Managing Risks to Financial Stability

HIGHLIGHTS

- **Businesses and households continued to demonstrate sound debt servicing capacity.**
- **Long-term domestic and foreign investors continued to provide stability to the domestic bond market.**
- **Domestic financial stability is expected to be preserved amidst sound financial institutions and orderly markets and liquidity conditions.**

Domestic financial stability remains intact

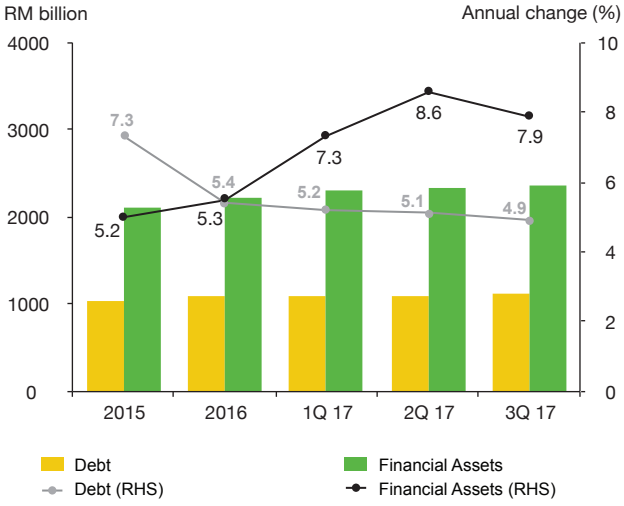
Domestic financial stability was preserved amidst strong support from resilient institutions and orderly market conditions. Overall volatility in domestic financial markets remained low amid improved domestic sentiments. Asset quality and profitability of domestic financial institutions remained sound while liquidity was sufficient to support intermediation activities and meet real economic needs.

Sustained debt servicing capacity of households and businesses

The expansion in household debt continued its moderating trend in the third quarter of 2017 (+4.9%; 2Q 2017: +5.1%). Housing loans remained the prime driver of growth (+8.5%; 2Q 2017: +8.8%). This resulted in a lower household debt of 84.6% of GDP at the end of the quarter (2Q 2017: 85.6%). Households continued to demonstrate sustained debt repayment capacity supported by adequate financial buffers and stable labour market conditions. The financial assets and liquid financial assets remained high at 2.1 and 1.5 times of debt, respectively. Further, growth of household financial assets (+7.9%) continued to outpace debt (+4.9%).

Annual growth of household financial assets continued to outpace that of debt

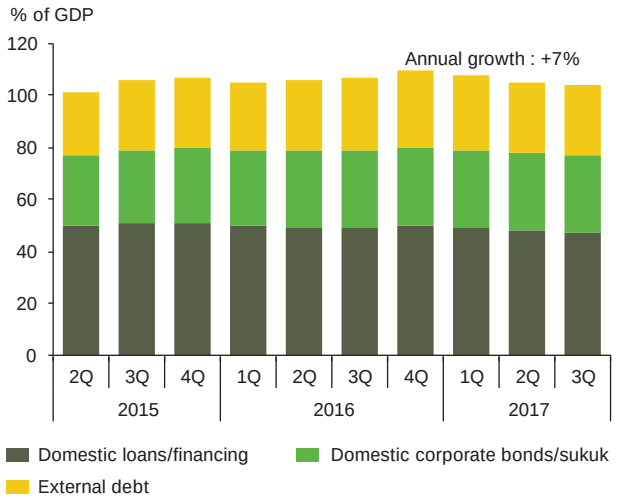
Chart 26: Household Sector Debt and Financial Assets



Source: Bank Negara Malaysia, Bloomberg, Department of Statistics, Malaysia, Securities Commission Malaysia and internal computation

Total business borrowings in the quarter was driven by sustained corporate issuances in the capital market

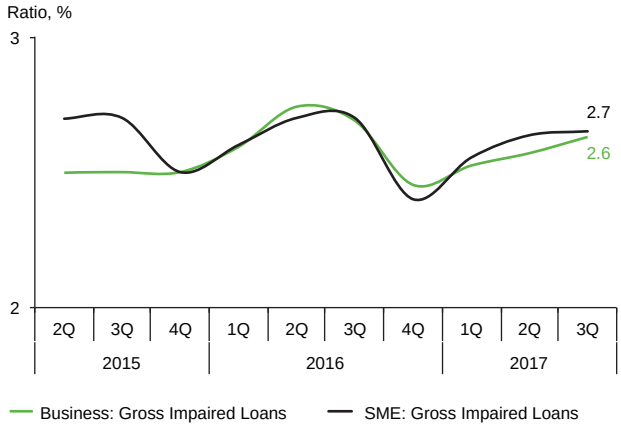
Chart 27: Business Sector NFC-Debt-to-GDP



Source: Bank Negara Malaysia

Overall banking system business loans portfolio remains sound

Chart 28: Business Sector Gross Impaired Loans



Source: Bank Negara Malaysia

Aggregate impairment ratio for banks and non-banks was sustained at 1.6% while delinquency ratio improved marginally to 1.4% (2Q 2017: 1.5%). Nonetheless, difficulty in repayment continued to be observed among borrowers in the vulnerable income segments (earning less than RM3,000 per month) living in urban areas given cost of living pressures. Of importance, potential systemic risks from financial institutions' exposure to the household sector are assessed to be limited given the following reasons. First, the majority of new household borrowers have prudent debt service ratios (DSR) (<60%), with 41% of borrowers having DSR of below 40%. Second, the share of borrowings by vulnerable borrowers declined further to account for 20.6% (2016: 21.9%) of total household debt. Third, under a simulated scenario using an assumption of a tripling of prevailing probabilities of default and severe loss given default, potential losses to banks from vulnerable households were estimated at less than 10% of banks' excess capital buffers (above regulatory minimum).

Business borrowings grew annually at 7% in the third quarter of 2017 (2Q 2017: +9%). This was driven by fund raising in the corporate bond and sukuk markets which grew by 10.2% (2Q 2017: 9.6%). Recent issuances were raised by the real estate, utilities and telecommunication sectors. Corporate external borrowings remained relatively stable as the positive exchange rate valuation effects from a stronger ringgit offset new borrowings. These borrowings mainly took the form of intercompany borrowings by businesses in the manufacturing, real estate and oil and gas (O&G) sectors. Financing by banks and development financial institutions (DFIs) to businesses continued to grow moderately with an annual growth of 5.4% (2Q 2017: +6.6%), due to slower growth in financing to all sectors. The growth of total financing by banks and DFIs to SMEs remained unchanged at 7% (2Q 2017: +7%).

Financial health of firms remained intact, given improving domestic and external demand. The aggregate leverage of Malaysian non-financial corporations (NFCs)[4] as measured by the median debt-to-equity ratio increased in 2Q 2017 (48.6%; 1Q 2017: 45.4%) due partly to lower earnings attributed to several firm-specific factors. Despite this, the aggregate debt servicing capacity and liquidity positions remained sound.

[4] Based on 120 listed firms on Bursa Malaysia with 85% market capitalisation (excluding financial institutions).

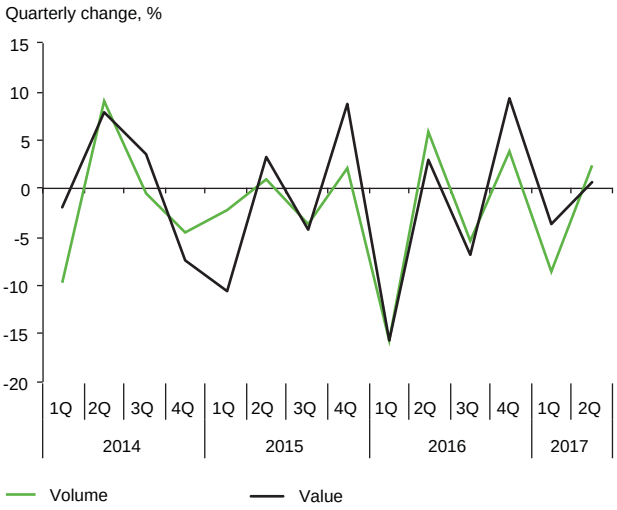
The median interest coverage ratio (ICR) remained significantly above the prudent threshold of two times (2Q 2017: 8.3 times). The median current assets-to-current liabilities ratio (current ratio) and cash-to-short-term debt ratio (CASTD) stood stable at 1.6 times and 1.4 times, respectively (1Q 2017: 1.6 times and 1.2 times, respectively), above the prudent threshold of one time. Overall, the ratio of impaired and delinquent loans remained low at 2.6% and 0.4% of total bank lending to businesses, respectively (2Q 2017: 2.6% and 0.4%, respectively). Higher impairment and delinquencies were observed in the real estate activities and O&G related sectors.

Despite oil price recovery in the third quarter supported by improvements in market sentiment, prices are expected to remain low amid expectations of higher supply. Certain segments of the O&G sector will continue to face challenges given this outlook. Nevertheless, the overall debt servicing capacity and liquidity positions of O&G companies recorded significant improvement from the first quarter, with the median ICR at 29.6 times (1Q 2017: 23.4 times) and median CASTD ratio at 4.7 times (1Q 2017: 3.4 times). This was driven mainly by companies in the downstream segment. Delinquent loans ratio stood at 0.1% (2Q 2017: 0.2%) while impaired loans ratio increased to 5% (2Q 2017: 4.5%) in the third quarter of 2017, due mainly to cashflow issues observed in service providers in certain upstream segments. However, risks to the banking system remained limited as exposures to the O&G sector accounted for about 6.5% of total exposures.

The housing market continued to exhibit signs of recovery in tandem with developments in the residential property market. During 2Q 2017, the housing transaction volume and value increased, on a quarter to quarter basis, by 2.5% and 0.5%, respectively (1Q 2017: -8.7% and -3.8%, respectively). The increase in activity was contributed mainly by transactions for the purchase of houses priced at RM500,000 and below, reflecting the sustained demand for affordable housing from the general public. House prices (as measured by the Malaysian House Price Index) continued to increase at a moderate annual pace of 6.7% in 1Q 2017 (4Q 2016: +7%), well below the previous peaks last observed during the 2012-2013 period (average growth of 12.3%).

Housing transactions were higher in 2Q 2017

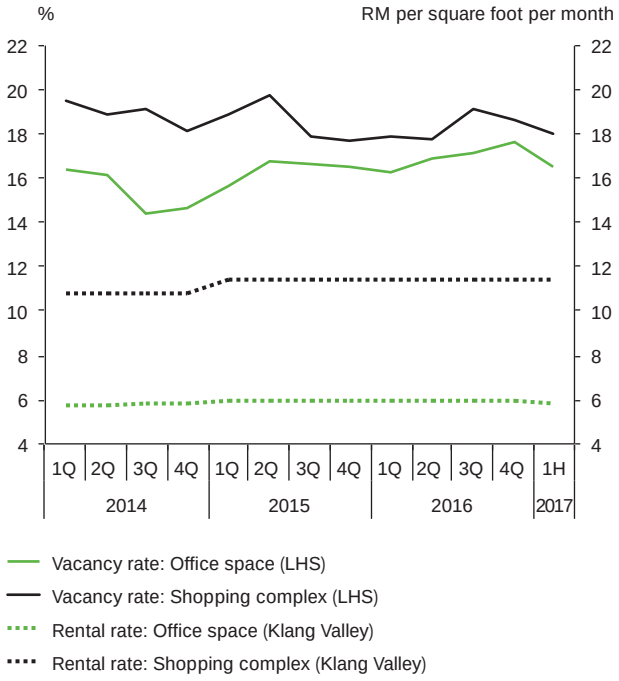
Chart 29: Property Sector Transaction Volume and Value



Source: National Property Information Centre

Rental rates of office space and shopping complex remained depressed

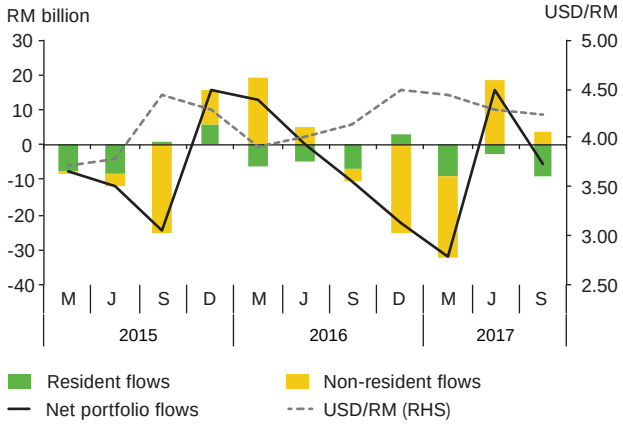
Chart 30: Office Space and Shopping Complex Vacancy and Rental Rates



Source: National Property Information Centre, Knight Frank, Jones Lang Wootton and internal computation

Net portfolio investment outflows mainly driven by residents' investment abroad

Chart 31: Financial Market Net and Gross Portfolio Flows and Ringgit Exchange Rate Movement



Source: Department of Statistics, Malaysia

Borrowers continue to have access to home financing, especially among first-time house buyers. The growth in outstanding house financing was sustained at 8.8% (2Q 2017: +8.9%), while the housing loan approval rate for the purchase of houses priced below RM500,000 remained high at 72.6% (2Q 2017: 74.1%).

Demand for financing for speculative house purchases remained muted. The share of the number of housing loans settled within three years (the typical duration required to complete construction after a property is acquired) stood at 10.5% (2Q 2017: 11%) of total settled housing loans. The annual growth in the number of borrowers with three or more outstanding housing loans (a proxy for speculative buyers) remained low at 0.8% (2Q 2017: +0.8%).

Rental rates in the office space and shopping complex segments remained depressed in 2Q 2017 amid the excess supply. This situation, if left unchecked, could become a long-term structural issue with wide implications to the greater economy. Direct risks to banks from end-financing exposures to the office space and shopping complex segments remained small at 3.2% of total bank loans, supported by sound lending and valuation practices. The delinquency and impairment ratios for these exposures remained low at 0.6% and 1.2 %, respectively (2Q 2017: 0.8% and 1.2%, respectively). Further discussion on this subject can be found in a box article entitled 'Imbalances in the Property Market' published in this report.

Domestic financial market conditions remained orderly

Investor sentiments remained affected by developments on the external front. These include concerns on the potential changes to economic policies under the Trump administration, increasing geopolitical tension in some countries and uncertainties surrounding the pace and timing of the US Federal Reserve interest rate and balance sheet normalisation. Despite these developments, overall volatility in the domestic financial markets remained low. This was attributed partly to improved domestic sentiments amid better-than-expected GDP growth in the second quarter. Average volatility of 10-year MGS yields and the FBM KLCI declined to 8.5% and 5.1% in the third quarter, respectively (2Q 2017: 10.2% and 6.4%, respectively). Average volatility of the ringgit increased slightly to 2.8% (2Q 2017: 2.6%).

In the third quarter, there were net portfolio investment outflows of RM5.1 billion (2Q 2017: net inflows of RM16 billion), mainly from residents due to continued investments in both equity and debt securities abroad by domestic fund managers and financial institutions. Despite some maturity-driven outflows from GII and MGS in August and September 2017, non-residents recorded net inflows of RM3.7 billion into both the government bond and equity markets. Non-resident investor holdings remained stable at 26.6% (2Q 2017: 26.0%) of total outstanding Malaysian government bonds. The bulk of the holdings is attributed to the long-term investors such as central banks, governments, pension funds and insurance companies (50% of total non-resident holdings). The stability of non-resident holdings can also be attributed to the distribution of holdings across different maturities. Of total non-resident holdings, 65% is in medium and longer-dated bonds of more than 3 years.

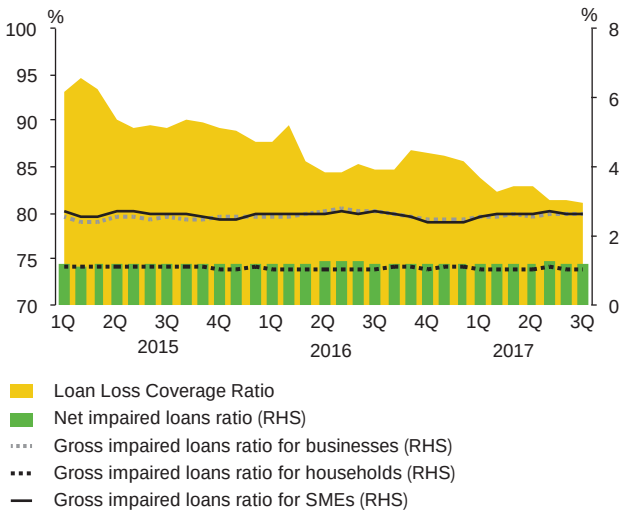
Non-resident participation in the domestic equity market remained stable at 23.3% of total equity market capitalisation (2Q 2017: 23%). The FBM KLCI ended the quarter slightly lower at 1755.58 points (2Q 2017: 1763.67 points). The average price-to-earnings (PE) ratio for the FBM KLCI stood at 16.7 times (2Q 2017: 17 times; 2010-2016 average: 16.8 times).

Trading liquidity in the financial markets remained intact. The bid-ask spread for MGS was stable at 0.1%, while the bid-ask spread for FBM KLCI improved to 0.3% of the mid-price (2Q 2017: 0.1% and 0.4%, respectively). Daily average USD/MYR bid-ask spread narrowed to 23.3 pips (2Q 2017: 26.1 pips). The monthly turnover ratios for MGS and FBM KLCI were slightly lower at 10.3% and 1.6%, respectively (2Q 2017: 11.3 % and 2%, respectively). Liquidity in the foreign exchange market improved with volume of transactions for ringgit pairs increased to a daily average of USD6.1 billion (2Q 2017: USD5.8 billion) of which spot and forward transactions accounted for USD2.7 billion (2Q 2017: USD2.6 billion).

The ringgit appreciated by 1.6% against the US dollar to end the quarter at RM4.2275 per US dollar (2Q 2017: RM4.2940). A similar trend was observed against other major currencies. The spreads on long-term onshore USD liquidity, as reflected by the 5-year cross-currency basis swap spreads, stood at 54 basis points (bps) (2Q 2017: 59 bps), lower than the average of 100 bps recorded during 2010-2016. Similarly, the 5-year sovereign credit default swap spread narrowed to 68.7 bps (2Q 2017: 85.5 bps).

Healthy asset quality observed in the banking system

Chart 32: Banking System Loan Quality



Source: Bank Negara Malaysia

Market risk exposures supported by risk management and hedging strategies

Banks' aggregate market risk exposures eased to 7.7% of total capital as at September 2017, due mainly to the reduction in foreign exchange (FX) risk (2Q 2017: 9.2%). FX risk, measured in terms of the net open position of foreign currency denominated exposures, eased to 5.7% of total capital (2Q 2017: 7%). Interest rate risk in the trading book and equity risk remained low at 1.1% and 0.9% of total capital, respectively (2Q 2017: 1.1% and 1.1%, respectively). For the insurance and takaful industry, market risk exposures remained unchanged at 14.9% (2Q 2017: 14.9%) of total capital available. Equity risk, which formed the bulk of insurers' market risk exposures, declined slightly to 8.8% (2Q 2017: 9.1%) of total capital available.

Sound profitability and sustained liquidity position of financial institutions

In the third quarter of 2017, the banking system financing (including interest) margin net of operating costs and loss provisions increased slightly to 0.69 percentage points (ppts) (2Q 2017: 0.65 ppts) as banks continued to extend financing to eligible borrowers. The banking system recorded lower pre-tax profits of RM9 billion (2Q 2017: RM9.2 billion), driven by lower dividend contributions from subsidiaries.

In the insurance and takaful sector, general insurers and takaful operators recorded lower operating profit of RM655.1 million in the third quarter (2Q 2017: RM762 million) on account of higher claims paid particularly in the motor segment. Correspondingly, industry claims ratio deteriorated to 61.2% (2Q 2017: 55.3%). Similarly, life insurers and family takaful operators recorded a reduction in profitability with excess income over outgo decreasing to RM3.5 billion (2Q 2017: RM4.4 billion). This was attributed largely to net capital losses of RM176.2 million (2Q 2017: RM953.6 million). The reduction was driven particularly by equity holdings, as the FBM KLCI index performed weaker towards the end of the quarter.

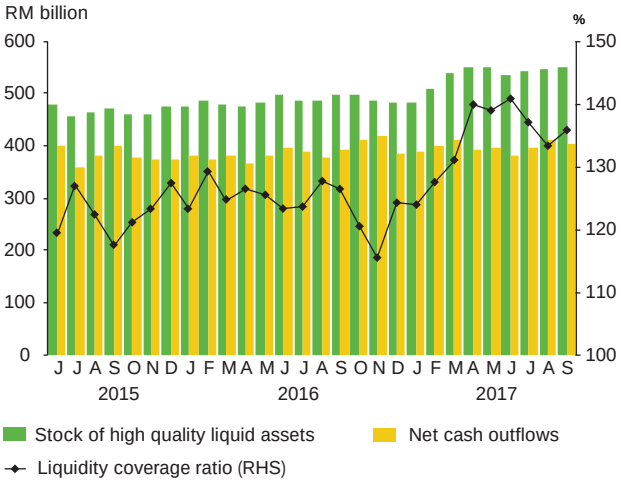
Banking system liquidity remained sufficient to support intermediation activity. Outstanding ringgit surplus liquidity placed with Bank Negara Malaysia in the form of placements, reverse repos and statutory reserves which can be unwound to meet liquidity needs, stood at RM189.4 billion. The banking system Basel III Liquidity Coverage Ratio (LCR)[5] stood at 136% as at end-September 2017 (2Q 2017: 141%). More than 95% of banks recorded LCR levels above 100%.

During the quarter, domestic funding conditions remained stable. Both the average cost of deposits[6] for banks and the 3-month KLIBOR were almost unchanged at 2.5% and 3.43%, respectively as at end-September 2017 (2Q 2017: 2.51% and 3.43%). The funding structure of banks continues to be predominantly deposit-based (70% of total funding) and in local currency. On aggregate, banking system deposits recorded a higher annual growth of +4.6% (2Q 2017: +3%), contributed by the continued expansion in household (+3.7%) and business sector deposits (+11.3%) (2Q 2017: +3.9% and +5.5%, respectively).

Banks continued to maintain diversification in their funding structure through the utilisation of medium-term ringgit and foreign currency denominated funding instruments. At the end of the third quarter, the loan-to-funds ratio[7] (LTF) remained stable at 83.1% (2Q 2017: 83.3%).

Banking system liquidity sufficient to buffer for adverse liquidity shocks

Chart 33: Banking System Basel III Liquidity Coverage Ratio



Source: Bank Negara Malaysia

[5] 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%.
[6] The average cost of deposit is computed based on rolling 12-months average of interest expense on deposit over total deposit.
[7] Funds comprise deposits and all debt instruments issued (including subordinated debt, debt certificates/sukuk, commercial papers and structured notes).

Access to Financing for SMEs: Perception vs. Reality

Recent findings of OECD[1] and domestic surveys conducted have shown increased access to financing by Malaysian SMEs. Nevertheless, common perceptions of financing difficulties faced by SMEs still persist. This article examines the perceptions based on available demand and supply side data, along with feedback from financial institutions (FIs) and SME chambers and associations:

Perception 1: Financing is a key constraint for Malaysian SMEs

According to the latest bi-annual survey by SME Corporation Malaysia (SME Corp), 97% of SMEs which applied for financing from FIs affirmed that they were able to obtain financing. Of this, 27% were first-time borrowers and 23% were without collateral and credit guarantee.

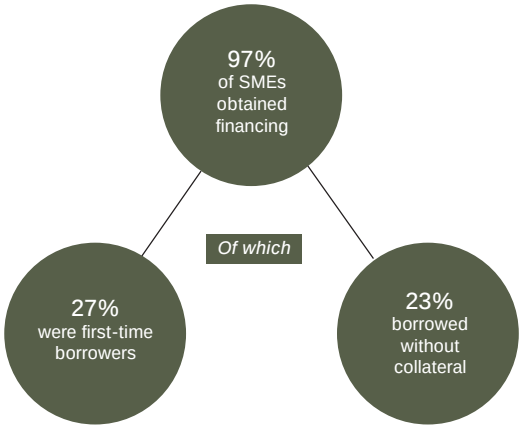
The key challenges cited by SMEs were non financing-related[2] and primarily focused on cyclical business challenges and the higher cost of doing business.

Supply side data from FIs further support the findings of the SME Corp survey:

1. Financing to SMEs by FIs continues to grow above 7%, outpacing households (5.1%) and large corporations (6.3%);
2. The approval rate for financing applications by SMEs, at 76.4%, is consistently higher than that for all consumer segments (62.3%); and
3. FIs' share of SME financing over total business financing has continued to trend upwards, accounting for 50% of total business financing by FIs as at September 2017 (2010: 38%).

FIs remain the primary source of financing for SMEs, with financing outstanding amounting to RM310.6 billion as at end-September 2017, or 97% of total financing outstanding to SMEs. This is complemented by various Government funds and schemes for SMEs. An allocation of RM10.4 billion is further provided under BNM's special funds for financing to SMEs.

Diagram 1
Reality: Majority of SMEs which require financing were able to obtain financing



Top concerns of SMEs are non-financing related	
High cost of doing business	64%
Ringgit depreciation	53%
Reduced domestic demand	40%
Low sales due to GST	38%
Weak business sentiment	29%

Source: 1Q 2017 SME Corp Survey

[1] Malaysia is cited as having sustainable SME financing growth among 39 countries, based on the report *Financing SMEs and Entrepreneurs 2017: An OECD Scoreboard (April 2017).*

[2] Only 10% of SMEs reported difficulties with current financing facilities mainly linked to delays in loan approvals/ disbursement, requests for additional guarantors or collateral and higher interest charged.

Perception 2: Applying for financing is an opaque and complicated process

In practice, banks have streamlined and simplified the application process for SME financing. The processing time for unsecured financing applications has improved significantly, from 70 days previously to 7-16 days[3] on average. The improvement has been driven largely by:

1. the PARTNER programme, under which banks adopt standardised loan application forms and provide a checklist of required documents to applicants;
2. dedicated SME desks at FIs to assist and advise applicants on the preparation of financing documents and measures that they can take to improve their eligibility for financing; and
3. the mobilisation of 20,363 bank officers nationwide to increase the capabilities, awareness and knowledge of SMEs on financing matters. Areas covered include credit application requirements and processes, financial management and business planning.

Perception 3: Banks do not extend financing to start-ups

Data on bank financing to SMEs show that 20% of SME financing approvals are for newly established SMEs (three years or younger), broadly in line with the share of applications received[4]. The rejection rate for new SMEs is also observed to be only marginally higher than the average rejection rate for all SMEs. Liaison with FIs indicates an increased appetite for financing younger SMEs, in line with ongoing improvements in approaches to assess risk and viability. These developments are consistent with the increasing focus by FIs on SMEs as a strategic growth segment.

Diagram 2
Reality: Simplified application process has improved processing time significantly

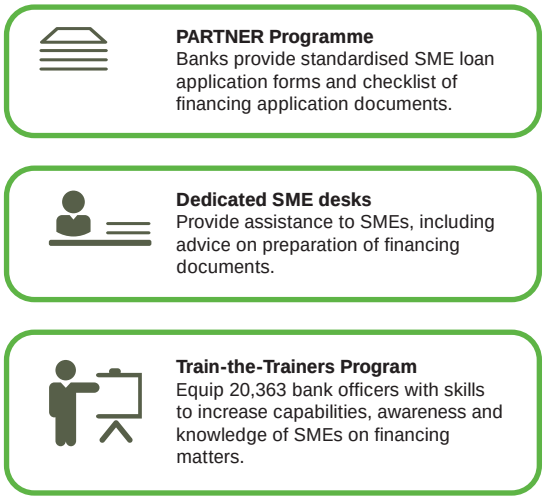
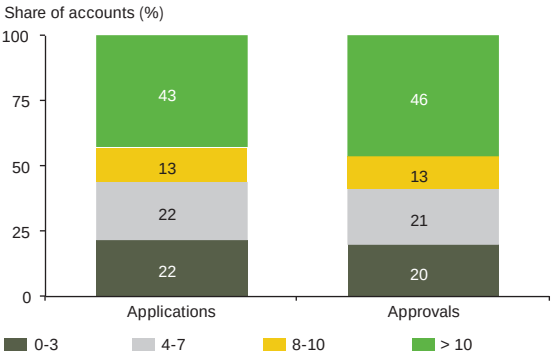


Diagram 3
Reality: Start-ups receive financing from FIs with similar approval rate

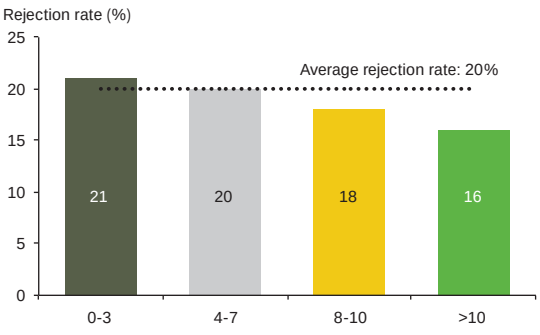
Banks lend across a broad spectrum of companies, including newly established SMEs (20% of total approvals)

Chart: Share of financing approvals and applications by years in operation



Rejection rate for young SMEs is only slightly higher than overall average

Chart: Financing rejection rate by years in operation

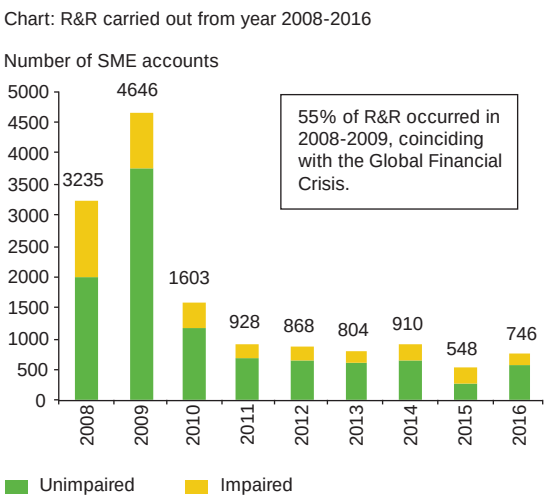


[3] Processing time is seven days for financing up to RM500,000 and 16 days for financing above RM500,000 on average.
[4] Based on CCRIS data (2016).

Perception 4: Banks are quick to withdraw financing lines and/or reduce credit limits of SMEs during economic downturns

Less than 2% of SMEs surveyed by SME Corp with existing financing from FIs reported difficulties due to reduced credit limits or a withdrawal of credit facilities. On the contrary, debt restructuring and rescheduling (R&R) assistance provided to viable but financially distressed SMEs generally increased during economic down-cycle, helping SMEs maintain their credit facilities. More than 14,000 SME accounts were restructured or rescheduled between 2008 and 2016, of which 73% were initiated on performing accounts, underscoring pre-emptive actions taken by FIs to assist SMEs.

Diagram 4
Reality: Pre-emptive assistance is actively provided to financially distressed SMEs



Conclusion

The evident differences between perception and reality underscore the need for continuing education and engagement programmes to reach more SMEs with information on financing sources available and avenues that they can approach to obtain assistance. The Bank continues to work with its partners to achieve this. The Bank is also pursuing additional initiatives to enhance financing to SMEs, including:

1. the development of an online SME Financing Platform by Credit Guarantee Corporation (CGC) to enable SMEs to source suitable financial solutions from multiple FIs and SME funds more efficiently and seamlessly; and
2. the implementation of a Financial Accelerator Lab that will work with key collaborators to deliver an end-to-end solution for SMEs that face higher hurdles to obtain financing.

Moving forward, the development of alternative financing avenues (e.g. equity crowdfunding, P2P, private equity and venture capital) to complement the banking system remains key to support SMEs, particularly in new growth areas. Bank financing will remain ill-suited to some businesses in such areas, given the fiduciary responsibility of banks to ensure the safety of the public's deposits and avoid excessive risk-taking.