MANAGING RISKS TO FINANCIAL STABILITY

The Malaysian financial system remains resilient. This resilience is expected to be maintained in the period ahead. While businesses and households continue to adjust to the more challenging operating conditions and higher cost of living, these adjustments are expected to have modest impact on financial institutions' earnings and asset quality. Supported by strong capital and liquidity positions, the Malaysian financial system is well-positioned to continue performing its intermediation function in an effective and efficient manner. Going forward, external events will continue to weigh heavily on investor sentiments and volatility in the domestic financial markets. These include increased uncertainty over policy adjustments and growth in the major economies, volatile commodity prices and developments in the UK post the EU referendum. Domestic financial system stability is nonetheless expected to be maintained.

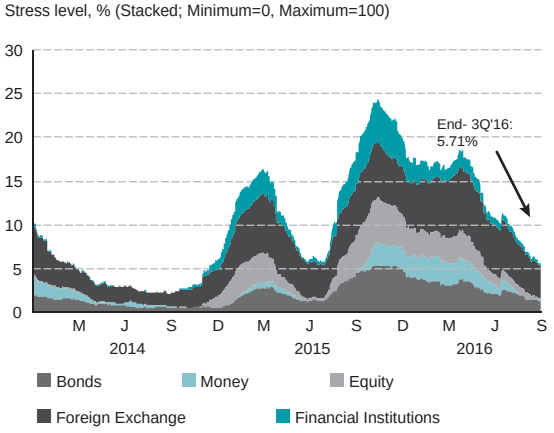
Domestic financial market conditions remained orderly

Conditions in the domestic financial markets remained orderly throughout the quarter. Overall volatility in the equity, money and ringgit foreign exchange markets was lower as implied by the Financial Market Stress Index. In the MGS market however, average volatility for the 10-year yields edged higher (3Q 2016: 10.3%; 2Q 2016: 9.5%) following the reduction in domestic OPR in July and subsequently, remained elevated amid continuous uncertainty on the timing of the next adjustment of the US interest rate ahead of the Federal Open Market Committee meeting.

Portfolio investments recorded a net outflow position of RM10.6 billion (2Q 2016: net inflow of RM77 million), mainly attributable to higher acquisitions of portfolio assets abroad by domestic institutional investors. Non-resident portfolio investment also registered a net outflow mainly driven by maturing foreign currency-denominated government sukuk and BNMN. As at end-3Q 2016, non-residents held about half of total outstanding MGS (51.3%; 2Q 2016: 49.8%), with 55.8% of the holdings maturing within the next 5 years (2Q 2016: 59.2%). Correspondingly, the 3, 5 and 10-year MGS yields eased to 2.88%, 3.24% and 3.55% respectively (2Q 2016: 3.15%, 3.37% and 3.74% respectively). In the equity market, non-resident holdings remained largely unchanged at 22.8% of total market capitalisation (2Q 2016: 22.9%).

Trading liquidity declined in the MGS and equity markets. The monthly turnover ratio averaged lower to 12.4% for MGS and 1.7% for FBM KLCI (2Q 2016: 14.9% and 2.1%, respectively). The bid-ask spreads were unchanged at 0.1% of mid-price for MGS and 0.4% of mid-price for FBM KLCI. In the currency market, ringgit depreciated by 3% against the US dollar to end the quarter at RM4.1455 per US dollar (2Q 2016: RM4.0225). The 5-year cross-currency basis swap spread narrowed to 55 bps (2Q 2016: 83 bps), while the 5-year sovereign credit default swap spread narrowed to 122.4 bps (2Q 2016: 156.1 bps).

Financial Market: Financial Market Stress Index (FMSI)



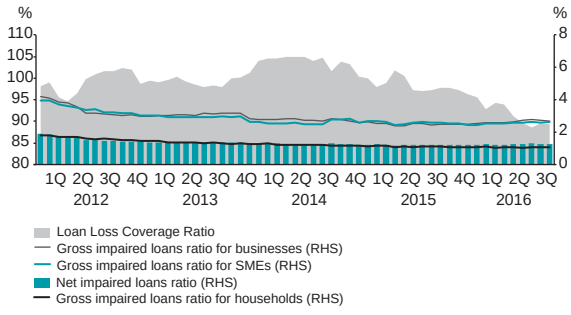
Note:
1. The FMSI is a risk monitoring tool for financial markets, developed based on the European Central Bank's (ECB's) Composite Indicators of Stress Index (CISS). It is constructed from indicators of volatility in five components of domestic financial markets - bonds, money, equity, foreign exchange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

Credit risk exposures are manageable amid sustained debt servicing capacity

At this juncture, credit risk exposures of financial institutions are stable. Asset quality continued to be supported by sustained debt servicing capacity of borrowers. For banks, this also reflects sustained credit underwriting and risk management practices. Delinquencies, measured by loans-in-arrears of between one and three months, increased marginally to 2.1% (2Q 2016: 2.0%) of total bank loans. Impaired loans, net of individual impairment provisions, was however unchanged at 1.3% of net loans in September 2016. Banks' loan loss coverage ratio[3] stood at 89.4%. In recent period, the ratio has been trending downwards (2Q 2016: 89.6%; 1Q 2016: 94.2%). This decline is supported by higher regulatory reserves thus positioning banks to manage potential losses from deterioration in credit portfolio. Taking into account regulatory reserves for loans and financing, banks have sufficient buffers[4] for potential credit losses. In the insurance and takaful industry, credit exposures were broadly stable at 4.0% of total capital available (2Q 2016: 4.2%).

Banking System: Loan Quality



Source: Bank Negara Malaysia

Household borrowings grew more moderately at 5.8% for the quarter (2Q 2016: +6.2%). House financing, the key driver of increase in household debt, expanded by 9.7% (2Q 2016: +10.2%) led mainly by sustained demand for affordable housing. Stable income and labour market conditions continued to support adjustments by some households to higher cost of living, particularly those living in urban areas. The share of total household debt borne by vulnerable borrowers[5] declined further to 22.6% (2014: 24.3%; 2013: 28.4%) of total bank and non-bank lending to households. For lenders, the risk of large losses from the household portfolio was also mitigated by improved affordability assessments and sustained underwriting practices. 73% of new loan accounts have a debt service ratio (DSR) of less than 60%.

Impaired loans for both banks and non-banks remained low and stable at 1.6% (2Q 2016: 1.6%) while delinquencies increased slightly to 1.5% of total household debt (2Q 2016: 1.4%). This came from lower income households whose variable income has been adversely affected. The potential risks to domestic financial stability, particularly from the vulnerable borrowers, however, remained mitigated and well within the excess capital buffers of banks.

For businesses, total debt grew by 3.7% (2Q 2016: 8.1%) y-o-y. This was mainly driven by fund raising from the capital market (+RM40.7 billion or 12.9%) and external borrowings (+RM28.4 billion or 10.9%). About 60% of the increase in external borrowings was attributed to exchange rate valuation effects with the remaining driven by net new borrowings in the second quarter of 2016. Outstanding business loans by banks recorded a slower growth of 2.0% as at end-3Q 2016 (2Q 2016: 4.2%) amid moderation in demand for financing, mainly in the real estate, oil and gas and palm oil sectors. Growth in financing to SMEs continued to be robust at 8.5% (2Q 2016: 9.9%). The supply of credit to businesses reflected the level of economic activity with limited evidence of broad-based tightening in access to financing especially by the banking industry.

[3] Refers to ratio of individual plus collective impairment provisions to total impaired loans
[4] Banks are required to maintain total collective impairment provisions and regulatory reserves of no less than 1.2% of net loans.
[5] Defined as borrowers with a monthly income of less than RM3,000.

Overall debt servicing capacity of Malaysian businesses[6] remained intact. This supported the low and steady level of expected default frequency for businesses at 0.62% (2Q 2016: 0.61%). The median interest coverage ratio (ICR) rebounded to 5.5 times in the second quarter from improved profitability in some export-oriented sectors (1Q 2016: 4.2 times). Leverage, as measured by the median debt-to-equity ratio, was only marginally higher at 42.8% in 2Q 2016 (1Q 2016: 41.9%). This was supported by satisfactory liquidity positions. The median current assets-to-current liabilities ratio (current ratio) and cash-to-short-term debt ratio (CASTD) were unchanged at 1.7 times and 1.1 times respectively (1Q 2016: 1.7 times and 1.1 times respectively). Although higher delinquencies and impairments were observed in the construction and manufacturing sectors, overall asset quality of banks' overall businesses portfolio remained sound. The ratio of impaired loans and delinquent loans stood unchanged at 2.7% and 0.3% of total bank lending to businesses respectively. Despite uncertainty in global demand condition, the export-oriented sectors also showed continued financial resilience, supported by strong financial buffers and modest leverage.

The outlook for the oil and gas (O&G) sector remains weak amid the low and volatile global crude oil price. This explained the weaker financial performance observed for O&G firms. The overall median ICR of the sector weakened in 2Q 2016 to 1.2 times (1Q 2016: 2.3 times). Liquidity position, on the other hand, improved marginally to 0.9 times (1Q 2016: 0.7 times). Financing to the O&G sector remained largely stable. Outstanding bank exposures (loans and corporate bonds) registered a negative growth of -4.9% to RM13.2 billion as at end 3Q 2016. In terms of concentration risk, banks' exposures to this sector are small, comprising only about 2.1% of total exposures to businesses. Impaired loans for this sector remained stable at 1.8% of total bank lending to businesses while delinquency ratios improved to 0.01% of total bank lending to businesses (2Q 2016: 1.7% and 0.4% respectively).

The housing market remained soft in both the primary and secondary markets. Housing transactions declined both in volume and value terms by 12.5% to 52,487 units (1Q 2016: -16.6% to 49,609 units) and 9.7% to RM16.7 billion (1Q 2016: -10.9% to RM15.9 billion) respectively. This trend was observed across all house price segments, particularly in major states such as Kuala Lumpur, Selangor, Johor and Penang. In the affordable housing segment, both volume and value of transactions recorded negative growth of 16.9% and 18.0% respectively (1Q 2016: -21.9% and -16.9% respectively) amid cautious sentiment and smaller number of newly launched units during the quarter. On the other hand, demand for home financing remained intact, supported by stable approval rate across all house price segments. Credit-induced speculative purchases of residential properties remained subdued. The growth in the number of borrowers with at least three outstanding housing loans (a proxy used for speculative house purchases) expanded at 1.7% in 3Q 2016 (2Q 2016: 1.9%) and accounted for only 2.8% of housing loan borrowers.

Market risk exposures supported by risk management and hedging strategies

Banks' exposures to market risks were mainly in the form of foreign exchange risk. At end-September, foreign exchange (FX) net open position of banks declined to 6.7% of total capital (2Q 2016: 7.1%), as banks continued to actively manage FX exposures amid ringgit volatility. Exposures to interest rate risk in the trading book and equity risk accounted for only 1.2% and 1.0% of total capital, respectively (2Q 2016: 1.2% and 0.8%, respectively). For the insurance and takaful industry, market risk exposures edged higher to 14.4% (2Q 2016: 13.7%) of total capital available, driven by increase in equity and interest rate risk. Equity risk, which forms the bulk of insurers' market risk exposures, rose to 7.6% (2Q 2016: 7.4%) of total capital available.

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

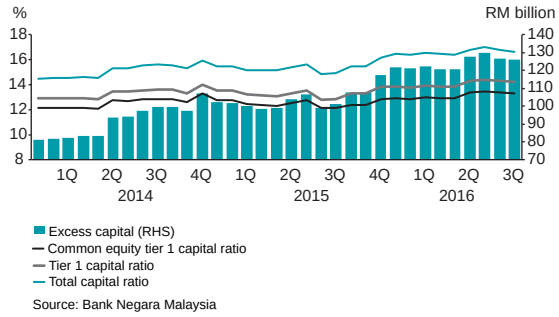
Sustained strength and resilience of financial institutions

Financial institutions are well-capitalised with combined capital buffers of RM160.8 billion. For banks, more than 90% of total capital consists of retained earnings, paid-up capital and reserves which have strong loss-absorbing quality. This reflects the high capital ratios – common equity tier-1, tier-1 and total capital ratios of banks stood at 13.3%, 14.2% and 16.7%, respectively (2Q 2016: 13.4%, 14.3% and 16.8% respectively). Similarly, the capital adequacy ratio for the insurance and takaful sectors remained high at 226.4% (2Q 2016: 228.1%).

Financing (including interest) margin net of operating costs and loss provisions of banks was unchanged at 0.59 percentage points (ppts) (2Q 2016: 0.56 ppts). Similarly, returns on assets and equity were largely stable at 1.39% and 12.9% respectively (2Q 2016: 1.40% and 13.1%, respectively) despite lower profitability. Pre-tax profit for the banking system declined to RM8.1 billion in 3Q 2016 (2Q 2016: RM9 billion), driven by lower fee-based income and dividend income from subsidiaries.

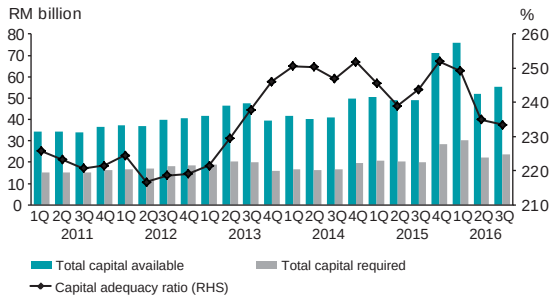
In the insurance and takaful sector, improved claims ratio, particularly in motor businesses, led to higher operating profit (3Q 2016: RM886.7 million; 2Q 2016: RM809.6 million) for the general insurers and takaful operators. The life insurers and family takaful operators, on the other hand, benefited from higher valuation of the bond market. Excess income over outgo rose to RM5.3 billion (2Q 2016: RM2.6 billion), mainly from higher net capital gains from the bond portfolio.

Banking System: Basel III Capitalisation



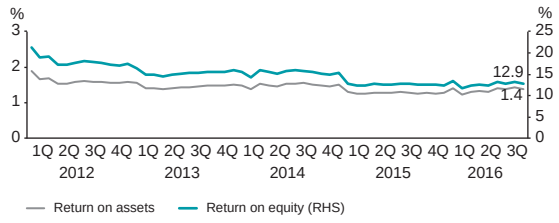
Source: Bank Negara Malaysia

Insurance Sector: Capitalisation



Source: Bank Negara Malaysia

Banking System: Profitability



Source: Bank Negara

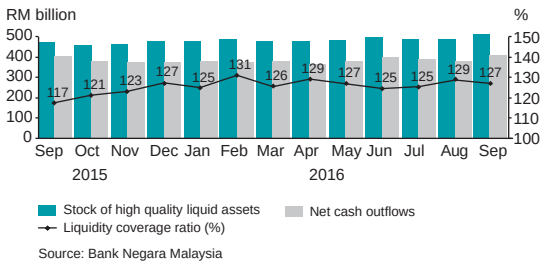
Insurance and Takaful Sectors: Indicators

	2015		2016		
	3Q	4Q	1Q	2Q	3Q
	RM million				
Life insurance & family takaful					
Excess of income over outgo	-417	5,246	4,622	2,637	5,325
General insurance & general takaful					
Operating profit	556	679	821	809	887
Claims ratio (%)	65.5	60.6	54.0	56.5	56.4
	Annual change (%)				
Life insurance & family takaful					
Excess of income over outgo	-110.9	147.4	-11.9	43.0	1377.7
General insurance & general takaful					
Operating profit	-29.5	-10.6	5.1	18.6	59.6
Claims ratio (percentage points)	3.3	1.1	3.7	-8.4	-2.2

Source: Bank Negara Malaysia

Banking system liquidity was ample and supportive of financing activities. The banking system has RM181.6 billion of liquidity with Bank Negara Malaysia. Such liquidity takes the form of direct placements, reverse repos and statutory reserves with Bank Negara Malaysia. The banking system Basel III Liquidity Coverage Ratio (LCR)[7] stood at 127.0% in September 2016 (2Q 2016: 124.7%), well surpassing the current minimum regulatory requirement of 70%. About 80% of banks recorded LCR levels above 100%.

Banking System: Basel III Liquidity Coverage Ratio



Source: Bank Negara Malaysia

Domestic funding conditions remained stable during the quarter. Average cost of deposits for banks was unchanged at 2.62% while the 3-month KLIBOR eased to 3.4% (2Q 2016: 3.65%), reflecting the change in OPR. On aggregate, banking system deposits recorded a positive growth of 0.8% (2Q 2016: -0.5%). Household deposits maintained a healthy expansion (3Q 2016: +4.6%; 2Q 2016: +4.4%), offsetting the decline in deposits from businesses (3Q 2016: -4.7%; 2Q 2016: -0.8%).

Banks' funding in the form of total deposits and investment accounts[8] accepted by banks expanded by 2.6% annually as at September 2016 (2Q 2016: +3.3%).

Banks' funding structure remains predominantly deposit-based (70.2% of total funding) reflecting the nation's high savings characteristics. Almost 90% of the funding is in local currency. In recent years, banks have begun to issue medium-term ringgit and foreign currency denominated funding instruments. This is intended to reduce maturity and currency mismatches in bank funding structures. As at September 2016, such instruments accounted for 4.7% of total liabilities (2Q 2016: 4.7%; end-2011: 3.5%). Taking into account the broadened funding structure, the loan-to-funds ratio[9] (LTF)improved to 83.4% during the quarter (2Q 2016: 82.6%).

Net external liabilities of banks expanded at RM146 billion at end-2Q 2016 (1Q 2016: RM128 billion), driven by higher interbank placements from related entities abroad. Malaysian banks' exposures to counterparties in Singapore and PR China are limited, at about 3% and less than 1% of total banking system assets respectively. This limits the prospect of an immediate contagion to the domestic banking system arising from developments in either country. Exposures via the currency channel were also contained. External claims denominated in Singapore dollar and Chinese renminbi accounted for 10% and 2% of total banking system capital respectively.

[7] 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. The current minimum requirement is set at 70%.
[8] Under the Islamic Financial Services Act 2013, Islamic banking institutions are required to reclassify Islamic deposits under the repealed Islamic Banking Act 1983 into Islamic deposits and investment accounts. A two-year transition period was accorded to banking institutions to ensure a seamless and effective process of reclassification. This transition period ended on 30 June 2015.
[9] Fund comprises deposits and all debt instruments (including subordinated debt, debt certificates/ sukuk issued, commercial papers and structured notes).