MANAGING RISKS TO FINANCIAL STABILITY

Domestic financial stability continued to be well-preserved

The Malaysian financial system remained resilient despite continued volatility in the domestic financial market arising from uncertainties in the external environment, prevalent in the latter half of September. Financial intermediation remained well-supported by sound financial institutions, orderly financial market conditions and sustained confidence in the financial system. While the period ahead is expected to remain challenging, the outlook for domestic financial stability continues to be positive.

Credit risk remained manageable supported by sustained debt servicing capacity of borrowers

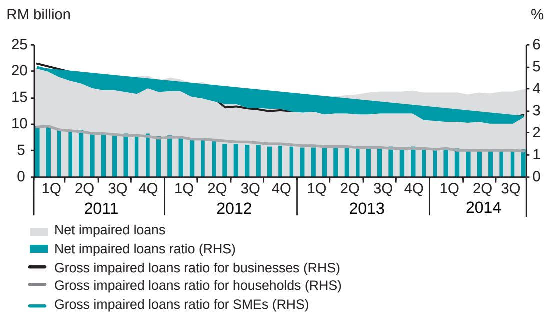
Credit risk in the banking system remained stable as the debt servicing capacity of majority of the borrowers remained intact. Loan impairment levels were unchanged at 1.3% of net loans (2Q 2014: 1.3%), while arrears between one to three months improved to 2.5% of total loans (2Q 2014: 2.7%). For insurers, the size of credit risk exposures, which largely emanate from holdings of private debt securities, stood at 3.8% of total capital base (2Q 2014: 3.5%).

Aggregate household borrowings via banks and major non-banks grew at a slower pace of 2.3% for the quarter (2Q 2014: 2.5%) to amount to RM918.2 billion (2Q 2014: RM897.8 billion), as the series of measures to contain household debt continue to take effect. The moderation in household borrowings was attributed to financing for the purchase of motor vehicles which grew at a slower pace of 0.7% during the quarter (2Q 2014: 0.9%). On a year-on-year basis, aggregate household debt continued to grow at a stable pace of 10.4% (2Q 2014: 10.3%). The risk to financial stability arising from high household indebtedness remained manageable, supported by prudent debt servicing ratio (DSR) associated with new household debt. Impaired loans were unchanged at 1.2% (2Q 2014: 1.2%) while loans-in-arrears of between one to three months stood at 1.9% (2Q 2014: 2.0%) of total household borrowings from the banking sector. These developments were underpinned by stable employment conditions and wage growth that supported the sustained trend in the ratio of loan repayments-to-disbursements. At the aggregate level, household financial assets remained healthy at 2.2 times of household debt, although at the lower end of the income spectrum, households are having to adjust to rising costs of living with smaller financial buffers available.

During the quarter, domestic borrowings (loans, private debt securities and sukuk) by the business sector grew by 1.6% (2Q 2014: 1.1%), driven mainly by the property sector. External borrowings were almost unchanged in the second quarter (2Q 2014: 0.1%; 1Q 2014: 2.0%). This contributed to a moderation in the year-on-year growth in external borrowings to 13.9% as at end of the second quarter (1Q 2014: 20.4%). The bulk of external borrowings was by businesses operating in the more capital-intensive economic sectors such as the oil and gas, telecommunications and power sectors. The quality of banking system credit exposures to businesses remained healthy despite a slight increase of 0.1 percentage point in impaired loans to 2.8% of total business loans (2Q 2014: 2.7%). Loans-in-arrears of between one and three months improved to 0.3% of total business loans (2Q 2014: 0.5%). The risk of delinquency, as measured by the expected default frequency, remained low at 0.14% (2Q 2014: 0.15%) on the back of sustained financial performance of businesses. Potential losses from banks' credit exposures to businesses were also minimised by the strong financial buffers accumulated by businesses against adverse changes in the operating environment. As at end of second quarter 2014, current assets of businesses stood at 1.7 times of current liabilities (1Q 2014: 1.8 times), while the leverage position of businesses, as measured by the debt-to-equity ratio, was little changed at 40.7% (1Q 2014: 40.2%). The interest coverage ratio of businesses stood at 6.5 times (1Q 2014: 7.2 times), remaining sufficiently above prudent levels despite lower operating profits recorded by some businesses in the manufacturing, and trading and services industries.

In the property market, the series of macroprudential and other measures introduced since 2010 to curb speculative activities in the domestic housing market continued to yield the intended outcomes. Annual growth of the Malaysian House Price Index (MHPI) has been stable for the past two quarters at 9.6% in the first quarter of 2014 (4Q 2013: 9.6%; 3Q 2013: 12.2%). The preliminary MHPI data also indicated that the annual growth in house prices moderated further to 6.6% in the second quarter. New launches and sales in the primary housing market continued to remain soft as developers adopt a more cautious approach given the series of measures. Credit-induced speculative house purchases remained well contained, with the number of multiple loan borrowers (i.e. those with three or more outstanding housing loans) expanding at a slower annual growth rate of 3.6% (2Q 2014: 3.7%). The loan-to-value ratio has also effectively capped such borrowers to about 3% of total housing loan borrowers.

Banking System: Loan Quality



Source: Bank Negara Malaysia

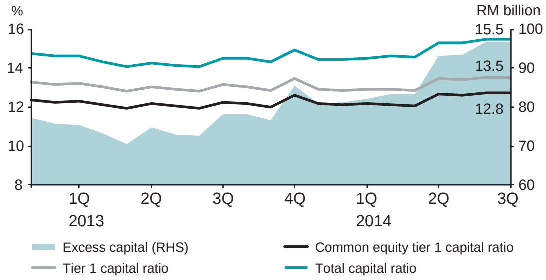
Domestic financial market conditions remained orderly

Portfolio investments recorded a net outflow position during the quarter amounting to RM11.0 billion (2Q 2014: net inflow of RM6.9 billion), mainly attributable to higher acquisitions of portfolio assets abroad by domestic institutional investors. Volatility in the financial markets eased although uncertainties in the external environment continued to affect market sentiment. The average volatility of 10-year MGS yield and FBM KLCI eased to 5.9% and 5.2% respectively (2Q 2014: 6.6% and 6.4% respectively) on account of the positive outlook on the domestic economy and improvements in market sentiment, arising from accommodative monetary policy actions in advanced economies. Yields for 10-year MGS declined slightly to 3.9% (2Q 2014: 4.0%), as investors' interests in ringgit denominated securities were sustained. In the equity market, the FBM KLCI rallied and hit a record high of 1,892.6 points on 8 July, before ending the quarter lower at 1,846.3 points (2Q 2014: 1,882.7 points). The price-to-earnings ratio of the FBM KLCI remained broadly stable at 16.8 times (2Q 2014: 17.1 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 (2Q 2014: 0.1% and 0.4% respectively). The turnover ratio for MGS and FBM KLCI was also stable at 8.5% and 1.7% respectively (2Q 2014: 8.5% and 2.0% respectively) reflecting continued and steady trading activities by domestic institutional investors and financial institutions.

Financial institutions' exposures to market risks were well-contained

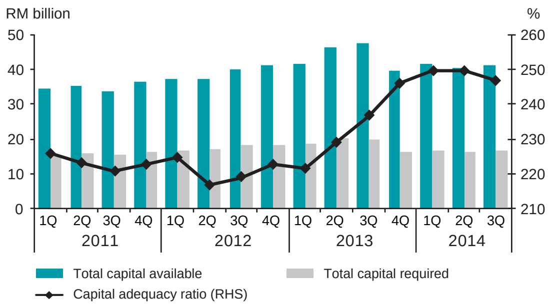
Overall risk taking behaviour of financial institutions was broadly unchanged. There was no material change in the proportion and composition of financial institutions' treasury portfolio. About 98.1% (2Q 2014: 97.8%) of the banking system treasury portfolio is in the form of fixed income securities. The size of banking system exposure to interest rate risk in the trading book declined slightly to 1.5% of total capital (2Q 2014: 1.6%), while exposure to equity risk was at 1.4% of total capital (2Q 2014: 1.2%). The banks' foreign exchange net open position narrowed marginally to 5.8% of total capital (2Q 2014: 5.9%) as banks maintained continued prudence in managing foreign currency exposures especially in light of volatility that has been experienced in the recent period. The market risk exposure of the insurance industry similarly remained within manageable levels, accounting for 12.7% of total capital (2Q 2014: 12.5%). Equity risk continues to form the bulk of insurers' market risk exposure at 8.5% of total capital (2Q 2014: 8.0%), amid the increase in equities holdings (3Q 2014: RM44.7 billion; 2Q 2014: RM43.8 billion). Fixed income securities represent 70% of the insurance industry's treasury portfolio.

Banking System: Basel III Capitalisation



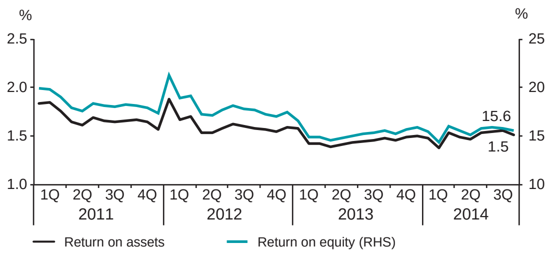
Source: Bank Negara Malaysia

Insurance Sector: Capitalisation



Source: Bank Negara Malaysia

Banking System: Profitability



Source: Bank Negara Malaysia

Financial institutions' soundness was sustained

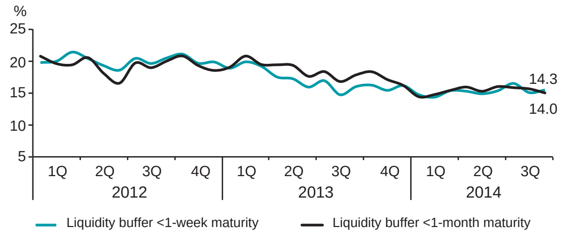
Financial soundness indicators of banks and insurers were strong as reflected in high capitalisation, profitable business and ample liquidity. The common equity tier 1 (CET1) capital ratio, tier 1 capital ratio and total capital ratio of the banks were well above the minimum regulatory levels, at 12.8%, 13.5% and 15.5% respectively. More than 80% of the banks' total capital consists of high quality capital, as represented by the strong CET1 level in the form of paid-up capital, retained earnings and reserves. Total capital buffers for banks, which are in excess of the minimum total regulatory capital requirement stood at more than RM90 billion. The Capital Adequacy Ratio of insurers stood at 246.9% (2Q 2014: 249.7%) with an excess capital buffer of RM24.4 billion (2Q 2014: RM25.7 billion).

Banks recorded RM8.1 billion in pre-tax profits for the quarter (2Q 2014: RM8.1 billion), with returns on assets and equity standing at 1.5% and 15.6% respectively (2Q 2014: 1.5% and 15.8% respectively). In the insurance industry, general insurance and takaful business recorded lower operating profits of RM788.3 million (2Q 2014: RM804 million) driven by lower underwriting profits. Excess income over outgo of the life insurers and family takaful operators declined to RM3.8 billion (2Q 2014: RM4.6 billion) amid lower net investment gains and new business premium across all products.

Liquidity in the banking system remained largely unchanged. The excess liquidity over the 1-week and 1-month horizons amounted to 14.3% and 14% of total deposits respectively (2Q 2014: 14.2%

and 14.6% respectively). In addition, banking institutions have net placements totalling RM103 billion (2Q 2014: RM 115 billion) with Bank Negara Malaysia, which can be drawn to meet additional and unanticipated liquidity needs. USD liquidity recorded a shortfall of RM3.4 billion in the less than 1-week maturity bucket following a higher amount of net outflows from maturing interbank borrowings and FX derivative contracts payable, but recorded a higher surplus of RM1.2 billion in the less than 1-month maturity bucket (2Q 2014: surplus of RM3.7 billion and RM0.7 billion respectively).

Banking System: Liquidity Buffer to Total Deposit Ratio



Source: Bank Negara Malaysia

Insurance and Takaful Sectors: Indicators

	2013		2014		
	2Q	3Q	1Q	2Q	3Q
	RM million				
Life insurance & family takaful					
Excess income over outgo	*4,617.1*	*1,433.2*	*3,164.8*	*4,592.7*	*3,835.9*
General insurance & general takaful					
Operating profit	*772.0*	*663.8*	*823.8*	*804.0*	*788.3*
Claims ratio (%)	*57.9*	*58.8*	*56.1*	*58.0*	*56.8*
	Annual Change (%)				
Life insurance & family takaful					
Excess income over outgo	*12.1%*	*72.6%*	*-15.2%*	*-0.7%*	*167.6%*
General insurance & general takaful					
Operating profit	*9.8%*	*-2.4%*	*11.4%*	*4.3%*	*18.8%*
Claims ratio (percentage points)	*-1.2*	*-0.4*	*-3.4*	*-0.1*	*-2.0*

Source: Bank Negara Malaysia