MANAGING RISKS TO FINANCIAL STABILITY

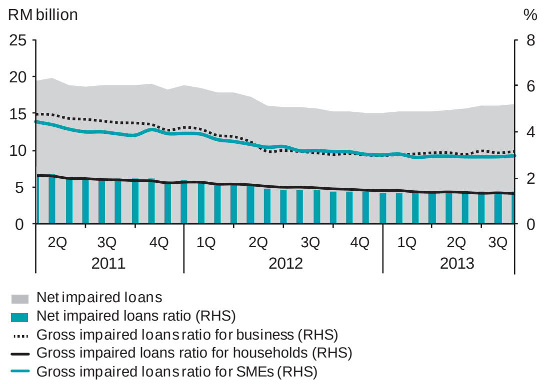
Financial stability continued to be preserved

The domestic financial system remained resilient throughout the third quarter, despite increased volatility in 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. Loans-in-arrears of between one and three months improved to 3.0% of total loans (2Q 2013: 3.1%), while the level of net impaired loans remained stable at 1.4% of net loans (2Q 2013: 1.4%). Credit risk exposures of the insurance industry, largely from holdings of private debt securities and reinsurance placements, declined slightly, accounting for 3.3% (2Q 2013: 3.4%) of capital base.

Growth in household debt via banks and selected non-bank financial institutions moderated to 2.5% during the quarter (2Q 2013: 3.2%). Compared to the third quarter in the previous year, financing to households also grew at a more moderate pace at 12.0% (2Q 2013: 13.0%). This was driven by a moderation in the expansion of personal financing (3Q 2013: 2.2%, 2Q 2013: 4.3%) and borrowings for the purchase of residential properties (3Q 2013: 1.9%, 2Q 2013: 3.2%). On an annual basis, borrowings for personal financing and purchase of residential properties expanded at a slower pace of 13.1% and 11.5% (2Q 2013: 17.2% and 12.8%) respectively. This development is an early indication of the effects of the macroprudential measures introduced by the Bank on 5 July 2013. At present, the overall debt servicing capacity of the household sector remained intact at the aggregate level, as reflected by the stable ratios of banks' impaired loans and loans-in-arrears of between one and three months of 1.3% and 2.2% of total household loans respectively. The level of impairment however varies across income groups, with those in the lower income category registering higher impairment levels and incidence, consistent with the higher leverage position of lower income individuals. At the aggregate level, household financial assets remained healthy at 2.2 times of household debt, although the strength of financial buffers is uneven across income levels. Household repayment capacity is expected to remain intact against the backdrop of sustained discipline in lending standards observed by banking institutions, improving employment conditions and sustained wage growth.

Banking System: Loan quality



Source: Bank Negara Malaysia

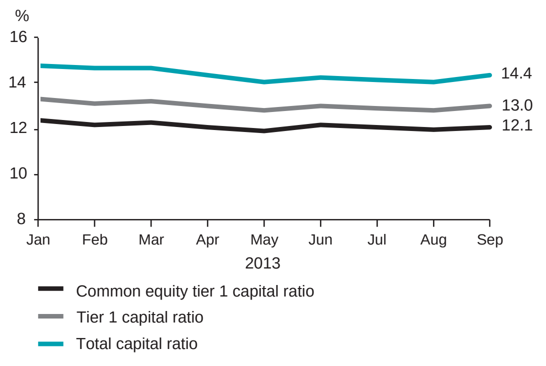
Financing to businesses expanded albeit at a slower pace of 0.9% during the quarter (2Q 2013: 3.2%). On an annual basis, financing to businesses grew moderately at 7.2% (2Q 2013: 8.2%). The debt servicing capacity of businesses generally remained intact despite a decline in the interest coverage ratio (2Q 2013: 5.0 times, 1Q 2013: 6.4 times) due to lower operating profits in several industries. Loans-in-arrears of between one and three months improved to 0.8% (2Q 2013: 1.0%), while the impaired loans ratio for the business portfolio stood at 3.1% (2Q 2013: 3.0%). Financial buffers accumulated by businesses continue to provide support against potential challenges in the operating environment, with liquid financial assets remaining stable at 1.8 times of current financial obligations. The risk of delinquency, as measured by the expected default frequency, remained low and stable at 0.33% (2Q 2013: 0.35%).

Market risk exposures of financial institutions were well-contained despite the increased financial market volatility amid uncertainties in the global environment. Volatility in short-term capital flows continued to be well-intermediated by the financial system. Average volatility for 10-year MGS yields and the FBM KLCI increased to 17.8% and 10.4% (2Q 2013: 8.0% and 9.3%) respectively. Trading activity, as measured by the turnover ratio for MGS and FBM KLCI, declined to 11.9% and 2.2% (2Q 2013: 17.5% and 2.6%) respectively. The bid-ask spreads for MGS and FBM KLCI remained tight, averaging at 0.2% and 0.4% of the mid price (2Q 2013: 0.1% and 0.4%) respectively. Banks' exposures to interest rate risks declined to 4.1% of total capital (2Q 2013: 4.4%), while exposures to equity risks remained stable at 0.6% of total capital (2Q 2013: 0.6%). Meanwhile, the FX net open position of the banking system declined slightly to 6.1% of total capital (2Q 2013: 7.2%). Similarly, the interest rate and equity risk exposures of insurers remained stable at 2.5% and 6.9% of total capital base (2Q 2013: 2.8% and 7.1%) respectively.

The financial sector continued to remain resilient

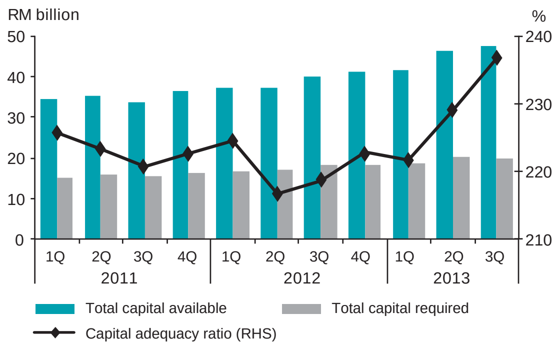
The banking system continued to be well-capitalised, with the common equity tier 1 (CET1) capital ratio, tier 1 capital ratio and total capital ratio remaining well above the minimum regulatory levels, at 12.1%, 13.0% and 14.4% respectively. Banks' capital buffers in excess of the minimum regulatory level stood at more than RM76.5 billion. In terms of capital quality, more than 84% of total capital consists of high quality CET1 capital, comprising paid-up capital, retained earnings and reserves. Similarly, the capital adequacy ratio of the insurance sector remained strong at 236.7% (2Q 2013: 229.5%), with an excess capital buffer of RM27.4 billion.

Banking System: Basel III Capitalisation



Source: Bank Negara Malaysia

Insurance Sector: Capitalisation

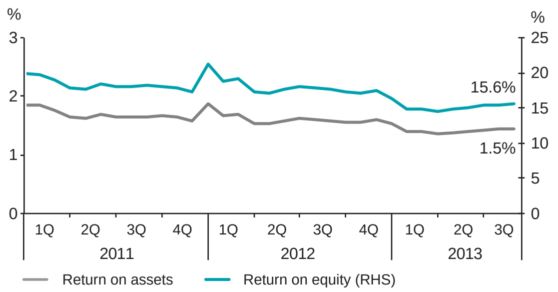


Source: Bank Negara Malaysia

Pre-tax profit of the banking system increased slightly to RM7.8 billion (2Q 2013: RM7.1 billion), attributable mainly to income from financing activities and higher gains from trading and investment activities. Profitability remained stable, with returns on assets and equity of 1.5% and 15.6% (2Q 2013: 1.4% and 15.1%) respectively. Life insurers and family takaful operators registered a lower profit (before surplus arising) of RM870.1 million (2Q 2013: RM4.6 billion profit), driven by unrealised valuation losses recorded by the large life insurers as a result of increased volatility in the financial markets which impacted valuation of insurers' investments in MGS and equities. Life insurers are one of the main players in the government security and equity markets, with investments totalling RM24.8 billion and RM33.0 billion respectively. However, the impact on the life funds was largely mitigated by lower valuations of the corresponding liabilities on life insurance contracts from higher MGS yields used to discount future liabilities. General insurers and takaful operators recorded a lower operating profit of RM663.8 million (2Q 2013: RM772.0 million), due to a marginal increase in overall claims experienced.

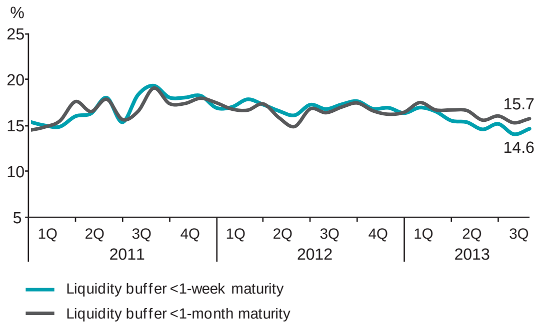
The resilience of the banking system is further supported by ample liquidity in the system. Buffers to meet short-term liquidity needs over the 1-week and 1-month horizons stood at 14.6% and 15.7% of total deposits (2Q 2013: 14.6% and 15.6%) respectively. Net placements by banking institutions with the Bank, which can be drawn to meet additional liquidity needs, stood at RM152.2 billion (2Q 2013: RM146.8 billion). US dollar mismatch positions in the less than 1-month maturity bucket registered a surplus of RM2.9 billion (2Q 2013: surplus of RM4.1 billion) while mismatch positions in the less than 1-week maturity bucket improved to register a shortfall of RM2.9 billion (2Q 2013: RM4.1 billion shortfall).

Banking System: Profitability



Source: Bank Negara Malaysia

Banking System: Liquidity Buffer to Total Deposit Ratio



Source: Bank Negara Malaysia

Insurance and Takaful Sectors: Indicators

	2012		2013		
	2Q	3Q	1Q	2Q	3Q
			RM million		
Life insurance & family takaful					
Excess of income over outgo	4,115.7	5,244.8	3,789.7	4,617.1	870.1
General insurance & general takaful					
Operating profit	703.0	688.5	738.7	772.0	663.8
Claims ratio (%)	59.2	59.1	58.3	57.9	58.8
			Annual Change		
Life insurance & family takaful					
Excess of income over outgo	8.9%	298.8%	-3.2%	12.1%	-83.4%
General insurance & general takaful					
Operating profit	26.2%	55.9%	13.2%	9.8%	-3.6%
Claims ratio (percentage points)	-2.2	-3.4	-2.3	-1.3	-0.3

Source: Bank Negara Malaysia