

# Financial Institution Soundness and Resilience

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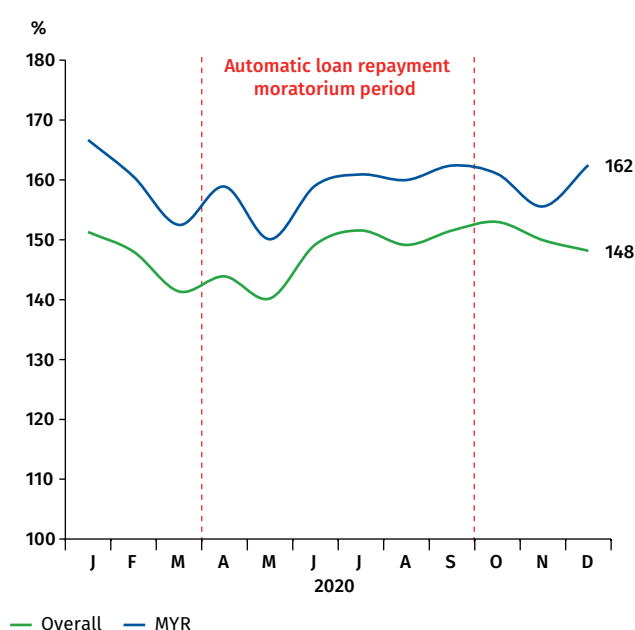
# Financial Institution Soundness and Resilience

## THE BANKING SECTOR

### Banking system liquidity conditions remained supportive of financial intermediation activities amid sustained growth in deposits and improvement in loan repayments

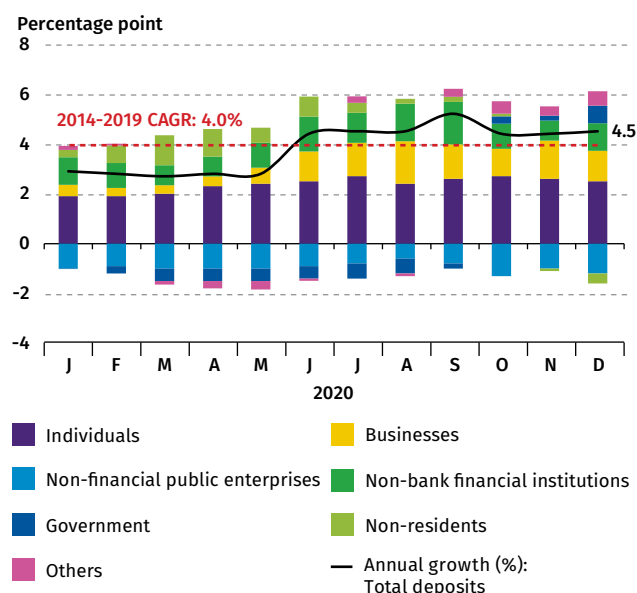
Banks continued to record healthy liquidity positions throughout the second half of 2020, with the aggregate banking system Liquidity Coverage Ratio (LCR) at 148.2% (Chart 2.1). This was supported by the resumption in loan repayments by most household and SME borrowers since October following the end of the automatic moratorium on these loans, with overall repayments

Chart 2.1: Banking System – Liquidity Coverage Ratio



almost returning to levels prior to the automatic moratorium. Banking institutions' placements with the Bank also increased significantly (+RM14.7 billion) as some banks shored up cash buffers in anticipation of potential withdrawals by the Government and/or non-bank financial institutions (NBFIs) to support various relief measures. Banks' operations continued to be supported by stable funding sources, with the aggregate Net Stable Funding Ratio (NSFR)<sup>1</sup> at 116%. Growth in banking system deposits remained firm, above the 5-year compounded annual growth rate (CAGR) of 4%, as households and businesses continued to hold precautionary cash buffers amid the challenging operating environment (Chart 2.2). Deposits from NBFIs also grew further, especially during the third quarter, as some of these institutions rebalanced

Chart 2.2: Banking System – Contribution to Growth in Deposits Accepted

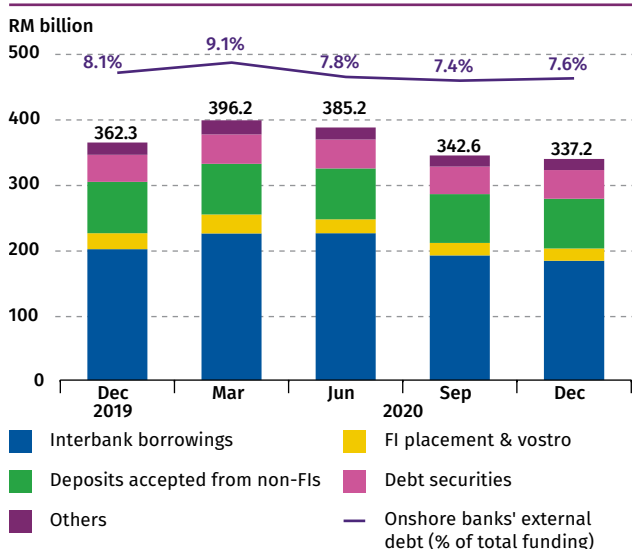


<sup>1</sup> Banks' funding profile is assessed using the NSFR, replacing the loan-to-fund (LTF) and loan-to-fund-and-equity (LTFE) ratios which were previously developed as interim funding indicators prior to the NSFR implementation. The LTF and LTFE ratios stood at 82.5% and 72%, respectively, as at December 2020 (June 2020: 82% and 71.5%).

their portfolios amid market developments and to accommodate the implementation of relief measures. Some banks have used the regulatory flexibilities accorded earlier by the Bank, which enables them to draw down on liquidity buffers and correspondingly, lower their internal LCR and/or NSFR limits. This has helped to support earnings while enabling these banks to continue lending to the economy and facilitate repayment assistance to borrowers facing temporary financial difficulties. Banks that have reduced available liquidity buffers are expected to be able to restore these buffers with relative ease. All banks are also well-positioned to meet the minimum NSFR requirement of 100% by 30 September 2021.

Banks' reliance on external funding continued to be limited (Chart 2.3). During the second half of 2020, overall banking system external debt declined by RM48 billion, primarily due to maturing intragroup borrowings by banks in the Labuan International Business and Financial Centre (LIBFC). At the same time, lower demand for foreign currency (FCY) financing domestically reduced banks' need for external FCY borrowings. The decline in external debt in the third quarter was partially offset by higher precautionary buffers accumulated by domestic banking groups (DBGs) in the fourth quarter. This was in anticipation of a potential tightening in domestic USD liquidity conditions towards year end, particularly amid uncertainty ahead of the US Presidential election in November. Valuation effects following the stronger ringgit against selected

**Chart 2.3: Banks' External Debt – by Instrument**



Note: 1. Banking system or onshore banks refer to only DBGs and locally-incorporated foreign banks (LIFBs)  
2. Banks' external debt in this context refers to external debt of DBGs, LIFBs, and LIBFC banks

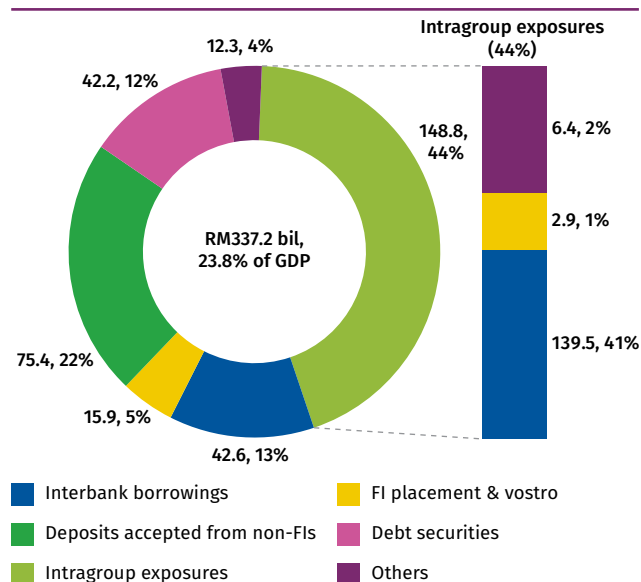
Source: Bank Negara Malaysia

major and regional foreign currencies during the period further reduced the amount of external debt.

## Funding and currency risks from banks' external debt exposures remained manageable

Risks from external debt exposures remained low. A large proportion (almost 60%) of external debt comprises intragroup placements and long-term debt securities that are generally more stable, thereby reducing withdrawal or rollover risks (Chart 2.4). 18% of external debt are also ringgit-denominated, which are not subject to valuation changes from fluctuations in the exchange rate. Risks associated with cross-currency mismatches are contained, with the foreign exchange net open position (FX NOP) remaining well within levels recorded in recent periods (December 2020: 5.3%; June 2020: 4.9%; 5-year average: 5.7%) (Chart 2.5). Banks also continued to maintain sufficient FCY liquid assets to cover almost three times the level of FCY external debt-at-risk (Chart 2.6).<sup>2</sup>

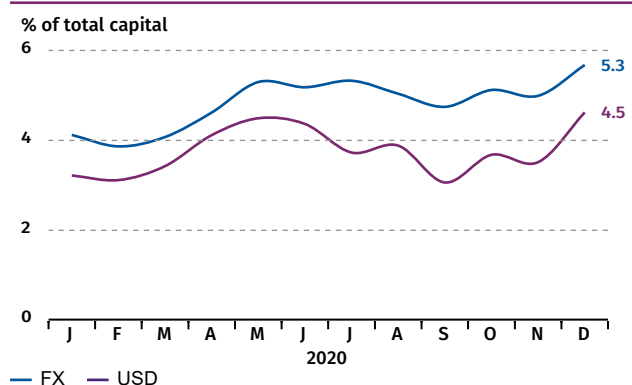
**Chart 2.4: Banks' External Debt – by Type of Exposure and Instrument**



Note: Banks' external debt in this context refers to external debt of DBGs, LIFBs, and LIBFC banks

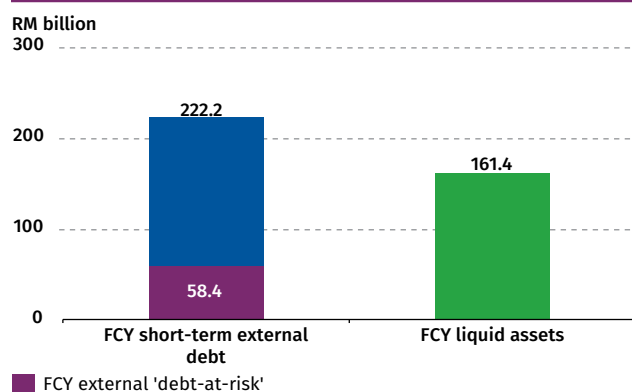
Source: Bank Negara Malaysia

<sup>2</sup> Banks' external 'debt-at-risk' comprises financial institutions' deposits, interbank borrowings and short-term loans from unrelated non-resident counterparties which are considered more susceptible to sudden withdrawal shocks.

**Chart 2.5: Banking System – FX and USD Net Open Positions**

Note: Banking system or onshore banks refer to only DBGs and LIFBs

Source: Bank Negara Malaysia

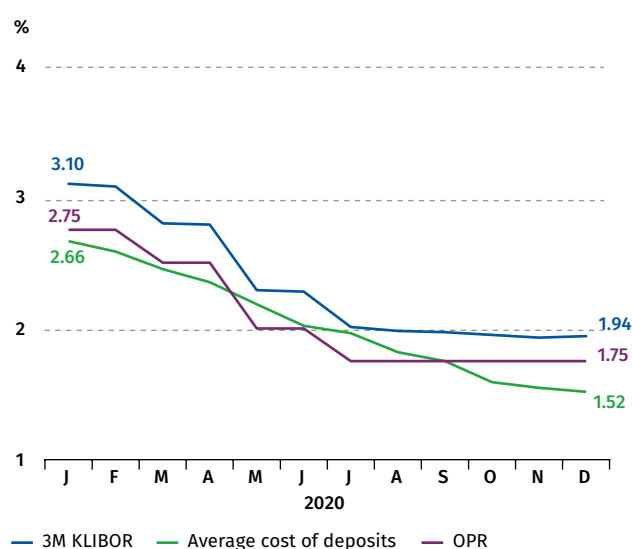
**Chart 2.6: Banking System – FCY External 'Debt-at-Risk' and Liquid Assets**

Note: 1. Banking system or onshore banks refer to only DBGs and LIFBs

2. Liquid assets comprise cash and cash equivalents, unencumbered debt securities held and interbank placements

Source: Bank Negara Malaysia

Overall, banks' funding costs continued to be on a declining trend amid strong pass-through of the earlier Overnight Policy Rate (OPR) cuts and ample liquidity conditions (Chart 2.7). While funding conditions are expected to remain broadly favourable in the near term, adverse changes in global market sentiment could lead to capital

**Chart 2.7: Banking System – Average Cost of Deposits, Kuala Lumpur Interbank Offered Rate (KLIBOR) and Overnight Policy Rate (OPR)**

Source: Bank Negara Malaysia

outflows and drive funding costs higher. Chunky withdrawals by the Government and/or NBFIs to support the implementation of further relief measures, as well as sizeable deposit drawdowns by distressed individuals and businesses following the implementation of MCO 2.0, could also put pressure on the liquidity position of some banks. Despite these challenges, banks are expected to remain resilient on account of their sizeable liquidity buffers and sound liquidity risk management practices, as well as continued progress in accumulating stable sources of longer-term funding. The extension of the flexibility for banking institutions to use Malaysian Government Securities (MGS) and Malaysian Government Investment Issues (MGII) to meet the Statutory Reserve Requirement (SRR) until 31 December 2022 will also augment liquidity in the banking system to support financial intermediation activity.

## Developments of the Benchmark Rate Reform in Malaysia

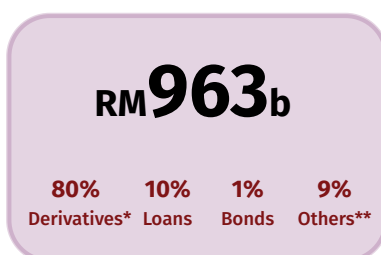
### London Interbank Offered Rate (LIBOR) Transition: Recalibration of Malaysia's Transition Signposts

There has been considerable progress since the first publication of the Bank's LIBOR transition<sup>3</sup> signposts in 2020.<sup>4</sup> Banks in Malaysia have been proactively engaging borrowers to renegotiate benchmark replacements and to develop fallback provisions in existing LIBOR-based loan contracts in an effort to manage tough legacy<sup>5</sup> contracts and reduce the consequential legal risk. Banks are also working through system enhancements needed to ensure their operational readiness to support products priced off alternative risk-free rates (RFR). These efforts were interrupted by COVID-19 in some banks, but are expected to pick up pace again in 2021. Malaysian banks with significant derivative exposures have also adhered to the International Swaps and Derivatives Association (ISDA) 2020 Interbank Offered Rate (IBOR) Fallbacks Protocol, which enables market participants to amend the terms of their derivative contracts. The Malaysian banking industry's LIBOR exposures<sup>6</sup> stood at RM963 billion as of 31 December 2020 (Diagram 2.1).

Cash products present a different hurdle in transitioning to RFRs due to the lack of a forward-looking term structure. While borrowers prefer certainty in their future monthly cashflows, the actual rate under the compounded-in-arrears convention of term RFRs is known only at the end of the interest period. Hence, there is a mismatch between the demand and supply of RFR-referenced products without a forward-looking term structure. In order to address the lagging demand, the Alternative Reference Rate Committee (ARRC)<sup>7</sup> in the United States of America (US) is working towards identifying a potential administrator to publish the forward-looking term Secured Overnight Financing Rate (SOFR) by the end of 2021. The success of this hinges upon liquidity conditions of the SOFR derivatives markets, from which the forward rate is derived.

Recently, the ICE Benchmark Administration (IBA), the global administrator of LIBOR, announced a delay to the cessation of the publication of USD LIBOR for the overnight, 1, 3, 6, and 12-month tenures by 18 months to 30 June 2023. The publication of all other USD LIBOR tenures and LIBOR currencies will, however, cease on 31 December 2021 as planned.

**Diagram 2.1: Malaysian Banks' LIBOR Exposures as of 31 December 2020**



\* Refers to notional amount

\*\* Mainly interbank lending/borrowing and customer deposits

Note: At consolidated banking group level

Source: Bank Negara Malaysia

<sup>3</sup> As part of the global reform of benchmark interest rates, LIBOR will be discontinued and replaced with alternative risk-free rates (RFR).

<sup>4</sup> Refer to the Information Box on 'Benchmark Rate Reform: LIBOR Transition' in the BNM Financial Stability Review for Second Half 2019 for further details.

<sup>5</sup> Existing LIBOR referencing contracts that are unable to be converted into non-LIBOR rates or amended to include fallback provisions when LIBOR is discontinued.

<sup>6</sup> Refer to the outstanding amount of on-balance sheet exposures and notional amount of derivatives at the consolidated banking group level.

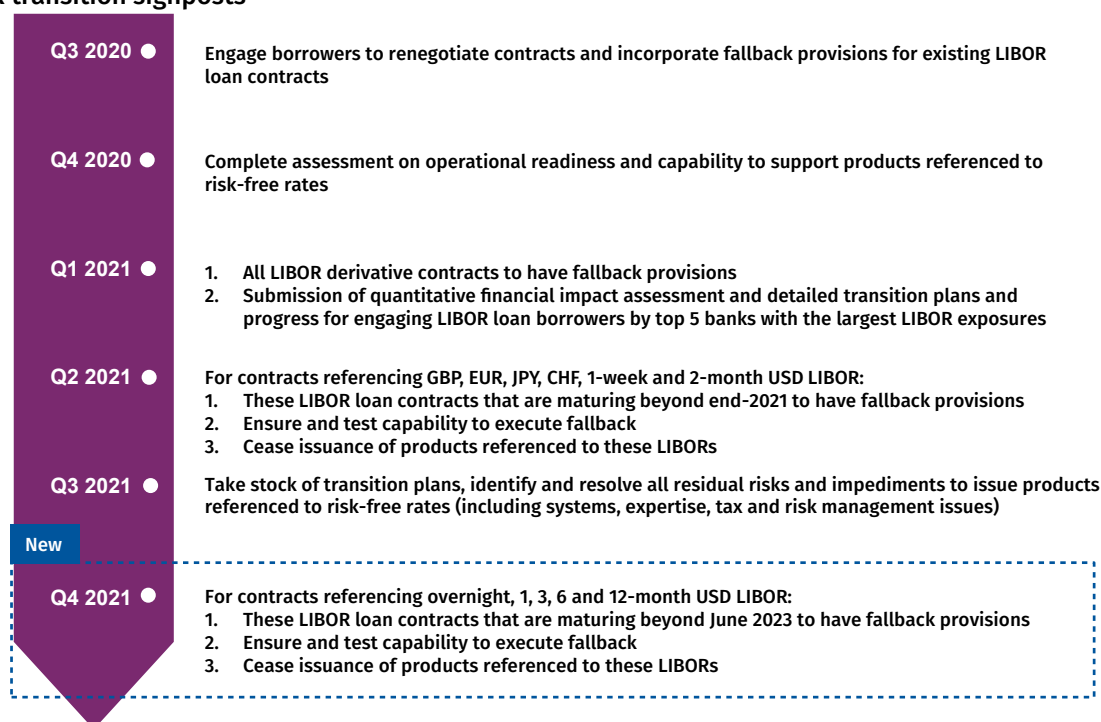
<sup>7</sup> ARRC consists of a group of private-market participants, convened by the Federal Reserve Board and the New York Fed, to help ensure a successful transition from the USD LIBOR to the Secured Overnight Financing Rate.



In line with this development, the Bank is recalibrating key signposts to facilitate renegotiations and provide sufficient time for the demand of SOFR-based cash products to grow, as the forward-looking term SOFR is expected to be published before end-2021. Two signposts will be shifted from the original target of the second quarter of 2021 to the fourth quarter of 2021. First, the cessation of new products referencing the overnight, 1, 3, 6, and 12-month USD LIBOR, and second, the incorporation of fallback provisions in existing USD LIBOR-referenced contracts maturing beyond June 2023 (Diagram 2.2).

**Diagram 2.2: Recalibrated Key Transition Signposts**

#### LIBOR transition signposts



End of Dec 2021: GBP, EUR, JPY, CHF, 1-week and 2-month USD LIBOR cease to exist

End of Jun 2023: Overnight, 1, 3, 6 and 12-month USD LIBOR cease to exist

Note: Signposts may be reviewed if there is any change in the global transition timeline  
Source: Bank Negara Malaysia

## Development of an Alternative Reference Rate (ARR) and Refinements to the Kuala Lumpur Interbank Offered Rate (KLIBOR)

As for domestic benchmark rates, in line with global benchmark reform efforts recommended by the Financial Stability Board (FSB), the Financial Markets Committee (FMC) will oversee efforts in developing an ARR, which adheres to the Principles for Financial Benchmarks by the International Organization of Securities Commissions (IOSCO). The ARR will run parallel to the existing KLIBOR, providing sufficient time for market participants to prepare for its adoption.

In the first half of 2021, the FMC will conduct a public consultation to gather feedback on the proposed ARR and methodology. This is to ensure that the development of the ARR will take into account views from key stakeholders, including both the sell and buy side (e.g. banks and institutional clients), and will serve as an effective reference rate for all products including derivatives, loans and securities. Upon its finalisation, the Bank intends to commence publication of the ARR in the second half of 2021, which will allow market participants to start designing and pricing financial products based on the ARR.

Alongside this exercise, the Bank also intends to introduce additional refinements to the KLIBOR framework, including the incorporation of fallbacks, to further enhance its integrity and reliability as a financial benchmark.

## Weaker credit risk outlook and uncertain economic recovery prospects raised credit costs and weighed down earnings

The impact of the pandemic on bank impairment levels remained largely contained in the second half of 2020 due to repayment assistance programmes offered by banks to help household and business borrowers manage temporary cashflow constraints. Gross impairment ratio of the banking system edged slightly higher to 1.6% (June 2020: 1.4%; 2019 average: 1.5%) (Chart 2.8) following the end of the blanket automatic moratorium, mainly driven by a slight increase in household impairments. However, with uncertainty around the ongoing pandemic and uneven economic recovery, the credit risk outlook remains challenging. The overall proportion of loans classified as Stage 2<sup>8</sup> under MFRS 9 rose to 10% of total banking system loans (June 2020: 8.4%), given expectations of rising impairments from households and a further deterioration in the financial performance of some businesses. In light of that, banks continued to build up provisions in anticipation of higher credit losses. On a year-on-year basis, provisions grew by 40.6% (June 2020: +9%) (Chart 2.9). Higher overall provisions set aside by banks in the second half of 2020 (+RM6.1 billion to RM30.9 billion as at end-December 2020) reflected adjustments to banks' provisioning model parameters to account for the downside risks to domestic economic growth. In addition, around 40% of additional provisions for the year were from the application of management overlays by banks over and above the expected credit loss (ECL) model provisions. This reflects continued challenges faced by banks in incorporating forward-looking information in the measurement of ECL given prevailing uncertainties in the economic recovery path, and reduced visibility on the debt-servicing capacity of borrowers under loan moratoriums.

Overall credit costs<sup>9</sup> remained at an elevated level, rising further to 78 basis points (bps) for the full year

of 2020 (June 2020: 57 bps; 5-year average: 15 bps) (Chart 2.10). Correspondingly, banks' profit before tax fell the most since the Asian Financial Crisis (AFC) (2020: -24.8%; 2H 2020: -31%), despite improvements in other sources of profits in the second half of the year (Chart 2.11). Net interest income recovered, supported by stabilising interest margins given the repricing of deposits from earlier OPR cuts (Chart 2.12). In addition, banks' trading and investment income was boosted by the sale of debt securities and fair value changes amid declining yields. Fee income also improved, mainly from equity brokerage and credit-related fees, amid a resumption in economic activity and higher retail participation in the equity market.

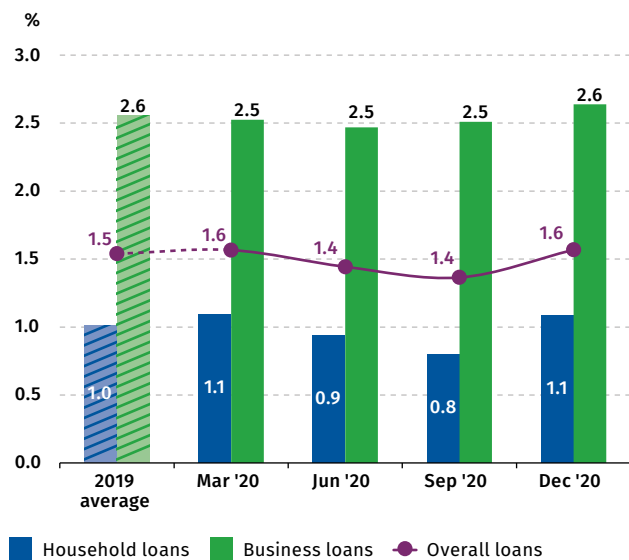
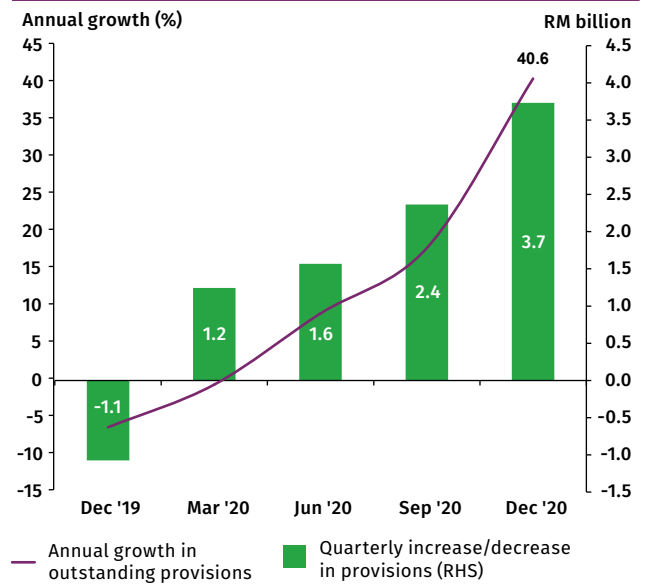
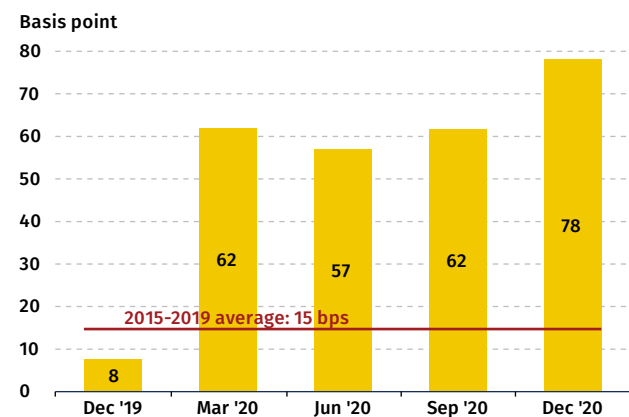
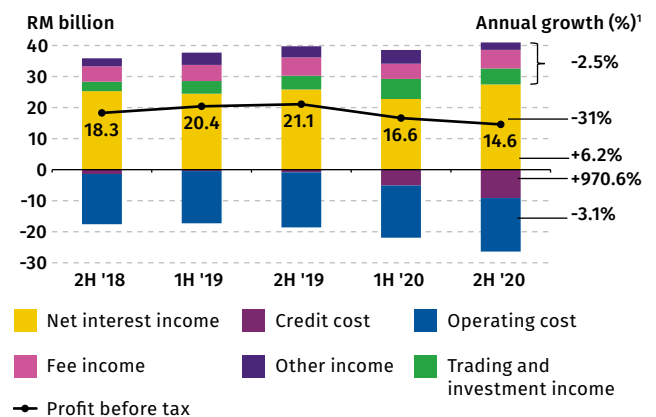
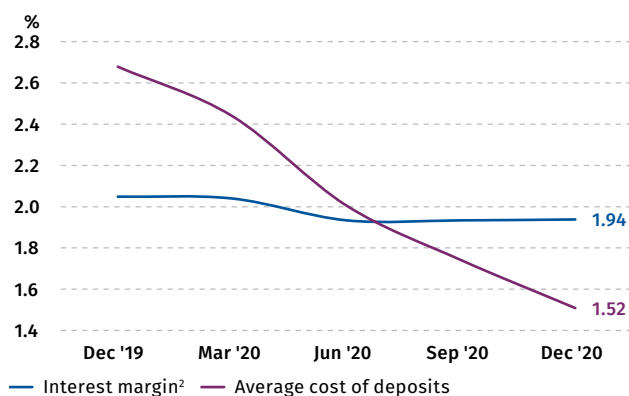
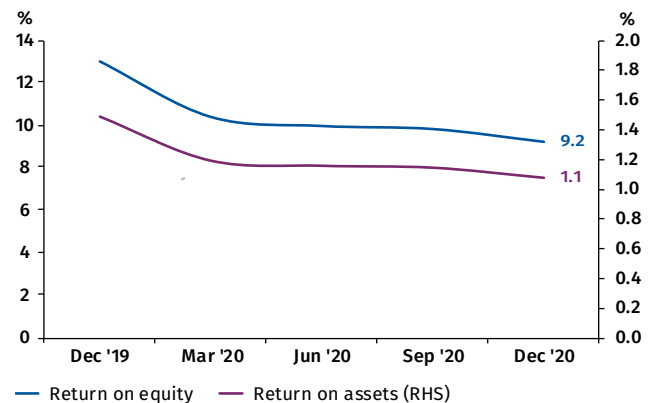
In line with weaker bank earnings throughout 2020, returns on equity and assets of the banking system declined to 9.2% and 1.1% (June 2020: 10% and 1.2%), respectively (Chart 2.13). Market valuations for listed banks, as measured by the median price-to-book (P/B) and price-to-earnings (P/E) ratios, however, improved towards the end of 2020 and into 2021, partly lifted by prospects of earnings support from pre-emptive provisions made by banks in 2020 and lower pressure on banks' interest margins moving forward. Notwithstanding this, the cautious credit risk outlook will continue to weigh on banks' profitability.

While downside pressure on earnings is likely to persist in the first half of 2021, the impact is expected to be less severe than that experienced in 2020. Banks are operationally better prepared to support borrowers affected by MCO 2.0 who are in need of temporary repayment assistance. The number of affected borrowers requiring assistance is also expected to be lower, with most household and SME borrowers resuming their loan repayments since the fourth quarter of 2020. The additional relief measures introduced by the Government under the 2021 Budget and fiscal stimulus packages will further help sustain debt serviceability. Credit costs are expected to begin normalising in the second half of 2021 following banks' pre-emptive provisioning in 2020.

<sup>8</sup> Stage 2 loans refer to loans that have exhibited deterioration in credit risk, for which banks are required to set aside provisions based on lifetime expected credit losses.

<sup>9</sup> Refers to annualised year-to-date loan loss impairment and other provisions charged to the income statement over outstanding loans. Excludes loans from DBGs' overseas operations.



**Chart 2.8: Banking System – Gross Impaired Loans Ratio**

**Chart 2.9: Banking System – Provisions**

**Chart 2.10: Banking System – Annualised Credit Cost Ratio**

**Chart 2.11: Banking System – Income, Cost and Profit before Tax**

**Chart 2.12: Banking System – Interest Margin and Average Cost of Deposits**

**Chart 2.13: Banking System – Profitability**


Note: 1. Annual growth computed based on figures for 2H 2019 and 2H 2020

2. Interest margin is the difference between interest rates at which banks extend financing and interest rates banks pay for funding, including deposits

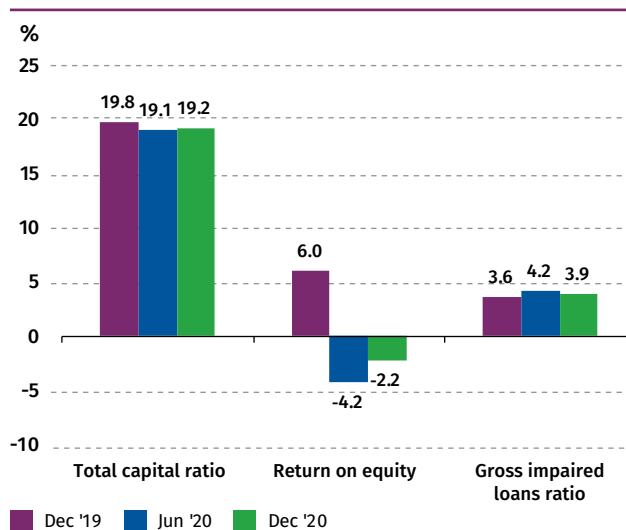
Source: Bank Negara Malaysia

The financial performance of the overseas operations of DBGs<sup>10</sup> remained subdued over the past year amid the COVID-19 pandemic and contraction in economic activities across most countries. Nevertheless, improvements in the performance of selected DBGs' overseas operations in Singapore (51% share of total overseas operations' assets) during the fourth quarter of 2020 lifted the overall average<sup>11</sup> return on equity (ROE) to -2.2% (1H 2020: -4.2%). Operations in Singapore recorded lower losses (average ROE of -5.1%; 1H 2020: -14.5%),<sup>12</sup> mainly due to lower provisions compared to the first half of 2020, but remained under pressure amid lower earnings from interest-related activities. On the other hand, operations' in Indonesia and Thailand continued to record profits, albeit at a lower ROE of 8.7% and 2.3% (1H 2020: 11.9% and 5.3%), respectively due to higher impairment allowances. Meanwhile, operations in Hong Kong SAR were impacted by higher provisions by some DBGs for exposures to large corporates affected by the pandemic, as well as lower trading and investment income. Collectively, overall asset quality of the DBGs' overseas operations improved slightly, with the gross impaired loans ratio<sup>13</sup> at 3.9% (June 2020: 4.2%), supported by ongoing moratorium and debt relief measures (Chart 2.14)

### Challenging credit conditions amid COVID-19 pressures continue to weigh on financial performance of banks' overseas operations

Risks posed by the overseas operations of DBGs are assessed to be limited as exposures to sectors directly and indirectly affected by the pandemic are small relative to DBGs' total gross loans. Moreover, funding of DBGs' overseas operations, mainly from local currency deposits (Chart 2.15), remained stable. Although pressure on asset quality remains

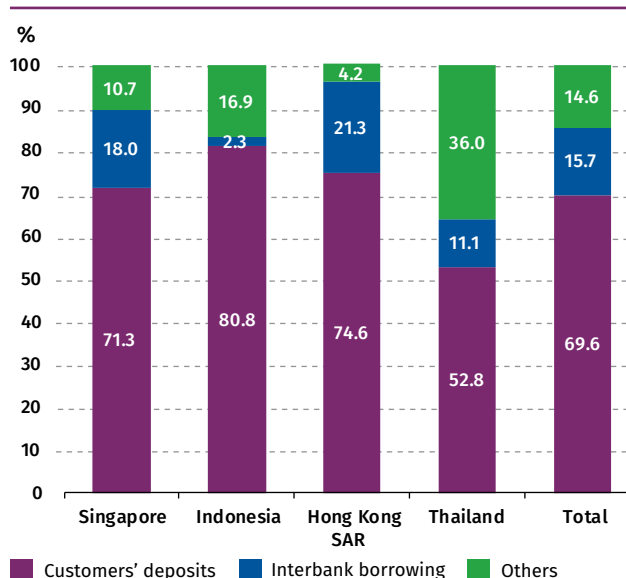
**Chart 2.14: Banking System – Key Financial Indicators of Overseas Operations**



Note: The average key financial indicators are weighted by the asset size of selected overseas operations

Source: Bank Negara Malaysia

**Chart 2.15: Banking System – Funding Profile of Major Overseas Operations**



Note: Figures may not add up due to rounding

Source: Bank Negara Malaysia

elevated given continued uncertainty on regional growth prospects, major overseas subsidiaries continue to maintain relatively high levels of capital, which serve to buffer against potential credit losses without having to draw on parental support. Based on stress tests conducted by DBGs on their overseas operations, all major foreign subsidiaries continued to maintain sufficient capital to withstand severe shocks associated with higher

<sup>10</sup> Refers to DBGs' overseas offices (branches and subsidiaries) operating outside of Malaysia and LIBFC. Cumulatively, DBGs have presence in 14 overseas jurisdictions, with major operations in Singapore, Indonesia, Thailand and Hong Kong SAR.

<sup>11</sup> Average figures are weighted by asset size of operations of each DBG in respective jurisdictions.

<sup>12</sup> Higher provisions made during the first half of the year were driven primarily by sizeable exposures to impaired borrowers from the oil and gas sector.

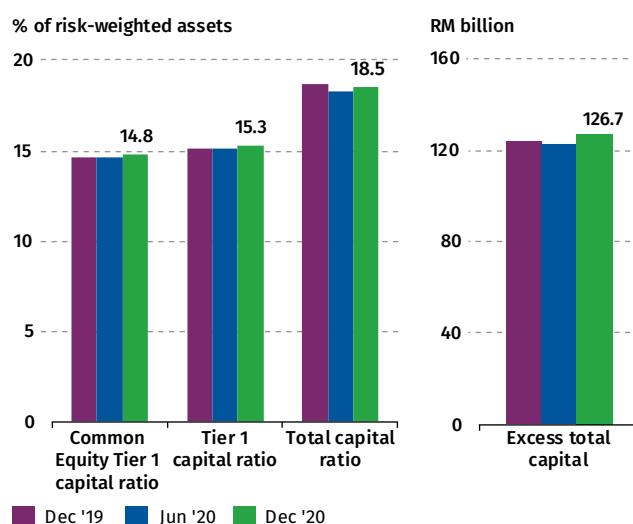
<sup>13</sup> Ratio is weighted by asset size of operations of each DBG in respective jurisdictions.

credit risks arising from the pandemic, weaker oil prices and a delayed recovery in global growth. Post-shock total capital ratios of these subsidiaries remained well above the regulatory minimum, ranging between 17% and 27%.

## The capitalisation of the banking system remains strong, bolstering banks' capacity to absorb potential shocks and support economic recovery

Despite lower profits during the period, banks continued to maintain strong capitalisation levels throughout the second half of 2020 (December 2020: 18.5%; 2019 average: 17.9%), with aggregate excess capital buffers<sup>14</sup> amounting to RM126.7 billion (Chart 2.16). Banks have sought to preserve their buffers in anticipation of higher credit losses going into 2021, by lowering dividends to shareholders, implementing dividend reinvestment programmes, and raising new equity. Some banks also issued Additional Tier 1 and Tier 2 capital instruments, replacing Tier 2 capital instruments that were being phased out as regulatory capital under the Basel III transitional arrangements. The stable capital buffers of

Chart 2.16: Banking System – Capital Ratios



Note: Excess total capital refers to total capital above the regulatory minimum, which includes the capital conservation buffer requirement of 2.5% and bank-specific higher minimum requirements

Source: Bank Negara Malaysia

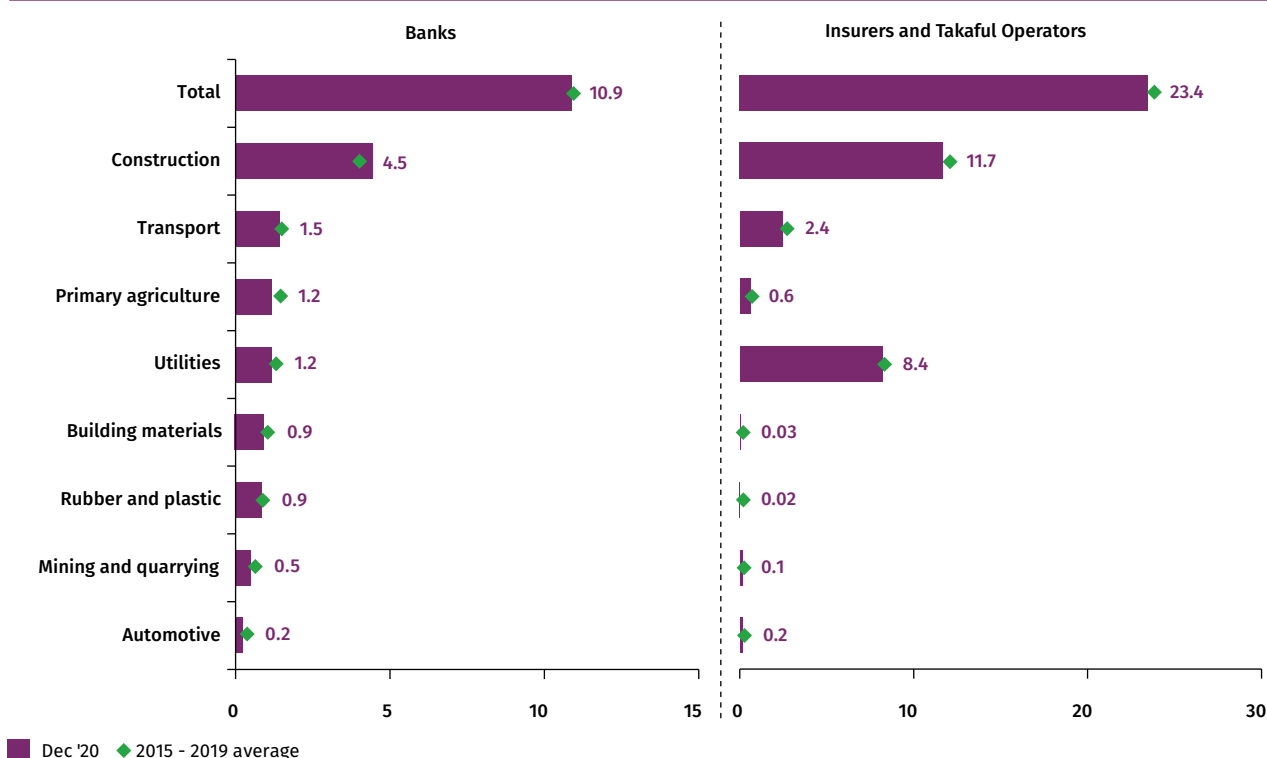
banks have been maintained, as the ratio of risk-weighted assets to total assets returned to pre-COVID-19 levels (December 2020: 57.4%; March 2020: 56.5%; December 2019: 57.5%), indicating that banks continued to support credit flows to the economy.

<sup>14</sup> Refers to capital held in excess of regulatory minimum, which includes the capital conservation buffer (2.5%) and bank-specific requirements.

## Climate Risk Management by Financial Institutions

Financial institutions have made progress in responding to climate-related risks. More financial institutions have begun to formulate their long-term strategies towards sustainability. These include rebalancing their portfolios, given the implications of potential climate risk exposures on their core lending, insurance businesses, deposit taking, and derivatives as well as investment activities (Chart 2.17). Increasingly, financial institutions are also promoting and helping their customers to adopt sustainable practices through their lending, advisory and/or investment activities.

**Chart 2.17: Exposures of Malaysian Financial Institutions in Sectors Potentially Exposed to Climate Change (as % of Total Assets)**



Note: 1. Construction includes civil engineering works and construction of residential and non-residential properties; utilities includes power and water; transport includes land, water and air transport; primary agriculture includes mainly palm oil

2. Figures refer to exposures as at end-December 2020. Exposures are based on existing reporting requirements and will be refined upon full implementation of the Climate Change and Principle-based Taxonomy






Source: Bank Negara Malaysia estimates

Following increased supervisory engagements with financial institutions since early 2020, positive developments have been observed in efforts by financial institutions to incorporate climate risk considerations in their strategies and operations. This included aligning governance arrangements, customer onboarding practices, disclosures and product solutioning (Diagram 2.3).

In 2021, the Bank will continue to work with the industry to further support strengthened climate risk management and disclosure practices. A key priority will be the implementation of the Climate Change and Principle-based Taxonomy (CCPT), and ongoing development of sectoral guides for the manufacturing, oil and gas, infrastructure and construction sectors. Work will also continue on producing additional practical resources to help financial institutions better evaluate and manage climate-related risks (Diagram 2.4). With finalisation of the taxonomy, financial institutions will begin capturing exposures based on the CCPT for internal risk management and supervisory purposes. This will help support risk management, scenario analysis, stress testing and disclosures. Initiatives to encourage greater adoption of climate-related disclosure by financial

Diagram 2.3: Key Developments Observed in Financial Institutions

Climate-related risk management is gaining traction but at an uneven pace across the industry

	Key observations	Leading initiatives
 <b>Governance &amp; strategy</b>	<ul style="list-style-type: none"> <li>Stronger leadership by Board and senior management on the need to integrate climate-related considerations in business strategies and decisions, and risk management practices</li> </ul>	<ul style="list-style-type: none"> <li>Established dedicated teams and senior management sponsors for climate-related initiatives</li> <li>Specific focus on climate risks as permanent agenda in Board and management committee meetings</li> </ul>
 <b>Policy &amp; framework</b>	<ul style="list-style-type: none"> <li>Increasing integration of climate-related considerations into risk management framework and practices</li> </ul>	<ul style="list-style-type: none"> <li>Established group climate risk framework and policies, and risk appetite</li> <li>Subjecting segments of customers to climate risk assessments including in underwriting practices</li> <li>Climate risks embedded in enterprise wide risk management. Developed transition risk management framework for effective monitoring and management of credit risk</li> </ul>
 <b>Capacity building</b>	<ul style="list-style-type: none"> <li>Greater focus on enhancing staff awareness and technical capabilities</li> </ul>	<ul style="list-style-type: none"> <li>Established structured training roadmap for staff</li> <li>Hired subject matter experts to provide technical support and expedite knowledge development</li> </ul>
 <b>Product development &amp; solutions</b>	<ul style="list-style-type: none"> <li>Introduction of new products such as sustainability-linked loans, insurance/takaful cover for weather and climate risks, and preferential rates for purchase of green products and solutions</li> </ul>	<ul style="list-style-type: none"> <li>Preferential rates for renewable energy technology</li> <li>Invested in alternative technologies and relevant infrastructure projects to support climate risk mitigation and adaptation</li> </ul>
 <b>Reporting &amp; disclosure</b>	<ul style="list-style-type: none"> <li>More financial institutions committing and taking active steps to adopt the TCFD recommendations and better quality disclosures</li> </ul>	<ul style="list-style-type: none"> <li>Embarked on data collection initiative</li> <li>Developed Malaysia Flood Catastrophe Modeling to enhance risk monitoring and reporting</li> </ul>

More financial institutions have become signatories to the United Nations Environment Programme Finance Initiative Principles for Responsible Banking as well as Principles for Sustainable Insurance

Source: Bank Negara Malaysia

institutions in line with the Task Force on Climate-related Financial Disclosures (TCFD) recommendations, as well as to expand the range of financial products, solutions and activities that support sustainable activities, will be pursued as part of the work of the Joint Committee on Climate Change (JC3). The JC3 will also establish a dedicated workstream to identify and bridge gaps in climate- and environmental-related data required by financial institutions to support risk assessments. In addition, efforts to scale up capacity building programmes for industry players to accelerate their knowledge and skill sets in climate risk management will continue (refer to the BNM Annual Report 2020 for further information on the role and initiatives of the Bank in addressing climate-related financial risks).

Diagram 2.4: Key Achievements in 2020 and Priorities in 2021

Supported by collaboration with industry and partners through the Joint Committee on Climate Change and Value-Based Intermediation Community of Practitioners to promote an orderly transition

### 2020 Key Achievements



Pilot implementation of Climate Change and Principle-based Taxonomy



Conducted assessment on disclosure practices of financial institutions and gaps against the TCFD recommendations



Increased awareness on climate risk-related areas among the public and industry through awareness and education programmes



Consultation on Value-Based Intermediation Financing and Investment Impact Assessment Framework (VBIAF) sectoral guides on renewable energy, energy efficiency and palm oil

### 2021 Key Priorities



Finalisation and implementation of Climate Change and Principle-based Taxonomy



Issuance of industry consultative paper on Guides for Climate Risk Management and Scenario Analysis, and TCFD Application Guide



Finalisation of VBIAF sectoral guides on renewable energy, energy efficiency and palm oil



Issuance of VBIAF sectoral guides consultative documents on manufacturing, oil & gas and construction & infrastructure



Scale-up capacity building programmes

Source: Bank Negara Malaysia



## THE INSURANCE AND TAKAFUL SECTOR

### The insurance and takaful sector registered higher profitability, driven by stronger equity investment performance

Insurance and takaful funds recorded higher profitability in the second half of 2020 compared to the same period in 2019, driven by stronger investment performance of life insurance and family takaful funds. Excess income over outgo more than doubled to RM16.8 billion (2H 2019: RM7.7 billion) on the back of gains from equity and bond investments (Chart 2.18). In the life and family takaful sector, underwriting performance was sustained despite a markedly slower growth in new business premiums<sup>15</sup> (9.2%; 2H 2019: 18.4%) (Chart 2.19). This reflected the lower demand for mortgage insurance and takaful products amid weaker property market conditions in the second half of 2020 compared to the same period in 2019. Takaful operators have higher exposures to the Mortgage Reducing Term Takaful (MRTT) business and were therefore more affected than conventional insurers. Overall net premium growth remained below pre-COVID-19 levels but has picked up since the first half of the year, mainly due to higher growth in new investment-linked business premiums (23.6%; 1H 2020: -25%; 2H 2019: 10.9%). Insurers and takaful operators (ITOs) have observed that Malaysians are increasingly aware of the importance of insurance and takaful products in providing financial protection. This has continued to support demand for insurance despite renewed containment measures in the second half of 2020 and early 2021.

In view of the resurgence in COVID-19 cases and the reintroduction of MCO in most states in early 2021, ITOs have extended<sup>16</sup> the option for affected

consumers<sup>17</sup> to defer premiums due under life insurance policies and family takaful certificates for three months without affecting the coverage. This option is now available for applications received until 30 June 2021. The impact of the temporary relief measures on ITOs' profitability has been limited as the cumulative amount of premiums deferred and on holiday<sup>18</sup> remained minimal at 7.7% of premiums in force. Total net policy benefit payouts have also remained largely stable. In 2021, total net policy benefit payouts could increase due to additional costs associated with COVID-19-related procedures and treatments that are incidental to covered conditions. However, the impact of this is expected to remain manageable. While death due to the COVID-19 pandemic is claimable under all life insurance policies and family takaful certificates, the low mortality rate observed among COVID-19 patients in Malaysia (0.4%; global: 2.2%)<sup>19</sup> will likely limit the impact from any additional death claims. Medical and health insurance policies/takaful certificates (MHIT) in Malaysia generally carry a pandemic exclusion clause in line with practices globally. These exclusions reflect the complexity of pricing for such events due to the incalculable impact and costs, an absence of viable risk diversification instruments for ITOs, and to avoid significant premium hikes following a pandemic event.

Some ITOs have made adjustments to their re-pricing plans in 2020 to reduce the financial burden on policyholders and preserve their MHIT coverage. These adjustments include deferring re-pricing plans to 2021, providing refunds to minimise the impact of price increases, and permitting extended deferral of premiums. ITOs are expected to be able to comfortably support the financial impact of these adjustments without affecting their overall resilience in the short term. Nevertheless, deferment of re-pricing over an extended period will not be financially sustainable for both the MHIT providers and policyholders as over the longer term, medical claims would reflect the underlying trends in medical inflation. Medical claims in 2021 are

<sup>15</sup> Refers to both premiums and contributions, unless otherwise stated.

<sup>16</sup> The three-month premium deferment option that was announced in March 2020 and expired on 31 December 2020.

<sup>17</sup> Affected consumers are individuals who have been infected, home quarantined or suffered a loss of income; and SMEs which have suffered a loss of income, as a result of the economic impact of COVID-19.

<sup>18</sup> Premium holiday refers to continued insurance/takaful coverage despite an absence of premium payments and applies to products with the premium holiday feature already in place such as investment-linked products. This flexibility is available to policyholders as long as the investment value in the unit fund remains sufficient to meet the necessary insurance cost during the holiday period.

<sup>19</sup> Based on the cumulative number of cases and deaths reported by the World Health Organization as at 23 March 2021.

expected to increase compared to 2020 as a result of the resumption of treatments and procedures that were earlier delayed by policyholders due to COVID-19 concerns. Thus, further delays in re-pricing plans can lead to much steeper premium increases or reduced capacity of the industry to provide coverage in the future.

General insurance and takaful funds recorded higher operating profit, supported by better underwriting results as claims paid declined (Chart 2.20), mainly due to lower motor claims during the movement control period. Meanwhile, growth of gross direct premiums was sustained (2.8%; 2H 2019: 2.8%) (Chart 2.21). Motor premiums grew at a faster pace, supported by higher car sales in the second half of 2020 that was bolstered by the introduction of sales tax incentives. Under the phased liberalisation of the motor and fire tariffs, premium rates continued to adjust in line with policyholder risk profiles and recent loss experience. Based on recent motor claims data, certain theft-prone models and the younger drivers' segment consistently recorded higher than average loss experience, while new cars tended to be below the average. Several providers also reduced rates significantly for the optional 'special perils' coverage that provides protection against vehicle damage due to flood events. In 2020, the premiums for 56% of private car comprehensive and third party fire and theft policies were higher than under the tariff, while 38% of rates were lower. Over 95% of policies experienced premium rate adjustments that were within 10% of the previous tariff rates. While these adjustments may be insufficient to achieve technical pricing<sup>20</sup> levels for some risks, this is in line with the current phase of liberalisation. The phased approach aims to avoid sharp adjustments that would otherwise occur, particularly for motor risks where losses have persistently exceeded premiums for many years under the tariff. General ITOs also continued to introduce new products which are better tailored to meet customer needs and enabled policyholders to save on premiums, including usage-based motor policies which saw a two-fold increase in take-up, and products which provide flexibility for policyholders to select the coverage options that they need.

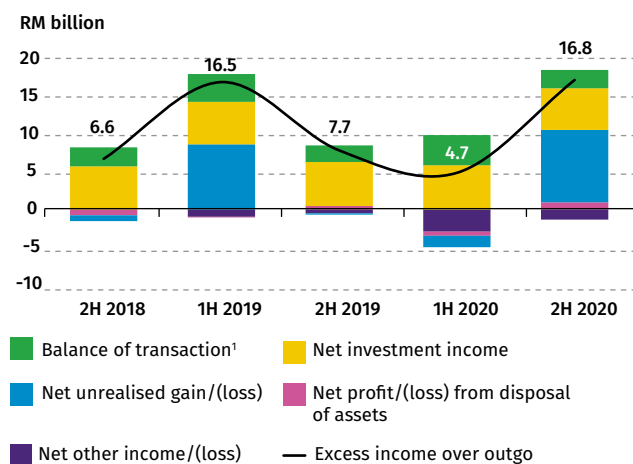
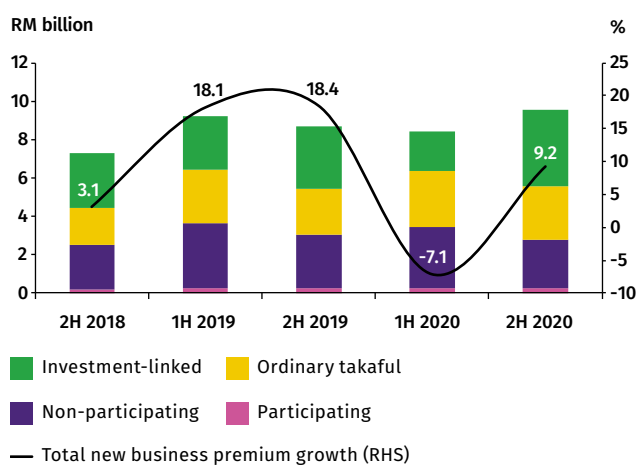
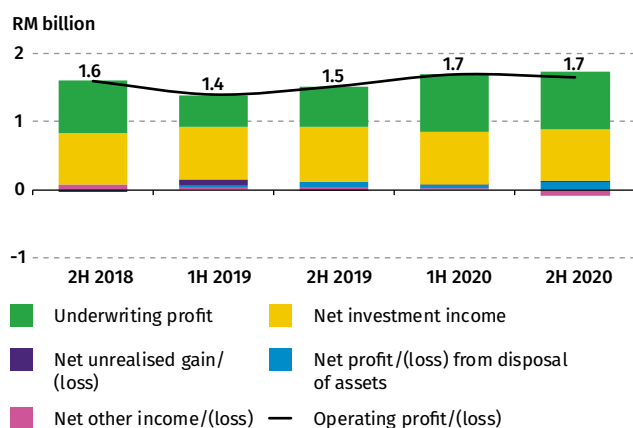
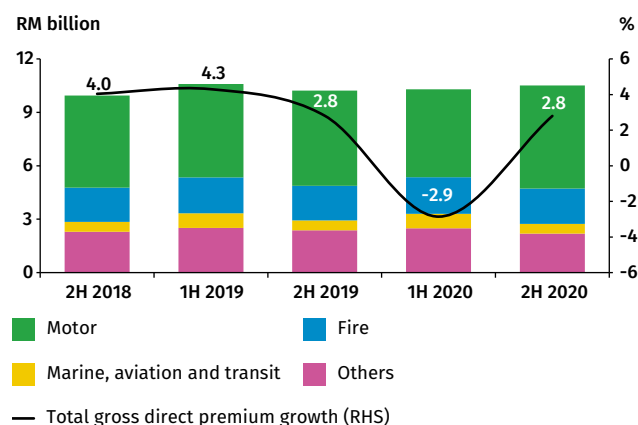
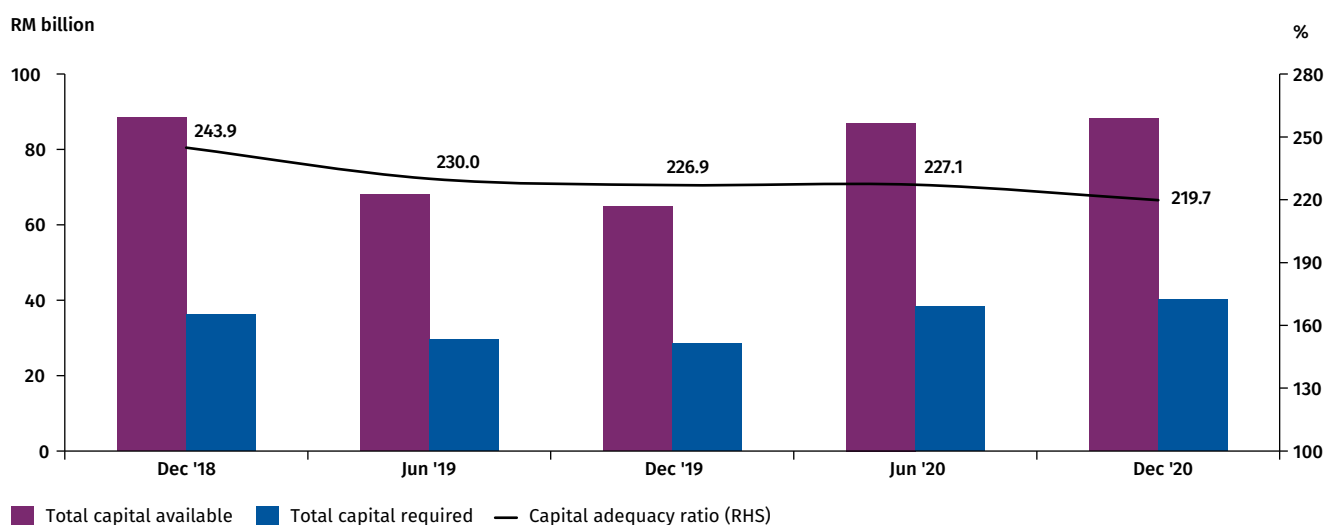
Meanwhile, personal accident premiums contracted as demand for travel insurance waned amid travel restrictions due to the pandemic. Claims from the floods in the east coast of Malaysia and several other states from late 2020 to early 2021 had a limited impact on general ITOs' profitability. Total gross claims from the floods were estimated to only account for 3.2% of general ITOs' operating profits for 2020.

Nevertheless, the insurance and takaful sector could face several challenges in the near future. ITOs continue to be exposed to heightened volatility in the financial markets from their sizeable bond and equity investments. The low interest rate environment also continues to pose challenges, especially for asset-liability management of life insurers and family takaful operators. Life insurers and family takaful operators generally operate with a negative duration gap given the lack of long-term financial assets available to match the duration of their liabilities (more than 15 years). Therefore, sustained periods of declining interest rates can have a detrimental impact on their solvency positions due to greater upward adjustments in the value of liabilities compared to assets.<sup>21</sup> A stronger recovery in new business growth will also depend on the easing of containment measures and a more entrenched economic recovery. Additionally, some general ITOs have indicated that they may face prospects of rising reinsurance costs during the next contract renewal following pandemic-related and natural catastrophe losses incurred by global reinsurers.

These developments could weigh on near-term profitability, but are unlikely to have a material impact on overall resilience. ITOs remain resilient, with strong capital positions. The aggregate capital adequacy ratio (CAR) stood at 219.7%, well above the regulatory minimum of 130% (Chart 2.22). Recent stress tests conducted also affirm that insurers are expected to have sufficient capital buffers to withstand potential shocks (refer to the section on stress test for insurers for further details).

<sup>20</sup> The level of premiums required to cover the actual claims experience of a group of similar risks and the relevant expenses incurred.

<sup>21</sup> While the impact could be amplified as asset and liability sensitivities, defined as the change in values of assets and liabilities from a 1% change in interest rates, tend to increase faster in a low interest rate environment partly due to the effects of convexity, the actual impact to the balance sheet would vary depending on the shape of the yield curve.

**Chart 2.18: Life Insurance and Family Takaful Fund – Composition of Income and Outgo****Chart 2.19: Life Insurance and Family Takaful Sector – New Business Premium Growth and Product Composition****Chart 2.20: General Insurance and Takaful Fund – Composition of Operating Profits****Chart 2.21: General Insurance and Takaful Sector – Gross Direct Premium Growth and Product Composition****Chart 2.22: Insurance and Takaful Sector – Capital Adequacy Ratio**

<sup>1</sup> Excess of net premium after deducting benefit payouts, agency remuneration and management expenses

Source: Bank Negara Malaysia

## ASSESSING THE RESILIENCE OF FINANCIAL INSTITUTIONS

Stress testing is an integral component of the Bank's financial stability framework, used to assess and manage risks to financial stability. The Bank typically performs a multi-year, top-down solvency stress test exercise in addition to regular supervisory stress tests. These exercises aim to assess the potential impact of financial and macroeconomic strains under two hypothetical adverse scenarios on the resilience of individual financial institutions and the broader financial system. The adverse scenarios are designed to capture extreme shocks that are plausible but have a low probability of occurring.

In the BNM Financial Stability Review for First Half 2020, the actual severe economic fallout from the COVID-19 pandemic prompted the Bank to shift the focus of its top-down, scenario-based stress tests towards assessing the ability of banks to withstand the unfolding stress based on assumptions around a likely recovery path at the time. This was supplemented with additional sensitivity analyses performed under a bottom-up approach to provide more granular assessments of resilience based on the specific risk profile of individual banks. As reported, the stress tests<sup>22</sup> affirmed the resilience of banks.

The prospects of an economic recovery are clearer now than before, but considerable uncertainty remains. The Bank's latest top-down macro solvency stress test therefore seeks to further stress the resilience of financial institutions in the event the economic recovery path turns out significantly weaker than anticipated. Two hypothetical adverse scenarios are applied, with the horizon of the test extended until the end of 2022. The first adverse scenario (AS1) assumes a sharp economic downturn in the first quarter of 2021 of similar magnitude to the downturn experienced in the second quarter of 2020, before recovering at a gradual pace akin to a V-shape. Under this scenario, the initial recovery, driven by pent-up demand, is unevenly distributed across industries before gradually normalising across all sectors by 2022. Simultaneously, broad success with vaccination efforts in most countries

results in global GDP returning to pre-pandemic levels by the third quarter of 2021, further bolstering domestic economic recovery. The second adverse scenario (AS2) assumes a much sharper economic contraction in the first quarter of 2021 surpassing the deepest slump experienced in the crisis thus far. In AS2, the recovery is assumed to be sluggish and L-shaped, with GDP recording negative growth in 2021 and remaining below pre-pandemic levels even by end-2022. This scenario assumes an ineffective vaccine and a marginal contraction in global growth in 2021, which will adversely impact Malaysian exports, investment and consumption. Given extended lockdown restrictions, domestic demand suffers a prolonged slump, with labour market conditions continuing to worsen throughout 2021. Both AS1 and AS2 assume sovereign rating downgrades in 2021. The economic scenarios used in this stress test do not represent the Bank's actual expectations for the trajectory of the economy, but rather, have been developed for the specific purpose of testing the ability of financial institutions to withstand more severe and prolonged economic shocks even as economic prospects are expected to continue to improve.

The latest banking system stress test broadly follows the enhanced methodology set out in the BNM Financial Stability Review for First Half 2020, with some key enhancements to selected assumptions (Table 2.1). Notably, the test continues to assume no further repayment assistance to household borrowers after the first quarter of 2021. Any rescheduling and restructuring (R&R) of business loans is assumed to end after the second quarter of 2021.

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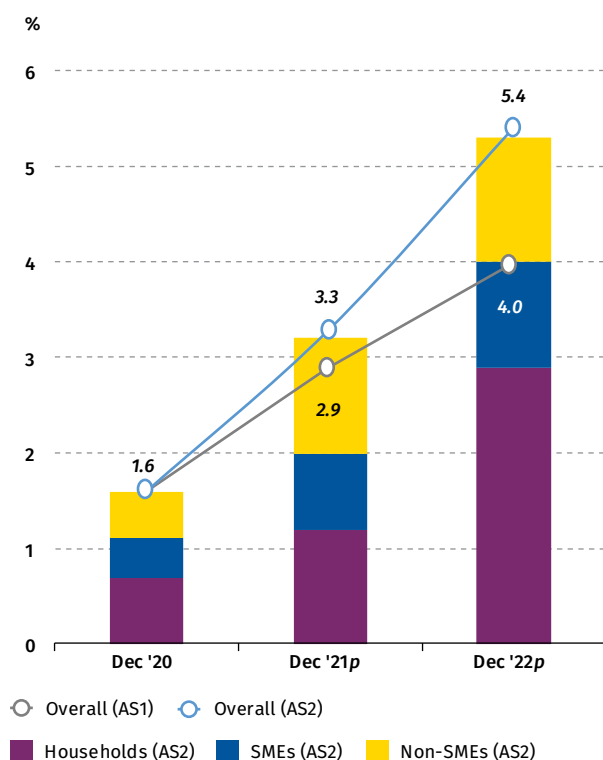
### Financial institutions continue to remain resilient under simulated severe credit, income and funding shocks

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Under the two adverse scenarios described earlier, banks may see overall impairments rise to 4.0% under AS1 and 5.4% under AS2 by end-2022 (Chart 2.23), with businesses driving the larger share of new impairments in 2021 and households contributing the larger share in 2022. Despite the greater degree of economic stress assumed in this exercise, impairments by end-2021 are expected to be lower than the results in the previous exercise (AS1: 2.9%, AS2: 3.3%, previous: 4.1%). This is

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<sup>22</sup> Refer to the information boxes on 'Key Features of the Enhanced Macro Solvency Simulation for Banks', 'Forecasting Business Impairments: Two-pronged Approach', and 'Forecasting Households' Time to Default' in the BNM Financial Stability Review for First Half 2020 for further details.

**Chart 2.23: Macro Stress Test: Banking System – Impaired Loans Ratio Under Adverse Scenarios 1 and 2**

P Projected

Source: Bank Negara Malaysia

primarily due to conservative assumptions applied previously in translating economic shocks into business impairments, where it was assumed all maturing bullet repayments in identified vulnerable business sectors would default. This has been updated to reflect the significantly better turnout for repayments that were observed, while retaining a substantial degree of conservatism in the revised assumptions used under AS2 (refer to the Information Box on 'Revised Assumptions of Maturing Bullet Business Loans' for further details).

In AS1, business impairments are driven by the default of both SMEs operating in vulnerable sectors and several non-SMEs. In AS2, higher impairments are mainly driven by SMEs as the prolonged weakness and sluggish recovery is expected to have a bigger impact on SMEs given their relatively thinner cash buffers and narrower profit margins (Diagram 2.5). For household borrowers under both AS1 and AS2, low-income household borrowers form the largest share of those projected to default, consistent with their lower financial buffers (Chart 2.25). Middle-income borrowers, however, drive the largest share of household impairments in value terms commensurate with the larger loan amounts when compared to lower-income defaulters.

**Table 2.1: Macro Stress Test: Key Changes in Banking System Stress Test Assumptions**

Aspect	Key Assumption Change
<b>Credit risk models</b>	<ul style="list-style-type: none"> <li>Revision of the share of maturing bullet business loans turning impaired, reflecting actual observations up to December 2020<sup>1</sup></li> <li>Revision of the definition of vulnerable business sectors<sup>2</sup></li> <li>Increase in the coverage of firms under the Cashflow Deficit Model to 798 non-financial corporate borrower groups<sup>3</sup></li> </ul>
<b>Net interest income</b>	<ul style="list-style-type: none"> <li>Incorporation of the impact of higher funding costs following sovereign rating downgrades</li> </ul>
<b>Repayment assistance</b>	<ul style="list-style-type: none"> <li>Revision of the share of business loans under repayment assistance to reflect actual experience up to December 2020</li> </ul>

Note:

<sup>1</sup> Share in previous exercise: 100%. Current share under AS1: 15%; AS2: 50%<sup>2</sup> The following sectors are assumed as vulnerable under AS1: wholesale and retail, real estate, construction, transport and storage, and hotels and restaurants. Vulnerable sectors under AS2 include manufacturing and mining and quarrying sectors, in addition to those in AS1. The previous exercise assumed all sectors in AS2 as well as the primary agriculture sector as vulnerable<sup>3</sup> These 798 non-financial corporate borrower groups cover about 70% of bank loans to non-SMEs (Previous exercise: 100 non-financial corporate borrower groups)

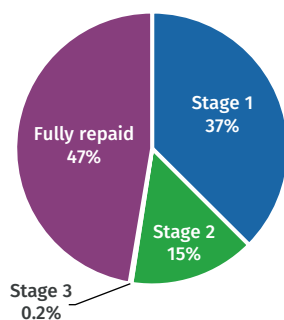
Source: Bank Negara Malaysia

## Revised Assumptions of Maturing Bullet Business Loans

In the previous exercise, the sectoral profiling model<sup>23</sup> was used to project impairments for businesses where firm-level financial data were not readily available. One of the key assumptions of the sectoral profiling model was that firms in vulnerable business sectors would default immediately on all their maturing bullet loans<sup>24</sup> as and when they become due. This assumption was premised on the large and immediate nature of bullet loan repayments, and limited visibility over the financial capacity of businesses in vulnerable sectors to meet such payments given the pandemic. Coupled with the high degree of uncertainty then, this highly conservative approach allowed the Bank to assess if banks could withstand harsher realisations of given economic shocks. Based on this assumption, maturing bullet business loans over the stress test horizon contributed 35% of new banking system impairments, or 28% of the increase in total credit costs to banks in the previous exercise.

With greater visibility over the actual repayment behaviour following the end of the blanket automatic loan moratorium, the Bank has refined this assumption based on observable data. Post-automatic moratorium, 47% of maturing bullet loans were fully repaid by December 2020. The remaining maturing bullet loans yet to be fully repaid had received some form of repayment assistance, with the bulk of these loans continuing to perform based on revised repayment terms. Only 15% of the total original maturing bullet repayments were assessed by banks (and reviewed by auditors) to exhibit signs of a significant increase in credit risk, while a very small portion (0.2%) of maturing bullet loans have turned impaired (Chart 2.24). Reflecting these observations, the updated stress test assumes that 15% of outstanding bullet loans of firms operating in identified vulnerable segments maturing during the stress test horizon will turn impaired under AS1. Under AS2, a considerable degree of conservatism has been maintained, reflecting lingering uncertainties over repayment behaviour. In this scenario, 50% of outstanding maturing bullet loans of firms operating in vulnerable sectors are assumed to turn impaired.

**Chart 2.24: Macro Stress Test: Business Sector – Profile of Vulnerable Sectors' Maturing Bullet Loans Post-automatic Moratorium**



Note: Figures may not add up due to rounding

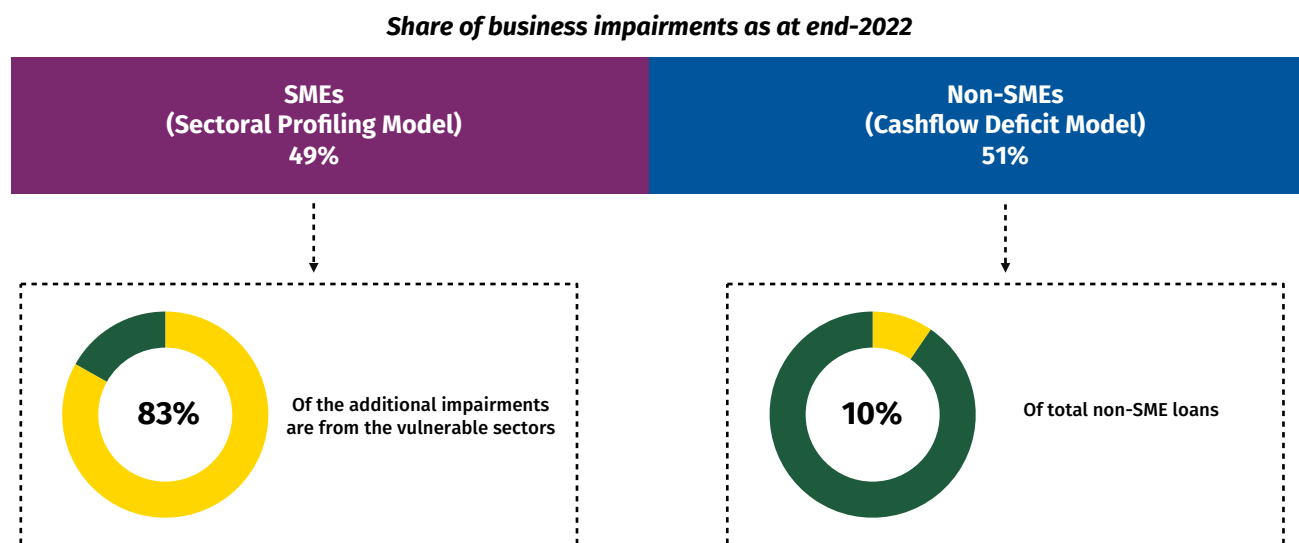
Source: Bank Negara Malaysia

<sup>23</sup> Refer to the Information Box on 'Forecasting Business Impairments: Two-pronged Approach' in the BNM Financial Stability Review for First Half 2020 for further details.

<sup>24</sup> Revolving credits are excluded as historical experience indicates that these exposures are typically rolled over.

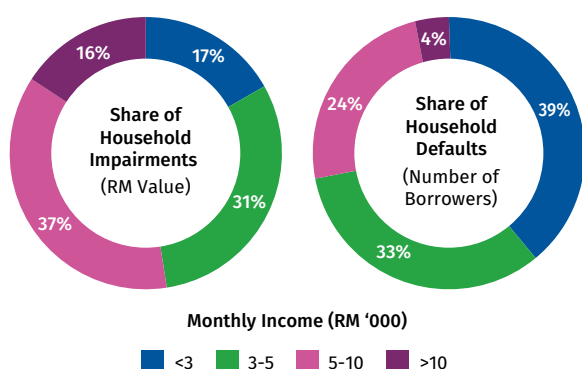


Diagram 2.5: Macro Stress Test: Business Sector – Impairment Profile Under Adverse Scenario 2



Source: Bank Negara Malaysia

Chart 2.25: Macro Stress Test: Household Sector – Impairment Profile Under Adverse Scenario 2



Note: Figures may not add up due to rounding

Source: Bank Negara Malaysia

Credit costs under the stress scenarios are projected to amount to RM19.3 billion and RM26.2 billion (or 1% and 1.5% of total loans) for AS1 and AS2, respectively, over the two-year horizon (Chart 2.26). Banks are expected to be adequately buffered against potential credit losses, having already bolstered provisions significantly in 2020 based on banks' internal stress tests (refer to the Banking Sector section in this chapter for further information). Banks are also projected to experience lower net interest income due to higher funding costs following sovereign

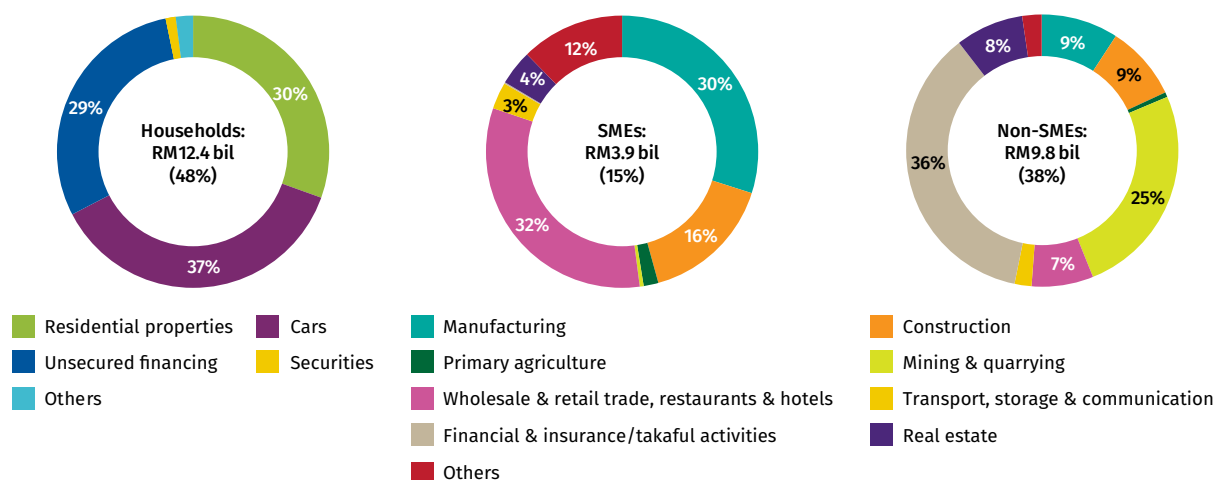
rating downgrades and weaker credit growth, although higher credit costs remain the main driver of the impact on banks' solvency positions. At the end of the stress test horizon, the banking system's capital ratio is projected to remain comfortably above the regulatory minimum, including the capital conservation buffers (Chart 2.27). Excess capital buffers are projected to decline by RM6.3 billion and RM9.8 billion under AS1 and AS2, respectively.

For insurers, the latest macro solvency stress test adopts the same adverse scenarios described earlier and additionally incorporates (i) COVID-19-related ex-gratia payments given to policyholders and higher claims for insurers without a pandemic exclusion clause, and (ii) a conservative increase in the general claims ratio by up to 17%.<sup>25</sup> Under both AS1 and AS2, the insurance sector is assessed to maintain aggregate CAR above the regulatory minimum (Chart 2.28), with capital buffers declining by RM11 billion under AS2. Market risk shocks remain the largest loss driver for life insurers under both scenarios. Meanwhile, general insurers are expected to see lower capitalisation, particularly in AS2, driven by higher claims for the motor and fire segments, and assumed reinsurance defaults (Chart 2.29). The solvency stress test exercise is supplemented with a liquidity assessment to gauge the ability of life insurers to honour expected short-term net outflows under stressed conditions,

<sup>25</sup> The average claims ratio during 2018-2019 was 59%. During the Asian Financial Crisis, the claims ratio was observed to rise by 17% to 69%.

Chart 2.26: Macro Stress Test: Banking System – Drivers of Cumulative Credit Losses Under Adverse Scenario 2

Cumulative credit losses (2021p + 2022p): RM26.2 bil

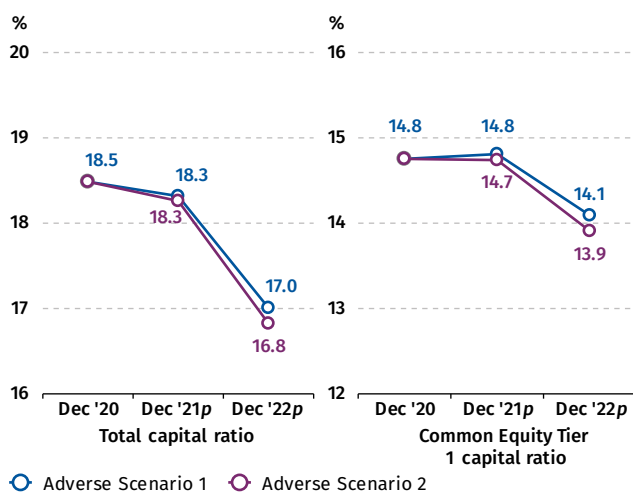


p Projected

Note: 1. (...) refers to % of overall cumulative credit costs  
2. Figures may not add up due to rounding

Source: Bank Negara Malaysia

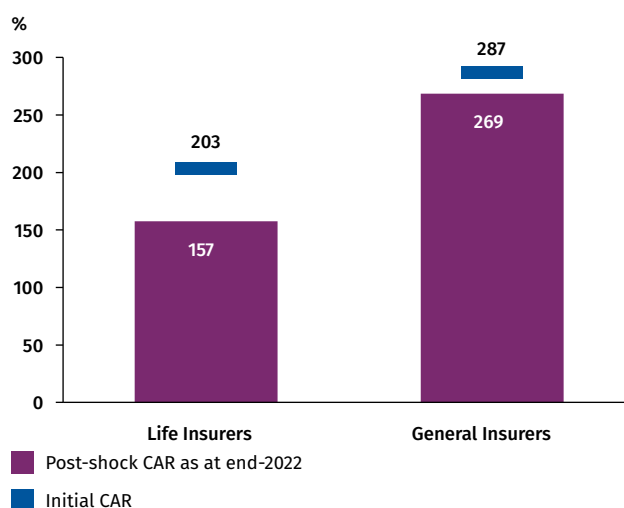
Chart 2.27: Macro Stress Test: Banking System – Capital Ratios Under Adverse Scenarios 1 and 2



p Projected

Source: Bank Negara Malaysia

Chart 2.28: Macro Stress Test: Insurance Sector - Capital Adequacy Ratio Under Adverse Scenario 2



Source: Bank Negara Malaysia

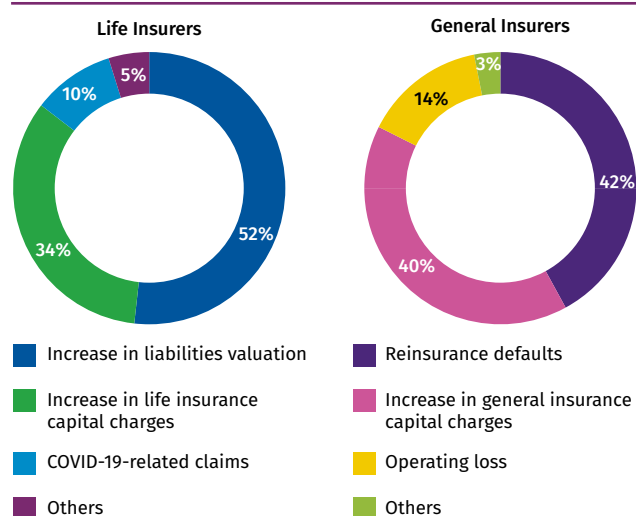
including potentially higher surrenders and COVID-19-related claims. The liquidity assessment affirmed that all life insurers have sufficient liquid assets<sup>26</sup> to fulfil these obligations.

While the overall financial system is expected to remain resilient under both simulated adverse

scenarios, heightened risk aversion by financial institutions given the uncertain and still-evolving pandemic situation could weigh on economic growth and recovery prospects. This in turn could increase risks to financial stability from more severe economic scarring. Such pro-cyclical behaviour could arise if banks are reluctant to draw down on their capital buffers despite the regulatory flexibilities accorded. The strong buffers of banks

<sup>26</sup> Refers to cash and deposits, and MGS.

**Chart 2.29: Macro Stress Test: Insurance Sector - Loss Drivers Under Adverse Scenario 2**



Note: Figures may not add up due to rounding

Source: Bank Negara Malaysia

remain important to mitigate this risk. Other factors that would reduce the resulting impact from the adverse economic shocks assumed under the stress tests include:

- Proactive management actions by financial institutions to shore up buffers through earnings retention strategies, new capital issuances, or capital injections from parent institution(s);
- Continued initiatives from financial institutions to offer short-term repayment assistance to viable borrowers, which would serve to rehabilitate and maximise the long-term viability of loans that are otherwise projected to turn impaired in the short term;
- Cures and recoveries by banks after loans turn impaired; and
- Additional policy interventions by the Bank, Government and/or other authorities to support the economy.