MANAGING RISKS TO FINANCIAL STABILITY

Financial stability continued to be preserved

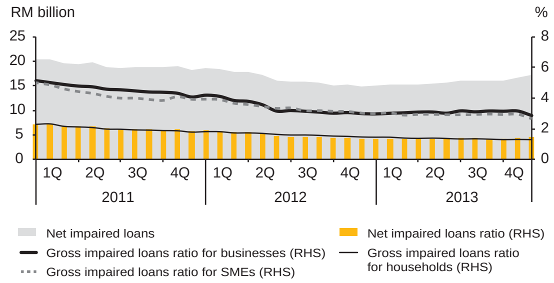
The domestic financial system remained resilient throughout the fourth quarter, despite continued volatility in global and domestic financial markets, and a challenging operating environment. The assessment of risks to financial stability revealed that financial intermediation continued to be well-supported by sound financial institutions, orderly financial market conditions and sustained confidence in the financial system. Risks to the financial system arising from financing to households and developments in the property market continued to be well-contained despite further growth in the financial institutions' exposures to these sectors. This is further supported by additional measures which were implemented in the second half of 2013 to contain further risk build-up in the property market amid continued supervisory vigilance over risk management and valuation practices of financial institutions and intensified financial education initiatives.

Credit risk in the banking system remained stable throughout the quarter with the quality of financing by banks remaining intact. As at end-2013, loans-in-arrears of between one and three months improved to 2.6% of total loans (3Q 2013: 3.0%), while the level of net impaired loans remained stable at 1.4% of net loans, supported by continued strength in borrowers' debt servicing capacity. Credit risk exposures of insurers, which largely emanate from holdings of private debt securities and reinsurance placements, were largely unchanged to account for 3.3% of capital base.

Household debt rose to RM848.1 billion (3Q 2013: RM824.3 billion) as at end-Dec 2013. This was attributed to bank lending for the purchase of residential properties and securities which expanded by 3.2% and 7.2% respectively during the quarter. In response to the series of macroprudential measures introduced by the Bank including measures on personal financing which took effect on 5 July 2013, growth in personal financing extended by banks and non-bank financial institutions to households slowed further to 0.6% (3Q 2013: +2.2%). Approvals for new personal financing facilities by banks also declined further by 21.8% during the quarter (3Q 2013: -8.2%).

The ratios of impaired loans and loans-in-arrears of between one and three months for banks were unchanged at 1.3% and 2.1% of banking system household loans. Household financial buffers remained intact at the aggregate level with financial asset, at a healthy level of 2.2 times of household debt.

Banking System: Loan Quality



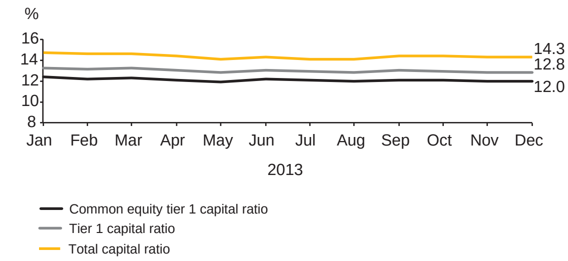
Source: Bank Negara Malaysia

The debt servicing capacity of businesses improved further supported by sustained revenue and operating efficiency. The interest coverage ratio improved to 6.1 times during 3Q 2013 (2Q 2013: 5.0 times) adding further to the debt servicing capacity of aggregate businesses amidst a lower leverage ratio of 39.2% (2Q 2013: 45.8%). Cash and cash equivalent holdings of aggregate businesses were sustained at 11.5 times of finance costs (2Q 2013: 12 times), while current assets remained stable at 1.9 times of current liabilities. Loans-in-arrears of between one and three months improved to 0.4% of total business loans (3Q 2013: 0.8%), while the gross impaired loans ratio improved to 2.9% (3Q 2013: 3.2%). The risk of delinquency, as measured by expected default frequency, continued to be sustained at a low level of 0.24% (3Q 2013: 0.30%).

Market risk exposures of financial institutions remained manageable despite heightened volatility in the financial markets stemming from external developments particularly the US Federal Reserve's tapering strategy. Volatile short-term capital flows were well-intermediated by the financial system. The domestic institutional investors exhibited strong support and continued to fill the void amidst selling pressure by non-residents, resulting in stable bid-ask spreads of bond and equity markets averaging at 0.1% and 0.7% of the mid-price (3Q 2013: 0.2% and 0.4%) respectively. Market activities and volatility declined towards the end of the quarter given greater clarity on the timing of the Federal Reserve's tapering programme and on account of seasonal year-end factor. Turnover ratio for MGS and FBM KLCI eased to 9.7% and 1.6% (3Q 2013: 11.9% and 2.2%) respectively. Average volatility for 10-year MGS yields and the FBM KLCI also declined to 15.5% and 8.8% (3Q 2013: 17.8% and 10.4%) respectively, in tandem with lower turnover ratios.

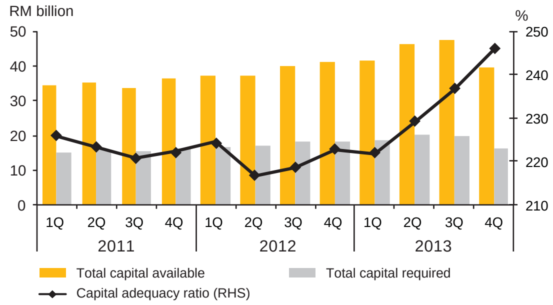
Banks' exposures to interest rate risk increased to 5.7% of total capital (3Q 2013: 4.1%) primarily due to an increase in interest rate derivative positions with tenures of less than 10 years maturity and exposures to equity risk increased slightly to 0.7% of total capital (3Q 2013: 0.6%). Meanwhile, the FX net open position of the banking system declined to 5.7% of total capital (3Q 2013: 6.1%). Market risk of the insurance industry increased to form 12.2% of the total capital available (3Q 2013: 11.7%). This was mainly due to increase in investment in equities of RM4.6 billion, driven mainly by the strong performance of FBM KLCI and new purchase of equities by life insurers of RM2 billion. Hence, equity risk exposures increased to 7.6% of total capital available while interest rate risk remained unchanged at 2.5% of total capital available.

Banking System: Basel III Capitalisation



Source: Bank Negara Malaysia

Insurance Sector: Capitalisation



Source: Bank Negara Malaysia

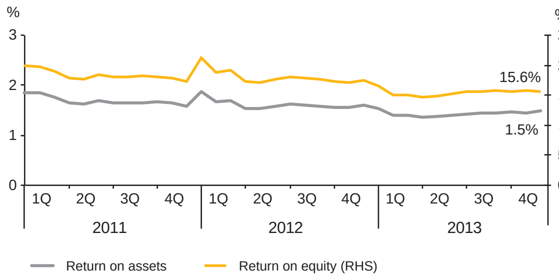
The financial sector continued to remain sound and resilient

The banking system continued to be well-capitalised. The common equity tier 1 (CET1) capital ratio, tier 1 capital ratio and total capital ratio were well above the minimum regulatory levels, at 12%, 12.8 % and 14.3%, respectively. The capital buffer of the banks in excess of the minimum total capital requirement stood at more than RM77 billion. More than 80% of total capital consists of high quality capital, namely paid-up capital, retained earnings and reserves. Similarly, the capital adequacy ratio of the insurance sector remained strong at 245.9% (3Q 2013: 236.7%), with an excess capital buffer of RM23.5 billion.

The banking system recorded pre-tax profits totalling RM8.3 billion (3Q 2013: RM 7.8 billion) on account of higher net interest income from lending activities and higher net fee and commission income. Profitability indicators remained stable with returns on assets and equity of 1.5% and 15.6% (3Q 2013: 1.5% and 15.7%). Life insurers and family takaful operators registered a higher profit amount of RM3.2 billion (3Q 2013: RM1.4 billion profit), driven by increases in net premium and net investment income which grew by 37% and 33.8% from the preceding quarter, respectively. Life insurers and family takaful operators continued to record net MTM revaluation losses, albeit at a much lower level of RM126.2 million (3Q 2013: RM1.9 billion of unrealised losses). Similarly, general insurers and takaful operators also recorded a higher operating profit of RM1 billion (3Q 2013: RM671.9 million), on account of an increase in earned premium income and investment income.

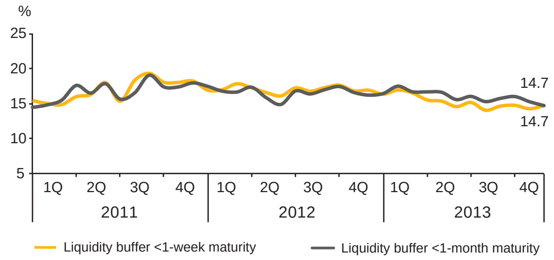
Banking system resilience was further supported by ample liquidity in the system. Buffers to meet short-term liquidity needs over the 1-week and 1-month horizons both stood at 14.7% of total deposits (3Q 2013: 14.6% and 15.7%) respectively. Net placements by banking institutions with the Bank, which can be drawn to meet additional liquidity needs, stood at RM135 billion (3Q 2013: RM152.2 billion). US dollar mismatch positions in the less than 1-week and 1-month maturity buckets registered a net surplus of RM1.5 billion (3Q 2013: surplus of RM2.9 billion) and RM5.3 billion (3Q 2013: shortfall of RM2.9 billion) respectively.

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		
	4Q	Year	3Q	4Q	Year
	RM million				
Life insurance & family takaful					
Excess of income over outgo	4,365.8	17,635.1	1,436.1	3,205.3	13,048.2
General insurance & general takaful					
Operating profit	882.6	2,926.7	671.9	1,036.7	3,219.3
Claims ratio (%)	57.3	57.3	58.8	57.1	57.1
	Annual Change				
Life insurance & family takaful					
Excess of income over outgo	1.2	39.5	-72.6	-26.6	-26.0
General insurance & general takaful					
Operating profit	276.7	63.8	-2.4	17.5	10.0
Claims ratio (percentage points)	-1.4	-1.4	-0.3	-0.2	-0.2

Source: Bank Negara Malaysia