MANAGING RISKS TO FINANCIAL STABILITY

Domestic financial stability continues to be preserved

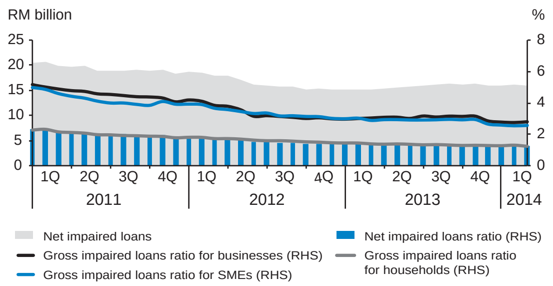
The Malaysian financial system continued to demonstrate resilience throughout the first quarter despite volatility in the global and domestic financial markets. Financial intermediation continued to be well-supported by sound financial institutions, orderly financial market conditions and sustained confidence in the financial system.

Credit risk in the banking system remained stable throughout the quarter, following the sustained debt servicing capacity of borrowers in general. The level of net impaired loans and loans-in-arrears of between one and three months were almost unchanged at 1.3% of net loans (4Q 2013: 1.3%) and 2.4% of total loans (4Q 2013: 2.5%). The size of credit risk exposures of the insurance industry, mainly attributed to holdings of private debt securities and reinsurance placements, remained stable at 3.4% of capital base (4Q 2013: 3.3%).

During the quarter, aggregate household borrowings via banks and major non-bank financial institutions grew at a more moderate pace of 2.3% as compared to the previous quarter (4Q 2013: +2.9%) to RM873.3 billion (4Q 2013: RM854.3 billion). On a year-on-year basis, aggregate household debt also grew more moderately by 11.0% (1Q 2013: 13.9%). These trends mainly reflected the slower growth in financing for personal use and the purchase of properties and motor vehicles during the quarter. Coupled with stable income and employment conditions, household sector impaired loans and loans-in-arrears of between one and three months declined further to account for 1.2% and 1.7% of total borrowings from the banking sector, respectively (4Q 2013: 1.3% and 2.1%, respectively). At the aggregate level, household financial assets remained healthy at 2.2 times of household debt.

The overall interest coverage ratio of businesses improved to 9 times in 4Q 2013 (3Q 2013: 6.1 times) underpinned by higher operating profit, while leverage as measured by the ratio of debt-to-equity was stable at 39.7% (3Q 2013: 39.2%). Aggregate cash and cash equivalent of businesses accounted for 11.5 times of finance costs (3Q 2013: 11.4 times). Similarly, current assets were stable at 1.8 times of current liabilities (3Q 2013: 1.9 times). The quality of banking system credit exposures to businesses remained healthy, with impaired loans and loans-in-arrears of between one and three months at 2.8% and 0.5% of total business loans, respectively (4Q 2013: 2.8% and 0.4%, respectively). The risk of delinquency, as measured by the expected default frequency, remained low and improved further to 0.18% (4Q 2013: 0.23%) amid the sustained financial performance of businesses.

Banking System: Loan Quality



Source: Bank Negara Malaysia

Volatile short-term portfolio flows were well-intermediated without any disruptive effects on the domestic financial markets and intermediation activities. Average volatility for 10-year MGS yields and the FBM KLCI declined to 10.7% and 7.1%, respectively (4Q 2013: 15.5% and 8.8%, respectively) amid greater clarity in the Fed's scale-back of its QE programme. Demand by local institutions for equities and bonds, to some extent, also contributed in attenuating some of the volatility in the domestic financial market. The bid-ask spreads of MGS and FBM KLCI averaged at 0.1% and 0.4% of the mid-price, respectively (4Q 2013: 0.1% and 0.7%, respectively). The turnover ratio for MGS and FBM KLCI remained stable at 9.1% and 1.8%, respectively (4Q 2013: 9.7% and 1.6%, respectively).

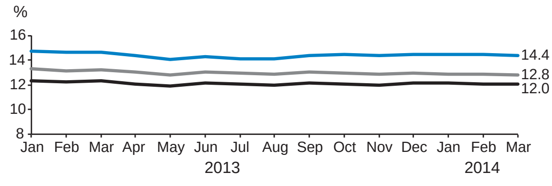
Market risk exposures continued to be well managed by financial institutions, supported by sustained pro-active risk management and hedging strategies. Bank exposures to interest rate risk in the trading book accounted for 1.7% of total capital (4Q 2013: 1.6%). Exposures to equity risk increased slightly to 0.9% of total capital (4Q 2013: 0.8%), while the foreign exchange (FX) net open position of the banking system increased to 6.2% of total capital during the quarter (4Q 2013: 5.7%). Market risk exposures of the insurance industry increased slightly to account for 12.4% (4Q 2013: 12.3%) of total capital available driven by higher equity risk which formed 7.7% (4Q 2013: 7.6%) of total capital available.

BNM continues to closely monitor signs of a potential build-up of risk in the financial system. While the growth of household indebtedness has continued to moderate following the implementation of macro and micro-prudential measures, household leverage particularly among lower income households remains high. There is a need to maintain a high degree of vigilance over lending practices in the household and property segments which can contribute to financial imbalances. Continued prudent risk management by financial institutions and businesses is also warranted in an environment where market conditions are likely to remain volatile.

The financial sector continued to remain sound and resilient

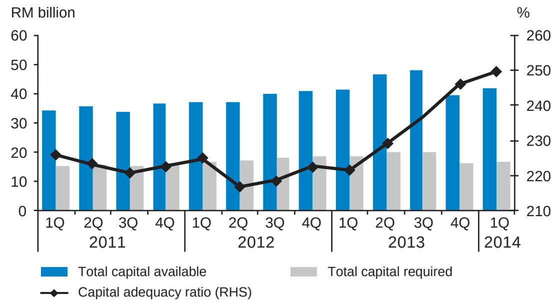
The banking system remained well-capitalised with the common equity tier 1 (CET1) capital ratio, tier 1 capital ratio and total capital ratio well above the minimum regulatory levels, at 12%, 12.8% and 14.4%, respectively. The total capital buffer of the banking system stood at more than RM80 billion. More than 80% of banks' total capital consists of high quality capital, in the form of paid-up capital, retained earnings and reserves. Similarly, the capital adequacy ratio of the insurance sector remained strong at 249.7% (4Q 2013: 246.1%), with an excess capital buffer of RM25 billion.

Banking System: Basel III Capitalisation



Source: Bank Negara Malaysia

Insurance Sector: Capitalisation

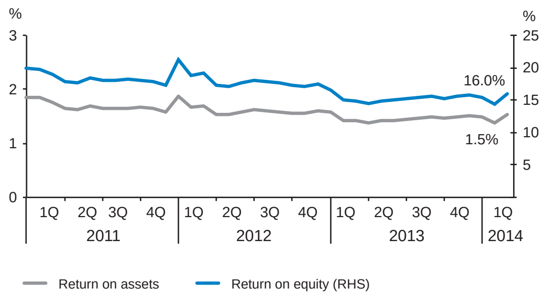


Source: Bank Negara Malaysia

The banking system recorded pre-tax profit of RM8 billion in the first quarter of 2014 (4Q 2013: RM8.2 billion), with returns on assets and equity at 1.5% and 16%, respectively (4Q 2013: 1.5% and 15.9%, respectively). The slightly lower profit level was attributed to lower income growth from trading activities, and underwriting and corporate advisory related services. The excess income over outgo of life insurers and family takaful operators remained unchanged at RM3.2 billion as lower net policy benefits payments offset the higher net unrealised investment losses during the quarter. General insurers and takaful operators recorded a lower operating profit of RM816.9 million (4Q 2013: RM1 billion) due to lower investment income and earned premium income.

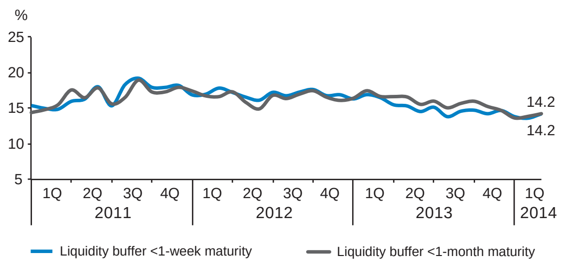
Liquidity in the banking system remained ample with the buffers to meet short-term liquidity needs over the 1-week and 1-month horizons remaining above minimum regulatory requirements, both at 14.2% of total deposits, respectively (4Q 2013: both stood at 14.7%). Net placements by banking institutions with BNM, which can be utilised to meet additional liquidity needs, stood at RM115 billion (4Q 2013: RM135 billion). US dollar mismatch positions in the less than 1-week and 1-month maturity buckets recorded a net surplus of RM1.7 billion and RM7.9 billion, respectively (4Q 2013: surplus of RM1.5 billion and RM5.3 billion, respectively) despite net capital outflows during the quarter.

Banking System: Profitability



Source: Bank Negara Malaysia

Banking System: Liquidity Buffer to Total Deposit Ratio



Source: Bank Negara Malaysia

Insurance and Takaful Sectors: Indicators

	2013			2014
	1Q	4Q	Year	1Q
	RM million			
Life insurance & family takaful				
Excess of income over outgo	3,784.1	3,322.3	13,165.3	3,205.9
General insurance & general takaful				
Operating profit	739.6	1,063.7	3,223.4	816.9
Claims ratio (%)	58.3	57.1	57.1	54.9
	Annual Change (%)			
Life insurance & family takaful				
Excess of income over outgo	-3.3	-28.2	-26.5	-15.3
General insurance & general takaful				
Operating profit	17.5	24.6	14.7	10.4
Claims ratio (percentage points)	-2.2	-0.2	-0.2	-3.4

Source: Bank Negara Malaysia