the region to offer convenience to consumers and to increase the efficiency of cross-border payments began in 2003 when the four central banks from Indonesia, Malaysia, Singapore and Thailand came together to assess the business and technical viability of establishing cross-border retail payment linkages. In 2005, the four central banks supported plans by the network switch operators in the four countries to link their shared ATM networks under the Asian Payment Network (APN) initiative.

> The Bank, together with several central banks in the region, formed a Working Committee on Payment and Settlement Systems in April 2010 to enhance regional cooperation and harmonisation in the area of payments in support of the ASEAN countries' vision of achieving an ASEAN Economic Community by 2015

A common guiding framework was formulated by the four central banks with the network switch operators to establish a common set of standards on cross-border payments, and to clarify the central banks' rules and regulations on cross-border transfers. The APN membership has since expanded from the original four countries to include the Philippines, South Korea and Vietnam. The MEPS SAN is now connected with ATM networks in Indonesia, Thailand, Singapore and South Korea, thus offering ATM cardholders of the Malaysian participating banks the ability to perform cash withdrawals at 14,330 ATMs in Indonesia, 470 ATMs in Singapore, 139 ATMs in South Korea and 12,146 ATMs in Thailand. MEPS' tie-up with China UnionPay (CUP) since September 2007 also enables CUP cardholders from the People's Republic of China to perform cash withdrawals in Malaysia. Plans are currently underway to link the MEPS SAN with those in the Philippines, Vietnam and Bangladesh.

While the initial phase of the APN initiative was to offer ATM cardholders the convenience of making cross-border cash withdrawals at the ATMs of participating banks in member countries, future plans include leveraging on the linked ATM networks to offer cross-border funds transfers and payments in the region. The offering of these services would be a positive step forward in reducing the use of cash in member countries and in improving payment efficiency in the ASEAN region.

The APN initiative is just one of the many regional payment collaboration initiatives on the cards. The Bank, together with several central banks in the region, formed a Working Committee on Payment and Settlement Systems in April 2010 to enhance regional cooperation and harmonisation in the area of payments in support of the ASEAN countries' vision of achieving an ASEAN Economic Community by 2015. The realisation of a single market and production base with the free flow of goods, services, investments and skilled labour, and a freer flow of capital, will critically depend on the availability of more effective cross-border payment mechanisms for trade settlement, retail purchases, remittances and capital market transactions. This in turn will need to be supported by lower costs and improved efficiency levels of the cross-border payment infrastructure in the region as intra-regional trade grows.

2010

ANNEX

CONTENTS

Key Financial and Payment Systems Statistics

Payment and Settlement Systems

Table A.1

Sources and Uses of Funds of the Financial System

	2006	2007	2008	2009	2010*p*
	RM million				
Sources of Funds					
Capital, reserves and profit	218,450.8	246,245.7	282,584.1	338,631.3	377,267.4
Currency	37,896.0	42,192.7	48,042.9	51,138.6	55,787.8
Demand deposits	165,166.1	166,128.4	174,928.3	203,410.3	221,328.0
Other deposits[1]	910,403.1	982,933.4	1,087,821.1	1,165,286.0	1,192,425.1
Banking and financial institutions	*319,550.6*	*312,240.1*	*341,894.6*	*356,083.3*	*336,691.5*
Public sector	*34,176.8*	*37,810.1*	*43,433.6*	*61,409.5*	*76,287.9*
Private sector	*544,589.0*	*616,863.7*	*681,576.7*	*720,620.4*	*753,393.0*
Foreign	*12,086.7*	*16,019.5*	*20,916.3*	*27,172.8*	*26,052.7*
Borrowings	96,094.2	82,022.8	94,408.4	88,423.0	99,383.2
Funds from other financial institutions	78,267.2	154,393.2	110,293.6	85,892.5	102,142.5
Domestic[2]	*45,784.2*	*100,138.1*	*59,063.5*	*49,094.6*	*62,069.5*
Foreign	*32,483.0*	*54,255.1*	*51,230.1*	*36,797.9*	*40,073.0*
Insurance, provident and pension funds	425,637.8	468,865.3	509,294.9	548,294.0	635,992.2
Other liabilities	226,362.6	333,615.8	265,940.6	268,634.6	345,057.9
Total Liabilities	**2,158,277.7**	**2,476,397.4**	**2,573,313.8**	**2,749,710.2**	**3,029,384.0**
Uses of Funds					
Currency	8,626.4	9,235.3	10,298.0	11,220.9	11,930.6
Deposits with other financial institutions	345,239.3	468,521.1	366,437.2	379,188.7	412,436.4
Domestic	*296,921.1*	*379,611.1*	*322,234.7*	*331,160.8*	*357,176.4*
Foreign	*48,318.2*	*88,910.0*	*44,202.5*	*48,027.9*	*55,260.0*
Loans and advances	784,425.9	864,470.9	960,362.3	1,014,912.1	1,125,899.2
Banking and financial institutions	*12,054.8*	*11,993.1*	*51,382.0*	*42,265.7*	*50,488.4*
Public sector	*55,863.5*	*61,539.2*	*61,712.9*	*101,024.9*	*111,205.9*
Private sector	*713,451.4*	*784,486.6*	*835,232.9*	*857,033.6*	*946,359.6*
Foreign	*3,056.3*	*6,452.0*	*12,034.5*	*14,587.8*	*17,845.3*
Securities	605,892.0	670,171.4	754,372.6	840,161.1	954,739.4
Treasury bills	*1,687.1*	*1,969.8*	*1,524.5*	*1,940.5*	*2,692.3*
Commercial bills	*6,250.2*	*10,912.4*	*13,224.0*	*12,508.0*	*14,954.0*
Malaysian Government Securities (MGS)	*174,424.5*	*202,055.1*	*234,493.3*	*272,702.6*	*305,622.9*
Corporate	*303,684.7*	*364,897.6*	*411,136.8*	*456,946.1*	*537,843.4*
Private Debt Securities (PDS)	*135,384.5*	*175,295.8*	*191,676.8*	*197,072.7*	*207,890.8*
Equities	*168,299.5*	*189,601.7*	*219,459.9*	*259,873.4*	*329,952.6*
Foreign	*7,399.2*	*5,221.3*	*6,141.2*	*6,424.9*	*13,283.3*
Others	*112,446.3*	*85,115.2*	*87,852.9*	*89,639.0*	*80,343.5*
Gold and forex reserves	288,921.8	334,410.9	315,746.1	322,922.4	321,446.2
Other assets	129,823.7	129,587.7	166,097.5	181,305.0	202,932.2
Total Assets	**2,158,277.7**	**2,476,397.4**	**2,573,313.8**	**2,749,710.2**	**3,029,384.0**

1 Includes savings, fixed, NIDs, repos and other deposits
2 Includes statutory reserves of banking institutions
p Preliminary
Note: Numbers may not necessarily add up due to rounding

Table A.2

Key Financial Soundness Indicators

	As at end				
	2006	2007	2008	2009	2010*p*
	% (or otherwise stated)				
Banking System					
Risk-Weighted Capital Ratio	13.5	13.2	12.6	15.4	14.8
Core Capital Ratio	10.7	10.2	10.6	13.8	13.0
Return on Assets	1.3	1.5	1.5	1.2	1.5
Return on Equity	16.2	19.8	18.6	14.0	16.5
Liquid Assets to Total Assets	8.0	9.3	10.3	11.5	12.8
Liquid Assets to Short-term Liabilities	10.3	11.8	13.1	14.5	16.4
Net Non-performing Loans Ratio	4.8	3.2	2.2	1.8	2.3
Duration Weighted Net Position to Capital Base	7.5	4.4	3.8	5.0	4.9
Net Open Positions in FX to Capital Base	4.7	4.9	5.2	4.4	3.8
Net Open Positions in Equities to Capital Base	2.5	2.5	0.9	0.9	1.2
Insurance Companies					
Capital Adequacy Ratio	139.6	158.4	187.6	225.7	224.6
Life Insurance & Family Takaful					
Excess Income over Outgo (RM billion)	12.2	14.8	8.8	12.7	14.1
New Business Premiums / Contributions (RM billion)	8.6	9.3	9.4	10.0	11.2
Capital Adequacy Ratio (conventional only)	146.1	151.8	200.0	254.4	253.2
General Insurance & General Takaful					
Underwriting Profit (RM billion)	0.5	-0.1	0.2	0.9	0.9
Operating Profit (RM billion)	1.5	1.4	0.8	2.1	2.2
Gross Direct Premiums / Contributions (RM billion)	10.5	11.0	12.0	12.8	14.1
Claims Ratio	60.0	65.0	61.2	60.3	62.3
Capital Adequacy Ratio (conventional only)	182.8	182.1	181.1	184.9	204.4
Household (HH) Sector					
HH Debt (RM billion)	395.5	429.5	472.1	516.6	581.3
HH Financial Asset (RM billion)	978.3	1,160.0	1,067.3	1,225.8	1,386.0
HH Debt to GDP Ratio	68.8	66.9	63.7	76.0	75.9
HH Financial Assets to Total HH Debt Ratio	247.4	270.1	226.1	237.3	238.4
HH Liquid Financial Assets to Total HH Debt Ratio	151.7	172.6	139.4	150.9	153.9
Debt Service Ratio	39.1	41.1	39.5	49.0	47.8
Non-performing Loans Ratio of Household Sector	7.1	5.3	4.1	3.1	2.3
Corporate Sector					
Return on Assets	5.1	5.7	3.7	4.2	4.4
Return on Equity	10.0	11.4	7.3	7.9	8.7
Debt-to-Equity Ratio	50.3	48.1	54.1	50.3	45.6
Interest Coverage Ratio (times)	4.6	5.4	4.3	5.1	5.9
Operating Margin	10.9	10.8	9.3	10.5	12.1
Non-performing Loans Ratio of Business Sector	10.2	8.0	6.0	4.7	5.2
Development Financial Institutions[1]					
Lending to Targeted Sectors (% change)	17.5	18.7	16.3	18.5	13.3
Deposits Mobilised (% change)	11.1	12.4	18.5	14.4	20.5
Non-performing Loans Ratio	10.0	8.8	6.6	6.8	8.5
Return on Assets	1.5	1.9	2.9	2.3	2.2

[1] Refers to development financial institutions under the Development Financial Institutions Act 2002

p Preliminary

Note: Insurance figures are based on unaudited calendar year, unless indicated otherwise

Beginning January 2010, non-performing loans include impaired loans for banks that have adopted the Financial Reporting Standards (FRS) 139

Source: Bank Negara Malaysia, Bloomberg and internal computation

Table A.3

Key Financial Indicators - Islamic Banking and Takaful Sectors

	As at end				
	2006	2007	2008	2009	2010*p*
Islamic Banking System	RM million (or otherwise stated)				
Total assets[1]	170,542.0	203,835.1	250,981.9	303,262.1	350,802.2
% of total assets of entire banking system[1]	14.4	15.5	17.4	19.6	20.8
Total financing[1]	102,955.0	121,988.9	150,499.0	186,864.3	222,282.0
% of total financing of entire banking system[1]	16.0	17.3	18.9	21.6	22.7
Total deposits[1]	126,555.7	154,763.0	194,385.5	235,938.1	277,549.7
% of total deposits of entire banking system[1]	14.7	16.8	18.8	20.7	22.6
	% (or otherwise stated)				
Risk Weighted Capital Ratio	17.0	15.8	14.0	15.6	14.9
Core Capital Ratio	12.9	13.0	11.8	13.2	12.7
Return on Assets	1.4	1.3	1.0	1.3	1.2
Net non-performing financing ratio[2]	4.7	3.3	2.3	2.2	2.0
Takaful Sector	RM million (or otherwise stated)				
Takaful Fund Assets	6,899.6	8,822.1	10,570.0	12,445.8	14,659.3
Family	5,800.9	7,445.7	8,900.6	10,536.6	12,420.9
General	1,098.6	1,376.4	1,669.4	1,909.2	2,238.3
% of insurance and takaful industry	6.3	7.1	8.0	8.3	8.7
Net Contributions Income	1,720.9	2,569.7	3,026.8	3,523.6	4,342.4
Family	1,241.5	1,990.5	2,374.7	2,719.8	3,326.9
General	479.4	579.3	652.1	803.8	1,015.5
% of insurance and takaful industry	6.8	9.5	10.7	11.8	13.3
Family Takaful					
New business contributions	1,266.6	1,488.6	1,981.7	2,177.8	2,587.1
General Takaful					
Gross direct contributions	713.9	766.0	869.4	1,052.1	1,325.7
Claims ratio	58.8	71.3	50.1	57.0	59.6

[1] Including development financial institutions under the Development Financial Institutions Act 2002
[2] Beginning January 2010, non-performing loans include impaired loans for banks that have adopted the Financial Reporting Standards (FRS) 139
p Preliminary

Table A.4

Banking System[1]: Income and Expenditure

	For the calendar year				
	2006	2007	2008	2009	2010*p*
	RM million				
Interest income	52,134.5	59,789.9	63,146.9	56,364.5	65,646.7
Less: Interest expense	27,809.1	32,847.4	34,058.1	26,557.8	31,339.7
Net interest income	24,325.4	26,942.6	29,088.8	29,806.8	34,307.0
Add: Fee-based income	5,167.9	6,896.4	7,385.8	7,856.8	8,747.6
Less: Staff cost	7,509.5	8,557.4	9,342.5	9,838.8	11,397.7
Overheads	8,211.3	9,522.0	10,826.0	10,840.7	12,363.6
Gross operating profit	13,772.5	15,759.6	16,306.1	16,983.9	19,293.3
Less: Loan loss and other provisions	6,538.3	5,370.1	4,170.1	4,903.7	4,336.2
Gross operating profit after provision	7,234.2	10,389.4	12,136.0	12,080.3	14,957.1
Add: Other income	5,715.0	7,312.4	7,033.8	4,910.5[2]	7,809.5
Pre-tax profit	**12,949.2**	**17,701.9**	**19,169.7**	**16,990.8**	**22,766.6**
Pre-tax profit / Average assets (%)	1.3	1.5	1.5	1.2	1.5
Pre-tax profit / Average shareholders' funds (%)	16.2	19.7	18.6	13.9	16.5
Pre-tax profit / Average employee (RM'000)	131.8	165.0	169.5	148.5	191.8
Cost incurred per ringgit of revenue earned (sen)	44.7	43.9	46.4	48.6	46.7
Cost incurred per ringgit of net interest income (sen)	64.6	67.1	69.3	69.4	69.3
Overheads to staff cost (%)	109.3	111.3	115.9	110.2	108.5
Staff cost per employee (RM'000)	74.8	79.8	82.6	86.1	96.0

[1] Includes Islamic banks
[2] Includes a significant non-recurring impairment on overseas investment by a commercial bank
p Preliminary
Note: Numbers may not necessarily add up due to rounding

Table A.5

Commercial Banks[1]: Income and Expenditure

	For the calendar year				
	2006	2007	2008	2009	2010*p*
	RM million				
Interest income	50,396.0	56,890.9	60,568.2	54,418.1	63,772.4
Less: Interest expense	26,486.7	30,619.2	32,180.0	25,402.6	30,146.7
Net interest income	23,909.3	26,271.7	28,388.2	29,015.5	33,625.7
Add: Fee-based income	4,885.7	5,596.7	5,967.2	6,289.2	6,858.7
Less: Staff cost	7,088.5	7,753.0	8,515.3	9,136.4	10,509.3
Overheads	7,926.3	8,590.1	9,949.8	10,065.5	11,324.8
Gross operating profit	13,780.2	15,525.4	15,890.3	16,102.9	18,650.3
Less: Loan loss and other provisions	6,339.3	5,517.7	4,128.3	5,011.4	4,181.3
Gross operating profit after provision	7,440.9	10,007.7	11,762.0	11,091.5	14,469.0
Add: Other income	4,642.2	5,647.8	6,726.6	4,667.5[2]	7,577.3
Pre-tax profit	**12,083.1**	**15,655.4**	**18,488.6**	**15,759.1**	**22,046.3**
Pre-tax profit / Average assets (%)	1.2	1.4	1.5	1.2	1.5
Pre-tax profit / Average shareholders' funds (%)	16.4	19.2	19.6	13.9	19.5
Pre-tax profit / Average employee (RM'000)	126.9	153.6	176.2	148.4	200.5
Cost incurred per ringgit of revenue earned (sen)	44.9	43.6	44.9	48.0	45.4
Cost incurred per ringgit of net interest income (sen)	62.8	62.2	65.0	66.2	64.9
Overheads to staff cost (%)	111.8	110.8	116.8	110.2	107.8
Staff cost per employee (RM'000)	73.2	76.1	81.2	86.1	95.6

1 Includes Islamic banks
2 Includes a significant non-recurring impairment on overseas investment by a commercial bank
p Preliminary
Note: Numbers may not necessarily add up due to rounding

Table A.6

Investment Banks: Income and Expenditure

	For the calendar year				
	2006	2007	2008	2009	2010*p*
	RM million				
Interest income	1,738.5	2,899.0	2,578.6	1,946.4	1,874.2
Less: Interest expense	1,322.4	2,228.2	1,878.0	1,155.2	1,192.9
Net interest income	416.0	670.9	700.6	791.2	681.3
Add: Fee-based income	282.2	1,299.7	1,418.5	1,567.5	1,888.9
Less: Staff cost	421.0	804.4	827.2	702.5	888.9
Overheads	285.0	932.0	876.1	775.2	1,038.4
Gross operating profit	-7.7	234.2	415.8	881.0	643.0
Less: Loan loss and other provisions	199.0	-147.5	41.8	-107.7	154.9
Gross operating profit after provision	-206.7	381.8	373.9	988.7	488.1
Add: Other income	1,072.8	1,664.7	307.1	243.0	232.2
Pre-tax profit	**866.2**	**2,046.4**	**681.1**	**1,231.7**	**720.3**
Pre-tax profit / Average assets (%)	1.5	2.9	1.0	2.0	1.2
Pre-tax profit / Average shareholders' funds (%)	13.8	26.4	7.5	14.2	8.4
Pre-tax profit / Average employee (RM'000)	281.8	276.9	83.6	150.0	82.7
Cost incurred per ringgit of revenue earned (sen)	39.9	47.8	70.2	56.8	68.8
Cost incurred per ringgit of net interest income (sen)	169.7	258.8	243.1	186.8	282.9
Overheads to staff cost (%)	67.7	115.9	105.9	110.4	116.8
Staff cost per employee (RM'000)	119.5	108.8	101.6	85.5	102.0

p Preliminary
Note: Numbers may not necessarily add up due to rounding

Table A.7

Islamic Banking System: Income and Expenditure

	For the calendar year				
	2006[1]	2007	2008	2009	2010*p*
	RM million				
Income	5,271.2	7,688.8	9,123.7	9,707.7	11,798.1
Less: Expense	2,418.9	3,528.8	4,161.6	3,611.3	4,955.9
Net income	2,852.3	4,159.9	4,962.2	6,096.4	6,842.1
Add: Fee-based income	297.7	461.4	489.0	595.2	676.8
Less: Staff cost	346.8	800.0	886.2	932.8	1,166.2
Overheads	812.7	1,454.6	1,873.0	2,100.4	2,401.7
Gross operating profit	1,990.5	2,366.7	2,692.0	3,658.4	3,951.1
Less: Financing loss and other provisions	575.3	917.9	1,200.6	1,386.4	1,298.9
Gross operating profit after provision	1,415.2	1,448.8	1,491.4	2,272.0	2,652.2
Add: Other income	197.2	445.3	319.3	368.9	434.7
Pre-tax profit	**1,612.4**	**1,894.1**	**1,810.7**	**2,640.9**	**3,086.9**
Pre-tax profit / Average assets (%)	1.6	1.3	1.0	1.3	1.2
Pre-tax profit / Average shareholders' funds (%)	18.7	15.6	12.4	13.9	14.5
Pre-tax profit / Average employee (RM'000)[2]	198.8	130.4	107.7	100.6	105.4
Cost incurred per ringgit of revenue earned (sen)	22.0	26.2	27.8	28.4	27.6
Cost incurred per ringgit of net income (sen)	40.7	54.2	55.6	49.8	52.1
Overheads to staff cost (%)	234.3	181.8	211.4	225.2	205.9
Staff cost per employee (RM'000)[2]	45.5	55.1	52.7	35.5	39.8

1 Excludes one Islamic bank that made exceptional loss
2 Number of employees is estimated based on the percentage of institution's Islamic assets
p Preliminary
Note: Numbers may not necessarily add up due to rounding

Table A.8

Banking System: Network and Workforce

	As at end				
	2006	2007	2008	2009	2010*p*
Number of institutions	42	47	54	54	55
Commercial banks	*22*	*22*	*22*	*22*	*23*
Investment banks	*10*	*14*	*15*	*15*	*15*
Islamic banks	*10*	*11*	*17*	*17*	*17*
Office network	2,139	2,245	2,271	2,298	2,312
Commercial banks	*1,952*	*1,968*	*1,979*	*1,999*	*2,006*
Investment banks	*19*	*120*	*131*	*131*	*133*
Islamic banks[1]	*1,167*	*1,272*	*2,039*	*2,087*	*2,102*
Number of banks with internet services	16	18	21	24	26
Number of employees	100,414	109,641	114,856	114,804	120,553
Commercial banks	*91,741*	*96,146*	*99,593*	*98,846*	*103,089*
Investment banks	*3,522*	*7,721*	*8,561*	*8,129*	*8,972*
Islamic banks	*5,151*	*5,774*	*6,702*	*7,829*	*8,492*

[1] Includes Islamic bank branches that are shared with conventional bank branches
p Preliminary

Table A.9

Commercial Banks[1]: Commitments and Contingencies

	As at end				
	2006	2007	2008	2009	2010*p*
	RM million				
Assets sold with recourse and commitments with drawdown	21,052.0	19,574.6	12,744.2	5,871.4	6,247.1
Credit extension commitments	258,026.1	303,862.7	348,118.2	376,604.0	379,674.9
Direct credit substitutes	16,404.2	19,424.7	21,179.7	19,922.4	19,292.2
Foreign exchange related contracts	212,377.6	368,769.5	364,511.3	341,651.1	407,639.0
Interest rate related contracts	552,340.1	642,812.1	752,070.1	648,232.1	643,923.3
Trade-related contingencies	20,767.3	17,756.9	13,608.4	12,553.5	12,155.4
Transaction-related contingencies	26,245.3	29,031.1	34,035.8	35,873.1	35,037.2
Underwriting obligations	1,310.4	2,282.7	1,383.5	1,532.2	1,187.7
Others	34,360.7	44,026.3	52,838.9	54,334.2	61,185.2
Total	**1,142,883.7**	**1,447,540.5**	**1,600,490.1**	**1,496,574.0**	**1,566,342.2**

[1] Includes Islamic banks
p Preliminary
Note: Numbers may not necessarily add up due to rounding

Table A.10

Investment Banks: Commitments and Contingencies

	As at end				
	2006	2007	2008	2009	2010*p*
	RM million				
Assets sold with recourse and commitments with drawdown	2,968.0	2,049.9	79.1	5.4	326.8
Credit extension commitments	1,681.3	4,140.4	2,328.8	2,640.4	2,796.8
Direct credit substitutes	855.5	1,165.9	729.4	484.3	258.2
Foreign exchange related contracts	5,669.7	2,812.3	464.4	801.5	2,864.4
Interest rate related contracts	38,010.1	44,180.0	14,154.2	10,018.0	13,852.2
Trade-related contingencies	0.0	1.1	0.0	0.0	0.0
Transaction-related contingencies	1,304.5	806.7	151.4	10.5	10.5
Underwriting obligations	4,599.8	3,486.7	2,551.8	987.6	679.8
Others	7,950.4	26,943.7	8,988.4	5,792.1	2,952.8
Total	**63,039.2**	**85,586.6**	**29,447.6**	**20,739.7**	**23,741.4**

p Preliminary
Note: Numbers may not necessarily add up due to rounding

Table A.11

Life Insurance[1]: Income and Outgo

	For the calendar year				
	2006	2007	2008	2009	2010*p*
	RM million				
Income					
Premium income	17,148.0	18,342.6	18,772.4	19,870.1	21,861.5
Net investment income	3,994.7	4,568.3	4,912.5	4,927.3	5,436.2
Profit on sale of assets and miscellaneous income	2,630.0	5,012.7	3,211.9	4,910.2	5,166.4
Total	**23,772.7**	**27,923.6**	**26,896.9**	**29,707.7**	**32,464.2**
Outgo					
Net policy benefits	7,320.2	9,081.8	10,025.4	11,857.3	13,032.9
Agency remuneration	2,462.4	2,582.9	2,718.7	2,944.4	3,250.3
Management expenses[2]	1,252.1	1,387.6	1,557.1	1,648.6	1,853.1
Loss on disposal of assets and other outgo	1,419.0	1,600.3	5,323.3	2,351.5	1,634.0
Total	**12,453.8**	**14,652.6**	**19,624.5**	**18,801.9**	**19,770.3**
Excess income over outgo	11,319.0	13,271.0	7,272.4	10,905.8	12,693.9

[1] Figures have been adjusted to reflect the global business of life insurance
[2] Inclusive of net bad and doubtful debts
p Preliminary
Note: Numbers may not necessarily add up due to rounding

Table A.12

General Insurance[1]: Underwriting and Operating Results

	For the calendar year				
	2006	2007	2008	2009	2010*p*
	RM million				
Underwriting profit	490.3	16.0	102.5	742.7	795.4
Investment income	730.0	796.6	820.0	772.0	813.2
Capital gains	334.1	635.4	153.3	439.9	325.8
Other income	119.6	60.2	113.0	125.2	133.4
Capital losses	166.0	107.1	534.0	133.4	81.8
Other outgo	47.5	62.0	40.8	97.9	88.1
Operating profit	1,460.5	1,339.0	614.0	1,848.5	1,897.9

1 Figures have been adjusted to reflect the global business of general insurance
p Preliminary
Note: Numbers may not necessarily add up due to rounding

Table A.13

Family Takaful[1]: Income and Outgo

	For the calendar year				
	2006	2007	2008	2009	2010*p*
	RM million				
Income					
Net contributions	1,241.5	1,990.5	2,374.7	2,719.8	3,326.9
Net investment income	232.0	282.2	298.8	354.8	451.6
Profit on sale of assets and miscellaneous income	120.5	103.1	165.1	307.1	251.8
Total	**1,594.0**	**2,375.8**	**2,838.6**	**3,381.6**	**4,030.2**
Outgo					
Net certificate benefits	400.8	535.5	633.4	905.4	1,603.3
Net commissions	118.5	178.0	297.1	432.7	524.6
Management expenses[2]	171.5	248.6	246.5	317.9	396.4
Loss on disposal of assets and other outgo	100.7	50.3	201.6	62.4	115.8
Total	**791.6**	**1,012.5**	**1,378.5**	**1,718.5**	**2,640.1**
Excess income over outgo	802.4	1,363.3	1,460.1	1,663.2	1,390.2

1 Figures have been adjusted to reflect the global business and actual expenses borne by family takaful funds
2 Inclusive of net bad and doubtful debts
p Preliminary
Note: Numbers may not necessarily add up due to rounding

Table A.14

General Takaful[1]: Underwriting and Operating Results

	For the calendar year				
	2006	2007	2008	2009	2010*p*
	RM million				
Underwriting profit	44.1	-26.9	117.4	170.1	145.8
Investment income	32.3	44.6	50.6	57.7	67.9
Capital gains	3.8	10.3	13.5	11.3	17.8
Other income	19.2	10.8	38.1	22.3	53.9
Capital losses	9.5	0.7	15.1	2.2	0.1
Other outgo	9.9	13.7	27.0	11.7	12.9
Operating profit	84.7	26.8	177.5	247.5	272.4

[1] Figures have been adjusted to reflect the global business and actual expenses borne by general takaful funds

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Note: Numbers may not necessarily add up due to rounding

Table A.15

Development Financial Institutions[1]: Sources and Uses of Funds

	As at end				
	2006	2007	2008	2009	2010
	RM million				
Sources:					
Shareholders' funds	15,091.1	17,767.8	23,057.2	24,533.2	27,021.7
Paid-up capital	*10,296.7*	*10,341.8*	*12,526.8*	*12,771.9*	*12,771.9*
Reserves	*3,006.0*	*3,390.7*	*5,004.2*	*5,298.6*	*5,809.3*
Retained earnings	*1,788.4*	*4,035.3*	*5,526.2*	*6,462.7*	*8,440.5*
Deposits accepted	60,402.0	67,067.9	79,542.8	95,599.1	109,991.3
Borrowings	23,239.1	24,771.4	21,501.0	24,698.0	24,391.7
Government	*14,823.7*	*17,188.6*	*13,599.1*	*14,066.2*	*16,975.9*
Multilateral/International agencies	*4,050.7*	*2,784.0*	*2,420.4*	*3,595.9*	*3,195.9*
Others	*4,364.7*	*4,798.8*	*5,481.5*	*7,035.9*	*4,219.9*
Others	14,829.9	19,163.3	20,328.2	21,085.1	24,885.3
Total	**113,562.1**	**128,770.4**	**144,429.2**	**165,915.4**	**186,290.0**
Uses:					
Deposits placed	18,831.3	20,519.5	20,118.8	25,134.7	26,807.6
Investments	28,819.7	32,762.5	36,535.1	38,263.5	45,325.6
of which:					
Government securities	*4,617.7*	*4,758.7*	*6,300.9*	*7,520.6*	*9,914.9*
Shares	*8,005.6*	*6,753.1*	*8,707.5*	*9,922.1*	*9,659.8*
Quoted	*7,561.4*	*6,434.7*	*8,422.7*	*9,012.8*	*8,698.3*
Unquoted	*444.2*	*318.4*	*284.8*	*909.3*	*961.5*
Loans and advances	55,527.8	65,279.2	75,376.7	88,509.7	100,222.6
Fixed assets	4,449.7	4,614.9	5,398.9	5,869.0	5,672.6
Others	5,933.6	5,594.3	6,999.7	8,138.5	8,261.6
Total	**113,562.1**	**128,770.4**	**144,429.2**	**165,915.4**	**186,290.0**
Contingencies:					
Guarantee	5,482.6	5,113.9	4,780.5	3,305.9	3,031.2
Export credit insurance	661.7	1,057.9	1,068.8	835.8	807.7
Total	**6,144.3**	**6,171.8**	**5,849.3**	**4,141.7**	**3,838.9**

[1] Refers to Bank Pembangunan Malaysia Berhad, Bank Kerjasama Rakyat Malaysia Berhad, Bank Simpanan Nasional, Export-Import Bank of Malaysia Berhad, Bank Pertanian Malaysia Berhad (Agrobank), Bank Perusahaan Kecil & Sederhana Malaysia Berhad (SME Bank), Malaysian Industrial Development Finance Berhad, Sabah Development Bank Berhad, Borneo Development Corporation (Sabah) Sendirian Berhad, Borneo Development Corporation (Sarawak) Sendirian Berhad, Credit Guarantee Corporation Malaysia Berhad, Sabah Credit Corporation and Lembaga Tabung Haji

Table A.16

Development Financial Institutions[1] under DFIA[2] : Sources and Uses of Funds

	As at end				
	2006	2007	2008	2009	2010
	RM million				
Sources:					
Shareholders' funds	10,484.2	11,498.3	16,814.5	18,840.8	19,912.3
Paid-up capital	*7,171.5*	*7,194.9*	*9,374.9*	*10,132.4*	*10,132.4*
Reserves	*2,207.7*	*2,533.7*	*4,092.8*	*4,459.6*	*4,883.0*
Retained earnings	*1,105.0*	*1,769.7*	*3,346.8*	*4,248.8*	*4,896.9*
Deposits accepted	45,098.7	50,450.3	59,210.4	71,268.6	83,050.7
Borrowings	18,729.1	19,877.1	15,913.3	17,806.7	18,512.1
Government	*13,758.7*	*15,917.4*	*12,162.6*	*12,268.9*	*14,990.0*
Multilateral/International agencies	*3,869.8*	*2,574.5*	*2,257.0*	*3,237.8*	*2,872.1*
Others	*1,100.6*	*1,385.2*	*1,493.7*	*2,300.0*	*650.0*
Others	11,343.1	15,269.5	16,238.8	16,797.7	21,793.4
Total	**85,655.1**	**97,095.2**	**108,177.0**	**124,713.8**	**143,268.5**
Uses:					
Deposits placed	12,713.4	11,171.7	11,673.7	14,325.5	17,309.5
Investments	17,500.6	20,873.3	19,597.9	19,097.5	23,378.6
of which:					
Government securities	*4,560.1*	*4,726.1*	*6,300.9*	*7,520.6*	*9,914.9*
Shares	*1,429.5*	*646.5*	*464.2*	*1,428.1*	*1,702.7*
Quoted	*1,325.5*	*571.4*	*421.1*	*1,059.8*	*1,385.8*
Unquoted	*104.1*	*75.1*	*43.1*	*368.3*	*316.9*
Loans and advances	50,961.4	60,473.0	70,338.4	83,354.5	94,425.9
Fixed assets	1,994.9	2,057.4	2,319.7	2,527.4	2,728.8
Others	2,484.8	2,519.8	4,247.3	5,408.9	5,425.7
Total	**85,655.1**	**97,095.2**	**108,177.0**	**124,713.8**	**143,268.5**
Contingencies:					
Guarantee	641.6	1,014.7	1,086.1	937.4	754.1
Export credit insurance	661.7	1,057.9	1,068.8	835.8	807.7
Total	**1,303.3**	**2,072.6**	**2,154.9**	**1,773.2**	**1,561.8**

[1] Refers to Bank Pembangunan Malaysia Berhad, Bank Kerjasama Rakyat Malaysia Berhad, Bank Simpanan Nasional, Export-Import Bank of Malaysia Berhad, Bank Pertanian Malaysia Berhad (Agrobank) and Bank Perusahaan Kecil & Sederhana Malaysia Berhad (SME Bank)

[2] Development Financial Institutions Act 2002

Table A.17

Development Financial Institutions[1]: Direction of Lending

	2006	2007	2008	2009	2010
	As at end				
	RM million				
Agriculture, forestry and fishery	3,575.7	3,968.3	4,976.9	6,340.3	6,166.2
Mining and quarrying	41.6	20.3	26.5	114.4	172.1
Manufacturing	4,655.7	5,687.8	5,852.2	5,560.1	6,821.4
Electricity, gas and water supply	2,920.9	3,497.5	3,763.1	3,590.5	3,345.9
Import and export, wholesale and retail trade, restaurants and hotels	761.2	1,030.8	1,493.2	1,989.4	2,039.4
Broad property sector	15,192.4	16,382.3	16,984.9	20,720.8	22,924.9
Construction	*7,057.1*	*7,542.1*	*8,637.2*	*12,367.1*	*14,560.1*
Purchase of residential property	*6,868.0*	*7,396.7*	*7,021.2*	*6,875.4*	*6,590.7*
Purchase of non-residential property	*545.8*	*614.1*	*296.3*	*339.8*	*497.6*
Real estate	*721.5*	*829.4*	*1,030.2*	*1,138.5*	*1,276.5*
Transport, storage and communication	6,281.1	5,610.0	5,705.5	5,847.5	5,773.3
Maritime	799.0	1,834.5	1,916.7	1,750.4	1,826.0
Finance, insurance and business services	877.4	1,056.6	785.5	1,209.0	1,632.3
Consumption credit	17,435.8	23,159.8	31,356.6	38,660.7	46,359.6
of which:					
Purchase of motor vehicles	*2,168.8*	*2,376.4*	*2,513.3*	*2,370.0*	*2,053.7*
Credit card	*50.4*	*86.7*	*174.8*	*320.5*	*443.3*
Purchase of securities	189.9	66.0	218.9	45.8	51.2
Others	2,797.1	2,965.3	2,296.7	2,680.8	3,110.3
Total	**55,527.8**	**65,279.2**	**75,376.7**	**88,509.7**	**100,222.6**

[1] Refers to Bank Pembangunan Malaysia Berhad, Bank Kerjasama Rakyat Malaysia Berhad, Bank Simpanan Nasional, Export-Import Bank of Malaysia Berhad, Bank Pertanian Malaysia Berhad (Agrobank), Bank Perusahaan Kecil & Sederhana Malaysia Berhad (SME Bank), Malaysian Industrial Development Finance Berhad, Sabah Development Bank Berhad, Borneo Development Corporation (Sabah) Sendirian Berhad, Borneo Development Corporation (Sarawak) Sendirian Berhad, Credit Guarantee Corporation Malaysia Berhad, Sabah Credit Corporation and Lembaga Tabung Haji

Table A.18

Development Financial Institutions[1] under DFIA[2] : Direction of Lending

	As at end				
	2006	2007	2008	2009	2010
	RM million				
Agriculture, forestry and fishery	3,513.7	3,864.8	4,862.9	6,234.3	6,114.8
Mining and quarrying	19.9	14.2	22.8	112.3	122.6
Manufacturing	3,422.1	4,475.3	4,646.7	4,290.9	5,563.9
Electricity, gas and water supply	2,919.7	3,496.5	3,762.2	3,589.8	3,345.9
Import and export, wholesale and retail trade, restaurants and hotels	502.2	779.8	1,276.2	1,774.8	1,798.6
Broad property sector	13,709.2	14,794.9	15,301.7	18,956.8	20,870.3
Construction	*6,566.4*	*7,030.1*	*8,072.6*	*11,895.2*	*14,013.6*
Purchase of residential property	*6,582.3*	*7,119.8*	*6,747.8*	*6,660.5*	*6,404.2*
Purchase of non-residential property	*480.8*	*561.4*	*237.4*	*256.1*	*413.6*
Real estate	*79.7*	*83.6*	*243.9*	*145.0*	*38.9*
Transport, storage and communication	6,200.0	5,534.6	5,640.8	5,794.9	5,698.6
Maritime	799.0	1,834.5	1,916.7	1,750.4	1,807.9
Finance, insurance and business services	763.1	939.7	750.7	1,176.1	1,618.1
Consumption credit	16,926.8	22,433.5	30,417.6	37,733.1	45,362.6
of which:					
Purchase of motor vehicles	*2,095.4*	*2,315.6*	*2,512.8*	*2,348.7*	*2,039.3*
Credit card	*50.4*	*86.7*	*174.8*	*320.5*	*443.3*
Purchase of securities	64.9	66.0	218.9	45.8	51.2
Others	2,120.8	2,239.2	1,521.2	1,895.3	2,071.4
Total	**50,961.4**	**60,473.0**	**70,338.4**	**83,354.5**	**94,425.9**

[1] Refers to Bank Pembangunan Malaysia Berhad, Bank Kerjasama Rakyat Malaysia Berhad, Bank Simpanan Nasional, Export-Import Bank of Malaysia Berhad, Bank Pertanian Malaysia Berhad (Agrobank) and Bank Perusahaan Kecil & Sederhana Malaysia Berhad (SME Bank)

[2] Development Financial Institutions Act 2002

Table A.19

Development Financial Institutions[1] under DFIA[2]: Non-performing Loans and Loan Loss Provisions

	As at end	
	2009	2010
	RM million	
General provisions	1,538.0	2,336.1
Interest-in-suspense	761.7	377.6
Specific provisions	3,248.8	3,582.5
Non-performing loans	5,634.2	7,873.3
	(%)	
Gross NPL ratio	6.8	8.5
Net NPL ratio	2.1	4.4
Total provisions/NPL	98.5	80.0

[1] Refers to Bank Pembangunan Malaysia Berhad, Bank Kerjasama Rakyat Malaysia Berhad, Bank Simpanan Nasional, Export-Import Bank of Malaysia Berhad, Bank Pertanian Malaysia Berhad (Agrobank) and Bank Perusahaan Kecil & Sederhana Malaysia Berhad (SME Bank)
[2] Development Financial Institutions Act 2002

Table A.20

Bank Pembangunan Malaysia Berhad

Year of establishment	1973
Objectives	To provide medium and long-term financing for infrastructure projects, maritime, capital intensive and high technology industries in manufacturing sector and other selected sectors in line with the national development policy.

Sector	Loans Outstanding		Loans Approved		Loans Disbursed	
	As at end		During the Year		During the Year	
	2009	2010	2009	2010	2009	2010
	RM million					
Infrastructure	18,160.6	20,166.9	7,758.1	1,904.7	4,910.1	3,248.4
Government programmes	*15,751.3*	*17,968.7*	*7,419.2*	*0.0*	*4,560.6*	*2,597.2*
Private programmes	*2,409.3*	*2,198.2*	*338.9*	*1,904.7*	*349.5*	*651.2*
Maritime	1,750.4	1,807.9	1,655.1	845.0	362.8	480.7
Shipping industry	*1,210.4*	*1,354.7*	*930.1*	*845.0*	*287.8*	*299.8*
Shipyard industry	*395.6*	*348.8*	*725.0*	*0.0*	*75.0*	*180.9*
Marine-related services	*144.4*	*104.4*	*0.0*	*0.0*	*0.0*	*0.0*
Manufacturing: High technology	1,210.3	1,530.2	248.6	284.8	213.6	146.7
Others	18.1	16.6	0.9	1.2	1.2	1.1
Total	**21,139.4**	**23,521.6**	**9,662.7**	**3,035.7**	**5,487.7**	**3,876.9**

Source: Bank Pembangunan Malaysia Berhad

Table A.21

Bank Perusahaan Kecil & Sederhana Malaysia Berhad (SME Bank)

Year of establishment	October 2005
Objectives	To provide financing and advisory services to SMEs involved in manufacturing, services and construction sectors, particularly Bumiputera entrepreneurs.

Sector	Loans Outstanding		Loans Approved		Loans Disbursed	
	As at end		During the year		During the year	
	2009	2010	2009	2010	2009	2010
	RM million					
SMEs	3,503.2	3,779.7	1,898.1	777.8	1,763.5	1,353.9
Micro	*388.6*	*410.8*	*213.7*	*80.6*	*265.5*	*172.2*
Small	*1,322.0*	*1,405.6*	*643.3*	*311.9*	*571.7*	*515.8*
Medium	*1,792.6*	*1,963.3*	*1,041.1*	*385.3*	*926.3*	*665.9*
Others	349.3	328.6	138.8	21.2	56.4	51.9
Total	**3,852.5**	**4,108.3**	**2,036.9**	**799.0**	**1,819.9**	**1,405.8**

Source: Bank Perusahaan Kecil & Sederhana Malaysia Berhad

Table A.22

Export-Import Bank of Malaysia Berhad

Year of establishment	1995
Objectives	To provide credit facilities to finance and support the exports and imports of goods, services and overseas project financing with concentration to the non-traditional markets, as well as to provide export credit insurance services, export financing insurance, overseas investment insurance and guarantee facilities, as well as other services which are normally offered by the export-import financial institutions and credit insurance financial institutions.

Loans Facility	Loans Outstanding (RM million)		Loans Approved (RM million)		Loans Disbursed (RM million)	
	As at end-2009	As at end-2010	2009	2010	2009	2010
Buyer credit facility	841.2	731.0	630.8	610.7	167.0	83.1
Overseas project financing	809.2	753.2	621.1	356.3	27.6	60.6
Overseas contract financing	451.5	399.0	156.7	106.9	172.8	122.1
Supplier credit facility	276.6	175.3	192.0	31.1	617.2	254.3
Malaysia Kitchen financing facility	13.1	14.2	3.0	13.9	8.4	2.1
Export credit refinancing	757.9	1,705.9	4,339.1	6,190.0	4,339.2	6,190.0
Others	0.0	4.2	64.1	14.5	0.0	6.9
Total	**3,149.5**	**3,782.8**	**6,006.8**	**7,323.4**	**5,332.2**	**6,719.1**

Guarantee and Insurance Policy	Contingent Liabilities (RM million)		Commitment Approved (RM million)	
	As at end-2009	As at end-2010	2009	2010
Guarantee	937.4	754.1	766.7	1,145.7
Insurance	835.8	807.7	2,188.0	1,194.0
Total	**1,773.2**	**1,561.8**	**2,954.7**	**2,339.7**

Source: Export-Import Bank of Malaysia Berhad

Table A.23

Bank Kerjasama Rakyat Malaysia Berhad

Year of establishment	1954					
Objectives	Mobilises savings and provides financing services to its members as well as non-members.					
Deposits Accepted	Deposits Accepted (RM million)					
	As at end-2009			As at end-2010		
	Members	Non-members	Total	Members	Non-members	Total
	1,606.9	36,856.4	38,463.3	1,771.1	47,856.2	49,627.3

Direction of Financing	Financing Outstanding (RM million)					
	As at end-2009			As at end-2010		
Sector	Members	Non-members	Total	Members	Non-members	Total
Agriculture	27.5	469.2	496.7	6.8	537.1	543.9
Purchase of residential property	2,620.3	1,006.1	3,626.4	1,720.8	1,540.6	3,261.4
Purchase of non-residential property	126.6	53.5	180.1	65.4	279.4	344.8
General commerce	5.8	986.8	992.6	1.7	1,242.9	1,244.6
Purchase of securities	26.9	14.9	41.8	17.7	31.9	49.6
Consumption credit	17,057.0	14,220.2	31,277.2	20,669.2	17,271.0	37,940.2
of which:						
Purchase of motor vehicles	*1,456.8*	*658.1*	*2,114.9*	*627.9*	*1,180.6*	*1,808.5*
Manufacturing	3.7	751.2	754.9	3.1	807.1	810.2
Others	125.5	2,231.5	2,357.0	71.4	2,347.1	2,418.5
Total	**19,993.3**	**19,733.4**	**39,726.7**	**22,556.1**	**24,057.1**	**46,613.2**

Source: Bank Kerjasama Rakyat Malaysia Berhad

Table A.24

Bank Simpanan Nasional

Year of establishment	1974	
Objectives	To focus on retail banking and personal finance especially for small savers.	
Deposits Facility	RM million	
	As at end-2009	As at end-2010
Fixed deposits	4,687.7	5,444.6
GIRO deposits	5,092.6	5,139.0
Islamic deposits	5,788.5	5,745.8
Premium savings certificates	1,289.7	1,454.6
Others	132.5	124.1
Total	**16,991.0**	**17,908.1**
Investments	RM million	
	As at end-2009	As at end-2010
Quoted shares	189.4	44.4
Government securities	6,367.2	7,060.6
of which:		
Malaysian Government Securities	*3,768.9*	*3,723.6*
Private debt securities	699.7	656.1
Subsidiary companies	34.5	34.5
Associate companies	231.8	231.8
Others	298.4	120.2
Total	**7,821.0**	**8,147.6**
Direction of Lending	RM million	
	As at end-2009	As at end-2010
Purchase of securities	4.0	1.6
Purchase of residential property	3,034.2	3,142.9
Purchase of non-residential property	76.0	68.8
Consumption credit	6,455.4	7,422.4
Others	280.5	269.6
Total	**9,850.1**	**10,905.3**

Source: Bank Simpanan Nasional

Table A.25

Bank Pertanian Malaysia Berhad (Agrobank)

Year of establishment	1969					
Objectives	To promote sound agricultural development in the country, through the provision of loans and advances. The main function of the bank is to co-ordinate and supervise the granting of credit facilities for agricultural purposes and mobilise savings, particularly from the agriculture sector and community.					
Agriculture, Forestry & Fishery	Loans Outstanding (RM million)		Loans Approved (RM million)		Loans Disbursed (RM million)	
	As at end		During the year		During the year	
	2009	2010	2009	2010	2009	2010
Sub-sector						
Oil palm	*1,033.3*	*1,218.6*	*880.1*	*240.7*	*203.7*	*149.9*
Food crops	*442.9*	*497.8*	*165.9*	*222.2*	*140.2*	*254.4*
Livestock	*595.6*	*684.2*	*116.2*	*229.4*	*124.0*	*145.5*
Fishery	*338.7*	*397.5*	*118.2*	*110.8*	*76.8*	*91.7*
Forestry	*110.3*	*119.0*	*3.5*	*6.0*	*0.8*	*3.1*
Tobacco	*1.3*	*2.1*	*0.6*	*0.6*	*6.0*	*1.3*
Rubber	*63.7*	*78.5*	*11.8*	*88.4*	*15.9*	*31.8*
Others	*3,050.1*	*2,497.1*	*903.2*	*966.2*	*1,926.8*	*876.1*
Total	**5,635.9**	**5,494.8**	**2,199.5**	**1,864.3**	**2,494.2**	**1,553.8**

Source: Bank Pertanian Malaysia Berhad

Table A.26

Development Financial Institutions: Selected Data

	As at end					
	2009			2010		
DFIs under DFIA[1]:	Branch	ATM	Staff	Branch	ATM	Staff
Bank Pembangunan Malaysia Berhad	-	-	380	-	-	363
Bank Kerjasama Rakyat Malaysia Berhad	122	310	3,857	127	388	4,055
Bank Simpanan Nasional	375	736	5,471	384	856	5,828
Export-Import Bank of Malaysia Berhad	-	-	231	-	-	227
Bank Pertanian Malaysia Berhad	167	180	3,026	167	200	2,954
Bank Perusahaan Kecil & Sederhana Malaysia Berhad	19	-	1,025	19	-	995
Sub-total	683	1,226	13,990	697	1,444	14,422
Other DFIs:						
Malaysian Industrial Development Finance Berhad	5	-	335	5	-	294
Sabah Development Bank Berhad	-	-	88	-	-	86
Borneo Development Corporation (Sabah) Sendirian Berhad	-	-	11	-	-	12
Borneo Development Corporation (Sarawak) Sendirian Berhad	-	-	33	-	-	35
Credit Guarantee Corporation Malaysia Berhad	16	-	453	16	-	492
Sabah Credit Corporation	11	-	198	10	-	193
Lembaga Tabung Haji	123	-	2,022	123	-	2,009
Sub-total	155	-	3,140	154	-	3,121
Total	**838**	**1,226**	**17,130**	**851**	**1,444**	**17,543**

[1] Development Financial Institutions Act 2002

Table A.27

Basic Payments Indicator

	2006	2007	2008	2009	2010
Population (million)	26.8	27.2	27.5	27.9	28.3
GDP (RM million)	574,441	642,049	740,907	679,687	765,966
Cash in circulation (CIC) (RM million)	33,519.4	36,247.1	40,424.6	43,439.2	47,685.2
Volume of transactions per capita (unit):					
Cheque[1]	7.5	7.8	7.5	7.3	7.3
E-payments:	29.3	35.6	39.8	41.9	43.6
Credit card	7.8	8.7	9.5	9.9	10.4
Charge card	0.2	0.2	0.2	0.2	0.2
Debit card	0.2	0.3	0.4	0.4	0.6
E-money	19.3	22.6	25.0	25.7	24.8
Interbank GIRO	0.7	1.0	1.3	1.6	1.8
MEPS Direct Debit	…	…	…	…	…
ATM[2]	0.1	0.8	0.8	0.9	1.4
Internet banking[3]	1.1	1.9	2.5	3.1	4.3
Mobile banking[3]	…	0.1	0.1	0.1	0.1
RENTAS - Third party transactions[4]	…	0.1	0.1	0.1	0.1
Value of transactions per capita (RM):					
CIC	1,249.3	1,333.3	1,467.8	1,557.2	1,687.9
Cheque[1]	53,741.7	63,049.5	63,962.9	60,068.5	65,209.1
E-payments:	33,328.9	233,205.8	305,940.3	297,306.2	333,453.3
Credit card	1,772.4	2,067.6	2,370.7	2,485.0	2,825.1
Charge card	87.2	89.0	111.1	148.6	183.3
Debit card	24.2	41.5	71.1	99.4	166.8
E-money	47.5	60.3	75.1	78.9	95.9
Interbank GIRO	1,705.2	2,462.9	3,254.1	3,902.0	4,490.9
MEPS Direct Debit	0.7	16.4	35.8	68.1	133.6
ATM[2]	80.0	857.6	696.8	708.9	1,107.4
Internet banking[3]	12,306.1	12,207.3	21,194.2	23,361.9	37,030.5
Mobile banking[3]	0.4	0.8	2.5	4.7	4.3
RENTAS - Third party transactions[4]	17,305.3	215,402.5	278,128.9	266,448.7	287,415.6
Turnover to GDP:					
CIC (%)	5.8	5.6	5.5	6.4	6.2
Cheque[1] (times)	2.5	2.7	2.4	2.5	2.4
E-payments (times):	1.6	9.9	11.4	12.2	12.3
% of GDP:					
Credit card	8.3	8.8	8.8	10.2	10.4
Charge card	0.4	0.4	0.4	0.6	0.7
Debit card	0.1	0.2	0.3	0.4	0.6
E-money	0.2	0.3	0.3	0.3	0.4
Interbank GIRO	8.0	10.4	12.1	16.0	16.6
MEPS Direct Debit	…	0.1	0.1	0.3	0.5
ATM[2]	0.4	3.6	2.6	2.9	4.1
Internet banking[3]	57.5	51.7	78.8	95.9	136.6
Mobile banking[3]	…	…	…	…	…
RENTAS - Third party transactions[4] (times)	0.8	9.1	10.3	10.9	10.6

[1] Cheques cleared via eSPICK
[2] Refer to payment transactions via ATM, including own and third party funds transfer. Data on own account and intrabank funds transfer available from 2007. Exclude cash withdrawals
[3] Exclude non-financial transactions, credit card and IBG transactions performed online
[4] Refer to Government, custom duty and third party payments via Interbank Funds Transfer System. Third party payments refer to transaction with a minimum amount of RM10,000, where the beneficiary or ordering party is a non-RENTAS member. Data available from November 2006
… Negligible
Note: Numbers may not necessarily add up due to rounding

Table A.28

Cashless Payment Instruments: Number of Transactions

	2006	2007	2008	2009	2010	2009	2010
	Million					% Annual change	
Cheque[1]	201.2	211.7	207.3	204.8	206.7	-1.2	0.9
Credit card	208.8	237.7	261.4	276.1	294.9	5.6	6.8
Charge card	6.0	5.6	5.6	5.2	5.0	-6.9	-4.5
Debit card	4.2	9.1	10.7	11.3	18.4	5.1	62.5
International debit	*2.4*	*4.5*	*5.4*	*6.3*	*13.3*	*16.4*	*111.2*
e-Debit[2]	*1.9*	*4.5*	*5.3*	*5.0*	*5.0*	*-6.5*	*0.8*
E-money	517.0	613.1	688.6	717.2	699.3	4.2	-2.5
Card-based	*516.0*	*609.3*	*674.4*	*707.4*	*692.2*	*4.9*	*-2.1*
Network-based	*1.0*	*3.8*	*14.2*	*9.8*	*7.1*	*-30.9*	*-27.8*

[1] Cheques cleared via eSPICK
[2] Domestic PIN-based ATM card

Table A.29

Cashless Payment Instruments: Value of Transactions

	2006	2007	2008	2009	2010	2009	2010
	RM million					% Annual change	
Cheque[1]	1,441,970	1,714,063	1,761,571	1,675,630	1,842,189	-4.9	9.9
Credit card	47,555	56,211	65,289	69,321	79,810	6.2	15.1
Purchases	*44,341*	*52,972*	*62,052*	*66,092*	*76,285*	*6.5*	*15.4*
Cash advances	*3,214*	*3,239*	*3,237*	*3,229*	*3,525*	*-0.3*	*9.2*
Charge card	2,340	2,419	3,060	4,144	5,177	35.4	24.9
Purchases	*2,333*	*2,405*	*3,028*	*4,113*	*5,140*	*35.8*	*24.9*
Cash advances	*6*	*14*	*32*	*30*	*37*	*-4.6*	*23.0*
Debit card	650	1,129	1,958	2,774	4,713	41.6	69.9
International debit	*344*	*545*	*748*	*1,198*	*2,208*	*60.1*	*84.3*
e-Debit[2]	*306*	*584*	*1,210*	*1,576*	*2,505*	*30.2*	*59.0*
E-money	1,274	1,639	2,067	2,201	2,708	6.5	23.0
Card-based	*1,257*	*1,591*	*1,903*	*2,020*	*2,113*	*6.2*	*4.6*
Network-based	*18*	*48*	*164*	*181*	*595*	*10.5*	*228.7*

[1] Cheques cleared via eSPICK
[2] Domestic PIN-based ATM card

Table A.30

Credit Card and International Debit Card Purchase Transactions: Five Largest Business Activities

	2009		2010	
	Volume	Value	Volume	Value
	% share of total			
Credit card				
Fuel/petrol	31.9	8.3	31.3	7.6
Retail[1]	26.3	31.4	27.3	31.1
Professional and commercial services[2]	9.4	20.1	11.0	21.6
Mail and telephone order	6.9	8.4	6.7	7.5
Utilities	5.3	5.2	5.2	4.7
Others	20.1	26.7	18.5	27.5
Debit card				
Retail[1]	48.9	35.2	49.2	34.7
Fuel/petrol	23.3	4.8	21.3	4.4
Professional and commercial services[2]	6.8	9.2	8.1	10.8
Food and restaurant	6.5	2.9	6.2	2.9
Utilities	3.1	2.1	3.9	2.6
Others	11.4	45.8	11.2	44.8

[1] Purchases made at wholesalers, hypermarkets, clothing stores and any other miscellaneous stores/retailers not included in other categories
[2] Include medical and insurance services, accounting, auditing, advertising services and other business services
Note: Numbers may not necessarily add up due to rounding

Table A.31

Payment Systems: Number and Value of Transactions

	2006	2007	2008	2009	2010	2009	2010
	Million/RM billion					% Annual change	
RENTAS[1]							
Number of transactions	2.2	2.7	3.0	3.0	3.2	0.6	5.0
Value of transactions	24,974.6	29,880.6	38,744.2	37,258.9	39,434.6	-3.8	5.8
Interbank GIRO							
Number of transactions	18.7	26.6	36.2	43.8	49.8	20.9	13.7
Value of transactions	45.8	67.0	89.6	108.8	126.9	21.5	16.6
	'000/RM million						
MEPS FPX							
Number of transactions	14.9	31.3	152.9	264.1	488.9	72.8	85.1
Value of transactions	5.9	9.5	45.8	107.1	309.9	134.0	189.3
MEPS Direct Debit							
Number of transactions	0.9	39.9	173.3	288.2	438.6	66.3	52.2
Value of transactions	19.1	445.0	986.3	1,899.1	3,774.0	92.6	98.7

[1] Malaysia large-value payment system, Real-time Electronic Transfer of Funds and Securities System

Table A.32

Payment and Securities Transactions Handled by RENTAS

Volume of Transactions	2006	2007	2008	2009	2010	2009	2010
	'000					% Annual change	
Total	**2,226.2**	**2,659.7**	**2,984.9**	**3,001.7**	**3,152.7**	**0.6**	**5.0**
IFTS[1]	**2,065.8**	**2,548.4**	**2,890.9**	**2,924.2**	**3,059.1**	**1.1**	**4.6**
Money market operations	103.2	108.3	111.5	96.7	98.2	-13.3	1.5
Foreign exchange settlement	32.9	47.7	68.0	64.6	74.0	-5.0	14.6
of which: USD CHATS[2]	*1.7*	*22.5*	*39.5*	*35.8*	*42.0*	*-9.5*	*17.5*
Third party transactions	168.7	1,567.0	1,905.1	1,965.7	2,086.1	3.2	6.1
Others	1,761.0	825.5	806.3	797.1	800.8	-1.1	0.5
SSDS[3]	**160.4**	**111.3**	**94.0**	**77.5**	**93.6**	**-17.6**	**20.8**
Value of Transactions	RM billion					% Annual change	
Total	**24,974.6**	**29,880.6**	**38,744.2**	**37,258.9**	**39,434.6**	**-3.8**	**5.8**
IFTS[1]	**22,804.6**	**27,909.7**	**37,256.3**	**35,653.1**	**37,437.6**	**-4.3**	**5.0**
Money market operations	10,576.4	12,261.8	17,627.0	18,754.0	18,354.9	6.4	-2.1
Foreign exchange settlement	1,531.4	2,179.0	3,310.8	1,874.1	2,618.9	-43.4	39.7
of which: USD CHATS[2]	*79.9*	*1,302.1*	*2,055.3*	*1,189.9*	*1,681.6*	*-42.1*	*41.3*
Third party transactions	464.3	5,855.9	7,659.8	7,432.7	8,119.6	-3.0	9.2
Others	10,232.5	7,613.0	8,658.7	7,592.3	8,344.1	-12.3	9.9
SSDS[3]	**2,169.9**	**1,970.9**	**1,487.8**	**1,605.8**	**1,997.0**	**7.9**	**24.4**
Turnover to GDP (times)	**43.5**	**46.5**	**52.3**	**54.8**	**51.5**		
Daily average:							
Volume of transactions ('000)	9.0	10.6	12.0	12.1	12.7	0.6	5.0
Value of transactions (RM billion)	100.7	119.5	156.2	150.2	159.0	-3.8	5.8

[1] Interbank Funds Transfer System
[2] Payment versus Payment (PvP) link established in 2006, for interbank settlement of ringgit-US dollar trades through RENTAS USD CHATS
[3] Scripless Securities Depository System for Malaysian Government Securities, Treasury bills, and scripless public debt securities
Note: Numbers may not necessarily add up due to rounding

Table A.33

Payment Channels: Number of Transactions

	2006	2007	2008	2009	2010	2009	2010
	Million					% Annual change	
Internet banking[1]	33.5	62.6	84.9	110.2	148.5	29.8	34.8
Individual	*27.7*	*40.3*	*57.0*	*79.7*	*104.7*	*39.7*	*31.4*
Corporate	*5.8*	*22.3*	*27.9*	*30.5*	*43.9*	*9.5*	*43.7*
Mobile banking	0.9	1.4	1.6	2.5	2.3	57.7	-5.3
ATM[2]	1.8	20.6	21.5	24.7	38.8	14.9	57.2

[1] Exclude non-financial transactions
[2] Refer to payment transactions via ATM, including own and third party funds transfer, excluding cash withdrawals. Data on own and intrabank funds transfer available from 2007

Table A.34

Payment Channels: Value of Transactions

	2006	2007	2008	2009	2010	2009	2010
	RM million					% Annual change	
Internet banking	334,774	417,811	624,362	699,902	1,100,332	12.1	57.2
Individual	*28,508*	*48,456*	*52,951*	*87,677*	*115,575*	*65.6*	*31.8*
Corporate	*306,266*	*369,355*	*571,412*	*612,225*	*984,757*	*7.1*	*60.8*
Mobile banking	11	21	72	141	138	96.9	-2.1
ATM[1]	2,146	23,314	19,190	19,774	31,286	3.0	58.2

[1] Refer to payment transactions via ATM, including own and third party funds transfer, excluding cash withdrawals. Data on own and intrabank funds transfer available from 2007

Table A.35

ATM Cash Withdrawals in Malaysia: Number of Transactions

	2006	2007	2008	2009	2010	2009	2010
	Million					% Annual change	
Total transactions	**313.9**	**378.4**	**470.9**	**502.3**	**518.8**	**6.7**	**3.3**
of which via:							
MEPS Shared ATM Network	94.1	133.3	158.3	176.0	191.8	11.1	9.0
- SAN regional link[1]	…	…	*0.1*	*0.2*	*0.2*	*63.1*	*32.2*
HOUSe network[2]	…	0.1	0.2	0.2	0.3	24.7	34.6

[1] Links established between MEPS Shared ATM Network and ATM network in Indonesia, Singapore, Thailand, PR China and Korea
[2] ATM network launched in 2006 for locally-incorporated foreign banks
… Negligible

Table A.36

ATM Cash Withdrawals in Malaysia: Value of Transactions

	2006	2007	2008	2009	2010	2009	2010
	RM million					% Annual change	
Total transaction value	**144,654.9**	**175,293.6**	**216,191.6**	**236,211.7**	**255,308.7**	**9.3**	**8.1**
of which via:							
MEPS Shared ATM Network	28,137.0	34,941.3	43,546.1	49,000.8	57,365.1	12.5	17.1
- SAN regional link[1]	*3.1*	*28.5*	*84.2*	*145.3*	*194.2*	*72.5*	*33.6*
HOUSe network[2]	17.8	68.5	96.0	121.0	170.1	25.9	40.6
Average value per transaction (RM)	460.9	463.3	459.1	470.2	492.1	2.4	4.7

[1] Links established between MEPS Shared ATM Network and ATM network in Indonesia, Singapore, Thailand, PR China and Korea
[2] ATM network launched in 2006 for locally-incorporated foreign banks

Table A.37

Number of Electronic Fund Transfer at Point-of-Sale (EFTPOS) Terminals

As at end of period	2006	2007	2008	2009	2010
	Unit				
International brand payment cards[1]	93,368	119,490	146,473	160,443	180,589
e-Debit[2]	21,592	34,754	67,581	91,328	118,467
E-money	28,115	28,771	29,236	30,641	30,803
Terminals per 1,000 inhabitant[3]	4.7	5.8	6.7	7.2	7.9

1 MasterCard, Visa, American Express and Diners Club
2 Domestic PIN-based ATM card
3 International brand payment card, proprietary ATM card and e-money terminals

Table A.38

Number of Merchants[1] Accepting Payment Cards

As at end of period	2009	2010
	Unit	
Credit card	148,600	216,945
Charge card	158,269	168,166
International debit card	109,424	125,528
e-Debit[2]	72,257	84,590

1 Include the merchants' outlets
2 Domestic PIN-based ATM card

Table A.39

Number of Cards and Users of Payment Instruments and Channels

As at end of period	2006	2007	2008	2009	2010
	'000				
Number of cards/accounts:					
Credit card	8,833	9,901	10,812	10,818	8,547
Charge card	272	246	286	285	182
Debit card	18,861	21,887	24,437	30,092	33,533
of which: e-Debit[1]	*14,582*	*17,352*	*19,480*	*23,221*	*24,583*
E-money	46,875	53,150	61,534	68,462	74,701
Number of subscribers:					
Internet banking	3,208	4,599	6,191	8,119	9,842
Individual	*3,162*	*4,523*	*6,057*	*7,958*	*9,638*
Corporate	*46*	*76*	*135*	*161*	*204*
Penetration rate (%) to population	*12.0*	*16.9*	*22.5*	*28.7*	*34.8*
Mobile banking	247	346	530	629	849
Penetration rate (%)					
to population	*0.9*	*1.3*	*1.9*	*2.2*	*3.0*
to mobile phone subscribers	*1.3*	*1.5*	*1.9*	*2.1*	*2.5*

1 Domestic PIN-based ATM card

Table A.40

Total Outward and Inward Remittances

	2006	2007	2008	2009	2010
	RM million				
Total outward[1]	**7,082.7**	**7,958.1**	**8,573.1**	**10,519.1**	**13,375.3**
Remitted via:					
Banks	6,370.3	7,093.0	6,561.7	6,575.4	6,672.7
Non-banks	712.4	865.1	2,011.4	3,943.8	6,702.6
Total inward[2]	**5,165.1**	**5,773.6**	**4,779.7**	**4,627.4**	**4,694.5**
Remitted via:					
Banks	5,148.2	5,721.1	4,696.4	4,361.6	4,200.6
Non-banks	16.9	52.5	83.3	265.7	493.9
No. of remittance service providers[3]	**36**	**46**	**67**	**81**	**81**
Commercial banks	32	33	38	39	40
DFIs	1	1	2	2	2
Non-banks[4]	3	12	27	40	39

[1] Refer to total funds remitted from Malaysia to other countries for workers' remittances and remuneration for employees
[2] Refer to total funds remitted from other countries to Malaysia for workers' remittances and remuneration for employees
[3] As at end of period
[4] Refer to total non-bank remittance service providers approved by Bank Negara Malaysia

Table A.41

Number of Participants and Instrument Issuers

As at end of period	2006	2007	2008	2009	2010
	Unit				
RENTAS	**53**	**54**	**60**	**62**	**65**
Bank Negara Malaysia	*1*	*1*	*1*	*1*	*1*
Banks	*47*	*48*	*54*	*54*	*55*
DFIs	*2*	*2*	*2*	*4*	*5*
Non-banks	*3*	*3*	*3*	*3*	*4*
SPICK/e-SPICK	**36**	**37**	**43**	**44**	**45**
Credit card	**18**	**18**	**23**	**24**	**26**
Banks	*16*	*16*	*21*	*21*	*22*
Non-banks	*2*	*2*	*2*	*3*	*4*
Debit card[1]	**15**	**14**	**19**	**22**	**22**
International debit card	*7*	*6*	*8*	*8*	*9*
e-Debit[2]	*10*	*10*	*11*	*13*	*13*
Other[3]	-	-	*6*	*8*	*9*
Charge card	**8**	**8**	**8**	**8**	**7**
Banks	*5*	*5*	*5*	*5*	*5*
Non-banks	*3*	*3*	*3*	*3*	*2*
E-money[4]	**13**	**15**	**19**	**20**	**20**
Banks	*2*	*4*	*4*	*4*	*5*
Non-banks	*11*	*11*	*15*	*16*	*15*
Internet banking	**17**	**19**	**23**	**24**	**27**
Mobile banking	**6**	**7**	**11**	**11**	**11**
MEPS FPX and Direct Debit	**16**	**16**	**16**	**16**	**17**
Interbank GIRO	**28**	**31**	**33**	**33**	**36**

1 There are banks issuing more than one type of debit card
2 Domestic PIN-based ATM
3 Cards with both international debit and domestic PIN-based applications
4 Include international brand prepaid card