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Bank Negara Malaysia Financial Stability and Payment Systems Report 2017

Risk Developments and Assessment of Financial Stability in 2017

The global economy and financial markets were influenced by major policy developments in several key economies, volatility in commodities markets and geopolitical risks. Against this global setting, domestic financial stability continued to be firmly supported by sound financial institutions, and deep and liquid financial markets which facilitated the smooth functioning of financial intermediation activities. Compared to 2016, the direction of credit and contagion risks remained broadly unchanged in 2017. Indicators of market, liquidity and funding risks were lower.

Risks to financial stability from elevated household debt levels continued to recede. The growth in household borrowings moderated for the seventh consecutive year and is now more in line with income growth. Against the stronger performance of the domestic economy, the ratio of household debt-to-gross domestic product declined further to 84.3% (2016: 88.3%). Underlying trends in debt accumulation by households also continued to improve. First, the growth of unsecured borrowings in the form of personal loans has been sharply lower than that observed in earlier periods (2017: 2.5%; 2008: 25.2%). Second, the debt servicing ratios of most households remained within prudent levels (median: 32.7%). Third, the growth in household financial assets (8.6%) outpaced that of debt for the first time since 2012. Despite these positive developments, lower income households could continue to face challenges in meeting debt repayments amid higher costs of living. Given that debt levels are still elevated, the series of macroprudential measures implemented since 2010 remain relevant in their current form.

In the property market, excess supply in the office space and shopping complex segments is a concern. While business conditions are improving, incoming supply of new office space and shopping complexes is expected to significantly outstrip demand in the medium term. This will continue to exert downward pressure on occupancy and rental rates. Banks have become more cautious in lending to these segments and have sufficient buffers to absorb potential losses arising from property price corrections. Notwithstanding this, concerted efforts to avert deeper imbalances in the office space and shopping complex segments are important to contain spillovers to other parts of the economy.

The financial positions of non-financial corporations (NFCs) remain healthy. At the aggregate level, the increase in leverage of NFCs has been supported by strong and improving debt servicing capacity. Residual risks in the oil and gas, and real estate segments are not expected to have a significant impact on financial institutions. Overall default risk of Malaysian corporations remains low and stable.

In the financial markets, a number of factors are contributing to greater stability. A larger proportion of non-resident investors in the bond market are stable, long-term investors. Strong domestic institutional investors continue to provide the necessary support to domestic financial markets during periods of heightened portfolio flows, thus preserving orderly market conditions. Following three series of measures introduced by the Financial Markets Committee (FMC) since December 2016, onshore foreign exchange (FX) liquidity has also improved, driven by a more balanced foreign currency demand and supply.

Overall liquidity and funding conditions were bolstered by a stronger pick-up in the growth of deposits. Banking system liquidity placed with the Bank which is available to meet liquidity needs rose to RM176.2 billion. Banks have also continued to diversify their funding base to include more stable medium-term instruments as a source of funds in anticipation of the implementation of the Net Stable Funding Ratio (NSFR). This, together with a high level of compliance with the Liquidity Coverage Ratio will further strengthen banks' resilience to liquidity stress.

Contagion risks from domestic non-bank financial institutions, and the external exposures and overseas operations of banks remained low and broadly unchanged. As in previous years, external exposures of the Malaysian banking system largely reflected centralised liquidity management practices and capital funds held to meet local capital requirements for banking operations. Domestic banking groups continued to expand their overseas operations in the region in line with the growing investment linkages within Asia. These operations continue to be supported by strong capitalisation and stable funding structures.

Based on stress tests conducted by the Bank, the Malaysian financial system is expected to remain resilient under severe market, credit, and funding and liquidity shocks. The Bank remains vigilant of external developments, including tighter global financial conditions that could lead to increased financial market volatility. Potential risks arising from the growth in financial technology and cyber threats will also shift into sharper focus.

Banking Sector

The banking sector's profitability improved, reflecting the slower growth in interest expenses and higher fee-based income from financing-related activities and stock broking activities. Average returns on equity and assets rose to 13% and 1.5% respectively. Conservative earnings retention policies contributed to higher capital buffers maintained by the banking sector, with all banks reporting capital ratios well above the minimum regulatory requirements.

Outstanding financing by banks grew 4.1% to RM1,584.4 billion in 2017, driven mainly by financing to households and small and medium enterprises (SMEs). In particular, growth in financing to SMEs remained healthy at 6%. Recognising the strategic importance of development financial institutions (DFIs) in financing and developing key economic sectors, the Bank has started to engage with DFIs to improve performance measurement frameworks in order to better capture the development impact of DFIs.

In promoting financial inclusion, technology featured more prominently in initiatives to improve access to financial services for those currently unbanked and underserved. This included the introduction of cashless clusters in designated communities leveraging on e-payments and the launch of Malaysia's first financing referral platform which provides a one-stop online access point to financing solutions and funds for SMEs. The Bank also introduced eCCRIS, enabling individuals and businesses to conveniently access their own credit histories online.

The domestic implementation of Basel III standards continued to be a key focus of regulation and supervision. The Leverage Ratio requirement took effect on 1 January 2018. The Bank also published proposals for the implementation of the NSFR, which will be implemented no earlier than 1 January 2019. In 2018, the Bank will communicate plans and further proposals for the implementation of the remaining Basel III requirements in Malaysia, including reforms to the capital framework that were recently finalised by the Basel Committee on Banking Supervision. This will take into account the features and risks specific to the domestic financial system.

Another key development was the issuance of strengthened standards on the management of credit risk. This also serves to provide a strong foundation for the implementation of new financial reporting standards on impairment (Malaysian Financial Reporting Standards 9) by financial institutions.

The Bank's supervisory framework was enhanced in 2017 to accord greater emphasis on organisational culture. This reflects growing concerns that a weak or indifferent culture within banks towards risks and ethical conduct can significantly undermine confidence in the banking system. Banks reported that 65% of losses from operational risk events were due to internal causes including internal fraud, regulatory non-compliance and operational lapses. Culture also has an important influence on risk-taking behavior within banks. In assessing the key drivers of organisational culture, the Bank takes into account both financial and non-financial aspects, including a bank's business model and structure, performance management and incentive systems, and the impact of control functions and internal interactions on behaviour. Industry-driven efforts to elevate professional standards in the banking sector have gained traction, with almost 200 senior officers and directors of banks enrolled in the Chartered Banker programme offered by the Asian Institute of Chartered Bankers (AICB). From 2018 onwards, key personnel in credit, compliance (including AMLA compliance), risk management, and audit functions will be required to obtain specialised qualifications from AICB.

Insurance and Takaful Sector

The insurance and takaful sector maintained positive growth underpinned by strong overall capitalisation. Growth was mainly driven by investment-linked and credit-related business in the life insurance and family takaful sector, respectively. The general sector in contrast experienced a marginal contraction, weighed down by contraction in the offshore-oil segment despite observed growth in other main classes of business. The industry as a whole remained profitable, with the life and family sector continuing to generate surpluses. Profits were however lower in the general sector due to higher claims experience recorded in the motor and medical lines of business.

The life insurance and family takaful penetration rate remains low, increasing only marginally over the last four years. Unsurprisingly, penetration is lower in the Bottom 40% household segment with only 30.3% owning a life insurance or family takaful policy. To increase penetration, Perlindungan Tenang, an initiative to make available products that are affordable, of good value, accessible, and simple, was launched. As at end-2017, 10 products were introduced under this initiative, which are also accessible through broader channels including bank branches, the internet and mobile platforms.

Two major components of the Life Insurance and Family Takaful Framework were implemented in 2017. The industry has started to offer pure protection term life insurance and family takaful products through direct channels, in particular through the internet. This aims to offer lower-cost alternative protection products to the public, while increasing reach to encourage a higher take up of insurance and takaful. This development has been accompanied by the emergence of product aggregators which allow consumers to easily compare between product offerings. After a pilot run of one and a half years, the Balanced Scorecard Framework for the agency force also came into effect on 1 January 2018 as planned. This will incentivise higher standards of productivity and professionalism among agents, in turn lifting their income potential. In parallel with these developments, broader initiatives are being pursued by the Bank to raise standards of professional integrity and ethical behaviour among other insurance and takaful intermediaries.

The general insurance and takaful sector entered into the second phase of the liberalisation of the motor tariff. With the liberalisation of premium rates for comprehensive and third party, fire and theft policies since 1 July 2017, premiums have begun to adjust to better reflect the underlying risk profile of drivers. Further differentiation in premiums is expected moving forward as insurers and takaful operators adopt a wider set of risk factors in setting premiums. Liberalisation has also facilitated broader product options for vehicle owners and ushered in technological innovation, most notably the use of motor telematics which rewards lower-risk drivers based on driving behaviour. The Bank continues to monitor developments to ensure that the liberalisation continues to proceed in an orderly manner.

The adoption of new financial reporting standards for insurance contracts (Malaysian Financial Reporting Standards 17) will introduce important changes to current approaches for reporting the performance of insurers and takaful operators. Preparations by the industry to implement the standards, which will come into force on 1 January 2021, will intensify in the coming years. The Bank has also initiated a review of the Risk-Based Capital Framework to ensure that capital requirements remain fit-for-purpose. The review, which will be conducted in phases beginning 2018, intends to reflect market developments and global regulatory and accounting standards, including MFRS 17.

Islamic Finance Development

The Islamic finance industry maintained healthy levels of profitability and capitalisation in 2017. Islamic financing grew by 9.4%, driven mainly by home and SME financing. Similarly, the takaful sector saw net contributions increase by 9.5%.

The industry advanced the Value-Based Intermediation (VBI) initiative, which promotes a new paradigm for finance embodying the intended outcomes of Shariah. The VBI principles advocate finance that advances social good and prevention of harm to the broader society and environment through the alignment of business practices of Islamic financial institutions. In support of this initiative, the Bank and the industry have jointly developed aspirations for the implementation of VBI in Malaysia. This is being further complemented by the establishment of a Community of Practitioners (CoP) comprising nine Islamic banks to pursue collaborative efforts by the industry to execute VBI strategies. VBI is also being realised through a greater and direct involvement of Islamic banks in social finance. The Islamic banking industry and 10 State Islamic Religious Councils have entered into arrangements to modernise collections, investments and disbursements of waqf (endowment) funds. Fund returns will be channeled into economic empowerment, education and health projects.

Progress has also been made in investment accounts. During the year, the Bank issued additional guidance to ensure that investment accounts function as intended to promote risk sharing and expand the mobilisation of capital businesses. Investment accounts grew by 6.9%, amounting to RM78.7 billion. Of this, funds raised and intermediated through the Investment Account Platform quadrupled to RM95.3 million in 2017, supporting business ventures in several industries.

In takaful, further progress was made to encourage innovation and support growth. The Bank is developing a regulatory framework that will facilitate the offering of trade credit takaful to meet the needs of businesses. An automated mechanism for takaful operators to expedite the processing of death claims will be launched in 2018. Additionally, the industry moved closer to developing a retakaful pool to expand the industry's underwriting capacity, thus reducing reliance on conventional reinsurance.

At the core of the Bank's Islamic finance initiatives is the ongoing effort to strengthen Shariah understanding and compliance. The Bank further reinforced end-to-end Shariah compliance with the publication of four additional Shariah standards. Comprehensive reviews of the Shariah Governance Framework and Takaful Operational Framework were also undertaken, ensuring that they remain relevant and commensurate with the growth and progress of the industry over time. The Bank's Shariah Advisory Council (SAC) continued to promote international harmonisation and mutual respect in Shariah. In conjunction with the SAC's 20th anniversary, the Bank launched a new website for the SAC as a repository of fiqh rulings and published compilations of the SAC's resolutions and the Bank's Shariah Standards.

The future of Islamic finance hinges crucially on the talent and professionalism of the workforce. The Bank introduced reforms to improve synergies among talent institutions and enhance the quality of talent offerings. The Certified Shariah Advisor and Certified Shariah Practitioner professional qualifications were launched in 2017, while the Chartered Professional in Islamic Finance accreditation will be rolled out in 2018. At the university level, an action-based learning approach was piloted by the International Centre for Education in Islamic Finance to equip students with greater applied knowledge and enable quicker time-to-competency when they enter the workforce. Through the Educator's Manual, the Bank also continued to embed Shariah standards within the university curriculum.

Cross-Sector Developments

Malaysia's debt securities market continued its upward trajectory in 2017, growing 10.1% to RM1.3 trillion or 97.6% of GDP. Despite more volatile capital flows, bond yields remained relatively stable, owing to the active participation of domestic institutional investors. Since the implementation of the FMC measures, onshore FX liquidity has improved considerably. Average daily trading volume in the onshore FX market increased to USD9.9 billion, up by over 20% from 2016, while the transaction volume of the ringgit non-deliverable forward market has contracted by 70% since November 2016. The more flexible hedging framework has also resulted in increased FX forward transactions by non-resident institutional investors. Importantly, the composition of onshore FX market transactions indicates that pricing is now mainly driven by real sector activities, rather than speculative transactions. Greater FX administration flexibilities provided under an expanded local currency settlement framework with the Bank of Thailand and a new local currency settlement framework with Bank Indonesia have also reduced the cost of doing business and further contributed to developing regional financial markets.

The legal and regulatory framework continued to be strengthened during the year to counter money laundering and terrorism financing (ML/TF) risks. The Companies Act was revised to improve transparency in the ownership of legal persons registered in Malaysia, while the Anti-Money Laundering, Anti-Terrorism Financing and Proceeds of Unlawful Activities Act 2001 (AMLA) was enhanced to broaden the scope of predicate offences relating to ML/TF risks. The Bank has also taken steps to extend AML/CFT obligations to digital currency exchangers, thereby improving the transparency of digital currency activities in Malaysia. Cooperation with regional authorities to counter terrorism financing was further reinforced with commitments to joint initiatives with financial intelligence authorities in Australia and Indonesia to address terrorism financing risks.

Reflecting a stronger focus by the Bank on conduct and culture within the financial industry, the Bank introduced requirements for financial institutions to consider the conduct histories (including disciplinary actions) of potential new hires as parts of the employee screening process. Requirements are also being developed to strengthen the individual accountability of those in significant senior roles within a financial institution. Given developments which have led to more extensive outsourcing by financial institutions in recent years, key improvements to the regulatory standard on outsourcing are being finalised to ensure that risk management practices for these arrangements remain robust.

In the area of consumer protection and empowerment, the formulation of the proposed Consumer Credit Act – a joint initiative between the Bank, the Ministry of Domestic Trade, Co-Operatives and Consumerism and the Ministry of Urban Wellbeing, Housing and Local Government – made further progress during the year. The proposed law will deliver more consistent standards in the level of protection afforded to retail borrowers and support the effective management of risks in the consumer credit market. Requirements for financial institutions to safeguard the confidentiality of customer information were also enhanced. In addition, the Bank is currently finalising specific proposals to promote the fair treatment of financial consumers through heightened expectations on the board and senior management to embed a culture of fair dealing and responsible behavior within the business.

It is equally important that consumers are empowered through education and accessible channels to exercise their rights. To this end, the Bank's public outreach efforts grew significantly in 2017. Over 75,000 people attended the Bank's Karnival Kewangan events held in Kuala Lumpur, Kota Kinabalu and Kuching to educate and inform the public on financial service and consumer rights. The public was also introduced to avenues available to address disputes with financial service providers. This included the Ombudsman for Financial Services, which has resolved 1,274 cases in the 15 months since commencing operations in October 2016. The proliferation of financial fraud schemes continued to be a concern. Following reviews by banks of accounts associated with the names of individuals and companies published on the Bank's Financial Consumer Alert, 884 accounts were closed during the year to prevent abuse of the financial system for fraudulent activities. The Bank also intensified efforts to alert the public to financial fraud schemes and steps that they should take to protect themselves against falling victim to fraud.

In the money services business (MSB) sector, growing usage of electronic remittance services (e-remittances) has become an important enabler for the migration of remittances from informal to formal channels. The Bank estimates that informal remittance reduced by about 8% in 2017. To further accelerate the migration to formal channels, the Bank has issued standards to enable e-remittance service providers to digitally on-board new customers while maintaining adequate standards of AML/CFT measures. This is expected to boost the market share of e-remittances which remains small at 12.3% of total remittances. Another key factor to encourage greater migration to formal channels is public awareness and education. In this regard, Project Greenback 2.0 in Johor Bahru – a collaboration between the Bank, the World Bank and the city of Johor Bahru – concluded a two-year pilot project in Malaysia that reached over 35,000 foreign workers and 3,700 SMEs. This contributed to a significant increase in the value of outward remittances in Johor Bahru through formal channels by 156% and 21% respectively for remittances by foreign workers and SMEs.

The implementation of the Regulatory Sandbox in October 2016 to provide a conducive environment for fintech innovation continues to receive strong interest from both financial institutions and fintech companies. New solutions in the areas of digital money services, insurance product aggregation and biometric authentication have been admitted for live testing. Experience from the Sandbox has been pivotal in enabling the Bank to determine appropriate regulatory approaches that would facilitate innovation while preserving adequate safeguards for the protection of consumers and financial stability and integrity. The Bank also collaborated with the industry to develop industry-wide infrastructure and standards in high-impact areas such as open application programming interfaces (API), a common Know-Your-Customer utility and distributed ledger technology (DLT). Alongside new technological adoptions, greater focus is being given to strengthen cybersecurity practices.

Payment and Settlement Systems

The payment and settlement systems remained resilient and operated without any major interruptions throughout the year. To mitigate cyber risk to key payment infrastructures, financial institutions have taken steps to comply with enhanced security controls, including those published by Society for Worldwide Interbank Financial Telecommunication (SWIFT), to fortify the local operating environment.

As part of the Bank's drive towards a cashless society, measures have been actively implemented to correct price distortions, enable a greater degree of competition, and establish market incentive structures to promote innovation and investments in payments infrastructure. These have been supported by extensive public awareness initiatives to encourage and accelerate the migration to e-payment. The financial system continued to make good progress in 2017. The number of e-payment transactions per capita has more than doubled to 111 (2011: 49) while cheque volume has declined by 41.9% to 119 million or four cheques per capita (2011: 204.9 million or seven cheques per capita). The number of point-of-sale terminals has expanded rapidly and the volume of debit card transactions increased by more than six times to 162.3 million transactions or 5.1 transactions per capita (2011: 25.1 million transactions or 0.9 transactions per capita). A major milestone in 2017 was the smooth transition from signature to the more secure PIN-based payment cards on 1 July 2017, which was achieved without disruptions to payment transactions.

In 2018, the Bank will focus on initiatives to promote mobile payments to complement debit cards in displacing cash. An area of primary focus will be the operationalisation of the Interoperable Credit Transfer Framework (ICTF). By ensuring fair and open access to a shared payment infrastructure by banks and non-banks, the ICTF is envisioned to drive greater competition, spur the development of innovative payment services to cater to the needs of different customer segments, and foster greater financial inclusion.

Bank Negara Malaysia
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Key Financial Soundness Indicators

	As at end				
	2013	2014	2015	2016	2017*p*
	% (or otherwise stated)				
Banking System					
Total Capital Ratio	14.9	15.9	16.6	16.5	17.1
Tier 1 Capital Ratio	13.5	14.0	14.2	14.0	14.3
Common Equity Tier 1 Capital Ratio	12.6	13.3	13.3	13.1	13.3
Return on Assets	1.5	1.5	1.3	1.3	1.5
Return on Equity	15.9	15.2	12.3	12.5	13.0
Liquid Assets to Total Assets	11.6	13.3	-	-	-
Liquid Assets to Short-term Liabilities	36.5	42.6	-	-	-
Liquidity Coverage Ratio[1]	-	-	127.4	124.3	134.9
Net Impaired Loans Ratio	1.3	1.2	1.2	1.2	1.1
Capital Charge on Interest Rate Risk in the Trading Book to Capital Base	1.5	1.4	1.2	1.1	1.0
Net Open Position in FC to Capital Base	5.7	4.7	6.1	6.3	6.1
Equity Holdings to Capital Base	0.8	1.3	0.7	1.5	1.0
Insurance and Takaful Sector					
Capital Adequacy Ratio (conventional only)	246.1	251.9	251.6	248.2	236.3
Life Insurance and Family Takaful					
Excess Income over Outgo (RM billion)	13.2	13.8	12.0	13.3	19.0
New Business Premiums / Contributions (RM billion)	12.1	12.9	13.2	14.2	15.1
Capital Adequacy Ratio (conventional only)	260.9	259.2	260.6	245.0	233.5
General Insurance and General Takaful					
Underwriting Profit (RM billion)	1.8	1.8	1.3	1.8	1.4
Operating Profit (RM billion)	3.2	3.2	2.7	3.4	2.7
Gross Direct Premiums / Contributions (RM billion)	17.8	19.1	19.5	19.7	19.9
Claims Ratio	57.1	57.5	60.2	55.9	58.3
Capital Adequacy Ratio (conventional only)	231.7	279.7	263.3	269.1	268.9
Household (HH) Sector					
HH Debt (RM billion)	877.4	960.0	1,030.5	1,086.1	1,139.9
HH Financial Asset (RM billion)	1,904.9	2,015.0	2,119.3	2,232.4	2,423.6
HH Debt-to-GDP Ratio	86.1	86.8	89.0	88.3	84.3
HH Financial Asset to Total HH Debt Ratio	217.1	209.9	205.7	205.5	212.6
HH Liquid Financial Asset to Total HH Debt Ratio	155.7	147.5	142.4	140.7	145.2
Impaired Loans Ratio of HH Sector	2.2	1.9	1.6	1.6	1.6
Business Sector					
Return on Assets	6.4	6.0	4.9	4.6	4.4
Return on Equity	11.3	10.2	8.8	7.9	7.7
Debt-to-Equity Ratio	39.1	39.2	43.2	43.0	47.0
Interest Coverage Ratio (times)	13.1	12.0	10.6	11.5	9.1
Operating Margin	16.1	15.9	14.8	14.5	15.4
Impaired Loans Ratio of Business Sector	2.9	2.6	2.5	2.5	2.5
Development Financial Institutions[2]					
Lending to Targeted Sectors (% change)	8.1	7.0	5.5	5.7	0.1
Deposits Mobilised (% change)	7.2	5.3	2.0	6.4	4.8
Impaired Loans Ratio	5.6	5.0	4.8	5.9	5.2
Return on Assets	2.2	1.6	1.4	1.0	1.4

[1] The Basel III Liquidity Coverage Ratio (LCR) Framework takes effect on 1 June 2015 and supersedes the guidelines on Liquidity Framework and Liquidity Framework-i issued on 1 July 1998

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

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Note: Figures may not necessarily add up due to rounding

Source: Bank Negara Malaysia, Securities Commission Malaysia, Bursa Malaysia, Bloomberg, Department of Statistics, Malaysia and internal computation