BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Letter of Transmittal

Yang Amat Berhormat Dato' Seri Abdullah bin Hj. Ahmad Badawi,
Prime Minister/Minister of Finance,
Malaysia.

YAB Dato' Seri,

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 2006 which are incorporated into this Financial Stability and Payment Systems Report 2006.

Respectfully submitted,

Zeti Akhtar Aziz
Governor

21 March 2007

PT Artajasa Pembayaran Elektronis in Indonesia in July 2005, Network for Electronic Transfers (Singapore) Pte. Ltd. in Singapore in March 2006 and National ITMX Co. Ltd. in Thailand in October 2006, to facilitate cross-border cash withdrawals. The facility allows Malaysian ATM cardholders travelling to these countries to withdraw cash at the participating banks' ATMs and likewise, their ATM cardholders at the participating Malaysian banks' ATMs at lower transaction fees compared to the current facility using international networks. To access this facility, Malaysian ATM cardholders will need to activate the facility at bank counters, via the ATM or call centre. The regional ATM services had recorded 6,989 withdrawals valued at RM3.1 million at the Malaysian ATMs since its launch. Over the course of 2007, efforts would continue to be taken by MEPS to recruit the remaining member banks to participate in the links as well as form new links with other shared ATM network providers in the region. Bank Negara Malaysia and the Central Banks of these three countries have supported the ATM cross-border link initiative and have encouraged a common broad framework and standards to be formulated to promote transparency and facilitate future links. The cross-border service would be expanded to balance inquiry and funds transfer later this year, and MEPS is considering other new collaboration such as regional e-Debit or Electronic Fund Transfer at Point-of-Sale (EFTPOS), which would facilitate the acceptance of e-Debit in the member countries.

Four locally-incorporated foreign banks had teamed up and established a new shared ATM network known as HOUSe, an acronym representing the first letter of each founding bank's name, with the last letter 'e' representing electronic channel. The network, which is open to all locally-incorporated foreign banks, was launched in July 2006. Its establishment is in line with the recommendation in the Financial Sector Masterplan to allow incumbent foreign banks to set up an alternative shared ATM network to provide greater customer convenience and competition in the payment system. ATM cardholders of the four banks can make cash withdrawals and balance inquiries at the banks' combined 300 ATMs nationwide. Interbank funds transfer capability would be added to its offerings in the future.

Cheque Truncation and Conversion System

In enhancing efficiency in cheque processing, the Bank is in the process of implementing a cheque truncation and conversion system (CTCS) to transform the current cheque clearing system into an electronic transfer of cheque information. This is in tandem with the Bank's objective to promote greater usage of e-payments. The objectives of CTCS are to implement a paperless cheque clearing process, achieve a common day-hold throughout the nation, increase the efficiency of the clearing and settlement process and facilitate an electronic fund transfer mechanism for cheques.

The CTCS will enable the clearing of cheques either through processing of their images and data (truncation) or data only (conversion). The introduction of the system is targeted at reducing transportation and labour costs and efforts associated with the physical handling of cheques. The clearing cycle will be shortened and funds will be made available earlier whilst expediting payments. It is envisaged that the system will also improve customer service levels and mitigate cheque fraud risks. The CTCS will leverage on the current imaging infrastructure that is already in place and will provide opportunities for banking institutions to streamline their back office operations to reap cost savings from further automating their cheque processing and clearing operations.

The CTCS project is scheduled to be implemented by the first half of 2008, initially in Kuala Lumpur and the neighbouring towns and extended thereafter in phases to the rest of the country in late 2008.

Roadmap for Migration to Electronic Payments

While Malaysia has made considerable progress in building and improving the payment system infrastructure, further work is needed to facilitate more widespread adoption of electronic payments and thus, accelerate the transition from paper-based systems to electronic payments. With the necessary payment infrastructure in place, supported by the effectiveness of the financial sector as an efficient mobiliser of savings as reflected in Malaysia's high deposit-to-gross domestic product (GDP) of 192.4% as at the end of 2006, the next stage is for Malaysia to migrate at a faster pace to electronic payments. New and bold steps are required in accelerating the migration to quicken the pace for the country to realise the potential of productivity enhancements and cost savings from electronic payments. The progression of payment system to the digital ecosystem on a nationwide basis requires commitment from all stakeholders to make the migration to electronic payments as a national agenda, a reality.

New and bold steps to accelerate the migration to quicken the pace for the country to realise productivity enhancements and cost savings.

To drive this agenda forward, the Bank has initiated the formulation of an electronic payments roadmap that provides a high level strategic direction for the country to migrate to electronic payments. The roadmap aims to channel and coordinate industry efforts into making migration to electronic payments as a national agenda, and would identify the objectives, underlying building blocks and lay the key implementation milestones up to 2010. The main focus and priority of the Bank is to create a conducive environment to foster the orderly transition to electronic payments.

The Bank has shared the roadmap with the National Payments Advisory Council (NPAC) members. The NPAC, which was established in May 2001, acts as a reference and advisory body whilst providing market input on matters relating to the payment systems in the country. The NPAC is chaired by the Governor and is represented by associations of financial institutions, related Government agencies, the Securities Commission, MEPS and two foreign central banks. Following the deliberation with NPAC members, the Bank would subsequently through a consultative process with the industry and other stakeholders, finalise the roadmap.

Working in Partnership with the Government Sector

Following the encouraging feedback from the Payment Systems Forum and Exhibition in November 2005, the Bank organised a Government sector workshop in July 2006 to provide a platform for more detailed discussions on the features of the various electronic payment services offered by the payments industry and to facilitate sharing of experiences on the efficiency gained by corporate users in adopting electronic payments. The workshop was participated by 80 officers from 20 different Government departments.

The Government is a critical stakeholder in the national agenda to migrate to electronic payments as it can be the catalyst for the uptake of electronic payments. In this regard, the Government has demonstrated a strong commitment to adopt electronic payments because of the potential efficiency gains it offers. This is also in line with plans to enhance the effectiveness of the public delivery system. In this respect, the Government, together with the Bank and the industry, will work together to accelerate the migration to electronic payments. One of the ongoing initiatives is the adoption of the Financial Process Exchange (FPX) as the payment gateway for the Malaysian Government portal, myGovernment.

Understanding the Cost of Payments

The Bank has initiated a payment cost study with several banks to better understand the cost of producing different payment methods and the pricing mechanism adopted. The study is based on both fixed and variable cost and price data for 2005. The study is to facilitate the proposal to move towards a direct-pricing framework that relates to the cost of producing the different payment methods as well as transparency in pricing. Learning from the experiences of Norway and Sweden, transparent and cost-based pricing is a powerful tool to foster the migration of users to electronic payments, which are less costly to produce and provide the opportunity to reap economies of scale. As users' choice is sensitive to price, by giving the right price signals to users, they would be able to see the economic incentives and switch from the more expensive payment methods to cheaper alternatives. This would in turn encourage investment in and the offering of more cost efficient payment services, thereby resulting in cost savings and efficiency gains for the nation as a whole.

Trends in Migration to Electronic Payment

The cash in circulation (CIC)-to-GDP ratio, which is the commonly used proxy to assess the role of cash in the economy, has been on a declining trend from 6.6% in 2002 to 6.1% in 2006. However, CIC per capita has increased from RM974.3 in 2002 to RM1,246.5 in 2006 and the average value of ATM withdrawals has increased from RM401 in 2002 to RM460 in 2006. While the decline in CIC-to-GDP ratio indicates a declining role of cash in the economy, cash remains a highly popular form of payment in Malaysia.

Over the recent five years, total non-cash retail payment transactions have increased significantly from 350.3 million to 868.9 million. The payment mode shifted from cheques to more electronic payments over the same period. In 2001, cheques dominated total non-cash retail payments at 56%. Today, cheques account for only 23.2% of total non-cash retail payments. This suggests that while cheques continue to be important, they have been replaced to a certain extent by more efficient electronic alternatives. Since 2002, the number of cheques issued per current account has steadily fallen from 72 to 66. The fall in cheque usage and the growth in the share of electronic payment may be attributed to the adoption of electronic payments in the Government sector, where the volume of cheques issued has fallen by 56.4% since 2004 and the use of electronic payments increased by 43.6% in the same period. However, in terms of transaction value, cheques still account for a significant portion of non-cash retail transactions and there was only a slight drop in its share of the wallet, from 98.1% in 2001 to 93.7% in 2006.

Table 4.1
Cash Holdings and Non-Cash Transactions

	2002	2003	2004	2005	2006
CIC per capita (RM)	974.3	1,030.9	1,106.6	1,144.0	1,246.5
CIC-to-GDP (%)	6.6	6.6	6.4	6.1	6.1
Number of non-cash transactions per capita	17	22	26	30	33

The volume of electronic payments has increased by 34.1% annually. Among the various types of electronic payments, payment cards experienced the biggest growth in terms

Chart 4.1a
Share of Non-Cash Retail Payments by Volume

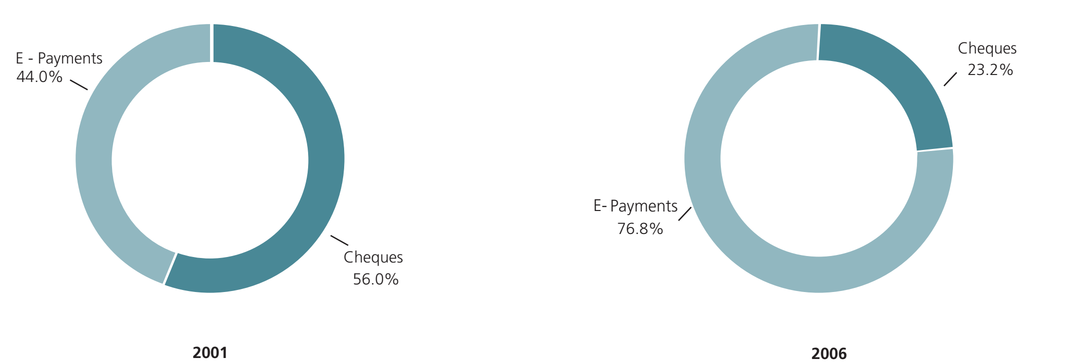

Chart 4.1b
Share of Non-Cash Retail Payments by Value

of numbers, with electronic money leading the way, followed by credit card. On average, every person made around 24 transactions per year using payment cards in 2006 as compared to 6 in 2001. Electronic money is gaining popularity with consumers as it represents half of the volume of non-cash transactions today. However, its use continues to remain mainly in the mass transit sector. The volume and value of credit card transactions have increased by 13.2% and 16.4% respectively in 2006. While its share of total non-cash transactions has declined from 40.7% in 2001 to 24.0% in 2006 in terms of volume, credit cards have experienced growth in the average transaction value from RM141 in 2001 to RM228 in 2006. Meanwhile, the use of charge cards continues to decline, representing only 0.7% of non-cash transactions in 2006. Debit cards are starting to gain some progress in the payments arena where their usage has grown at a rate of 28.6% and 33.3% in terms of volume and value respectively in 2006.

Recent years have seen an encouraging growth in the number and value for newer electronic payment channels such as the IBG, Internet banking and mobile banking.

- IBG recorded an average annual growth of 172.3% and 111.5% in terms of volume and value respectively over the last five years. Its share of the total number of non-cash retail payments has increased from 0.04% in 2001 to 2.2%, amounting to RM45.8 billion in 2006. This growth is partly attributed to the Government sector using IBG in place of cheques to effect payments.
- Internet banking has been recording an average annual increase of 74.2% and 93.7% in terms of volume and value respectively since 2001. It is popularly used for salary and bill payments, third party and

Chart 4.2a
Trend of Non-Cash Retail Payments by Volume

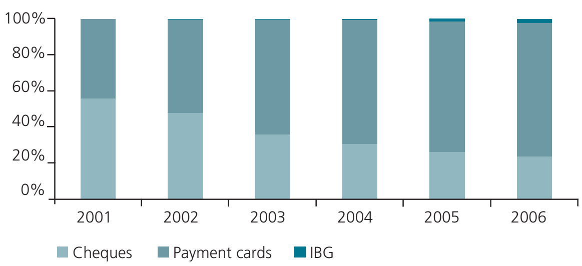

Chart 4.2b
Trend of Non-Cash Retail Payments by Value

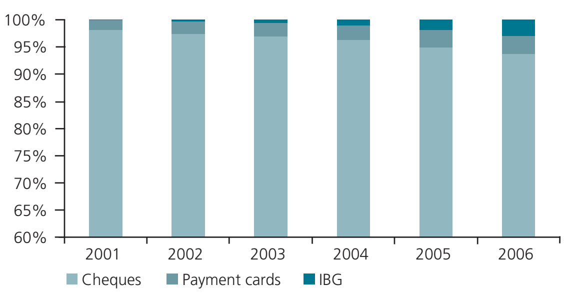

Chart 4.3
Internet Banking Growth and Penetration

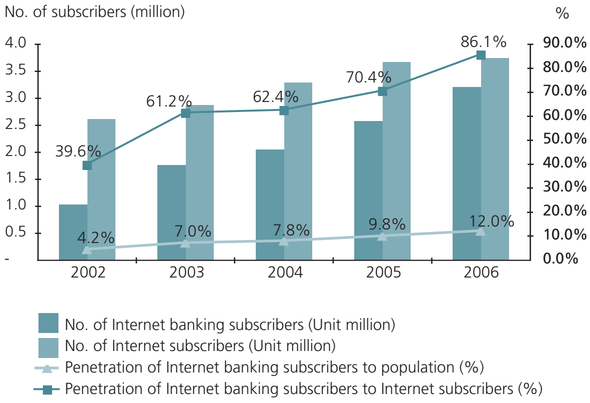

Table 4.2
Electronic Payment Growth (2001-2006)

Payment method	Transaction volume (%)	Transaction value (%)
Debit card	30.2	52.7
Credit card	7.9	18.8
Charge card	-11.4	4.3
E-purse	54.9	49.2
IBG	172.3	111.5
FPX[1]	2,542.6	76.7
Internet banking	74.2	93.7

[1] Refers to growth in 2006 as compared to 2005 in view that the FPX was introduced in October 2004

own account funds transfer and payment of credit card balances.

- Mobile banking subscriber base has increased by 93.3% from the previous year, accounting for 1.3% of mobile phone subscribers as at end-2006. This service is mainly utilised for account enquiries, prepaid reload and bill payments.

The FPX which was introduced in October 2004 has yet to gain wide acceptance. However, it is expected to increase in usage with the participation of five banks in 2007.

Thus far, the switch to electronic payments has been gradual but is expected to gain momentum in the future. This will be driven by advances in technology, greater focus by the payment industry, the increased collaboration of all stakeholders in overcoming the barriers towards the adoption of electronic payments and the increased preferences for more cost-effective payment services.

EXTERNAL RELATIONS

The Bank continued to participate actively in regional fora, particularly in the EMEAP (Executives' Meeting of East Asia-Pacific Central Banks) Working Group on Payment and Settlement System to enhance the safety and efficiency of the national payment and settlement systems in the region. With increased regional trade and economic co-operation, central banks in the region have enhanced regional collaboration in promoting the development of safe and efficient cross-border payment systems. Systemically important payment and settlement systems with a cross-border reach can be major conduits by which shocks can be transmitted across international financial systems and markets. Hence, a safe and efficient payment and settlement system infrastructure is a key requirement in maintaining and promoting financial stability and the development of financial markets across the region.

Strengthening Regional Collaboration

In 2006, the EMEAP Payment and Settlement Systems Working Group shared experiences on issues of common interest and explored opportunities for mutual guidance and assistance. The two meetings held in Kuala Lumpur and Sydney facilitated an ample discussion of the results of self-assessments against the CPSS-IOSCO "Recommendations for Securities Settlement Systems" shared by members and the oversight activities carried out by members in relation to retail payment systems. In addition, the meetings also provided a platform for the Working Group to discuss and have a better understanding of the risk management arrangements and oversight framework on global infrastructure systems, such as SWIFT (Society for Worldwide Interbank Financial Telecommunication) and the CLS Bank, that play a critical role in the international payment system infrastructure. Given the high dependency of the financial institutions in the region on these international infrastructure, and owing to the systemic importance of these systems to the stability of the payment systems in the region, oversight of these international infrastructure is crucial. Collaborating as a group would lend the EMEAP countries a greater voice in the oversight of these international infrastructure. In this regard, since 2005, the Working Group and the National Bank of Belgium (NBB) had been working towards putting in place an arrangement which would allow NBB to share information on its oversight of SWIFT with the Working Group. NBB is the lead overseer of SWIFT.

Recognising the considerable benefits that accrue from this regional collaborative initiative, the member central banks were in agreement that greater regional co-operation constitutes an important step towards achieving greater economic prosperity in Asia. The central banks agreed that the activities of the Working Group be expanded and focused on strengthening regional co-operation in the area of payment and settlement systems. In this regard, a roadmap would be drawn up to effectively support the pursuit of this objective and reap the gains from closer economic and trade ties in the region.

MOVING FORWARD

A major focus of the Bank in the next few years would be to accelerate the migration to electronic payments and act as a catalyst in enabling electronic payments to deliver its full potential benefits. In this respect, the Bank will play a more active and leading role in making further progress towards the migration to electronic payments in line with the electronic payments roadmap. To successfully move forward, concerted efforts would be made to work collaboratively with other stakeholders to remove unnecessary roadblocks that would affect its success and to improve efficiencies across the payment industry. The Bank's work on improving price transparency under its payment cost study would facilitate this process. To a certain extent, the success of electronic payments as a more cost effective alternative is dependent on how attractive the payment services are being priced to both merchants and consumers. Equally important to spur the migration to electronic payments is to generate greater awareness of the benefits and potential of electronic payments and build public confidence in electronic payment systems. Part of the Bank's mission is to develop an integrated awareness and educational programme with the industry to encourage the use of electronic payments.

Regulatory framework will promote the development of efficient and innovative payment services while maintaining the overall stability and integrity of the payment system.

In ensuring the success of the agenda, it is crucial for the Bank to continue to review the regulatory framework in order to promote the development of efficient and innovative payment services while maintaining the overall stability and integrity of the payment system. It is also recognised that with rapid technology advancement, the emergence of new payment instruments and channels may create new risks. The Bank will therefore continuously strengthen the way in which oversight is conducted and will engage with the industry to monitor new developments and issues.

Table A.43
Number of System's Participant and Instrument Issuer

Items	2002	2003	2004	2005	2006
	Unit				
RENTAS	55	54	52	55	53
Banks	54	53	48	50	48
Non-banks	1	1	4	5	5
Credit card	19	19	18	19	18
Banks	18	18	17	17	16
Non-banks	1	1	1	2	2
Debit Card					
Banks	8	9	13	13	13
Charge card	5	5	5	5	6
Banks	1	1	1	1	3
Non-banks	4	4	4	4	3
Prepaid card					
Banks	-	-	-	1	2
E-money					
Non-banks	3	4	5	7	11
Internet banking					
Banks	12	13	14	14	16
Mobile banking					
Banks	1	3	4	5	6
FPX					
Banks	-	-	4	5	11
Merchants	-	-	5	15	66
Interbank GIRO					
Banks	13	14	13	17	16