MANAGING RISKS TO FINANCIAL STABILITY

Domestic financial stability is sustained

Financial stability remained intact throughout the second quarter of 2012 underpinned by strong capitalisation of financial institutions and orderly financial market conditions. Financial markets continued to demonstrate strong capacity to withstand external shocks and volatility arising from the escalation of sovereign risk in the Euro area. Confidence in the financial system was also preserved during the quarter.

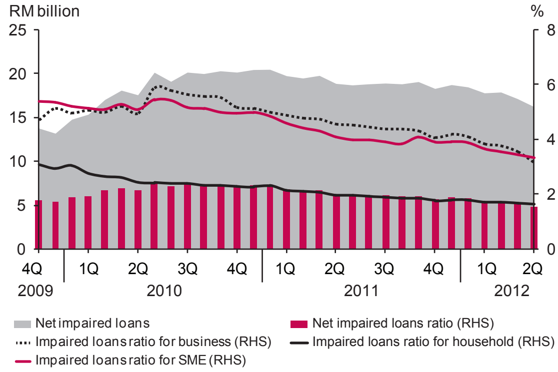
Sound economic fundamentals supported the stable credit risk outlook of the banking system. Impaired loans and loans that are in arrears between one to less than three months improved slightly in terms of value and ratio. As at end-June 2012, impaired loans and loans-in-arrears ratios were at 1.5% of net loans (1Q 12: 1.8%) and 3.4% of gross loans (1Q 12: 3.5%) respectively. Insurers' credit exposures accounted for only 3.3% of insurers' total capital (1Q 12: 3.4% of total capital).

Household debt-to-GDP stabilised at 75.6% as at end-June 2012. Accumulation of debts by the household sector continued to be supported by a commensurate expansion in financial assets. On a quarterly basis, household debt grew by 2.9% (1Q 12: +2.2%) while household assets grew by 2.5% (1Q 12: +4.7%). Although outstanding credit card balances increased by 1.3%, the amount of overdue balances recorded a decline of 8.7%. Additionally, financing for the purchase of residential properties grew at a slower pace of 2.8% (1Q 12: 3.4%). Impaired loans ratio for the household sector improved to 1.6% (1Q 12: 1.7%) demonstrating households' continued ability to meet debt obligations.

The growth in credit to businesses accelerated to 6.7% for the quarter (1Q 12: 0.9%) driven primarily by lending for real estate and other business activities. Impaired loans ratio for the business sector continued to decline to 3.2% of business loans (1Q 12: 3.8%) amid a favourable operating environment. Credit risk for this portfolio remained manageable, with default risk, as measured by the expected default frequency, rising only slightly to 0.6% (1Q 12: 0.5%).

Despite renewed pressures in the European economies, domestic equity market volatility improved during the quarter to 7.9% (1Q 12: 12.3%), underpinned by sustained positive domestic market sentiment. Trading liquidity in the debt and equity market remained intact with relatively stable turnover ratios and bid-ask spread observed. Banking system exposures to interest rate risk and equity risk remained stable at 4.7% and 0.8% of capital base respectively. Interest rate and equity risks were well-contained in the insurance sector, accounting for 3.3% and 6.7% of total capital available respectively.

Banking System: Loan quality

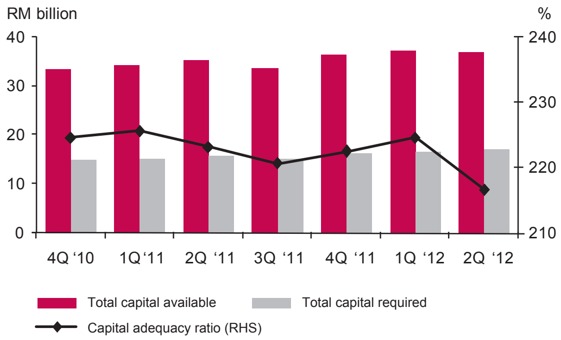


Source: Bank Negara Malaysia

The financial sector remained resilient

Strong capitalisation continued to support the resilience of the domestic financial sector to withstand potential shocks. Capitalisation of the banking sector remained stable with the core capital ratio and risk-weighted capital ratio at 12.9% (1Q 12: 13.2%) and 14.7% (1Q 12: 14.8%) respectively. Total capital in excess of the minimum regulatory level of 8% remained strong, at above RM70 billion. The quality of banks' capital remained high, with about 88% in Tier 1 capital, comprising mainly paid-up capital and reserves. Similarly, the insurance sector recorded a strong capital adequacy ratio of 216.7% (1Q 12: 224.6%) and a high capital buffer above RM20 billion.

Insurance Sector: Capitalisation

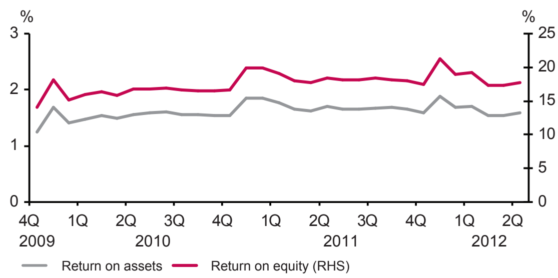


Source: Bank Negara Malaysia

Banking system profitability was sustained with returns on assets and equity of 1.6% (1Q 12: 1.7%) and 17.7% (1Q 12: 19.1%) respectively. Pre-tax profit for the quarter amounted to RM6.8 billion (1Q 12: RM7.6 billion) attributable to revenue from continued growth in financing activities. Nevertheless, net trading and investment income declined by 37% amid more volatile market conditions.

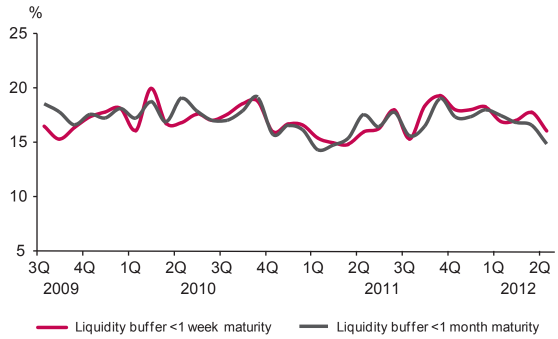
The life insurance and family takaful businesses recorded lower excess of income over outgo totalling RM3.7 billion (1Q 12: RM3.9 billion) due to a lower net investment gain of RM0.2 billion (1Q 12: RM0.7 billion). Nevertheless, business premiums continued to grow by 12.5% during the quarter. Profitability of the general insurance and takaful sector remained stable with underwriting and operating profits of RM402.5 million and RM684.3 million respectively. This was driven mainly by the higher premium income from motor business and slight moderation in

Banking System: Profitability



Source: Bank Negara Malaysia

Banking System: Liquidity Buffer to Total Deposit Ratio



Source: Bank Negara Malaysia

claims. The claims ratio for the Motor 'Act' cover (mandatory insurance cover required under the Road Transport Act 1987) remains an area of concern, as it continued to rise to 240.7% (1Q 12: 206.7%).

Liquidity in the banking system remained ample to meet the demands for deposit withdrawals and other liquidity obligations. The liquidity buffer accounted for 14.9% of total deposits for liquidity needs maturing within 1 month. Banks' foreign currency liquidity mismatch remained manageable with the slight easing of on-shore USD liquidity. The negative mismatch position in the less than one month maturity bucket improved to RM7.9 billion.

Insurance and Takaful Sectors: Indicators

	2011		2012			2011		2012		
	2Q	1H	1Q	2Q	1H	2Q	1H	1Q	2Q	1H
	RM million					Annual Change (%)				
Life Insurance & Family Takaful										
Excess of Income Over Outgo	3,780.0	7,012.1	3,912.9	3,661.9	7,574.8	27.1	19.2	21.1	-3.1	8.0
General Insurance & General Takaful										
Operating profit	557.2	1,111.1	652.6	684.3	1,336.9	-3.1	1.0	17.8	28.1	23.0
Claims ratio (%)	61.4	61.4	60.6	59.0	59.0	-1.1	-1.1	-1.5	-4.0	-4.0

Source: Bank Negara Malaysia