MANAGING RISKS TO FINANCIAL STABILITY

Domestic financial stability continued to be preserved

The Malaysian financial system remained resilient throughout the quarter against the backdrop of significant decline in oil prices which had impacted the financial market and exchange rate movements. Financial intermediation remained well-supported by sound financial institutions, orderly financial market conditions and sustained confidence in the financial system. The outlook for domestic financial stability is expected to remain positive, albeit in the face of a more challenging operating environment.

Credit risk exposures remained manageable amid sustained debt servicing capacity

Credit risk exposures of the banking system remained stable throughout the fourth quarter, supported by sustained debt servicing capacity of borrowers. Impaired loans as a percentage of net loans and loans-in-arrears of between one and three months as a percentage of total loans were at 1.2% and 2.5% respectively (3Q 2014: 1.3% and 2.5% respectively). The size of credit risk exposures of the insurance industry, comprising largely holdings of private debt securities, remained stable at 3.7% of total capital base.

Risks to domestic financial stability arising from exposures to the household sector remained well-contained as the series of incremental measures to curb excessive debt accumulation continue to take effect. Aggregate household borrowings from banks and non-bank financial institutions (NBFIs) grew by 2.4% (3Q 2014: +2.3%) during the quarter to RM940.4 billion (3Q 2014: RM918.2 billion). This was attributed mainly to the sustained growth in financing for the purchase of residential properties (+3.3%, 3Q 2014: +3.2%) and credit card balances (+3.7%, 3Q 2014: +0.5%). The latter reflected seasonal trends of typically higher credit card usage at year end. On a year-on-year basis, growth in aggregate household debt (banks and non-banks financial institutions) continued to moderate over the past two years to 9.9% (3Q 2014: +10.4%) since the first macroprudential measures were introduced in 2010. This was attributed mainly to the significant moderation in the annual growth of personal financing by NBFIs, which more than halved to 5.3% (2013: +13.9%) during the year. Aggregate financial assets of households continued to account for more than two times of debts. The composition of financial assets was largely stable, although the value of investments in equities declined in tandem with changes in equity valuations. Banks continued to maintain credit underwriting standards and observe prudent debt service ratios for new financing to households. Impaired loans and loans-in-arrears of between one and three months remained low and stable at 1.2% and 1.8% of total household borrowings from banks respectively.

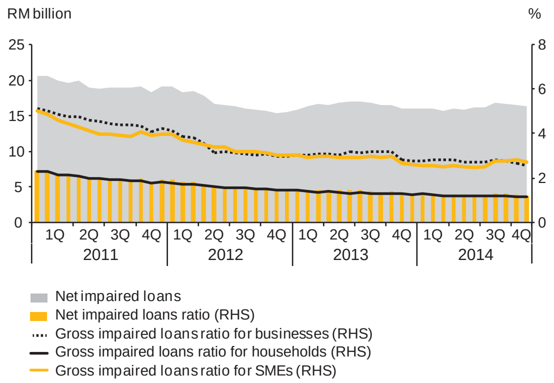
Domestic borrowings (loans, private debt securities and sukuk) by the business sector recorded a quarterly growth of 3.0% (3Q 2014: +1.6%), driven mainly by the property sector. External borrowings declined by 4% during the third quarter (2Q 2014: +0.1%) due mainly to maturing bonds. On a year-on-year basis, domestic borrowings recorded a growth of 8.5% (3Q 2014: 7.6%), while external borrowings declined by 0.5% (2Q 2014: +13.9%). Potential losses from banks' credit exposures to the business sector remained manageable. As at end of the third quarter, the leverage position of businesses[4], as measured by the median debt-to-equity ratio, improved further to 42.7% (2Q 2014: 43.6%). This leverage was supported by strong debt servicing capacity, as measured by the median interest coverage ratio of 6.2 times (2Q 2014: 6.5 times). This is despite the lower operating profits recorded by businesses in the agriculture, construction and engineering, and oil and gas related sectors. Overall liquidity also remained sound, as measured by the median ratio of current assets to current liabilities of 1.9 times (2Q 2014: 1.7 times). The sustained strong fundamentals of businesses were reinforced by the low and stable impaired loans and loans-in-arrears of between one and three months, which

[4] Based on financial data of 160 companies that are listed on the FBM KLCI, covering major economic sectors and 80% of market capitalisation

accounted for 2.5% and 0.3% of total business loans (3Q 2014: 2.8% and 0.3%) respectively. In addition, the risk of overall delinquency, as measured by the expected default frequency, remained low at 0.19% (3Q 2014: 0.12%). While developments in oil prices and volatile ringgit movements in the fourth quarter are expected to weigh on profitability of some businesses, these developments would also be positive for export-oriented manufacturing sectors. The net effects on banking system are therefore expected to remain manageable.

Aggregate house prices recorded three consecutive quarters of slower annual growth since end-2013, following the introduction of additional measures in July 2013. The annual growth of the Malaysian House Price Index (MHPI) slowed to 8.4% in the second quarter (1Q 2014: +9.6%). Preliminary MHPI data also indicated further moderation in the third quarter across most house types and major employment centres. In addition, borrowings for speculative purchases remained subdued. The number of borrowers with three or more outstanding housing loans continued to account for less than 3% of individuals with outstanding housing loans with banks.

Banking System: Loan Quality



Source: Bank Negara Malaysia

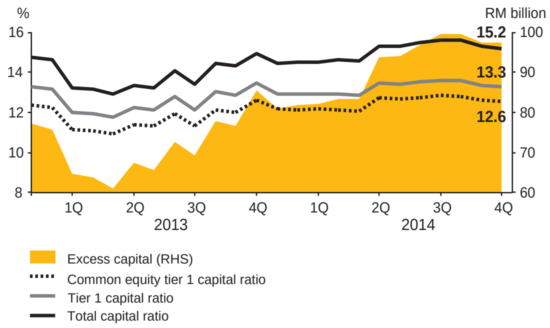
Domestic financial market conditions remained orderly

Domestic financial markets remained resilient despite heightened volatility following investors' reaction to the decline in oil prices and other external developments. Portfolio investments recorded a net outflow of RM20.4 billion in the fourth quarter (3Q 2014: net outflow of RM11 billion). The average volatility of the 10-year MGS yield rose to 6.7% (3Q 2014: 6.0%) as investors consolidated their investment positions towards the year-end. The average volatility of the FBM KLCI also increased to 7.7% (3Q 2014: 5.2%) as investors remained cautious over the potential downside risk of declining oil prices on the domestic economy. Yields for the 10-year MGS rose but only slightly to 4.15% (3Q 2014: 3.92%), while the FBM KLCI ended the year lower at 1,761.3 points (3Q 2014: 1,846.3 points). The price-to-earnings ratio of the FBM KLCI remained broadly stable at 15.8 times (3Q 2014: 16.7 times), underpinned by the strong economic fundamentals. Trading liquidity, both in terms of price and volume, remained intact. The bid-ask spreads of MGS and FBM KLCI were unchanged at 0.1% and 0.4% of the mid-price respectively (3Q 2014: 0.1% and 0.4% respectively). The turnover ratio for MGS and FBM KLCI was also relatively stable at 10.8% and 1.8% respectively (3Q 2014: 8.4% and 1.7% respectively) reflecting continued and steady trading activities by domestic institutional investors and financial institutions.

Market risk exposures were well-managed by financial institutions

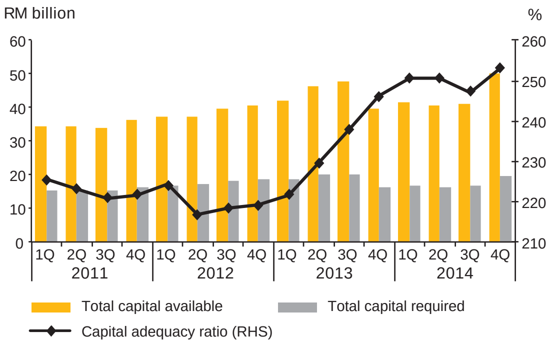
The continued active risk management and hedging by financial institutions kept market risk exposures within manageable levels. Bank exposures to interest rate risk in the trading book remained at 1.5% of total capital. Exposures to equity risk accounted for 1.3% (3Q 2014: 1.4%) of total capital, while the foreign exchange (FX) net open position of the banking system narrowed to 4.9% (3Q 2014: 5.7%) of total capital during the quarter. Market risk exposures of the insurance industry reduced to 12.2% of total capital (3Q 2014: 12.7%) due to lower investments in equities, in line with stock market movements in the final quarter. Equity risk continues to form the bulk of insurers' market risk exposures at 7.6% of total capital.

Banking System: Basel III Capitalisation



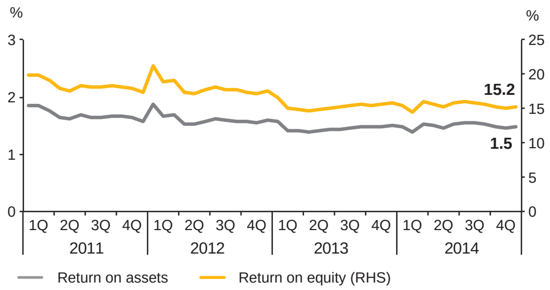
Source: Bank Negara Malaysia

Insurance Sector: Capitalisation



Source: Bank Negara Malaysia

Banking System: Profitability



Source: Bank Negara Malaysia

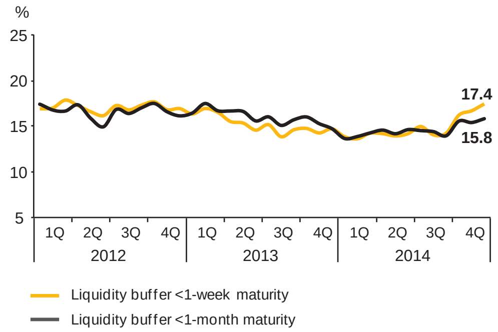
Financial institutions remain sound and resilient

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 12.6%, 13.3% and 15.2% respectively. The total capital buffer for banks which are in excess of the minimum regulatory capital requirement stood at more than RM90 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 253% (3Q 2014: 246.9%), with an excess capital buffer of RM30.2 billion.

The banking system recorded a lower pre-tax profit of RM7.8 billion (3Q 2014: RM8.1 billion) in the quarter, with returns on assets and equity of 1.5% and 15.2% respectively (3Q 2014: 1.5% and 15.6% respectively). This was attributed mainly to higher deposit expense and staff costs. For the general insurance and takaful businesses, the lower operating profit of RM661.1 million (3Q 2014: RM788 million) was driven mainly by lower premium volume and lower net profit from disposal of assets. The excess income over outgo of life insurers and family takaful operators was also lower at RM2.1 billion (3Q 2014: RM3.8 billion) due to net investment losses of RM924 million (3Q 2013: net investment gains of RM718.3 million) mainly from investment in equities.

Competition for deposits intensified during the quarter amid banks' strategies to increase the level of stable funding towards compliance with the Liquidity Coverage Ratio standards. Liquidity in the banking system remained ample with sufficient buffers to meet short-term liquidity needs, despite outflows of portfolio funds in the quarter. The liquidity buffers for maturities within the 1-week and 1-month horizons remained well above minimum regulatory requirements at 17.4% and 15.8% of total deposits respectively (3Q 2014: 14.2% and 13.9%, respectively). Net interbank placements by banks with Bank Negara Malaysia, which can be utilised to meet additional liquidity needs, amounted to RM91.1 billion. US dollar liquidity recorded surpluses of RM6.6 billion and RM5.1 billion in the less than 1-week maturity bucket and in the less than 1-month maturity bucket respectively (3Q 2014: shortfall of RM3.4 billion and surplus of RM1.2 billion respectively).

Banking System: Liquidity Buffer to Total Deposit Ratio



Source: Bank Negara Malaysia

Insurance and Takaful Sectors: Indicators

	2013		2014		
	4Q	Year	3Q	4Q	Year
	RM million				
Life insurance & family takaful					
Excess income over outgo	*3,345*	*13,188*	*3,834*	*2,117*	*13,757*
General insurance & general takaful					
Operating profit	*1,041*	*3,224*	*788*	*661*	*3,077*
Claims ratio (%)	*57.1*	*57.1*	*56.8*	*57.6*	*57.6*
	Annual Change (%)				
Life insurance & family takaful					
Excess income over outgo	*-26.3%*	*-27.7%*	*167.5%*	*-36.7%*	*4.3%*
General insurance & general takaful					
Operating profit	*21.9%*	*11.2%*	*17.3%*	*-36.5%*	*-4.6%*
Claims ratio (percentage points)	*-0.2*	*-0.2*	*-2.0*	*0.5*	*0.5*

Source: Bank Negara Malaysia