MANAGING RISKS TO FINANCIAL STABILITY

Domestic financial stability continued to be preserved

The Malaysian financial system remained resilient despite heightened volatility during the quarter. The domestic financial markets demonstrated continued resilience and orderly conditions, while sound financial institutions and ample banking system liquidity continued to lend support for financing to businesses and households. Fragile investor sentiment is expected to persist in the period ahead, with prospects of a repricing of risks continuing to weigh on sentiment. Domestic financial system stability is nonetheless expected to be maintained. This is underpinned by the strong financial buffers of financial institutions, a sustained focus on prudent risk-taking, especially among banks, and deep domestic financial markets.

Sustained debt servicing capacity of borrowers

Outstanding financing by banks recorded a more moderate growth of 9.7% as at end of the quarter in line with developments in the real economy. The debt servicing capacity of most borrowers remained intact, with the ratio of net impaired loans unchanged at 1.2%. Delinquencies, as measured by loans-in-arrears of between one and three months, also remained stable at 2.2% of total loans. In the insurance industry, credit exposures, mainly in the form of holdings of private debt securities, remained unchanged at 4.1% of total capital available.

Stable employment conditions have supported the financial resilience of households. The overall impairment level for bank loans extended to the household sector has thus far been sustained at a low level of 1.1% of total household borrowings. While overall delinquencies have also remained low and unchanged at 1.6% of total household borrowings, some signs of late payments are emerging among more highly leveraged borrowers as higher costs of living begin to stretch incomes. Small increases in delinquencies have been observed in some pockets of financing for the purchase of securities and properties. Although the level of household indebtedness remains high, the growth of household borrowings has continued on the moderating trend observed in the past several years (3Q 2015: +7.6%; 2Q 2015: +8.3%). Of significance, unsecured borrowings by households have remained subdued, increasing by 3.4% (2Q 2015: +3.7%).

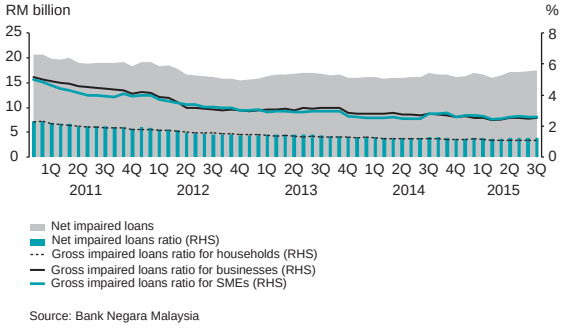
Banks generally continue to observe sound underwriting standards for lending to households. About half of new loans approved were to borrowers with an aggregate debt service ratio not exceeding 40%, with the average debt service ratio for all new household borrowings remaining below 60%. Competition has started to lead some lenders, including non-bank financial institutions, to ease debt service ratios for households in the higher income segments. While having greater capacity to service debt, the Bank will continue to exercise close vigilance to ensure that banks carry out robust affordability assessments when granting financing especially for cases involving higher debt service ratios. Overall household financial buffers remained comfortable, with financial assets at slightly above two times of total household debt. This was despite the more moderate expansion in household financial assets (3Q 2015: +3.6%; 2Q 2015: +5%) following slower deposit growth and lower market valuations of household holdings of equities and unit trusts.

In the business sector, the impact of the depreciation of the ringgit and lower commodity prices has so far not affected the debt servicing capacity of most Malaysian businesses to the extent that earnings performance has remained positive. Businesses in the export-oriented industries, especially crude palm oil producers, have benefitted from higher sales proceeds amid lower selling prices. Domestic-oriented businesses on the other hand, particularly in the retail trade sector, performed less favourably compared to the previous quarter as the effects of front-loaded consumer purchases ahead of the implementation of the goods and services tax (GST) wore off.

Total business sector borrowings increased modestly by 2.2% during the quarter (2Q 2015: +1.6%) or 11.1% on an annual basis. External borrowings of businesses also grew at a slower pace (2Q 2015: +1.1%; 1Q 2015: +4.5% (excluding a large issuance)) during the quarter. This maintained the aggregate leverage of businesses within prudent levels at below 50%. Overall, businesses remained well-positioned to service their debt. The median interest coverage ratio (ICR) of Malaysian businesses[2], while lower at 5.2 times in 2Q 2015 (1Q 2015: 6.3 times), remains well above the prudent level of two times by international standards. This was further supported by satisfactory liquidity positions, with both the median current ratio (current assets-to-current liabilities) and cash cover to meet short-term debt obligations remaining stable at 1.7 times and 1.2 times respectively. While the overall risk of potential delinquency, using the expected default frequency as a proxy, edged higher, it remained low at 0.63% (2Q 2015: 0.54%).

The annual growth of the Malaysian House Price Index (MHPI) moderated to 7.8% in 1Q 2015 (4Q 2014: +8.0%), in line with the decline in the number and value of residential properties transacted (-6.4% and -11.9% respectively). Transactions involving residential properties priced below RM250,000 registered a positive growth, reflecting continued strong demand for affordable housing. Debt-funded speculative purchases of residential properties, as proxied by the number of borrowers with three or more outstanding housing loans, accounted for a small and stable share of below 3% of individuals with existing housing loans.

Banking System: Loan Quality



Source: Bank Negara Malaysia

Orderly conditions in domestic financial markets facilitated efficient price discovery

Net outflows of portfolio investments amounted to RM24.4 billion during the third quarter (2Q 2015: net outflows of RM11.8 billion), driven by external and domestic developments. This exerted significant pressure on the ringgit against major currencies. The Malaysian currency depreciated by 14.8% during the quarter and recorded its weakest level at RM4.4725 per US dollar on 29 September 2015. Despite increased risk aversion among investors, orderly conditions in the domestic financial markets were sustained throughout the quarter. The presence of domestic institutional investors and financial institutions supported liquidity and demand in the market, thus containing surges in volatility.

In the bond market, the yield curve shifted upwards with yields for the 10-year MGS rising to 4.15% (2Q 2015: 4.03%) as investor risk aversion increased. Compounded by prevailing uncertainties in the financial markets, the quarter also saw the 5-year credit default swap, an indicator of market-perceived sovereign risk, for Malaysia overshoot to 232 bps (2Q 2015: 137 bps). Consolidation of exposures and position-taking in the equity market took place during the quarter, causing average volatility of the FBM KLCI to increase to 10.8% (2Q 2015: 8.9%). The monthly turnover ratio for the MGS and FBM KLCI rose to 14.4% (2Q 2015: 10.3%) and 2% (2Q 2015: 1.8%) respectively. Trading liquidity was preserved, with the bid-ask spreads for the MGS and FBM KLCI unchanged at 0.1% and 0.4% of the mid-price respectively. The FBM KLCI ended the quarter lower, in line with regional equity markets, at 1,621.0 points, with overall market capitalisation registering a decline of 4.8% to amount to RM1.60 trillion (2Q 2015: 1,706.6 points and RM1.66 trillion respectively). The price-to-earnings ratio of the FBM KLCI nonetheless remained broadly stable at 17 times. At the close of the quarter, non-resident holdings accounted for 45.6% of total outstanding MGS and 23.0% of equity market capitalisation (2Q 2015: 48.5% in the MGS market and 23.6% in the equity market).

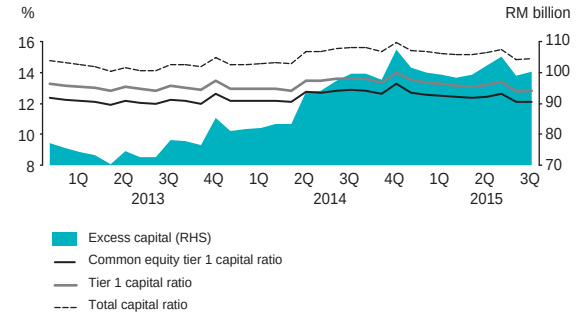
[2] Based on 160 companies listed on Bursa Malaysia with market capitalisation of 80% (excluding financial institutions) covering 10 key economic sectors

Onshore US dollar liquidity conditions remained manageable. The 5-year cross-currency basis swap spread peaked at 150 bps in August, in tandem with movements in the ringgit, before easing to 115 bps at end 3Q 2015 (2Q 2015: 83 bps; Global Financial Crisis, Oct 2008: 200 bps) on improved investor confidence towards the end of quarter.

Sustained resilience of financial institutions

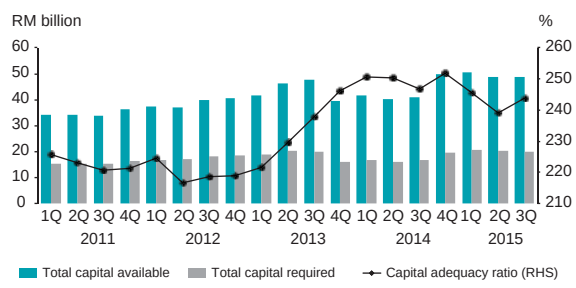
The capitalisation of financial institutions remained strong and is sufficient to absorb potential losses from adverse developments in financial and economic conditions. For banks, the common equity tier-1 capital, tier-1 capital and total capital ratios were sustained well above the minimum regulatory levels at 12.1%, 12.8% and 14.8% respectively. More than 80% of banks' total capital is of high quality, comprising retained earnings, paid-up capital and reserves. The capital adequacy ratio for the insurance sector was similarly healthy at 243.8% (2Q 2015: 239.0%). In aggregate, financial institutions have capital buffers totalling RM132 billion (banks: RM100.2 billion; insurers/ takaful operators: RM31.8 billion), that can be used to absorb potential losses from adverse credit and market events.

Banking System: Basel III Capitalisation



Source: Bank Negara Malaysia

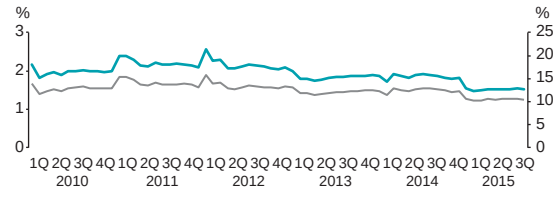
Insurance Sector: Capitalisation



Source: Bank Negara Malaysia

The pre-tax profit of the banking system amounted to RM7.3 billion in 3Q 2015 (2Q 2015: RM7.5 billion), a little lower than the preceding quarter. Higher provisions for loan losses recorded by some banks along with rising deposit rates saw interest/ financing margins (net of administrative costs and expenses on loss provisions) narrow further to 0.53 ppts (2Q 2015: 0.60 ppts). Returns on assets and equity remained healthy at 1.2% (2Q 2015: 1.3%) and 12.6% (2Q 2015: 12.7%) respectively. In the insurance sector, operating profits recorded by general insurers and takaful operators was lower on account of lower investment income at RM556.8 million (2Q 2015: RM681.7 million). Underwriting profits declined to RM69.7 million (2Q 2015: RM72 million) driven by higher claims costs in the fire insurance segment. The performance of life insurers and family takaful operators turned marginally negative with a net deficiency in income over outgo of RM0.4 billion (2Q 2015: positive excess income over outgo of RM1.8 billion). This stemmed from a larger net capital loss of RM3.1 billion (2Q 2015: net capital loss of RM1.1 billion) following higher valuation losses on debt investments, in line with the increase in bond yields during the quarter.

Banking System: Profitability



Source: Bank Negara Malaysia

Insurance and Takaful Sectors: Indicators

	2014		2015		
	3Q	4Q	1Q	2Q	3Q
	RM million				
Life insurance & family takaful					
Excess of income over outgo	3,836	2,120	5,336	1,844	-416
General insurance & general takaful					
Operating profit	788	760	781	682	557
Claims ratio (%)	56.8	57.5	50.3	57.4	60.1
	Annual Change (%)				
Life insurance & family takaful					
Excess of income over outgo	18.3	4.3	66.2	-59.9	-110.9
General insurance & general takaful					
Operating profit	10.7	-1.5	-5.2	-15.2	-29.3
Claims ratio (percentage points)	-2.0	0.4	-4.67	0.45	3.29

Source: Bank Negara Malaysia

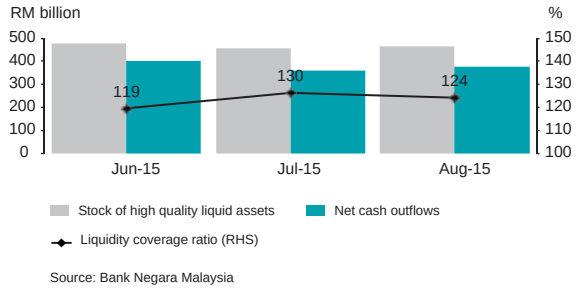
Banks continued to actively manage market risk exposures given the heightened volatility in recent periods. There were no observed changes in the risk-taking behaviour of financial institutions. Banks' exposures to interest rate risk in the trading book and equity risk remained limited at 1.4% and 0.7% of total capital respectively (2Q 2015: 1.3% and 0.8% respectively). The foreign exchange net open position of banks was higher but manageable at 5.9% (2Q 2015: 5.1%) of total capital during the quarter. Market risk exposures of the insurance industry were lower at 12.2% (2Q 2015: 13.3%) of total capital, reflecting lower valuations of investments. Equity risk, which forms the bulk of insurers' market risk exposures, contracted to 7.3% (2Q 2015: 7.9%) of total capital.

Domestic funding conditions remained favourable and supportive of financing activities despite portfolio outflows which led KLIBOR higher during the quarter (3Q 2015: 3.74%; 2Q 2015: 3.69%). Aggregate liquidity in the banking system continued to be in a surplus position. Under the Basel III Liquidity Coverage Ratio (LCR) standards which has been phased in since 1 June 2015[3], the banking system LCR stood at 124% in August 2015 (June 2015: 119%), with all banks reporting LCR levels that are above the current minimum regulatory requirement of 60%. As at 3Q 2015, banking system liquidity placed with Bank Negara Malaysia, which can be unwound to meet liquidity needs, continued to be ample at a level in excess of RM100 billion, providing comfortable buffers against unexpected cash outflows or adverse liquidity shocks.

Banks' funding continues to be predominantly deposit-based and in local currency. Among Islamic banks, deposit growth moderated since July following the reclassification of previously recognised deposits as investment accounts in line with requirements under the Islamic Financial Services Act 2013 (IFSA). The decline has been gradual since IFSA came into force, due largely to the two-year transition period provided by the Bank. However, this has been more pronounced in the recent quarter with the expiry of the transition period on 30 June 2015. The loan-to-deposit ratio for the banking system was higher at 90.1% in 3Q 2015 (2Q 2015: 88.0%), following a slower pace in the growth of deposits (+5.4%) vis-à-vis financing (+10.2%). In recent years, banks have also begun to tap the domestic bond market in efforts to reduce liquidity and maturity mismatch through the issuance of medium term papers. The quarter also saw continued competition among banks for corporate deposits which caused average cost of deposits for banks to edge upwards to 2.28% (2Q 2015: 2.23%).

[3] In the first phase, compliance is set at 60% with progressive increment of 10% each year to the full compliance beginning 2019

Banking System: Basel III Liquidity Coverage Ratio



Source: Bank Negara Malaysia

Banks' external exposures expanded moderately, in line with the continued growth in regional operations. During the first half of the year, growth in banks' external assets (+9.1%) outpaced that of external liabilities (+6.9%). As at 2Q 2015, banks' net external liabilities remained broadly stable at RM135 billion (2014: RM131 billion). This comprised mainly deposit placements and capital funds from parent entities of locally incorporated foreign banks. Short-term deposit placements with domestic banks partly relate to centralised liquidity management operations which involve pooling excess liquidity from overseas banking operations at the parent entity in Malaysia. Risks from such short-term placements are largely mitigated by stringent regulations requiring banking entities to maintain adequate liquidity buffers in each jurisdiction of operation.