MANAGING RISKS TO FINANCIAL STABILITY

Domestic financial system remains resilient

The Malaysian financial system remained resilient against potential risks related to spillovers from the weaker global growth prospects and continued volatility in the international financial and commodity markets. Domestic risks more broadly have continued to moderate. However, more challenging business conditions and rising costs will likely weigh on the revenue and loan performance of financial institutions in the period ahead, requiring close vigilance. Any adverse developments are expected to remain well within the loss absorption capacity of financial institutions given the healthy capital buffers which strengthened further since end-2015. This, along with sound underwriting practices observed by financial institutions, will continue to lend firm support to domestic financial intermediation. Ample domestic liquidity has also remained supportive of credit growth and orderly market conditions.

Manageable credit risk exposures amid sustained debt servicing capacity

Credit risk exposures of banks remained manageable, underpinned by the sustained debt servicing capacity of borrowers. Loan impairments and delinquencies as a share of total bank loans were largely unchanged at 1.2% and 2.1% respectively. The overall loan loss coverage for the banking sector, while slightly lower, remained above 90%. This was supported by measures to shore up provisions over the last two years, including measures taken in response to the Bank's call for banking institutions to maintain loan loss reserves at a minimum level of at least 1.2% of bank loans. In the insurance and takaful industry, credit exposures (mainly from holdings of highly-rated private debt securities and Malaysian Government Securities) rose slightly to 4.3% of total capital available (4Q 2015: 4.2%).

Growth in household borrowings continued to moderate in the first quarter of the year (1Q 2016: +6.5%; 4Q 2015: +7.3%; 1Q 2015: +9.1%). House financing remained robust, expanding by 10.7% (4Q 2015: +11%; 1Q 2015: +12%) amid sustained strong demand for affordable housing. Growth in personal financing picked up slightly to 5.4% (4Q 2015: +4.6%), likely reflecting adjustments to higher costs of living by households. Generally, prudent debt service ratios continued to be observed by both banks and non-banks for new household lending. This has led to improved quality of new financing to households, and preserved overall household resilience. The average debt service ratio (against net income) for new household loans remained below 60%. About half of new financing approved for the period were to borrowers with a debt service ratio below 40%.

The ratio of impaired household loans edged slightly higher to 1.7% (4Q 2015: 1.6%) of total household loans by banks and non-banks amid emerging signs of weaker repayment capacity observed for borrowers that are more reliant on cyclical income sources such as commission-based jobs. Risks of a broader deterioration in the performance of household loans appear contained as overall household delinquencies improved to 1.4% of total household borrowings (4Q 2015: 1.5%). The banking system also continued to record improvements in the retail lending portfolio during the quarter, with impairments and delinquencies accounting for 1.0% and 1.4% of bank lending to households respectively as at end first quarter of 2016. The overall debt servicing capacity of households is also supported by the net accumulation of financial assets over debt which increased further by RM27.4 billion during the quarter.

Risks from banks' exposures to the business sector remain contained. The aggregate leverage of Malaysian businesses[3], as measured by the median debt-to-equity ratio, improved to 44.5% in the fourth quarter of 2015 (3Q 2015: 46.8%). Business sector borrowings expanded at a slower pace of 8.8% as at end first quarter of 2016 (4Q 2015: +13.2%) in line with the moderation in domestic economic activity. Bank financing to businesses expanded by 4.9% (4Q 2015: +8%), with financing to small and

[3] Based on 160 companies listed on Bursa Malaysia with market capitalisation of 80% (excluding financial institutions) covering 10 key economic sectors.

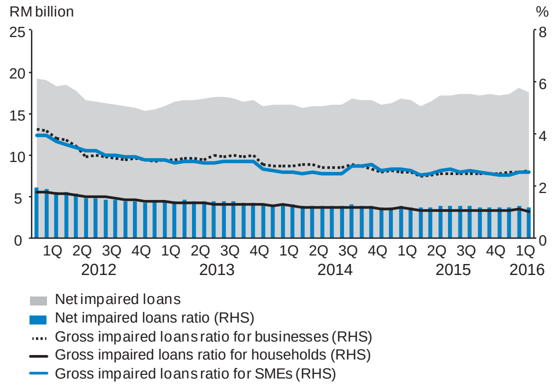
medium enterprises remaining a key driver of business loan growth (+9.0%). Outstanding external borrowings by businesses amounted to RM287.4 billion, lower than in the previous quarter (RM296.5 billion), on account of sustained healthy repayments and the strengthened ringgit as at end fourth quarter of 2015. More than 40% of total external borrowings remained in the form of inter-company obligations by multinational corporations with operations in Malaysia, which continue to present limited potential rollover and funding risks.

The effects of weak commodity prices and softer external demand on the financial health of overall businesses in the export-oriented sectors have generally been contained. In the domestic-oriented sectors, weaker consumer sentiment, higher import costs and increased competition continued to pose a drag on corporate earnings. Reflecting these conditions, the median interest coverage ratio (ICR) was lower at 4.4 times in the fourth quarter (3Q 2015: 5.0 times). This measure of the ability to service debt remains comfortably above the level of two times which is generally considered to be prudent. The aggregate liquidity buffers of businesses to meet short-term debt obligations also remained intact, with the median current ratio (current assets-to-current liabilities) and cash-to-short-term debt ratio (CASTD) unchanged at 1.7 times and 1.2 times respectively in the final quarter of 2015.

The ratio of impaired and delinquent business loans remained stable during the quarter at 2.6% and 0.3% of total bank lending to businesses respectively (4Q 2015: 2.5% and 0.3% respectively). Delinquencies were slightly higher in the construction and real estate sectors, reflecting softer operating conditions for businesses in these segments. Correspondingly, the overall expected default frequency for businesses increased to 0.69% (4Q 2015: 0.61%), suggesting a slight weakening in the credit risk outlook for sectors that are more exposed to uncertainties in global demand, and movements in exchange rate and commodity prices. Notwithstanding this, risks to the banking system are limited. Banks' exposures to the crude palm oil and oil and gas sectors remained small at 3.8% and 2.2% of total credit exposures to businesses respectively. Exposures to large business borrowers with weak financials (ICR below 1.5 times and CASTD below one time) remained limited at 6.7% of total bank credit exposures to corporations. Furthermore, exposures to large borrower groups with a higher concentration of foreign currency denominated borrowings (i.e. more than 30% of total borrowings) and weak financials represented less than 2% of total bank credit exposures to businesses.

In the third quarter of 2015, the annual growth of the Malaysian House Price Index moderated marginally to 7.4% (2Q 2015: +7.5%). Across states, average house price increases ranged between 3% - 8.9% (2Q 2015: 0.2% - 8.7%). Housing transactions, particularly in the higher-priced segments, remained soft in both the primary and secondary markets. On an annual basis, the total transaction volume and value declined by 3.1% to 58,859 units (3Q 2015: -9.4% to 57,662 units) and 4.1% to RM19.3 billion (3Q 2015: -18.1% to RM17.7 billion) respectively as at end fourth quarter of 2015. In contrast, the volume and value of transactions in the affordable segment (houses priced below RM250,000) continued to register positive growth of 7.5% and 14.6% respectively (3Q 2015: +5% and +10.2% respectively). Credit-induced speculative purchases of residential properties remained subdued. The number of borrowers with at least three outstanding housing loans (a proxy used for speculative house purchases) expanded at a slower annual rate of 2.9% in the first quarter of 2016 (4Q 2015: 3.2%).

Banking System: Loan Quality



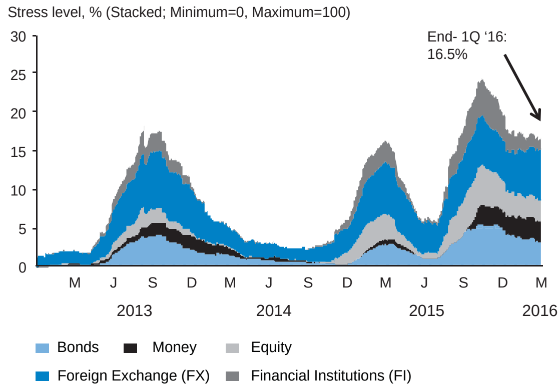
Source: Bank Negara Malaysia

Domestic financial market conditions remained orderly

Orderly conditions in the domestic financial markets were preserved as volatility in the bond and equity markets eased during the quarter. Average volatility of the 10-year MGS yield and FBM KLCI declined to 13.5% and 11.7% respectively (4Q 2015: 17.2% and 14.5% respectively). Improved investor sentiment broadly reflected some recovery in commodity prices and the prospects of further US policy rate increases being deferred. This attracted foreign capital inflows and renewed participation in the domestic asset markets. Portfolio investments recorded a larger net inflow of RM13.1 billion (4Q 2015: net inflows of RM15.9 billion) on the back of sustained strong interest by non-residents in the MGS and equity markets.

Non-residents' holdings of MGS rose to 48.7% (4Q 2015: 47.7%) of total outstanding MGS, of which 62.6% comprised holdings of short- to medium-term MGS with maturities up to 5 years. Yields on the 3, 5 and 10-year MGS eased to 3.21%, 3.43% and 3.80% respectively (4Q 2015: 3.27%, 3.47% and 4.19% respectively). The FBM KLCI ended the quarter higher at 1,717.6 points (4Q 2015: 1,692.5 points) in line with most regional markets. Equity holdings by non-residents stood at 22.9% of total market capitalisation (4Q 2015: 22.3%). The price-to-earnings (PE) ratio of FBM KLCI rose to 19 times against a long-term average PE ratio of 17 times following the more subdued corporate earnings in the first quarter. Trading liquidity, both in terms of price and volume, remained intact. The bid-ask spreads for MGS and FBM KLCI remained tight at 0.1% and 0.4% of the mid-price respectively. The monthly turnover ratio for the MGS and FBM KLCI also held firm at 11.9% and 2.0% respectively as at end first quarter of 2016 (4Q 2015: 10.5% and 2.1% respectively). The ringgit strengthened against the US dollar, appreciating by 9.4% to end the quarter at RM3.9220 per US dollar (4Q 2015: RM4.2920), in line with the performance of the domestic bond and equity markets. Investors' perception of Malaysia's sovereign credit risk and onshore US dollar liquidity conditions improved further during the quarter. The 5-year sovereign credit default swap spread eased to 153.9 basis points (4Q 2015: 180.2 basis points, 3Q 2015: 238.9 basis points), while the 5-year cross-currency basis swap spread was almost unchanged at 73 basis points (4Q 2015: 75 basis points, 3Q 2015: 115 basis points).

Financial Market: Financial Market Stress Index (FMSI)



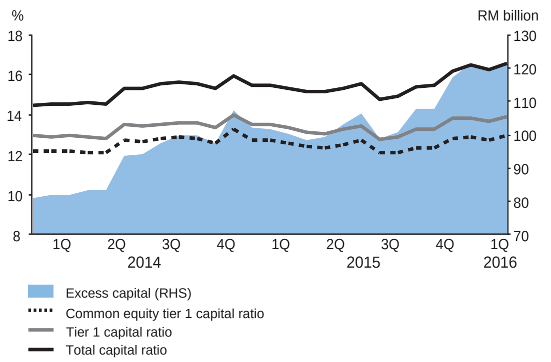
Note: The FMSI is constructed from indicators of volatility in the five components of the domestic financial markets - the foreign exchange (FX), equity, bond, money markets and financial institutions (FIs). The stress level at a specific date is expressed as a value between 0 and 100, which signifies the lowest to highest stress level.

Source: Bloomberg and internal computation

Sustained strength and resilience of financial institutions

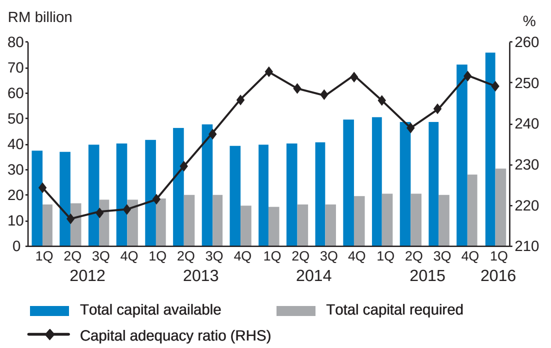
Malaysian banks, insurers and takaful operators continued to maintain a high level and quality of capitalisation, of which more than 90% is in the form of retained earnings, paid-up capital and reserves. At end first quarter of 2016, the common equity tier-1 capital, tier-1 capital and total capital ratios of banks were sustained well above the minimum regulatory levels at 13.0%, 13.9% and 16.5%, respectively. The capital adequacy ratio for the insurance and takaful sectors stood healthy at 242.6% (4Q 2015: 245.4%). Financial institutions are well-positioned to withstand potential adverse macroeconomic and financial shocks, with combined capital buffers of RM170.4 billion as at end first quarter of 2016 (banks: RM121.9 billion; insurers and takaful operators: RM48.5 billion).

Banking System: Basel III Capitalisation



Source: Bank Negara Malaysia

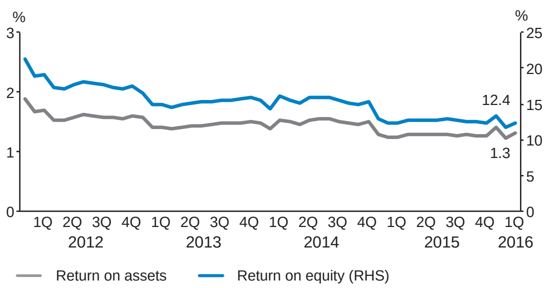
Insurance Sector: Capitalisation



Source: Bank Negara Malaysia

Bank earnings remained resilient during the quarter in spite of a more challenging operating environment. The pre-tax profit of the banking system increased to RM7.7 billion as at end first quarter of 2016 (4Q 2015: RM7.2 billion) following improved revenue from treasury related activities and lower operating expenses. Returns on assets and equity were unchanged at 1.3% and 12.4% respectively (4Q 2015: 1.3% and 12.4% respectively). General insurers and takaful operators recorded higher operating profits of RM730.2 million for the quarter (4Q 2015: RM679.5 million), on account of more favourable claims experience with the claims ratio improving to 54.1% (4Q 2015: 60.6%). In contrast, life insurers and family takaful operators recorded a lower excess income over outgo of RM4.7 billion (4Q 2015: RM5.2 billion). This was mainly due to the lower net capital gains of RM1.5 billion (4Q 2015: RM2.0 billion), reflecting the weaker equity performance in the first two months of the quarter.

Banking System: Profitability



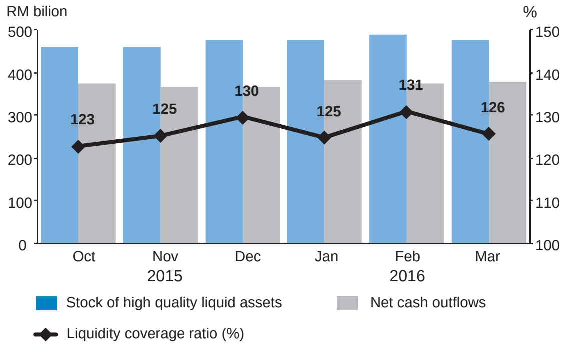
Source: Bank Negara Malaysia

Market risk exposures remained well-contained within the risk appetite and internal limits of financial institutions, supported by active risk management and hedging strategies. Bank exposures to interest rate risk in the trading book and equity risk remained low at 1.1% and 0.8% of total capital respectively (4Q 2015: 1.2% and 0.7% respectively). The foreign exchange net open position of banks rose slightly to 6.5% of total capital (4Q 2015: 6.1%). Market risk exposures of the insurance and takaful industry were broadly unchanged at 13.1% (4Q 2015: 12.9%) of total capital available, while equity risks, which forms the bulk of insurers' market risk exposures, edged lower to account for 7.3% (4Q 2015: 7.5%) of total capital available.

Ample liquidity in the banking system has continued to support financing activities. As at end-1Q 2016, banking system placements and reverse repos with Bank Negara Malaysia which can be unwound to meet liquidity needs, increased to RM135 billion (4Q 2015: RM127 billion), preserving comfortable buffers against unexpected cash outflows or adverse liquidity shocks. Under the Basel III Liquidity Coverage Ratio (LCR) standards which have been phased in since June 2015[4], the banking system LCR stood at 126% as at end first quarter of 2016 (4Q 2015: 130%). All banks maintained LCR levels that are above the current minimum regulatory requirement of 70%, with 38 banks recording LCR levels above 100%.

Domestic funding conditions improved during the quarter. The average cost of deposits[5] was stable at 2.54% (4Q 2015: 2.53%, 2014: 2.38%) while the 3-month KLIBOR eased to 3.71% (4Q 2015: 3.84%) following some easing in competition for corporate deposit placements since January 2016. The quoted 1-month fixed deposit rates for large corporate depositors fell between 15 basis points and 85 basis points during the quarter. Similarly, quoted 3-month fixed deposit rates declined between 50 basis points and 65 basis points during the same period. Household deposits continued to register a healthy growth of 5% (4Q 2015: +5.3%). However, overall deposits in the banking system declined by 0.9% (4Q 2015: +1.8%) as the outstanding deposits accepted from businesses fell by 4.2%. This was partly attributed to an isolated withdrawal by a large corporate depositor. Notwithstanding this, deposits and investment accounts accepted by banks expanded by 2.4% (4Q 2015: +4.7%) as at end first quarter of 2016. Banks continued to diversify their funding structure through the issuance of medium-term ringgit and foreign currency denominated funding instruments, which grew annually by 13% to RM102 billion (4Q 2015: +24%) as at end first quarter of 2016. This has contributed towards further reducing maturity and currency mismatches in bank funding structures. Taking into account the broadened funding base of banks, the loan-to-funds ratio[6] (LTF) improved to 82.4% during the quarter, while the loan-to-deposit ratio[7] was lower at 87.7% (4Q 2015: 83.0% and 88.7% respectively).

Banking System: Basel III Liquidity Coverage Ratio



Source: Bank Negara Malaysia

Insurance and Takaful Sectors: Indicators

	2015			2016
	1Q	4Q	Year	1Q
	RM million			
Life insurance & family takaful				
Excess of income over outgo	5,336	5,246	12,009	4,689
General insurance & general takaful				
Operating profit	781	679	2,698	730
Claims ratio (%)	50.3	60.6	60.2	54.1
	Annual Change (%)			
Life insurance & family takaful				
Excess of income over outgo	66.2	147.4	-12.7	-12.1
General insurance & general takaful				
Operating profit	-5.2	-10.6	-15.1	-6.5
Claims ratio (percentage points)	-4.7	1.1	2.7	3.7

Source: Bank Negara Malaysia

[4] In the first phase, compliance is set at 60% with progressive increments of 10% each year until 100% with effect from 2019. The current minimum requirement is set at 70%.
[5] Revision in the computation of the average cost of deposits (calculated as the interest expense on deposits as a percentage of total deposits accepted).
[6] Fund comprises deposits and all debt instruments (including subordinated debt, debt certificates/ sukuk issued, commercial papers and structured notes).
[7] Beginning July 2015, loans exclude financing funded by Islamic investment accounts.