Managing Risks to Financial Stability

HIGHLIGHTS

- Businesses and households continued to demonstrate sound debt servicing capacity.
- Domestic bond market conditions remained orderly, with the support of long-term domestic and foreign investors.
- Domestic financial stability is expected to remain intact, supported by sound financial institutions and orderly markets and liquidity conditions.

Financial stability preserved

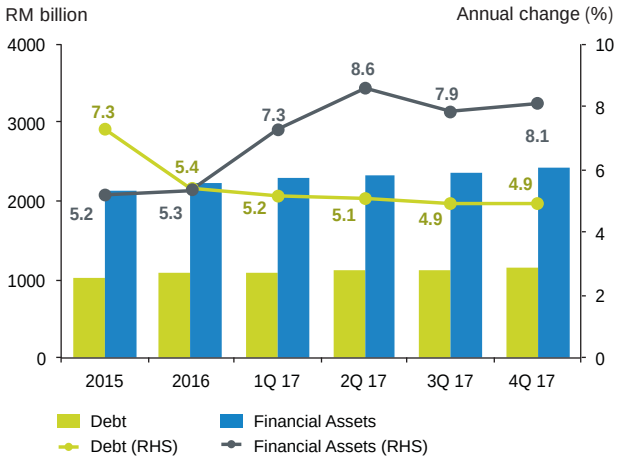
Financial stability was sustained, supported by sound financial institutions and orderly domestic financial market conditions. Overall volatility in domestic financial markets remained low amid improved sentiment. Domestic financial institutions continued to demonstrate resilience amid healthy asset quality and sound profitability. Credit conditions in the domestic banking system remained conducive for real economic activities.

Sustained debt servicing capacity of households and businesses

Household debt registered an annual growth of 4.9% in the fourth quarter of 2017 (3Q 2017: +4.9%) with the bulk of debt mainly for wealth accumulation (64%). Loans for the purchase of residential property continued to be the key driver of growth (+8.5%; 3Q 2017: +8.5%). The overall debt repayment capacity of households is expected to remain sound supported by steady income growth and stable labour market conditions. Aggregate household financial assets and liquid financial assets continued to be high at 2.1 and 1.5 times of debt, respectively. Further, growth of household financial assets (+8.1%) continued to outpace debt (+4.9%). At the end of the quarter, total household debt amounted to 84.3% (3Q 2017: 84.6%) of GDP.

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

Chart 26: Household Sector Debt* and Financial Assets

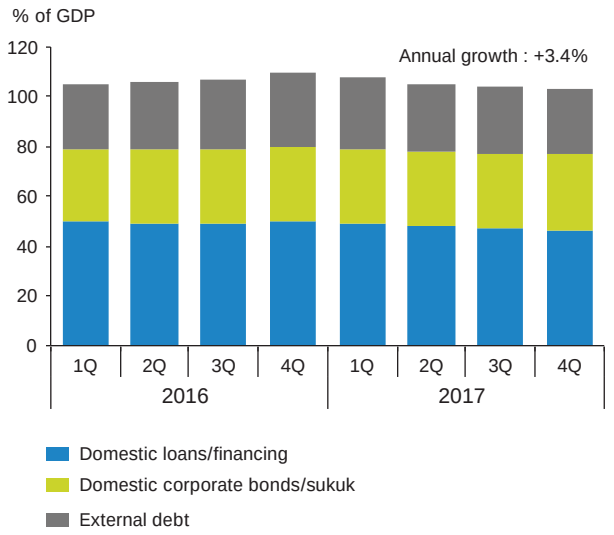


* Loans extended by banks, development financial institutions and major non-bank financial institutions

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

Aggregate impairment and delinquency ratios for both banks and non-banks were sustained at 1.6% and 1.4%, respectively. Based on engagement with banks, vulnerable borrowers (individuals earning less than RM3,000 per month) living in the urban areas continued to experience difficulty in debt repayment on account of the high cost of living. Overall risks to financial stability from the household sector are, however, assessed to have receded further. The majority of new household borrowers continued to observe prudent debt service ratios (DSR) of below 60% with 41% of borrowers having DSR of below 40%. The share of borrowings by vulnerable borrowers also declined further to account for 20.6% (2016: 21.9%) of total household debt as loan affordability assessments continued to improve.

Potential losses to banks from vulnerable households were estimated at less than 10% of banks' excess capital buffers (above the regulatory minimum). This is under a simulated scenario based on the assumption of a tripling of prevailing probabilities of default and severe loss given default.

In the fourth quarter of 2017, total business borrowings grew annually at 3.4% (3Q 2017: 7.0%). This was driven by fund raising in the corporate bond and sukuk markets which grew by 14.3% (3Q 2017: 10.2%). Recent non-financial corporate bond/ sukuk issuances during the quarter were led by the real estate, utilities and infrastructure sectors. Corporate external borrowings were lower, largely driven by valuation effects from a stronger ringgit and net repayment of trade credit. Financing by banks and development financial institutions (DFIs) to businesses expanded moderately by 1.3% (3Q 2017: 5.4%), reflecting slower growth in financing across most sectors. Total financing by banks and DFIs to SMEs remained modest, recording an annual growth of 5.3% (3Q 2017: 7%).

Financial position of firms remained healthy amid improving domestic and external demand. The aggregate leverage of Malaysian non-financial corporations (NFCs)[7] as measured by the median debt-to-equity ratio increased in 3Q 2017 (51.9%; 2Q 2017: 48.6%) led by the real estate and services sectors. The aggregate debt servicing capacity and liquidity positions remained sound.

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

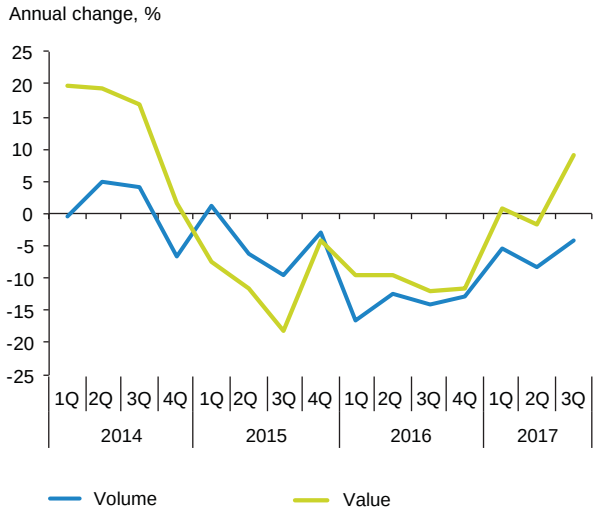
The median interest coverage ratio (ICR) improved to 9.6 times (2Q 2017: 8.3 times), and remained significantly above the prudent threshold of two times. The median current cash-to-short-term debt ratio (CASTD) improved to 1.6 times (2Q 2017: 1.4 times), above the prudent threshold of one time. Overall, the ratio of impaired and delinquent loans improved slightly to 2.5% and 0.3% of total bank lending to businesses, respectively (3Q 2017: 2.6% and 0.4%, respectively).

The Organization of the Petroleum Exporting Countries' (OPEC) announcement to extend cuts in crude oil production until end 2018 supported oil prices. The oversupply position in the oil market, however, is expected to persist at least until the first quarter of 2018. For Malaysian O&G companies, overall debt servicing capacity remained stable in 3Q 2017, with the median ICR at 29.6 times. However, the liquidity position (median CASTD ratio) moderated to 2.2 times (2Q 2017: 4.7 times). This was mainly due to new short–term borrowings for working capital and acquisitions. Delinquent and impaired loans ratio in the segment increased to 0.6% (3Q 2017: 0.1%) and 5.5% (3Q 2017: 5.0%), respectively, in the fourth quarter of 2017. This was driven by continued cash flow issues faced by non-SMEs in the shipping-related segment, which are servicing the O&G sector. Risks to the banking system remained limited as exposures to the O&G-related sector accounted for about 6% of total exposures with banks already setting aside provisions for current and future expected impairments.

On an annual basis, activities in the housing market have shown some improvements. Total housing transaction volume recorded a smaller contraction of 4.2% (2Q 2017: -8.4%) with 47,501 units of houses being transacted in 3Q 2017. The value of housing transaction also showed signs of improvement, recording a positive annual growth of 8.9% (2Q 2017: -1.5%). The improvement was contributed largely by transactions of houses priced at RM500,000 and above. House prices (as measured by the Malaysian House Price Index) continued to increase at a moderate annual pace of 6.8% in 2Q 2017 (1Q 2017: +6.7%), well below previous peaks observed during the 2012-2013 period (average growth of 12.3%).

Housing market activities improved during 3Q 2017

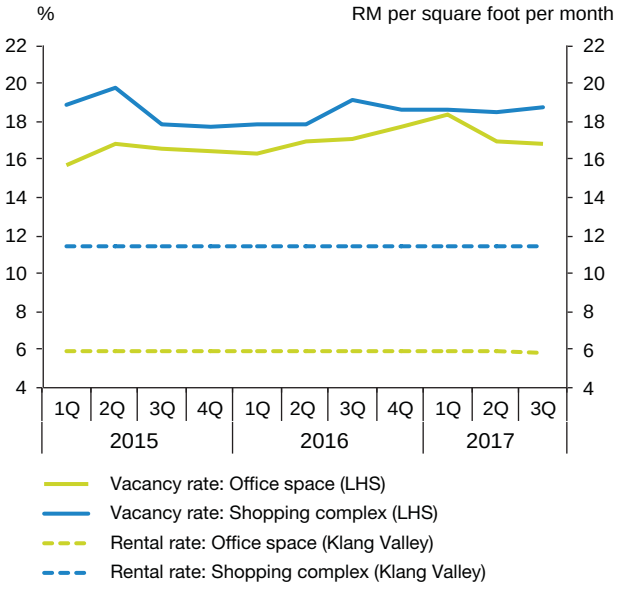
Chart 28: Property Sector Transaction Volume and Value



Source: National Property Information Centre

Rental rates of office space and shopping complex remained depressed

Chart 29: Office Space and Shopping Complex Vacancy and Rental Rates



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

Borrowers continued to have access to home financing, especially the first-time house buyers. The growth in outstanding house financing increased to 8.9% (3Q 2017: +8.8%), while the overall housing loan approval rate for the purchase of houses priced below RM500,000 remained high at 72.3% (3Q 2017: 73.9%).

Demand for financing for speculative house purchases remained muted. During the quarter, 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 7.9% (3Q 2017:10.5%) 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 0.9% (3Q 2017: +0.7%). The credit quality for overall housing loans also remained sound, with delinquency and impairment ratios at 1.3% and 1.0% of total bank loans, respectively (3Q 2017: 1.2% and 1.1%, respectively).

Rental rates in the office space and shopping complex segments remained low in 3Q 2017 amid excess supply. 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 non-residential property segment remained low at 0.7% and 1.1%, respectively (3Q 2017: 0.6% and 1.2%, respectively).

Domestic financial market conditions remained orderly

Investor sentiment continued to closely follow developments on the external front. This included the announcement of the new Federal Reserve chairman, the passing of the US tax reform bill, the rate hike in the US and OPEC's decision to extend production cuts until the end of 2018. Overall volatility in the domestic financial markets remained at low levels. This was attributed partly to improved domestic sentiments amid the release of better-than-expected 3Q GDP growth and expectations of monetary policy normalisation by the Bank. Average volatility of 10-year MGS yields was unchanged at 8.5% while average volatility of the FBM KLCI declined to 4.4% (3Q 2017: 8.5% and 5.1%, respectively). Average volatility of the ringgit increased slightly to 3.2% (3Q 2017: 2.8%).

In the last quarter of 2017, there were net portfolio investment inflows of RM11.7 billion (3Q 2017: net outflows of RM5.1 billion) due mainly to foreign inflows into both the government bond and equity markets. Consequently, non-resident investor holdings of government bonds increased to 27.7% (3Q 2017: 26.6%) of total outstanding Malaysian government bonds. The composition of non-resident investors in the government bond market remained relatively unchanged, with bulk of the holdings attributed to 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 is further supported by the distribution of holdings across different maturities. Of total non-resident holdings, 62% were in medium- and longer-dated bonds of more than 3 years.

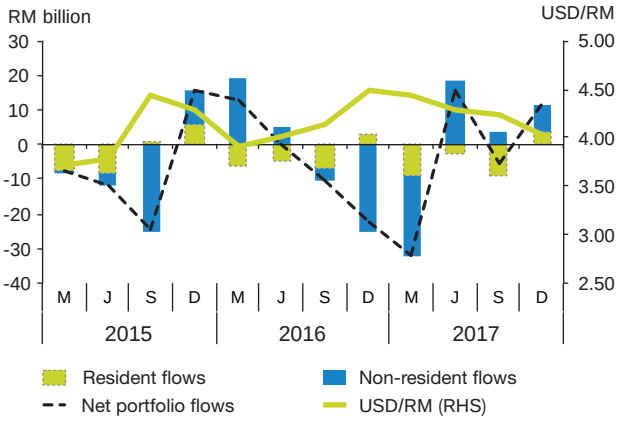
Non-resident participation in the domestic equity market remained stable at 23.2% of total equity market capitalisation (3Q 2017: 23.3%). The FBM KLCI ended the quarter at its highest point of the year at 1796.81 points (3Q 2017: 1755.58 points), supported by the stronger ringgit and higher crude oil prices. The average price-to-earnings (PE) ratio for the FBM KLCI stood at 16.2 times (3Q 2017: 16.7 times; 2010-2016 average: 16.8 times).

Market liquidity remained healthy. The bid-ask spread for MGS was stable at 0.1%, while the bid-ask spread for FBM KLCI widened slightly to 0.4% of the mid-price (3Q 2017: 0.1% and 0.3%, respectively). Daily average USD/MYR bid-ask spreads remained narrow at 24 pips (3Q 2017: 23.3 pips). In the foreign exchange market, a daily average volume of USD9.9 billion (3Q 2017: USD10.4 billion) was recorded, of which spot and forward transactions accounted for USD4.6 billion (3Q 2017: USD4.7 billion).

The ringgit appreciated by 4.1% against the US dollar to end the quarter at RM4.0620 per US dollar (3Q 2017: RM4.2275). A similar trend was observed against most other major currencies. Spreads on long-term onshore USD liquidity, as reflected by the 5-year cross-currency basis swap spreads, narrowed to 25 basis points (bps) (3Q 2017: 54 bps). Similarly, the 5-year sovereign credit default swap spread declined to 58.4 bps (3Q 2017: 68.7 bps).

Net portfolio investment outflows mainly driven by residents' investment abroad

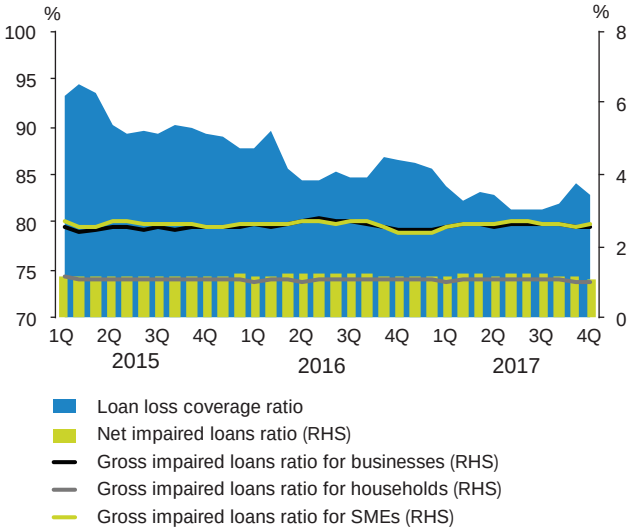
Chart 30: Financial Market Net and Gross Portfolio Flows and Ringgit Exchange Rate Movement



Source: Department of Statistics, Malaysia

Healthy asset quality observed in the banking system

Chart 31: Banking System Asset Quality



Source: Bank Negara Malaysia

Market risk exposures supported by risk management and hedging strategies

Banks' aggregate market risk exposures remained stable. FX risk, measured in terms of the net open position of foreign currency denominated exposures, stood at 6.1% of total capital (3Q 2017: 5.7%). Interest rate risk in the trading book and equity risk remained low at 1.0% and 1.0% of total capital, respectively (3Q 2017: 1.1% and 0.9%, respectively). Interest rate risk in the banking book also remained stable at 3.7% (3Q 2017: 3.6%) of total capital. For the insurance and takaful industry, market risk exposures stood at 15.4% (3Q 2017: 14.9%) of total capital available. Equity risk, which formed the bulk of insurers' market risk exposures, increased to 9.1% (3Q 2017: 8.8%) of total capital available.

Sound profitability and sustained liquidity position of financial institutions

The banking system recorded higher pre-tax profits of RM10 billion (3Q 2017: RM9 billion) in the fourth quarter of 2017. This was driven by higher fee-based income from brokerage and syndication activity, followed by dividend contributions from overseas subsidiaries. The financing (including interest) margin net of operating costs and loss provisions increased slightly to 0.71 percentage points (ppts) (3Q 2017: 0.69 ppts), owing mainly to higher recoveries from impaired loans.

In the insurance and takaful sector, general insurers and takaful operators recorded higher operating profit of RM748.3 million in the fourth quarter (3Q 2017: RM655.1 million) on account of more favourable claims experiences with the industry claims ratio improved to 49.5% (3Q 2017: 61.2%). Similarly, life insurers and family takaful operators recorded an increase in profitability with excess income over outgo standing at RM4.9 billion (3Q 2017: RM 3.5 billion). This was attributed largely to net capital gains of RM821.1 million (3Q 2017: net capital losses of RM176.2 million).

Liquidity in the banking system remained ample to support intermediation activity. Outstanding ringgit surplus liquidity placed with Bank Negara Malaysia stood at RM188.7 billion in the form of placements, reverse repos and statutory reserves. The Basel III Liquidity Coverage Ratio (LCR)[8], a measure of short-term liquidity resilience for the banking system stood at 134% as at end-December 2017 (3Q 2017: 136%). All banks recorded LCR levels above 90%, the current minimum requirement.

Domestic funding conditions remained stable during the quarter. Both the average cost of deposits[9] for banks and the 3-month KLIBOR were almost unchanged at 2.51% and 3.45%, respectively as at end-December 2017 (3Q 2017: 2.50% and 3.33%, respectively). Banks continued to be predominantly funded by deposits (70% of total funding) mostly in local currency. Banking system deposits grew by 4% (3Q 2017: +4.5%), contributed by the sustained expansion in business sector and household deposits. The loan-to-funds ratio[10] (LTF) remained stable at 84% (3Q 2017: 83.1%).

Disaster Relief Facility activated to assist SMEs affected by floods

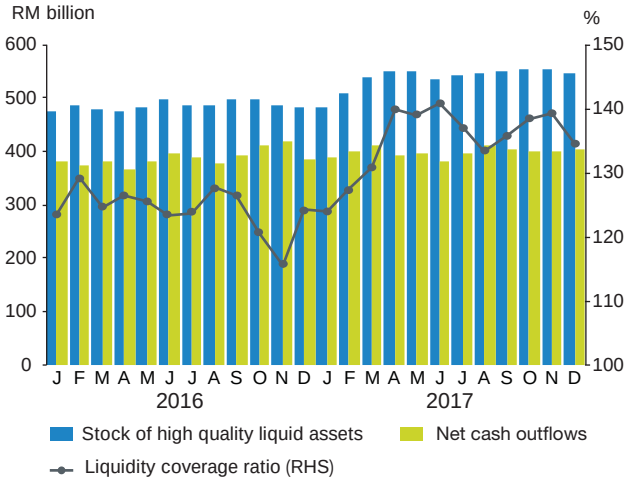
The recent floods resulted in 67 districts throughout the country being identified as flood disaster areas by the National Disaster Management Agency (NADMA). In response, the Bank activated its Disaster Relief Facility (DRF) on 8 November 2017 to alleviate the financial burden of SMEs affected by floods and assist in the resumption of their businesses operations. To date, more than 200 SMEs have sought financial assistance amounting to RM75 million under the DRF.

Malaysian SMEs affected by the floods in the districts identified by NADMA as flood disaster areas may apply for assistance via 49 financial institutions for the replacement of damaged assets and working capital needs. The maximum amount of financing under the DRF is RM500,000 per group of companies at an effective financing rate of up to 2.25% per annum for a term of five years. The facility is available until 31 May 2018.

Financial institutions have also proactively assisted 170 SMEs to rehabilitate their loans via loan restructuring and rescheduling.

Banking system liquidity sufficient to buffer for adverse liquidity shocks

Chart 32: Banking System Basel III Liquidity Coverage Ratio



Source: Bank Negara Malaysia

[8] 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 2018, the minimum requirement is set at 90%.
[9] The average cost of deposit is computed based on rolling 12-months average of interest expense on deposit over total deposit.
[10] Funds comprise deposits and all debt instruments issued (including subordinated debt, debt certificates/sukuk, commercial papers and structured notes).