MANAGING RISKS TO FINANCIAL STABILITY

Domestic financial stability was preserved

Financial system resilience remained intact despite persistent volatility in the global and domestic financial markets during the quarter. The domestic financial markets continued to function in an orderly manner. Combined with continued ample domestic liquidity and institutional soundness, financial intermediation activities continued to function efficiently to support the financial and financing needs of the domestic economy. In the near term, domestic financial system stability is expected to be maintained, thus providing continued support to real sector activities amid a challenging operating environment. Stress tests[4] conducted by the Bank have also shown that banks and insurers are expected to remain well capitalised under a simulated scenario of significant portfolio outflows.

Credit risk exposures remained manageable, underpinned by sustained debt servicing capacity

Credit risk exposures of financial institutions were stable during the quarter supported by sustained debt servicing capacity of most borrowers. Loans-in-arrears of between one and three months remained low at 2.2% (1Q 2015: 2.4%) of total loans. The net loan impairment ratio was unchanged at 1.2%. In the insurance industry, credit exposures, mainly in the form of holdings of private debt securities, increased slightly to 4.1% (1Q 2015: 3.9%) of total capital available.

Credit risk associated with exposures to the household sector remained well-contained on account of continued balance sheet strength of most households. The expansion in household borrowings moderated further to 1.6% for the quarter (1Q 2015: +1.9%). This was driven by the slower growth in outstanding credit card balances and financing for the purchase of securities. On an annual basis, growth in household borrowings also moderated to 8.3% in 2Q 2015 (1Q 2015: +9.1%). Expansion in financing for the purchase of residential properties remained strong at 11.9% (yoy). At the aggregate level, households continued to maintain strong buffers - household financial assets remained above two times of debt. In value terms, financial assets of households were little changed from the preceding quarter as the increase in deposit and deposit-like instruments was moderated by the lower value of equities and unit trust funds, in line with overall financial market performance. On an annual basis, household financial assets recorded a growth of 5.2%. The high quality of loans extended to the household sector was sustained. Impairment and delinquency levels are stable and low at 1.1% and 1.6% of total household borrowings respectively. Overall underwriting standards were also generally sustained, where about 80% of new loans were approved to borrowers with an aggregate debt service ratio not exceeding 60%.

Potential credit losses on exposures to the business sector remained manageable on account of sustained overall financial strength of businesses. Developments in commodity prices and ringgit exchange rates have had limited impact on the debt servicing capacity of most Malaysian businesses. The leverage position of Malaysian businesses[5], as measured by the median debt-to-equity ratio, was stable at 41.3% (4Q 2014: 41.5%) at end-1Q 2015. The median interest coverage ratio (ICR), on the other hand, improved slightly to 6.5 times (4Q 2014: 6.3 times), while the ratio of current assets-to-current liabilities was unchanged at 1.8 times. The strong financials were sustained despite higher borrowings particularly foreign currency debt. Total business sector borrowings grew by 1.4% during the quarter (1Q 2015: +3.5%) driven largely by a strong growth of 11.1% (4Q 2014: +2.4%) in the external debt of non-financial corporations in 1Q 2015. The strong expansion in external debt was attributed to a sizeable

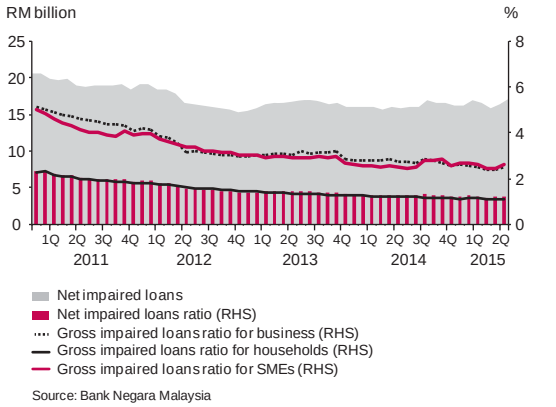
[4] This assessment has incorporated a range of extreme shock parameters, including mark-to-market losses from holdings of equities, interest rate risk in the trading books and foreign currency exposures in the balance sheets and credit losses from businesses affected by significant exchange rate volatility. Based on preliminary data

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

foreign currency denominated bond issuance by a domestic conglomerate in the oil and gas sector. Excluding this issuance, external debt of non-financial corporations only expanded by 3% during the quarter. On a sectoral basis, a higher median ICR was more evident in the domestic-oriented industries (particularly the construction and infrastructure) which benefitted from lower raw material prices. On the other hand, the median ICR for crude and palm oil producers almost halved due to weaker commodity prices but remained sound at 4.5 times, well above the general prudent threshold of two times. The risk of overall potential delinquency, using the expected default frequency as a proxy, was stable at 0.21% (1Q 2015: 0.19%).

The Malaysian House Price Index (MHPI) recorded a moderate increase of 8% in 4Q 2014 (3Q 2014: +7.9%). Preliminary MHPI data indicated a further moderation in its pace of growth for 1Q 2015. The total number of housing transactions remained subdued registering a marginal annual growth of 1.5%, while in value terms, total transactions declined by 3.3%. This trend was partly attributed to less new launches in properties priced above RM1 million. Debt-funded speculative purchases of residential properties remained well-contained, accounting for a stable small share of 2.8% of individuals with existing housing loans.

Banking System: Loan quality



Source: Bank Negara Malaysia

Domestic financial market conditions remained orderly

During the quarter, portfolio investments recorded a net outflow position of RM11.8 billion (1Q 2015: net outflows position of RM7.9 billion), in line with global and regional developments. Average volatility of the FBM KLCI and 10-year MGS yields eased slightly to 8.9% (1Q 2015: 11.7%) and 11.8% (1Q 2015: 13%) respectively. The FBM KLCI ended the quarter lower at 1,706.6 points (1Q 2015: 1,830.8 points) in line with other regional equity markets amid concerns due to the developments in Greece and as investors rebalance investment portfolios in anticipation of the start of a hike in US interest rates. Consequently, overall market capitalisation decreased to RM1.66 trillion (1Q 2015: RM1.74 trillion). The yield curve steepened as yields for the 10-year MGS rose slightly to 4.03% (1Q 2015: 3.89%), while yields at the shorter term of the curve declined (3-year MGS decreased to 3.30% (1Q 2015: 3.35%)) due to strong demand for shorter tenures from foreign investors. The price-to-earnings ratio of the FBM KLCI remained broadly stable at 17 times, underpinned by strong economic fundamentals. Trading liquidity, both in terms of price and volume, also remained intact. The bid-ask spreads for the MGS and FBM KLCI were unchanged at 0.1% and 0.4% of the mid-price respectively. The turnover ratio for the MGS and FBM KLCI was lower at 10.3% (1Q 2015: 14.5%) and 1.8% (1Q 2015: 2%).

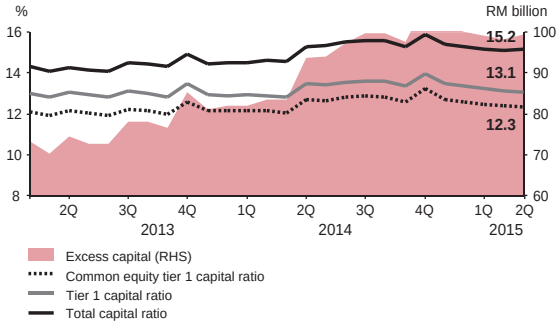
Financial institutions' exposures to market risks were well-contained

Overall risk-taking behaviour of financial institutions was broadly unchanged, with continued active market risk management and hedging strategies observed. Banks' exposures to interest rate risk in the trading book remained limited at 1.4% of total capital. Exposures to equity risk remained small at 0.8% of total capital (1Q 2015: 1.2%). The foreign exchange net open position narrowed marginally to 5.2% (1Q 2015: 5.9%) of total capital during the quarter on account of active management of foreign currency exposures by banks in light of the heightened exchange rate movement in the recent period. Similarly, market risk exposures of the insurance industry remained stable and manageable at 13.3% of total capital. Equity risk continues to form the bulk of insurers' market risk exposures at 7.9% of total capital.

Financial institutions continued to remain sound and resilient

Banks' capitalisation was maintained at strong levels. At end-2Q 2015, the common equity tier-1 capital ratio, tier-1 capital ratio and total capital ratio stood well above the minimum regulatory levels at 12.3%, 13.1% and 15.2% respectively.

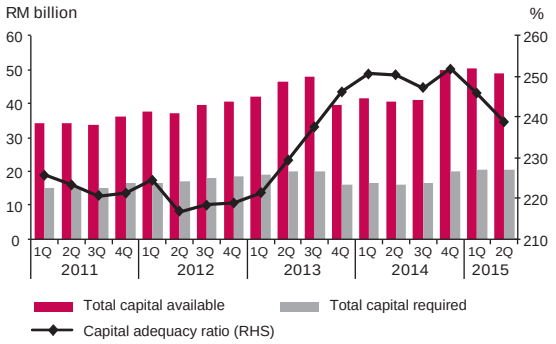
Banking System: Basel III Capitalisation



Source: Bank Negara Malaysia

More than 80% of banks' total capital consists of high quality capital comprising retained earnings, paid-up capital and reserves. The capital buffer of the banking system was sustained in excess of RM100 billion above the regulatory minimum. Similarly, the capital adequacy ratio for the insurance sector remained strong at 239.1% (1Q 2015: 245.7%) with an excess capital buffer of RM28.5 billion.

Insurance Sector: Capitalisation



Source: Bank Negara Malaysia

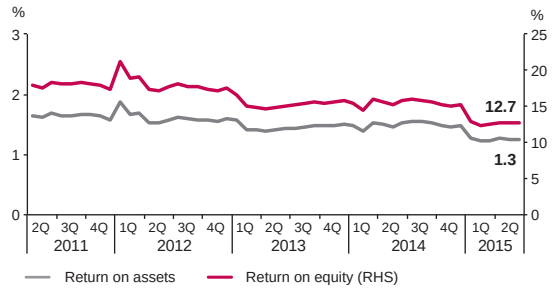
The banking system registered a pre-tax profit totalling RM7.5 billion (1Q 2015: RM7.0 billion) in the second quarter, mainly due to higher contribution of revenue from financing-related activities and dividend income from subsidiaries. Returns on assets and equity were sustained at 1.3% (1Q 2015: 1.2%) and 12.7% (1Q 2015: 12.4%) respectively. The operating profit for the general insurance and takaful operators totalled RM681.7 million (1Q 2015: RM781.1 million) on account of lower underwriting profit, mainly due to higher claims liabilities. Excess income over outgo for the life insurers and family takaful operators declined to RM1.9billion (1Q 2015: RM5.3billion) due to a net capital loss of RM1.1 billion (1Q 2015: net capital gain of RM2.1 billion) arising from higher valuation losses on the equity investments, in line with overall FBM KLCI performance.

Insurance and Takaful Sectors: Indicators

	2014		2015		
	2Q	1H	1Q	2Q	1H
	RM million				
Life insurance & family takaful					
Excess of income over outgo	4,593	7,804	5,336	1,907	7,243
General insurance & general takaful					
Operating profit	804	1,628	781	682	1,463
Claims ratio (%)	57.0	57.0	50.3	57.4	57.4
	Annual Change (%)				
Life insurance & family takaful					
Excess of income over outgo	-0.7	-7.2	66.2	-58.5	-7.2
General insurance & general takaful					
Operating profit	4.3	7.8	-5.2	-15.2	-10.1
Claims ratio (percentage points)	-3.4	-3.4	-4.7	0.4	0.4

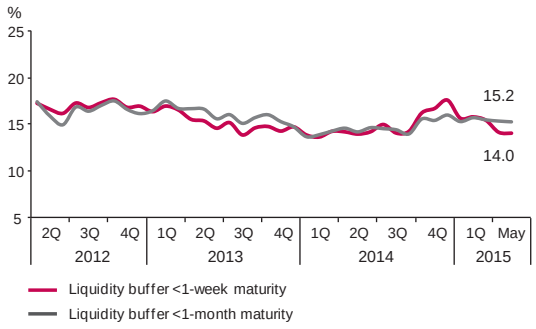
Source: Bank Negara Malaysia

Banking System: Profitability



Source: Bank Negara Malaysia

Banking System: Liquidity Buffer to Total Deposit Ratio



Source: Bank Negara Malaysia

Liquidity in the banking system remained ample. As at end-May 2015, liquidity buffers for maturities over the 1-week and 1-month horizons remained well above the minimum regulatory levels at 14% (1Q 2015: 15.4%) and 15.2% (1Q 2015: 15.4%) of total deposits respectively. Banks recorded USD liquidity surpluses of RM12.4 billion (1Q 2015: surplus of RM20 billion) and RM 5 billion (1Q 2015: surplus of RM2.4 billion) in the less than 1-week and 1-month maturity bucket respectively. At end-June 2015, banks' net interbank placements and reverse repo with Bank Negara Malaysia, which can be unwound to meet liquidity needs, increased to a level above RM120 billion. The Basel III Liquidity Coverage Ratio (LCR) standards came into effect on 1 June 2015 and will be gradually phased in by 2019[6]. At end-June 2015, the banking system LCR stood at 119%, with all banks reporting LCR levels that are comfortably above the current minimum regulatory requirement of 60%. The loan-to-deposit ratio remained stable at 88% at end-June 2015.

Financial institutions' external exposures continued to expand in line with regional operations, including centralised liquidity management, trade and investment activities. During the first quarter of 2015, external assets of banks grew at a faster pace (+11.7) than external liabilities (+1.7%) in line with developments in many of the regional economies. Deposit placements, mainly with banks in Singapore, Hong Kong and US contributed to more than half of the growth in external assets. Net external liabilities of the banking system, largely in the form of custodian-related activities and capital funds of locally incorporated foreign banks, declined to RM110 billion during the first quarter of the year (4Q 2014: RM131 billion).

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