BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

2011

# Financial Stability and Payment Systems Report

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 2011 which are incorporated into this Financial Stability and Payment Systems Report 2011.

Respectfully submitted,

Zeti Akhtar Aziz
Governor
21 March 2012

# PREFACE

The Financial Stability and Payment Systems Report 2011 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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## Payment Systems Report

### PAYMENT AND SETTLEMENT SYSTEMS



### ANNEX

# GOVERNOR'S STATEMENT

Despite the deterioration in the global economic and financial conditions in 2011, domestic financial stability in Malaysia was preserved. The year saw renewed turbulence in financial markets following the heightened market concerns over the sovereign debt crisis in Europe. In addition, funding pressures and the weakening pace of economic recovery continue to affect the financial sector in the advanced economies. While recent measures taken by European policymakers have improved market conditions, considerable challenges remain ahead to restore and strengthen global financial stability.

While not insulated, the Malaysian financial sector has held up well against these developments. The financial sector is expected to continue to remain resilient going forward and is well positioned to continue the intermediation process without disruption. This is not only due to the limited exposures to sovereigns and institutions in the affected euro area economies, but also due to the strong governance and risk management practices. This has resulted in strong balance sheets, continued profitability, strong asset quality and healthy liquidity positions. While there has been some tightening of wholesale funding conditions, particularly in foreign currency, this has had a modest impact on domestic banks given the stable funding structures and continued ample domestic liquidity. The deeper and more diversified domestic financial markets have also supported orderly conditions despite the stronger two-way capital flows experienced during the year.

Following wide-ranging measures introduced during the year, Malaysia's household debt level relative to GDP has stabilised during the second half of 2011. These measures, including the normalisation of interest rates, the raising of the statutory reserve requirement, and the macroprudential measures and the close supervision by the Bank, have aimed at ensuring that household debt will remain sustainable going forward. These measures have started to take effect, most notably in the moderation of property prices which represents the largest component of household debt. New credit card debt has also moderated and there has been improved discipline among banks in assessing affordability. At the aggregate level, the expansion of household debt continues to be supported by positive underlying conditions which include the favourable labour market conditions, rising incomes, and growth in household financial assets. In addition, a larger proportion of the debt is attributed to households that have the capacity to repay. There are however, early signs emerging that there are pockets of households in the lower-income segments, notably those living in urban areas, that are accumulating debt above levels considered prudent, rendering them more vulnerable to income shocks. To address this, in addition to the macroprudential measures, arrangements for debt restructuring and resolution have been introduced by the Bank for addressing stressed conditions, in particular, for this target group. This is reinforced by financial education programmes for the household.

Although the Malaysian financial sector is in a position of strength with capital and liquidity buffers at their highest levels since the Asian Financial Crisis and underpinned by strengthened risk management capacity and oversight, the Bank will maintain a heightened level of intensity in its risk monitoring, supervision and regulation in the period ahead. An anticipatory approach in managing risks to financial stability aims to pre-empt potential risks to financial stability while at the same time reduce the potential costs to the financial system and the economy. Going forward, three important developments are expected to have bearing on domestic financial stability: (i) the prevailing uncertainty in global economic and financial conditions; (ii) an increased pace of financial innovation by domestic financial institutions; and (iii) the more pronounced regional and international complexion of the Malaysian financial sector.

To a large extent, the important preconditions and supporting framework for financial stability are already for the most part in place in Malaysia, both for the conventional and Islamic financial systems. These include an effective legal and regulatory framework, a strong supervisory system, and comprehensive institutional arrangements to support orderly debt resolutions in the event of an increase in the number of defaults. Also in place is an effective financial safety net which reinforces strong incentives for sound risk management through differential deposit insurance premiums. Financial reporting and disclosure standards which promote market confidence and transparency have also been further strengthened by Malaysia's full convergence with the International Financial Reporting Standards from 2012. These factors cumulatively contribute towards reducing the probability and impact of market and institutional failures.

The highly dynamic domestic, regional and international environment however does not provide any room for complacency. The Bank's efforts going forward remain focused on preserving and strengthening the foundations for financial stability. During this year, substantial work was advanced to further strengthen the core elements of the legal and prudential framework for the financial sector. In 2012, we will be bringing new legislation for the financial sector to Parliament that is more aligned with current regulatory and supervisory approaches, and that supports the supervision of more complex financial undertakings. The Bank has also announced the plans to implement Basel III in Malaysia. Efforts to strengthen regional arrangements for financial stability have also seen significant progress with active engagements through supervisory colleges, initiatives to promote greater harmonisation of regulatory standards and the development of enhanced arrangements for cross-border crisis management and resolution. The Bank also concluded two cross-border collateral arrangements with its counterparts in the region to support more efficient liquidity management by financial institutions with cross-border operations, both during normal and crisis periods. The Bank will this year undergo the Financial Stability Assessment Programme by the International Monetary Fund and the World Bank.

The internationalisation of Islamic finance has intensified during the year despite increased uncertainties in global financial markets. As an international Islamic financial centre, Malaysia has worked to ensure that the growth is firmly supported by a sound prudential framework, and developed financial infrastructure and instruments for managing risk. The Bank will also continue to contribute to the global development of Islamic finance, including strengthening the global financial architecture through its active participation in the Islamic Financial Services Board and the International Islamic Liquidity Management Corporation, for ensuring financial stability in the Islamic financial system and hence its sustainability.

The stability of Malaysia's payment systems has continued to be preserved with no disruptions in the operations of the major payment and settlement systems during the year. The payment systems were further strengthened during the year with enhancements to key payment infrastructure and contingency arrangements, as well as the adoption of new measures to increase payment security by financial institutions. Work also significantly progressed during the year to support cross-border payments and settlements and this will further accelerate the pace of regional financial integration. Moving forward, increasing payment efficiency represents a key priority of the Bank and will entail pricing reforms to encourage the migration to electronic payments along with continuing enhancements to domestic and regional payment infrastructures.

The implementation of recommendations under the Financial Sector Blueprint released by the Bank in December 2011 also aims to further contribute to financial stability in Malaysia. Priority will be accorded to promoting effective financial intermediation in a changing economy, and the development of orderly foreign exchange and money markets - two key dimensions of financial stability for which the Bank is responsible under the Central Bank of Malaysia Act 2009. An important part of these efforts is that the development of the financial sector is accompanied by the development and supply of talent for the sector, and a careful consideration of how regulatory safeguards would need to evolve to ensure that changes in banking and financial landscapes, practices and business models do not increase overall risks to financial stability.

Zeti Akhtar Aziz
Governor
21 March 2012

2011

EXECUTIVE SUMMARY

**Risk developments and assessment of financial stability in 2011**

Financial stability continued to be sustained throughout 2011, providing an environment conducive to economic growth in Malaysia despite the uncertain global growth prospects and heightened risks emanating from the advanced economies. While global financial conditions have come under renewed stress particularly in the last quarter of 2011, the Malaysian financial sector remains strong, and the impact of unfolding developments in the external environment on financial institutions in Malaysia has been modest owing to the significantly strengthened financials and capacity to manage risks. This has enabled financial intermediation to continue functioning effectively. Domestic financial market conditions have also remained orderly.

After a continued upward trend since 2009, household debt grew at a more moderate pace as the range of measures introduced earlier by the Bank began to take effect. Malaysian households in general remain financially sound, with strong financial buffers to service debt obligations and cushion against income shocks. The debt servicing capacity of households continue to be supported by favourable employment conditions and rising incomes, with loans in arrears continuing to trend downwards and the impaired loan ratio at its lowest since 2000. While lower-income borrowers residing in urban centres are facing difficulties in managing their financial obligations, with higher leverage positions and a limited capacity to save, this segment of borrowers continue to account for a relatively small share of banking system loans. The continued observance of sound underwriting practices by banks, reinforced by the pre-emptive measures undertaken by the Government and the Bank to address emerging strains among the more vulnerable segments of the household sector, further contain the build-up of excessive risks in the household sector. This is also addressed by the Bank's close supervision of the lending practices of individual banking institutions, and the availability of debt resolution mechanisms that are already in place to provide assistance to borrowers in financial difficulty.

Renewed turbulence in global financial markets driven by events in the euro area and in the US led to a surge in short-term portfolio flows during the year, although these flows were effectively and efficiently intermediated. Orderly conditions were preserved in Malaysia without disruptive effects on the domestic financial markets, with market volatility levels significantly lower than those observed at the height of the global financial crisis in 2008, and in other regional markets. Malaysian banking institutions were also less affected by the volatile conditions in offshore wholesale markets, given local institutions' stable funding structures which are supported mainly by domestic savings and deposits. Banks have also not taken on excessive risks, with risk-taking behaviour observed among banks continuing to remain within prudent levels despite the ample liquidity conditions and divergence in market prices between emerging and advanced economies.

With limited exposures to counterparties in affected euro economies, the impact of any further escalation of the sovereign debt and banking crisis in the euro area on Malaysian financial institutions is well contained. The transmission of risks through the Malaysian operations of European banks also remains controlled as these are carried out by separately-capitalised subsidiaries which are supervised by the Bank. The contagion risks from the cross-border operations of Malaysian banking groups are also low as these operations are backed by sound capital and funding positions, with manageable credit exposures.

For the year as a whole, the banking sector continued to sustain healthy capitalisation levels and profitability on account of higher interest/financing income, lower impairment charges and higher fee-based income. The aggregate risk-weighted capital ratio and core capital ratio for the banking system stood at 15.1% and 13.2% respectively, well above the current regulatory minimum as well as the more stringent standards under Basel III. The insurance and takaful sectors experienced lower profitability due to lower investment returns as a result of the volatile market conditions, and higher claims and benefits paid. The impact on the capitalisation level of the industry was, however, not material with the capital adequacy ratio declining only marginally and sustained at a strong level of 222.5%. Stress tests conducted by the Bank, which assume adverse scenarios of domestic economic contraction, further affirm the resilience of Malaysian financial institutions.

Risks to domestic financial stability in 2012 are expected to continue to be driven mainly by external developments, particularly in the euro area, with key risks remaining largely unchanged. Risk aversion and volatility in the global financial markets are likely to remain elevated given the uncertainty surrounding the recovery of the global economy and progress towards strengthening the global financial system. Domestically, developments in the level and profile of household debt will continue to be closely monitored, while measures already taken should continue to improve the resilience of the household sector.

**Development of the financial sector**

With strong fundamentals of the financial sector well entrenched, priorities in the financial sector development in 2011 were focused on reinforcing Malaysia's long-term growth potential by strengthening the capacity of the sector in intermediating funds for new growth areas and enhancing Malaysia's regional and international financial linkages, with appropriate safeguards to preserve financial stability. The strategies to achieve this have been set out under the Financial Sector Blueprint (the Blueprint) which was released by the Bank in December 2011. The Blueprint charts the future direction of the Malaysian financial system in the next 10 years and builds on the achievements of the first Financial Sector Masterplan to position the financial sector to assume an enhanced role in supporting Malaysia's transformation towards becoming a high value-added, high-income economy.

The market structure of the financial industry continued to strengthen during the year with the emergence of stronger and more competitive banking groups and insurers as a result of mergers and acquisitions. The Competition Act 2010, which came into effect on 1 January 2012, further reinforces the competitive environment in the financial sector and complements the Bank's efforts to enhance consumer protection in Malaysia. In the insurance sector, a comprehensive solution to the long-standing challenges affecting the ability of insurers to provide compulsory motor liability insurance protection on a sustainable basis was achieved with the introduction of a new motor cover framework that will address pricing distortions and inefficiencies in the claims settlement process. Gradual adjustments to the premium levels commenced in January 2012 and will be phased in over a four-year period.

Throughout the year, the financial system continued to perform its intermediation function efficiently to support the diverse needs of the economy, as evidenced by the positive loan growth in the business and household sectors. Significant strides were also made to streamline the loan application processes for small and medium enterprises (SMEs) and enhance credit assessment procedures for the green technology industry, to improve the prospect of obtaining financing in these sectors. Focus was thus placed on enhancing the supporting infrastructure and institutional arrangements to meet the needs of SMEs, increasing capacity to support new growth areas and innovative industries, and developing a robust pension framework.

Continued efforts were made to deepen and broaden the financial markets. The debt securities market continues to assume an increasingly important role in meeting the financing needs of Malaysian businesses, with stronger demand observed for more innovative Islamic financial products and services. Danajamin as a financial guarantee insurer continues to provide vital support for Malaysian corporations to access the bond market, particularly for longer-term financing. To promote the legal certainty of financial market contracts, specifically derivatives and repurchase agreements, the Bank will be proposing legislative amendments to provisions in the Central Bank of Malaysia Act 2009 this year to provide further certainty with respect to the operations of financial market contracts and to allow financial institutions to determine exposures to counterparties in Malaysia under such contracts on a fully net basis.

Financial inclusion remains a key priority of the Bank. Financing to micro-entrepreneurs continued to increase both by value and number of accounts. All 144 districts in Malaysia now have access to essential financial services provided through physical branches, mobile banking units of banks and development financial institutions (DFIs), or under shared banking services arrangements with Pos Malaysia Berhad. A comprehensive agent banking framework will be developed to further widen access to financial services at the sub-district level. While Malaysia already has one of the highest levels of financial inclusion, efforts have also been focused on promoting the more effective use of financial services. This can be achieved through the better understanding of the financial requirements and behaviour of different target groups, including the underserved, with the provision of more targeted education programmes, and by addressing the specific challenges faced by low- to middle-income households in urban centres. The launch of the Bank's MobileLINK unit during the year will also enable the Bank to further expand its information and consumer support services to consumers in semi-urban and non-urban areas.

Malaysia's financial integration within the region and with other parts of the world gained considerable momentum, with the progressive liberalisation of the domestic financial system and the continued growth in the overseas operations of Malaysian financial institutions. Efforts to strengthen Malaysia's interlinkages are pursued in a mutually advantageous manner with the broader aim of enhancing the growth potential of the region and promoting regional financial stability. Arising from the 2009 liberalisation measures, three new locally-incorporated foreign banks, one new International Islamic Bank and two new joint-venture family takaful operators commenced operations in 2011.

Efforts to promote deeper financial integration within the Asian region resulted in several advancements which include: (i) the establishment of the ASEAN Infrastructure Fund where nine ASEAN countries, including Malaysia, have pooled resources for infrastructure development in the ASEAN region; (ii) the endorsement of a high-level framework by the central banks of ASEAN countries to reinforce cross-border coordination and cooperation in the financial sector; and (iii) the establishment of reciprocal bilateral arrangements among central banks in the region to promote more efficient cross-border liquidity management and the provision of liquidity support in periods of stress.

Malaysia continued to evolve as an international Islamic financial centre, with robust growth recorded in Islamic banking assets, takaful contributions and the volume of foreign currency business. Malaysia retained its leading position in the global sukuk market, with an increasing amount of outstanding USD-denominated sukuk. The year also saw some landmark innovations in Islamic financial market instruments, including the issuance of the well-received Wakala Global Sukuk, the first 10-year sovereign USD sukuk in the world, and the world's first renminbi sukuk issued out of Malaysia. These achievements were accompanied by infrastructural developments that will further enhance the transparency, liquidity and pricing efficiency of Islamic financial products. The planned issuance of the first short-term sukuk by the International Islamic Liquidity Management Corporation (IILM) by mid-2012 will also contribute towards the more efficient intermediation of cross-border flows and supporting global liquidity needs. The development of talent in Islamic finance was also further advanced with the increased numbers of qualified Chartered Islamic Finance Professionals and the introduction of a comprehensive training roadmap by the Islamic Banking and Finance Institute Malaysia (IBFIM).

Malaysian financial consumers have also become more engaged in financial matters, supported by sustained awareness and education programmes, and improved disclosures on financial products and services. More consumers are using various channels provided by the Bank and the industry to seek financial information, advice and redress. A study by the Organisation of Economic Co-operation and Development (OECD) showed that financial literacy levels in Malaysia are comparable to those in developed economies. During the year, substantial progress was made in efforts to build a strong foundation for financial capability at an early age. This was done in close collaboration with the Ministry of Education to embed financial education within the revised school curriculum which will be introduced from 2014.

Significant efforts also continued to be directed towards supporting the development of high quality talent for the financial sector, across all levels of an institution, from entry to leadership positions. Institutions established by the Bank to spearhead these efforts, including the Financial Sector Talent Enrichment Programme (FSTEP), the Asian Institute of Finance (AIF) and the Iclif Leadership and Governance Centre, continued actively during the year to enhance and expand their programme offerings to meet the new requirements of the rapidly-changing financial sector. These institutions have also significantly strengthened their internal capabilities, including in research and through the addition of new faculty, in order to better deliver their training mandates.

**Regulatory and supervisory framework**
In 2011, the Bank continued to reinforce and advance further the core tenets of regulation and supervision, building on earlier work undertaken to strengthen the legislative framework and improve risk management, governance and business conduct practices.

The implementation of global regulatory reforms was a key priority of the regulatory and supervisory framework during the year. In December 2011, the Bank released details of the implementation of Basel III in Malaysia which is aimed at further strengthening capital and liquidity standards for banking institutions. The reform package will be implemented in phases, beginning 2013 until 2019, in line with the globally-agreed levels and implementation timelines. This will allow banking institutions to gradually adjust to the new requirements, thus mitigating any adverse impact on credit intermediation. For the insurance industry, changes were made to the Bank's Risk-Based Capital Framework (the RBC framework) to converge the valuation rules underpinning the determination of regulatory capital with the Financial Reporting Standards. The Bank will continue to review the RBC framework to further improve the alignment of capital with risk and support a more consistent approach to capital standards for financial groups in line with international standards. A new risk-based capital framework for takaful operators was introduced for consultation and is now being finalised, taking into account feedback received from the industry. The proposed new capital framework will take into account the objectives of prudential and Shariah principles.

A focus on promoting sound risk management practices remained central to the Bank's regulatory and supervisory priorities with enhancements of prudential standards in a number of aspects on risk management. This included proposals issued to strengthen standards on risk governance which address requirements for financial institutions to observe sound practices in defining the risk appetite for the institution, and implementing effective controls (including appropriate incentive systems) over risk-taking activities. The control of counterparty risks was also strengthened with proposed enhancements to existing regulatory limits on exposures to single counterparties. With competition in the retail lending space remaining intense and signs of continued pressure on loan pricing, new guidelines on sound pricing practices for retail loans/financing were also issued as a pre-emptive measure to ensure that banks' pricing practices are appropriately supervised by their board and management, and broadly aligned with their risk and capital management strategies. During the year, corporate governance standards for DFIs were strengthened to promote more robust assessments of the fitness and propriety of appointments to the board and management, consistent with standards already adopted for other financial institutions.

The Bank continued to strengthen the consumer protection framework and market conduct practices of financial institutions by promoting more responsible financing practices, enhancing the transparency and disclosure of financial products and elevating the quality and efficiency of financial services. The Guidelines on Responsible Financing was issued to promote more consistent practices across the industry in the assessments of customers' creditworthiness and their ability to service debt obligations. In the Islamic banking sector, the Guidelines on Late Payment Charges was issued to promote more prudent financial discipline among borrowers, with clearly-established parameters for the imposition of penalties (*gharamah*) and compensation charges (*ta'widh*) on delinquent customers. The Bank also devoted significant attention to addressing mis-selling practices by financial institutions. Financial institutions that were found to have been involved in such practices were compounded, ordered to provide restitution to affected customers and required to strengthen internal oversight arrangements over the product origination, approval, sales and complaints handling process.

To reduce the scope for the regulated financial sector to be used for illegal purposes and to maintain the integrity of, and public confidence in the financial system, efforts were intensified to ensure an effective legal framework and adequate systems and processes within financial institutions to promptly detect and prevent illegal activities. The enactment of the Money Services Business Act 2011 which came into force on 1 December 2011 provides for the strengthened regulatory and supervisory oversight of money changing and remittance services business. The Bank also actively supported closer international cooperation with relevant authorities to facilitate information sharing and cross-border financial crime investigations. With the growing expansion of domestic financial institutions across borders and increased presence of foreign financial institutions operating in Malaysia, more structured approaches to supervisory cooperation with other supervisory authorities have been put in place. This includes supervisory colleges for regionally-active Malaysian financial groups and foreign institutions operating in Malaysia, which provide a platform for sharing supervisory assessments and the coordination of supervisory activities. On the domestic front, the Bank also continued to coordinate its supervisory and surveillance activities with the Securities Commission and the Malaysia Deposit Insurance Corporation (Perbadanan Insurans Deposit Malaysia, PIDM) and has started a process to further enhance the existing cooperation arrangements with these agencies.

**Payment and settlement systems**
The payment and settlement systems in Malaysia remained resilient and supportive of the growth of the financial system and the economy. The Bank's oversight activities were directed at ensuring the continued reliability of the major interbank clearing and settlement systems, and improving the security of widely-used payment instruments, thus maintaining public confidence in these systems. The Real-time Electronic Transfer of Funds and Securities System (RENTAS) achieved 100% systems availability, with improvements noted in market efficiency and liquidity management by RENTAS participants. The Bank also continued to collaborate with the industry and enforcement agencies to avert potential incidents of fraud, promote enhanced business practices to better protect consumers against new methods of perpetrating fraud, and educate the public on fraud prevention. Losses due to fraud in retail payments remained negligible in 2011.

The Bank continued to take steps to promote compliance by RENTAS with the relevant principles and recommendations issued by the Bank for International Settlements and the International Organisation of Securities, while also elevating its capability to support cross-border payments and settlements with the provision of an onshore multi-currency funds and securities settlement facility and custodian services for foreign securities denominated in any currency.

In promoting the migration to electronic payments (e-payments), the Bank's efforts were focused on improving the accessibility, speed, certainty and convenience of payment services. A key milestone was the completion of a multi-bank and mobile network neutral infrastructure that would enable access to mobile banking and payment services from any location at any time, under the brand label 'MyMobile'. The Bank's wholly-owned subsidiary, Malaysian Electronic Clearing Corporation Sdn. Bhd. (MyClear), also acquired the major retail payment systems from MEPS in September 2011 to rationalise overlapping e-payment infrastructures and introduce a pricing structure that would further encourage the adoption of e-payments. There was also encouraging progress in the adoption of e-payments by priority sectors such as the Government and financial institutions, with firm commitments to and achievements noted in the migration of internal payments to electronic channels. In the capital market, plans have been formulated to further extend the adoption of e-payments to include initial public offering refunds, subscriptions and redemptions of unit trusts, and subscriptions of rights issues beginning in 2012. Moving forward, the Bank will continue to focus on promoting e-payments as the preferred medium for economic transactions in Malaysia, through the initiatives outlined in the Blueprint.

# RISK DEVELOPMENTS AND ASSESSMENT OF FINANCIAL STABILITY IN 2011

# RISK DEVELOPMENTS AND ASSESSMENT OF FINANCIAL STABILITY IN 2011

## OVERVIEW

Domestic financial stability was preserved throughout 2011, providing an environment conducive to economic growth in Malaysia even as risks associated with the sovereign debt crisis in Europe and weaker growth in advanced economies increased sharply in the second half of the year. Underpinned by strong fundamentals, the Malaysian financial system continued to demonstrate a high degree of resilience to unfolding developments in the external environment. Financial soundness indicators were sustained at strong levels, including under the assumptions of stressed scenarios, affirming the capacity of Malaysia's financial sector, both at the system and institution levels, to withstand shocks. The continued vigilance over areas of potential risk on the domestic front maintained throughout the year has allowed for the early implementation of wide-ranging measures, including supervisory measures, to be taken by the Bank to address emerging risks. These measures ensured that financial intermediation continued to function efficiently, as reflected by the steady broad-based expansion in financing activities. Domestic financial market conditions have also remained orderly despite the higher degree of volatility, and confidence in the financial system remained firmly intact.

Household debts grew at a more moderate pace as the range of measures introduced earlier by the Bank began to take effect. Overall, the financial position of Malaysian households remained sound. Strong aggregate financial buffers continued to support the ability of households to service debt obligations and provided a cushion against potential shocks. This is further reinforced by steady income growth, favourable employment conditions and a high level of savings. Borrowers in the lower-income categories and residing in urban centres, however, face more challenges in managing their financial obligations. While these groups of borrowers account for a relatively small share of the banking system's total credit exposures, the series of measures undertaken by the Bank, together with the debt resolution mechanisms already in place, will contribute towards alleviating the financial stress faced by these borrowers, thus containing the build-up of risks in the household sector.

External contagion from events in the euro area and in the US saw higher volumes and speed in movements in portfolio flows during the year. These flows were effectively intermediated with domestic financial markets remaining orderly despite the higher observed volatility. Funding conditions for Malaysian financial institutions have remained broadly favourable with limited impact observed from the tightening in global wholesale funding markets given the stable funding structures. Malaysian banks also had limited direct and indirect credit exposures to counterparties in the affected Euro economies, while for insurers, these exposures were with counterparties that had maintained strong financial positions.

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The Malaysian financial system demonstrated continuing high degree of resilience to unfolding external developments. The continued vigilance over areas of potential risk on the domestic front has allowed for the early implementation of wide-ranging measures, including supervisory measures, to be taken by the Bank to address emerging risks

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The financial sector continued to sustain healthy capitalisation levels and profitability, although the insurance and takaful industry was more challenged by the volatile market conditions. Financial institutions have thus been able to demonstrate considerable agility in responding to the more challenging financial and operating conditions, particularly in managing the market risk exposures. Malaysian banks are also well placed to meet the more stringent capital requirements under Basel III.

Risks to domestic financial stability in 2012 are expected to continue to be mainly externally driven, with developments in the euro area

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