MANAGING RISKS TO FINANCIAL STABILITY

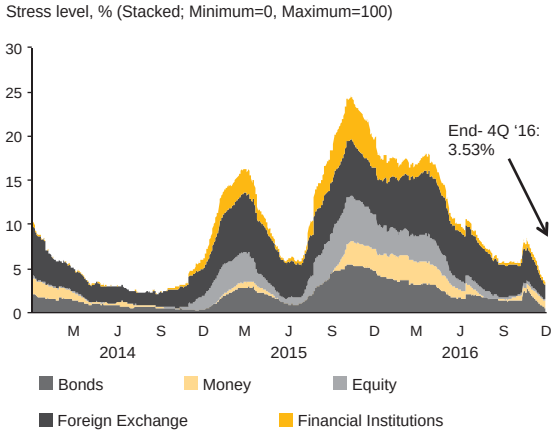
Domestic financial system remains resilient

The Malaysian financial system remains resilient despite global uncertainties over policy adjustments in the major economies. The domestic banking system remains well-capitalised, with ample liquidity to support the financing needs of businesses and households. As businesses and households continue to adjust to the challenging economic outlook and higher cost of living, these financial buffers will support the resilience of the financial institutions. Going forward, external events will continue to weigh heavily on the volatility in domestic financial markets. These include increased uncertainty over political developments and growth in the major economies as well as volatile commodity prices. Domestic financial system stability is nonetheless expected to be preserved given the loss absorption capacity of financial institutions supported by strong capital and liquidity buffers.

Domestic financial market conditions remained orderly

Global uncertainties emanating from the US presidential elections outcome, the timing and frequency of the US Federal Reserve interest rate normalisation and on-going volatility in the commodities market heavily influenced investor sentiments and behaviour throughout the quarter, particularly in November. Average volatility in the domestic financial markets was, nevertheless, lower in the final quarter, despite the slight uptick in the Financial Market Stress Index. In the MGS market however, average volatility for the 10-year yields edged higher (4Q 2016: 14.0%; 3Q 2016: 10.3%) following global re-pricing of sovereign bond yields after the US presidential elections.

Financial Market: Financial Market Stress Index (FMSI)



Note:
1. The FMSI is a risk monitoring tool for financial markets, developed based on the European Central Bank's (ECB's) Composite Indicators of Stress Index (CISS). It is constructed from indicators of volatility in five components of domestic financial markets - bonds, money, equity, foreign exchange and financial institutions.
2. The FMSI 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

Portfolio investments recorded a net outflow position of RM22.3 billion (3Q 2016: net outflow of RM 10.6 billion), driven mainly by non-resident outflows from the bond market. This reduced non-resident holdings to 32.1% (3Q 2016: 35.4%) of total outstanding MGS and GII at end of the year, with about 63% (3Q 2016: 58%) of the holdings maturing within the next five years. The 3-, 5- and 10-year MGS yields increased to 3.50%, 3.70% and 4.23%, respectively (3Q 2016: 2.88%, 3.24% and 3.55%, respectively) following an upward shift in the global bond yields. The FBM KLCI ended the quarter lower at 1641.73 points (3Q 2016: 1652.55 points), with non-resident holdings declining slightly to 22.3% (3Q 2016: 22.8%) of total market capitalisation.

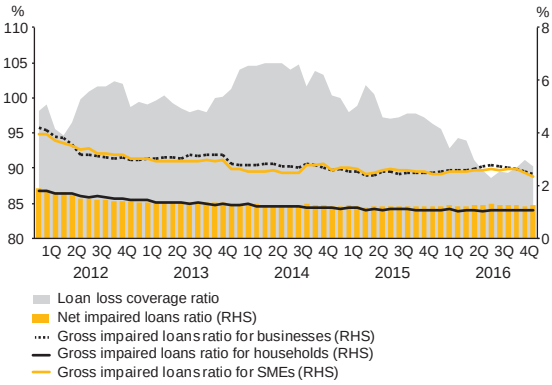
Trading liquidity in the markets were generally sustained with the monthly turnover ratio for MGS declining slightly to 11.8% (3Q 2016: 12.4%), while the equities market turnover ratio for FBM KLCI edged higher to 1.9% (3Q 2016: 1.7%). The bid-ask spreads were unchanged at 0.4% of mid-price for FBM KLCI, but increased slightly to 0.2% of mid-price for MGS.

In the currency market, pricing of the ringgit in the onshore market was influenced by the spillover from speculative activities in the offshore ringgit non-deliverable forward (NDF) market. This exacerbated adjustment in ringgit post the US presidential election, which saw the ringgit depreciating against the US dollar by 5.9% to RM 4.4680 by 1 December 2016. As-at 4Q 2016, the 5-year cross-currency basis swap spread had widened to 68 bps (3Q 2016: 55 bps), while the 5-year sovereign credit default swap spread had widened to 137.5 bps (3Q 2016: 122.4 bps). In November 2016, the Bank reinforced the existing rules on non-recognition of the ringgit NDF market to limit the spillover effects from the offshore market on the domestic foreign exchange (FX) market. In addition, several measures were introduced on 2 December 2016 to stabilise conditions in the financial markets. These include measures to promote the onshore hedging market and improve the depth and liquidity of the domestic FX market. While these measures will take some time to yield the desired effects, average volatility in the onshore ringgit market has eased (November 2016, December 2016 and January 2017: 7.5%, 6.4% and 5.4%, respectively). The ringgit further depreciated only by 0.4% to end the quarter at RM 4.4860 per US dollar (3Q 2016: RM4.1455). The 5-year cross-currency basis swap and sovereign credit default swap spread both eased to 58 bps and 131 bps, respectively, as at end-January.

Manageable credit risk exposures amid sustained debt servicing capacity

Credit risk exposures and asset quality of financial institutions remain intact, underpinned by sustained debt servicing capacity of borrowers. Loan delinquencies, measured by loans-in-arrears of between one and three months remained stable at 2.1% of total bank loans. Impairment ratio, net of individual impairment provisions, improved to 1.2% of net loans. Banks' loan loss coverage ratio[3] was ample at about 90.2% (3Q 2016: 89.4%). In addition, banks have also set aside regulatory reserves as buffers for potential credit losses on loans and financing portfolio. Credit exposures for insurance and takaful industry were largely unchanged at 4.1% (3Q 2016: 4%) of total capital available.

Banking System: Loan Quality



Source: Bank Negara Malaysia

Household debt continued to grow more moderately on an annual basis at 5.4% (3Q 2016: +5.8%; 4Q 2015: +7.3%) in the final quarter of the year. House financing, which grew by 9.1% (3Q 2016: +9.6%), remains the key driver of the increase in household debt amid sustained demand for affordable housing. The annual expansion in outstanding financing for personal use grew by 4.8% (3Q 2016: +5%). The debt repayment capacity of households remains supported by generally stable income and employment conditions, coupled with strengthened affordability assessments by lenders. About 74% of borrowers with newly approved loans have debt service ratios (computed based on income net of statutory deductions) of less than 60%. The share of total household debt borne by vulnerable borrowers[4] declined further to 22.2% (2015: 22.8%; 2014: 24.3%) of total bank and non-bank lending to households. For banks, the share is lower at 19.1% (2015: 19.6%; 2014: 20.9%).

The overall quality of lending to households by both banks and non-banks was generally sustained. Both aggregate impaired and delinquent loans ratios remained unchanged at 1.6% and 1.5%, respectively. The level of impairment for personal use increased, but remained low and stable at 2% (3Q 2016: 2%) of total personal financing. Higher delinquencies were due mainly to financial difficulties faced by borrowers who were affected by lower variable income and retrenchment by specific firms. However, the potential risks to domestic financial

[3] Refers to ratio of individual plus collective impairment provisions to total impaired loans.
[4] Defined as borrowers with a monthly income of less than RM3,000.

stability, particularly from vulnerable borrowers, remains mitigated amid the ample excess capital buffers of banks.

Credit conditions remained conducive with limited evidence of broad-based tightening in the supply of financing to businesses. Total borrowings grew annually by 6.2% (3Q 2016: +6%) for the fourth quarter of 2016. This increase was mainly contributed by fund raising from the bond and sukuk markets (+RM25 billion or +7.3%) and external borrowing (+RM15.5 billion or +5.2%). Outstanding bank financing to businesses expanded by 4.9% (3Q 2016: +2%) driven by higher disbursements to the transportation, real estate and manufacturing sectors. Financing to SMEs also sustained a robust growth of +9.2% (3Q 2016: +8.5%).

Financial health of firms remained intact despite the more challenging business climate. The aggregate leverage of Malaysian businesses[5], as measured by the median debt-to-equity ratio increased slightly to 44.2% (2Q 2016: 42.8%) as at end of the third quarter of 2016. This was supported by satisfactory debt servicing capacity and liquidity positions. The median interest coverage ratio (ICR) remained above prudent thresholds of two times, albeit moderating to 4.1 times (2Q 2016: 5.5 times). The moderation was driven by weaker profitability of firms in the food and beverage manufacturing and automotive industries. On aggregate, firms continued to maintain sufficient liquidity buffers to meet short-term obligations - the cash-to-short-term debt ratio (CASTD) has remained stable at 1.1 times. As expected, higher impairment and delinquencies were observed in the oil & gas (O&G), water transport, wholesale and retail, and infrastructure sectors. Overall, the ratio of impaired loans remained low at 2.4% (3Q 2016: 2.7%), while the ratio of delinquent loans increased slightly to 0.4% (3Q 2016: 0.3%) of total bank lending to businesses.

The outlook for the O&G and automotive sectors remained weak given expectations of persistent low levels of global crude oil prices and soft consumer spending. The overall median ICR of the O&G sector was sustained in 3Q 2016 at 1.2 times while CASTD declined to 0.7 times (2Q 2016: 0.9 times). Similarly, the debt servicing capacity and liquidity position for the automotive industry also weakened, with ICR and CASTD of 4.4 times and 1.1 times, respectively (2Q 2016: 9.3 times and 1.5 times, respectively). The impairment and delinquency ratios for the O&G sector were higher at 4.1% and 0.32%, respectively (3Q 2016: 1.8% and 0.01%, respectively). In the automotive industry, impaired and delinquent loans remained low and fairly stable at 0.4% and 0.01% of total bank lending to businesses. In terms of concentration risks, banks' exposures to the O&G-related and automotive sectors remain small at 3.1% and 0.8% of total exposures to businesses, respectively. Banks have gradually been increasing the level of provisions and regulatory reserves for collective impairment since 2015 to strengthen buffers against potential loss events.

The average annual growth of the Malaysian House Price Index (MHPI) for the first nine months of 2016 was lower at 6.4% compared to an average of 9.5% during 2010-2015. Primary and secondary housing markets remained soft across major states and house type amid cautious consumer sentiments. Against this backdrop, housing transactions in terms of volume and value declined by 13.9% to 49,640 units (2Q 2016: -12.5% to 52,487 units) and 12% to RM15.6 billion (2Q 2016: -9.7% to RM16.7 billion), respectively. Notwithstanding this, demand for affordable housing remains strong, supported by stable loan approval rates. Speculative activity in the housing market was subdued as the growth in the number of borrowers with three or more outstanding housing loans remained low and stable at 1.4% (3Q 2016: 1.6%).

Market risk exposures supported by risk management and hedging strategies

Banks' exposures to market risks were mainly in the form of FX risk. At end-December, FX net open position of banks declined to 6.2% (3Q 2016: 6.7%) of total capital, as banks continued to actively manage FX exposures amid ringgit

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

volatility. Exposures to both interest rate risk in the trading book and equity risk remained low and accounted for only 1.1% and 0.8% of total capital, respectively (3Q 2016: 1.2% and 1.0%, respectively). For the insurance and takaful industry, market risk exposures were lower at 13.3% (3Q 2016: 14.4%) of total capital available, driven by improvement in interest rate risk. Equity risk, which forms the bulk of insurers' market risk exposures, rose slightly to 7.7% (3Q 2016: 7.6%) of total capital available.

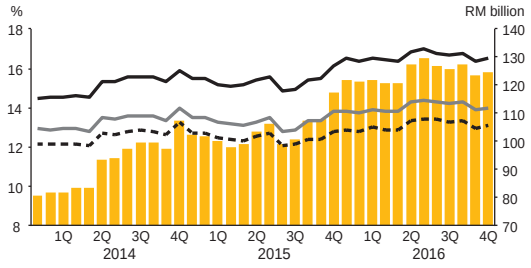
Sustained strength and resilience of financial institutions

Financial institutions remained well-capitalised. The combined capital buffers of banks, insurers and takaful operators stood at RM172.5 billion. Banks maintained a high level and quality of capitalisation. This is reflected in the high common equity tier-1, tier-1 and total capital ratios of banks which stood at 13.1%, 14.0% and 16.5%, respectively (3Q 2016: 13.3%, 14.2% and 16.7%, respectively). Similarly, the capital adequacy ratio for the insurance and takaful sectors remained high at 243.8% (3Q 2016: 226.3%).

Pre-tax profit of the banking system amounted to RM7.7 billion in the fourth quarter (3Q 2016: RM7.9 billion), with the growth in fee-based income partially offsetting the lower dividend income from subsidiaries, and trading and investment activities. Notwithstanding this, financing (including interest) margin net of operating costs and loss provisions improved to 0.6 percentage points (ppts) (3Q 2016: 0.58 ppts).

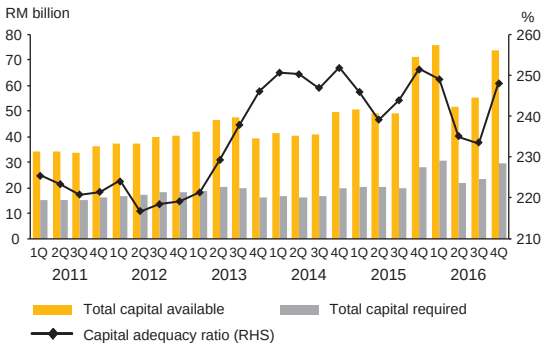
In the insurance and takaful sector, general insurers and takaful operators recorded higher operating profit of RM891.4 million in the fourth quarter of 2016 (3Q 2016: RM885.4 million), on account of higher investment income. Unlike the previous quarter where higher valuation in the bond market benefitted the life insurers and family takaful operators, the situation reversed in the fourth quarter due to the increase in bond yield. This explained the significant decrease of excess income over outgo to RM0.7 billion (3Q 2016: RM5.3 billion).

Banking System: Basel III Capitalisation



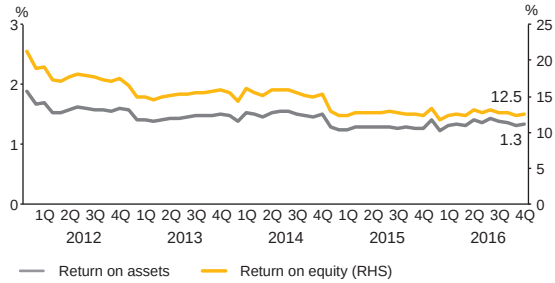
Source: Bank Negara Malaysia

Insurance Sector: Capitalisation



Source: Bank Negara Malaysia

Banking System: Profitability



Source: Bank Negara Malaysia

Insurance and Takaful Sectors: Indicators

	2015		2016		
	4Q	Year	3Q	4Q	Year
	RM million				
Life insurance & family takaful					
Excess of income over outgo	5,257	12,020	5,348	651	13,253
General insurance & general takaful					
Operating profit	679	2,698	885	891	3,406
Claims ratio (%)	60.6	60.2	56.4	56.9	56.0
	Annual change (%)				
Life insurance & family takaful					
Excess of income over outgo	148.2	-12.6	1,382.0	-87.6	10.3
General insurance & general takaful					
Operating profit	-10.6	-15.1	59.3	31.2	26.3
Claims ratio (percentage points)	1.1	2.7	-9.1	-3.7	-4.2

Source: Bank Negara Malaysia

Liquidity in the banking system remains ample to support intermediation activities. Total banking system placements, reverse repos and statutory reserves with Bank Negara Malaysia which can be unwound to meet liquidity needs, stood at RM179.9 billion. The banking system Basel III Liquidity Coverage Ratio (LCR)[6] stood at 124.8% as at end-December 2016, well above the current transitional minimum regulatory requirement of 70% (3Q 2016: 127%). About 80% of banks recorded LCR levels above 100%.

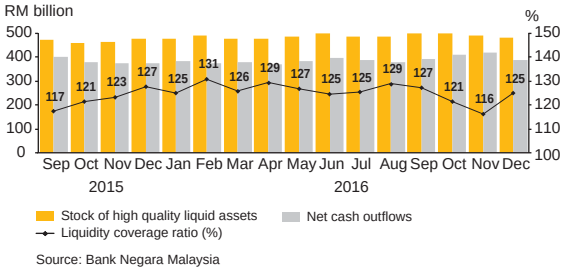
Domestic funding conditions remained stable during the quarter. Average cost of deposits for banks and the 3-month KLIBOR was stable at 2.6% and 3.4%, respectively. Banks' funding structure remained stable and predominantly deposit-based (69.4% of total funding) and in local currency. On aggregate, banking system deposits recorded a positive growth of 1.5% (3Q 2016: 0.8%). Household deposits continued to grow at a rate of 5.1% (3Q 2016: +4.6%), offsetting the decline in deposits from businesses (4Q 2016: -2.3%; 3Q 2016: -4.7%).

While the bulk of banks' funding remained in the form of deposits, banks continued to diversify their funding structure through the issuance of medium-term ringgit and foreign currency denominated funding instruments. The total net issuance of debt securities for 4Q 2016 amounted to RM4.8 billion (3Q 2016: RM0.3 billion). This contributed towards further reducing maturity and currency mismatches in the banks' funding structures.

Taking into account the broadened funding structure, the loan-to-funds ratio[7] (LTF) stood at 84.3% (3Q 2016: 83.4%) at the end of the quarter.

Net external liabilities of Malaysian banks stood at RM157 billion (2Q 2016: RM146 billion) as at end-3Q 2016, amid continued centralised liquidity management practices among Malaysian banks with related overseas entities. Some smaller locally incorporated foreign banks' (LIFB) have been gradually reducing intra-group placements with overseas parents to comply with the Single Counterparty Limit[8] (SCEL) requirement which comes into effect on 1 January 2017. The SCEL requirement on exposures with related banking entities has a two-year transition period to allow a gradual adjustment and to minimise the impact on the LIFBs' operations. Notwithstanding this, the structure of external exposures of Malaysian banking system has remained largely unchanged.

Banking System: Basel III Liquidity Coverage Ratio



Source: Bank Negara Malaysia

[6] The Basel III LCR has been phased in since June 2015, with initial compliance set at 60% and progressive increments of 10% each year until 100% with effect from 2019. As of 1 January 2017, the minimum requirement is set at 80%.

[7] Fund comprises deposits and all debt instruments (including subordinated debt, debt certificates/ sukuk issued, commercial papers and structured notes).

[8] The SCEL requirement limits exposures of a banking institution to a counterparty which is a related banking entity to 50% of the banking institution's total capital (subject to obtaining prior approval from the Bank).