MANAGING RISKS TO FINANCIAL STABILITY

Financial stability continued to be preserved

Domestic financial stability remained intact in the first quarter despite continued uncertainties in the global financial markets, especially in the euro area. Financial intermediation remained effective, supported by institutional soundness, orderly financial market conditions and sustained confidence in the financial system.

Credit risk in the banking system was stable throughout the quarter, reflecting the sustained debt servicing capacity of borrowers, following continued expansion in domestic economic activity. As at end-March, the ratio of net impaired loans of banks remained stable at 1.3% (4Q 2012: 1.4%), while loans-in-arrears of between 1 and 3 months were lower at 3.4% of total loans (4Q 2012: 3.5%). Similarly, credit risk exposures of the insurance industry, primarily through holdings of private debt securities and reinsurance placements, were stable at 3.3% of insurers' total capital base.

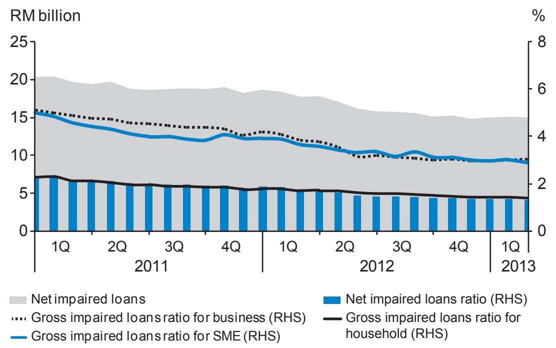
Household financial assets grew by 2.8% during the quarter (4Q 2012: 2.2%), which was higher than the expansion in household debt of 2.5% (4Q 2012: 3.1%). The accumulation of debts by the household sector continued to be primarily for the financing of residential properties. Delinquencies were largely intact, with impaired loans and loans-in-arrears of between 1 and 3 months for household borrowings from banking institutions remaining stable at 1.4% and 2.2% of household loans respectively (4Q 2012: 1.5% and 2.4% respectively), indicating households' continued ability to service debt.

Banking system financing to businesses continued to expand during the quarter (1.7%; 4Q 2012: 1.2%). Financial buffers accumulated by businesses continued to provide support against the potential impact from the weaker external environment.

Business sector cash and cash equivalent holdings grew by 0.6% (3Q 2012: 0.2%). Financial institutions' credit risk to the overall business sector remained manageable as debt servicing capacity of businesses remained intact (interest coverage ratio: 5.6 times; 3Q 2012: 5.8 times), supported by sustained profitability and operational efficiency amidst low and stable leverage positions. The level of impaired loans is sustained at 3% of total business loans at the end of the quarter (4Q 2012: 3%), while the ratio of loans-in-arrears of between 1 and 3 months remained low at 1.4% (4Q 2012: 1.2%).

In the near term, no major change is expected in the direction of credit risk in the banking system. Household and business finances would continue to be supported by an expansion in domestic economic activity, with stable employment conditions resulting in sustained debt servicing capacity. Financial institutions generally continued to observe robust underwriting and sound risk management practices. The capacity of businesses to withstand the weaker external environment is expected to remain strong, with the risk of delinquency, as measured by the expected default frequency, improving slightly to 0.49% at the end of the quarter (4Q 2012: 0.50%).

Banking System: Loan quality



Source: Bank Negara Malaysia

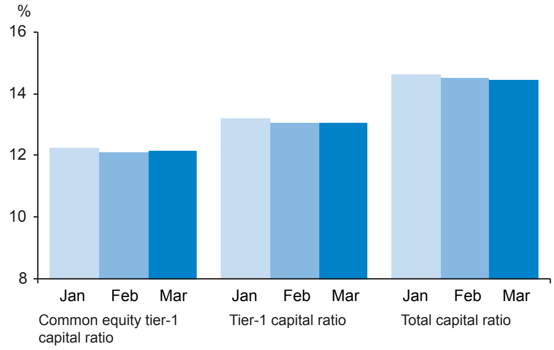
Exposures of financial institutions to market risk remained relatively unchanged. Volatility in short-term capital flows continued to be smoothly intermediated by the financial system without disruptive effects on the domestic financial markets. Volatility in the public bond market eased, with the average volatility of 10-year MGS yields declining to 4.7% (4Q 2012: 8.6%). Trading activity, as measured by the turnover ratio, increased to 12.9% (4Q 2012: 10.3%). The bid-ask spreads of MGS remained tight, averaging at 6.9% of the average mid-price (4Q 2012 average: 7.8%). Volatility in the equity market rose during the quarter on renewed concerns in Europe and domestic political uncertainties to 7.6% (4Q 2012: 6.6%). However, interest rate and equity risk exposures of banks remained relatively unchanged at 4.9% and 0.5% of capital base respectively (4Q 2012: 4.9% and 0.6% respectively). Similarly, the insurers' exposures to interest rate and equity risks were well-contained at 3.5% and 6.4% of total capital base respectively (4Q 2012: 3.7% and 6.6% respectively). Moreover, basis risk moderated as the spreads between Interest Rate Swap (IRS) and MGS stabilised from the beginning of the year, driven by declining IRS rates after recording a rising trend since the second half of 2012.

Potential risks emanating from direct exposures of financial institutions to Europe and from deleveraging by European financial institutions remained limited. Direct credit exposures of the banking sector to Europe continued to account for less than 10% of banks' capital base. Locally incorporated European banks continued to report healthy profits and showed no evidence of scaling down operations in Malaysia.

Financial sector continued to remain sound and resilient

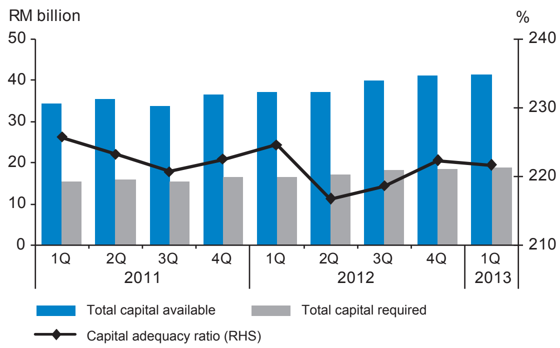
The banking system remains resilient to adverse developments in the economy and financial system, with deep capital buffers in excess of RM74 billion at the end of the first quarter of 2013. In line with globally determined timelines, the new capital standards under Basel III are being phased in beginning January 2013. Despite the strengthened capital requirements, banks continued to be well-capitalised, with the banking system recording Common Equity Tier 1 (CET1) Capital Ratio, Tier 1 Capital Ratio and Total Capital Ratio well above the minimum regulatory levels, at 12.2%, 13.1% and 14.5% respectively. More than 84% of total capital consists of high quality common equity tier 1 capital, comprising paid-up capital, retained earnings and reserves. Similarly, the insurance sector also maintained a sound capital adequacy ratio of 221.6% (4Q 2012: 222.8%), with an excess capital buffer of RM22.7 billion.

Banking System: Basel III Capitalisation



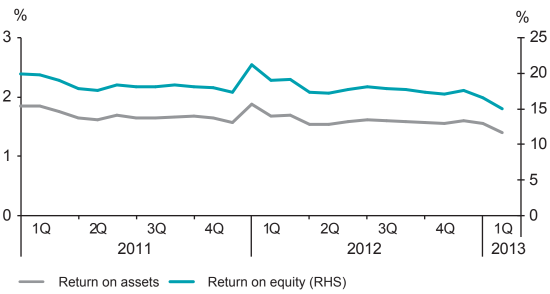
Source: Bank Negara Malaysia

Insurance Sector: Capitalisation



Source: Bank Negara Malaysia

Banking System: Profitability



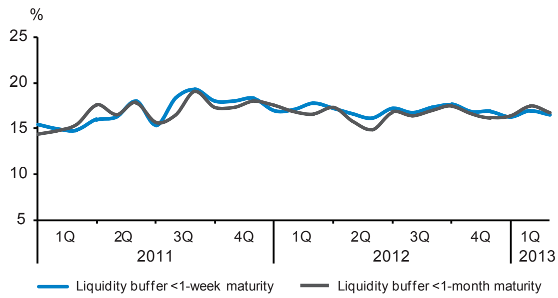
Source: Bank Negara Malaysia

Pre-tax profit of the banking system for the quarter declined slightly to RM6.9 billion (4Q 2012: RM7.7 billion), due to lower income from fee-based and investment-related activities, and higher loan loss provisions and overhead costs. Returns on assets and equity remained stable at 1.4% and 15.3% respectively (4Q 2012: 1.6% and 17.5% respectively).

In the insurance and takaful industry, excess of income over outgo registered by life insurers and family takaful operators was lower, due primarily to lower net premiums income, particularly in the investment-backed and participating products (RM3.8 billion; 4Q 2012: RM4.5 billion). Lower net gains also contributed to lower profit, but were offset by higher profit from the sale of assets. General insurers and takaful operators registered an operating profit of RM721 million (4Q 2012: RM854 million), amid lower underwriting profit.

The resilience of the banking system is also supported by ample liquidity in the system. Liquidity buffers to meet short-term liquidity needs over a 1-week and 1-month horizon remained comfortable at 16.5% and 16.8% of total deposits respectively (4Q 2012: 17% and 16.2% respectively). Net placements by banks with BNM, which can be utilised to meet additional liquidity needs, stood at a further RM142 billion. The US dollar mismatch position in the less than 1-month maturity bucket improved to record a larger surplus of RM4.5 billion (4Q 2012: RM3.1 billion surplus). This contrasted with the marginal shortfall of RM0.8 billion that was recorded in the less than 1-week maturity bucket (4Q 2012: RM4.3 billion surplus). This shortfall position, however, was predominantly driven by interbank placements and foreign currency contracts, which are used mainly for treasury activities and for hedging against underlying contracts with businesses.

Banking System: Liquidity Buffer to Total Deposit Ratio



Source: Bank Negara Malaysia

Insurance and Takaful Sectors: Indicators

	2012			2013	
	1Q	4Q	Year	1Q	
	RM million				Annual change (%)
Life insurance & family takaful					
Excess of income over outgo	3,912.9	4,451.1	17,724.4	3.786.6	-3.2
General insurance & general takaful					
Operating profit	652.6	854.0	2,898.1	721.1	10.5
Claims ratio (%)	60.6	57.4		52.8	-7.8 (ppt)

Source: Bank Negara Malaysia